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Concluding Remarks

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I took a lot of notes during the conference at which all these papers were presented and discussed. I organized my thoughts around the following nine points:

1. We have entered a brave new world. The economic crisis has put into question many of our beliefs. We have to accept the intellectual challenge.
2. In the age-old discussion of the relative roles of markets and of the state, the pendulum has swung, at least a bit, toward the state. We probably have revised our views on the need for regulation and on the limits of regulation. Both are stronger than we thought earlier.
3. The crisis has made it clear that many distortions are relevant for macro, many more than we thought earlier. We had ignored them, thinking that they were the province of microeconomists. But as we start to integrate finance into macro, we are discovering them anew. Agency theory is needed to explain how financial institutions work or do not work and how decisions are taken. Regulation and agency theory applied to regulators is also important. Behavioral economics and its cousin, behavioral finance, are central as well. With capital controls, for example, central issues are why investors are coming in or going out, what is behind their decisions, and how much herding plays a role in their decisions.
4. A theme that emerged from this conference is that macropolicy is a game (in the sense of game theory—policy is serious business) with many targets and many instruments. For example, a recurring theme in monetary policy has been that inflation stability alone is not enough; output stability and financial stability need to be added to the list. With fiscal

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policy, we have to go from thinking about fiscal policy as just "government spending minus taxes" and an associated multiplier to realizing that there are 100 tools that can be used, that they have their own dynamic effects, and those effects depend on the state of the economy and other policies. I wonder whether we should not move the discussion away from multipliers. Working with multipliers makes you look for one number—if you only knew it, then you would be done—whereas we have to think of complex dynamic responses. Reducing discussions about fiscal policy to what is the right multiplier is not doing service to the issue (a point that Robert Solow makes in chapter 8).

The third example—again, I could choose many—is capital-account management. I like the provocative argument (made by Rakesh Mohan in chapter 15) that it may be possible to achieve the impossible trinity of an open capital account, a fixed exchange rate, and an independent monetary policy by using more instruments. Whether or not it can actually be done, using more instruments allows you to resolve, at least in principle, something that looks impossible with fewer instruments.

5. We may have many instruments, but we are not sure how to use them. In many cases, we are really uncertain about what they are, how they should be used, and whether they will work. Many examples came up during the various sessions at the conference. Liquidity ratios: because we do not know how to define liquidity in the first place, a liquidity ratio is one more step into the unknown. Capital controls: some people believe that they work and some people believe that they do not, and where you end up depends very much on that belief. Another example is Paul Romer's corollary to what he calls Myron's law, which is that if you adopt a set of financial regulations and keep them unchanged, the markets will find a way around them, and ten years later, you will have a financial crisis (chapter 12). Yet another example is Michael Spence's observations about the relative roles of self-regulation and regulation (chapter 19). Both are needed, and how we should combine them is extremely unclear.

6. Although these instruments are potentially useful, their use raises a number of political economy issues.

Some are hard to use politically. For cross-border flows, putting in place a regulatory structure is going to be difficult. Even at the domestic level, some of the macroprudential tools work by targeting a specific

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sector or a specific set of individuals or firms. This may lead to strong political backlash by the groups that are being directly targeted.

And instruments can be misused. The more instruments there are, the more the scope for misuse. Many people think that although there may be an economic case for capital controls, governments are going to use them instead of what they should be doing, which is choosing the right macroeconomic policy. Dani Rodrik argues for industrial policy as the right tool to increase the production of tradables without getting a current-account surplus (chapter 17). But in practice, the limits of industrial policy have not gone away.

7. Where do we go from here? In terms of research, the future is exciting. Many topics need work—namely, macro issues with (as Joseph Stiglitz, chapter 4, might say) the right microfoundations. For example, on capital controls, thinking of the exact source of distortions (if any) would allow for a much more informed discussion of the issues, a point that Ricardo Caballero makes forcefully in chapter 13.

8. Things are harder, I find, on the policy front. Given that we do not quite know how to use the new tools and they can be misused, how do policymakers go at it? Although we have to have a good sense of where we want to go in the end, a step-by-step approach is probably the way to do it. For example, I was critical of inflation targeting, but I do not think that one should, from one day to the next, give it up and move to a system with, say, five targets and seven instruments. We do not know how to do it, and it would be dangerous. Instead, we should introduce these macroprudential tools one by one or at least at a slow speed, see how they work, and then try to use them in the right way. But that process will take time.

Step by step is also the way to proceed in reforming the international monetary system. With SDRs, for example, it seems relatively easy to create a private market in private SDR bonds, see how it functions, and note whether it becomes deep enough to allow for large changes in supply and demand. If it is deep enough, one can think about a next step, such as having the IMF borrow by issuing SDR bonds to the private sector. If this turns out to be feasible, then one can think about the IMF doing this in times of systemic crisis to mobilize the funds needed to respond to large liquidity needs. All these steps have to be taken carefully.

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A related point is that, in this new world, pragmatism is of the essence. That comes up, for example, in Andrew Sheng's discussion of the adaptive Chinese growth model (chapter 18). We have to try things carefully and see how they work.

9. We have to keep our hopes in check. There are going to be new crises that we have not anticipated and are not ready for. Despite our best efforts, we could well have old-type crises again. That is an interesting theme in Adair Turner's discussion of credit cycles (chapter 11). If we draw the implications from agency theory and put in place the right regulations, can we eliminate credit cycles? Or are they part of basic human nature, so that no matter what we do, they will come back in some form? I tend to be more of the second school than the first. So we need to be modest in our hopes.

A journalist asked me whether the conference on Macro and Growth Policies in the Wake of the Crisis was Washington Consensus 2. It was not intended to be, and it was not. It was the beginning of a conversation and an exploration. Time will tell where it takes us.

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Leading Economists Reassess Economic Policy

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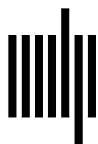

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