Alternative Perspectives on Macro Theory and Some Policy Implications

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Maekawa Lecture
2010 International Conference: Future of Central Banking under Globalization
May 26 – 27, 2010
Institute for Monetary and Economic Studies, Bank of Japan
Introduction

“We are in a colossal muddle......“ JM Keynes
The current crisis was generally unanticipated
... which had important implications for policy
... but also for macroeconomic theory?
Keynes versus Hayek, or Keynes and Hayek?
Modern Macroeconomics and its Practical Shortcomings

- New Classical, New Keynesian and DSGE models
- Have spread from academic circles into central banks
- Analytically tractable but based on many simplifying assumptions:
- A self-stabilising economy, rational expectations, efficient markets, and the irrelevance of money and the financial system
Applied Keynesian Models and their Practical Shortcomings

- Empirical IS/LM in its various guises
- Has never been good at turning points
- Because it treats the future as an extrapolation of the past
- And largely ignores the influence of the financial sector
Credit, Stocks, “Imbalances“ and Crises

- None of the above models incorporate multi period considerations (like moral hazard) and non-linear outcomes
- Insights from the Austrians; excessive credit leading to “malinvestments“ and eventual crisis
- A broader set of “imbalances“ explaining the current crisis; which is not over yet
- Insights from Minsky; the Wiley Coyote moment
Improving the practical usefulness of existing macro models will not be easy

Focussing on credit driven imbalances (debt and other excesses) has promise

Modelling financial instability is only part of the challenge

As is the modelling of “inefficient“ financial markets
Some Implications for Macro Policy (1)

- Implications in **normal** circumstances:
- Recognize that price stability is no guarantee of good macro performance; the particular problem of productivity growth
- Lean against credit driven “imbalances“
- Be more tolerant of minor downturns
Some Implications for Macro Policy (2)

- **Negative** implications in **current** circumstances:
- Fiscal stimulus and its limitations
- Monetary policy and its limitations
- Support for the financial system and its limitations
- Support for jobs and its limitations
- **Conclusion**: a bias towards exit and against exacerbating existing imbalances
Some Implications for Macro Policy (3)

- **Positive** implications in **current** circumstances:
  - Not all global spending categories are debt constrained
  - Private and public investment offer scope for stimulus
  - Debt burdens can be reduced through structural reform and debt writedowns
  - Inflation is an unhealthy alternative for reducing debt burdens

- **Conclusion**: there is a way out, but a more lengthy one.
A Methodological Postscript

- Formal modelling work ("science") must increasingly reflect the complexity of the real world.
- We need more practical attention ("engineering") to economic history, the history of economic thought and other methodologies.
- We need to admit to great uncertainties about how the economy actually operates.
- All of which leads to more "humble" policy objectives:
  - Above all, **do no harm.**