Cournot Center Conference

What's Right With Macroeconomics?

1. A Panorama of Concepts and Approaches

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What's Wrong With Modern Macroeconomics?

Michael Wickens:

- Modern macroeconomics has received a huge stimulus
- The financial crisis was brought about more by a failure to employ modern macroeconomics than by the failings of macroeconomics.

My View:

- Modern macro is just an abstract language
- We have all the tools needed to include models of „financial crises“ But: It was not done until recently

Before the crisis

- Mainstream View:
  New Keynesian Paradigm - DSGE Model
- Monetary Policy Rule (Taylor Rule)
  Monetary Policy should aim to stabilize inflation (and output) around low level (below, close to 2%)
  (Inflation [Forecast?] Targeting)
  No specific need to target asset prices
- Great Moderation (partly due to better policy)
- Limited scope for countercyclical fiscal policy

Challenges after the crisis

- „Is this time really different?“ *Rogoff/Reinhart* (2010)
  → New Paradigm
- Or let‘s go back to neoclassical repair shop
  to build next generation of synthesis models?

(Re-)Introduce Financial Intermediation
(Re-)Introduce Multiple Equilibria
(Bifurcations); Self fulfilling Traps
Key ingredients of models of financial crises
(financial crises models: Generation 1, 2, 3, 4)
Calvo 1988 Servicing Public Debt
Multiple equilibria with zero bound/ Liquidity Trap
Benhabib/Schmitt Grohe/Uribe AER 2001

Real puzzle:

- Why did we not take these insights seriously?
- **Examples**:
- Fiscal policy may be extremely powerful in a liquidity trap (Eggertson; Christiano/Eichenbaum;
  Corsetti et. al. Fiscal Stimulus with Spending Reversals)
- Ricardo equivalence not relevant for countercyclical policy
- Asset Price Misaligments (Boom/Bust Cycles)
  Models of limits of arbitrage
  Risk of fire sales (due to high leverage) →
  Need for regulation of financial markets
  (Hyun Shin, Brunnermeier/Pederson)

My presentation at Centre Cournot on 1. December 2006

Financial Stability and Monetary Policy – A Framework

Summary:

- High social cost of fire sales: →
  Commitment not to intervene is not credible

- Challenge: Prevent building up of imbalances by stronger dampening of shocks during the boom period

- → Trade off between efficient stabilisation and
  prevention of financial imbalances

- Superior approach compared to commitment not to intervene:
  Use additional instruments to tackle the underlying problem (such as regulation of liquidity holding)

Complacency before the financial crisis

- Successful handling of past crises:
- 1987 Crash; LTCM crisis 1998;
  Crash of Internet Bubble 2001

  → Overconfidence in policy; at the same time:
  Belief in benefits of deregulation;
  Panglossian view: wonderful free market world

Jean-Bernard Chatelain/ Xavier Timbeau

Excellent summary of current challenges

No need to discard models with rational agents (no need to „reject“ No Ponzi Game condition; consumption smoothing etc.)

Crisis can be explained as result of individually rational behaviour resulting in aggregate failure (creating negative externalities)

Richer modelling structure with heterogenous agents generate key features: Credit constrained agents; role of pro-cyclical leverage in amplifying shocks

Heterogenous agent models: Distributional issues play key role

Giancarlo Corsetti

- Timing Fiscal Retrenchment in the Wake of Deep Recessions

Ben S. Bernanke, **Rebalancing the Global Recovery, Frankfurt** November 19, 2010
„However, in general terms, a fiscal program that combines near-term measures to enhance growth with strong, confidence-inducing steps to reduce longer-term structural deficits would be an important complement to the policies of the Federal Reserve.“

Corsetti et. al. Fiscal Stimulus with Spending Reversals

- NYT November 29, 2010
Amid Deficit Fears, Obama Freezes Pay

Corsetti et. al. at Centre Cournot?

Corsetti

New Keynesian DSGE model, hitting zero lower bound

- Standard monetary policy impotent
- Liquidity trap → Paradox of thrift
- Fiscal Policy very powerful (upward sloping AD curve)

Message: With perfect credibility, Bernanke strategy is optimal

- Combine short term fiscal stimulus with long run consolidation

Saint Augustine (354-435)

Oh ***Lord***, ***give me*** chastity, but do not give it yet.

Problem: Lack of credibility

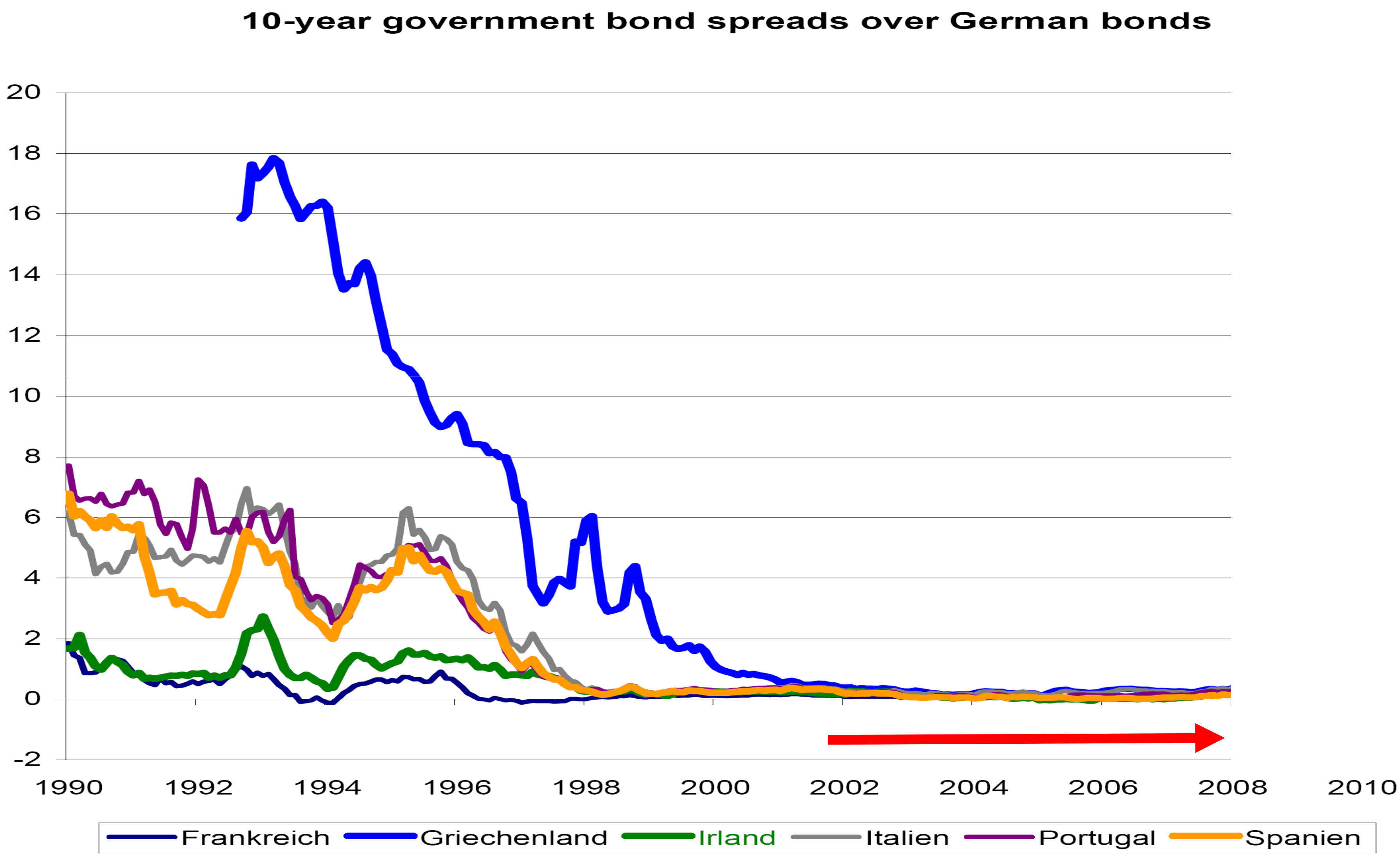
Bond Vigilants get nervous: ask for high risk premium

- Multiple, self-fulfilling equilibria path

Problem: Risk premia are introduced ad hoc; not really endogenous

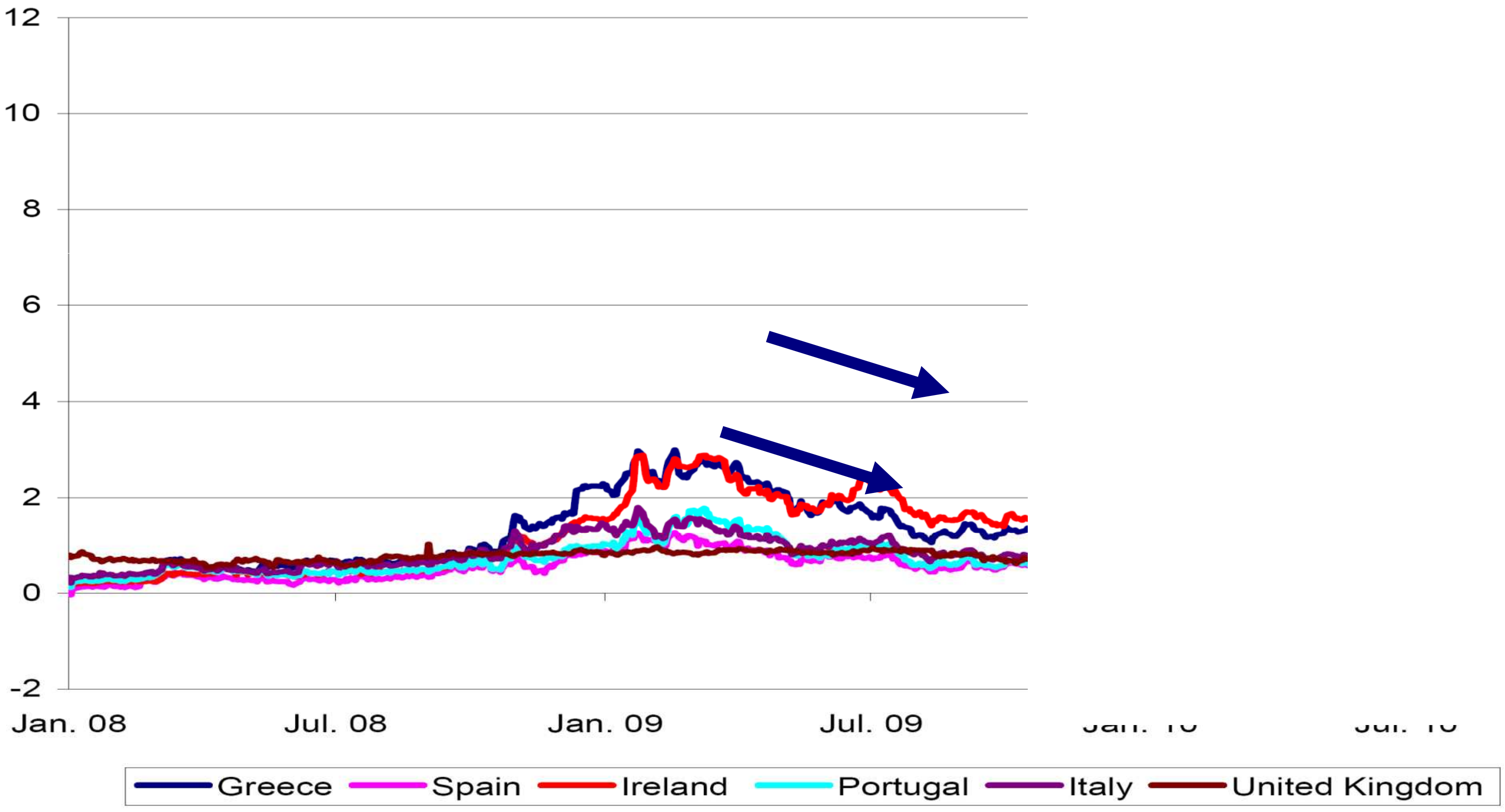
How rational are your Bond Vigilants?

Diligent Bond Vigilants?

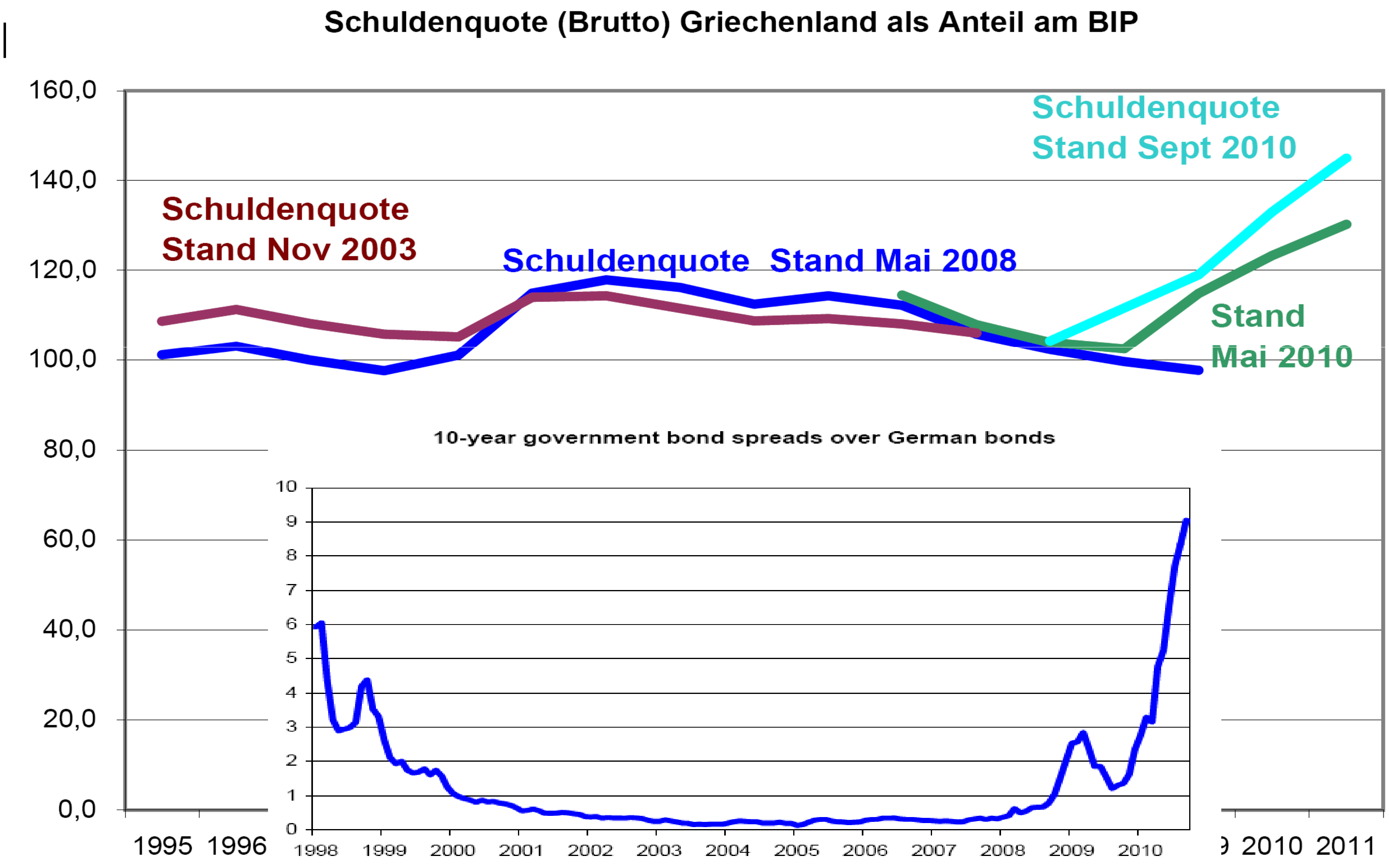


Diligent Bond Vigilants?

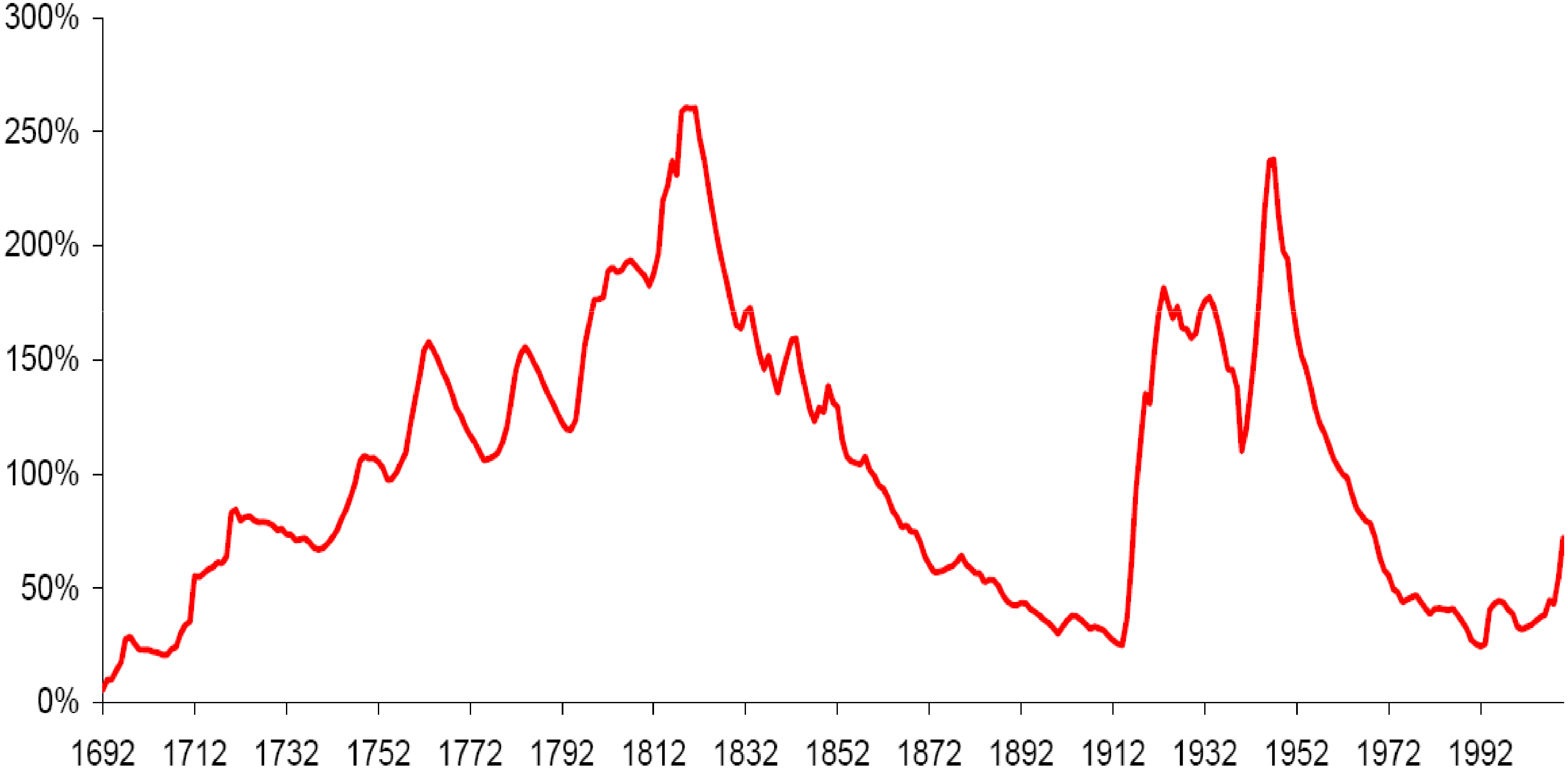
10-year government bond spreads over German bonds; Source: Thomson Reut



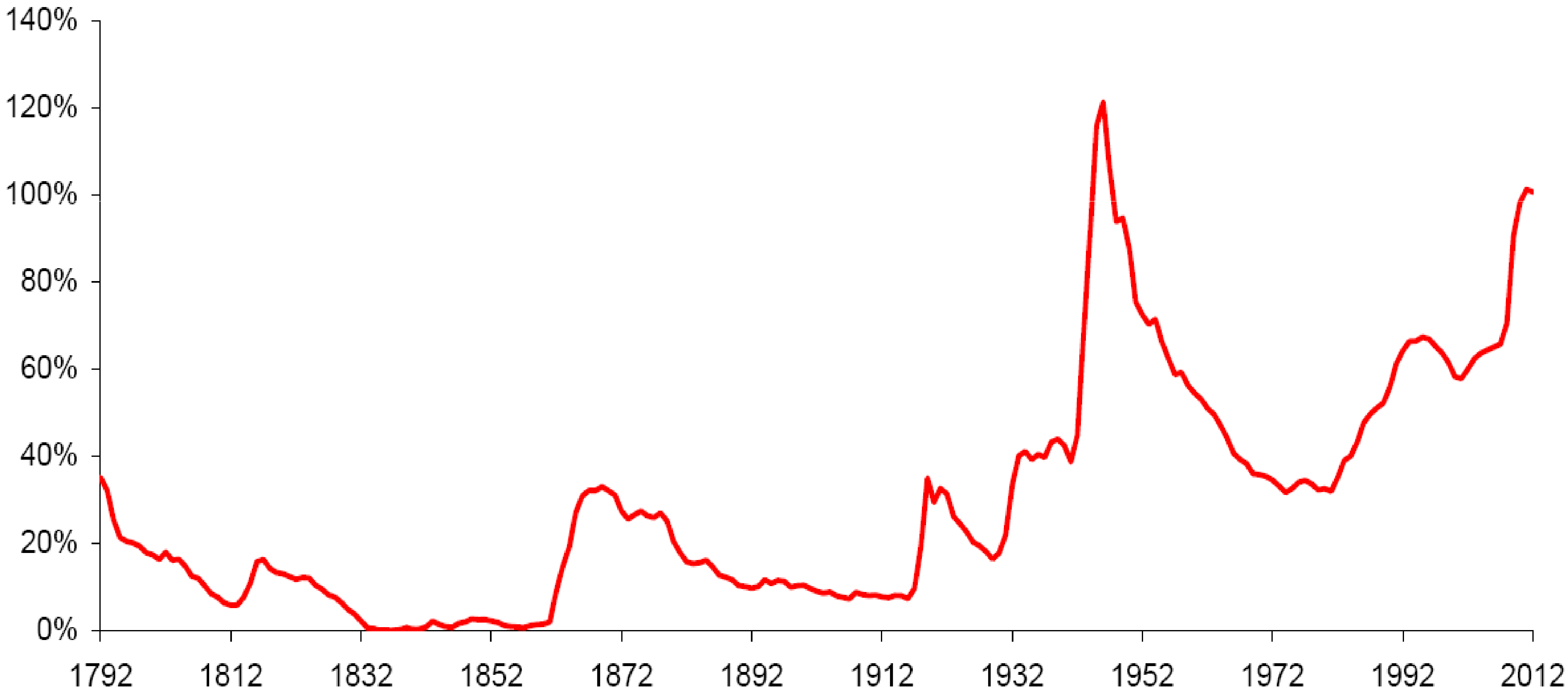
Debt/GDP ratio Greece, OECD data



Debt/GDP ratio UK 1692-2010



Debt/GDP ratio USA 1792-2010



Problem: Risk premia are introduced ad hoc; not really endogenous

How rational are your Bond Vigilants?

Optimal Strategy in your model:
„A fiscal program that combines near-term measures to enhance growth with strong, confidence-inducing steps to reduce longer-term structural deficits“ (Ben Bernanke)

Crucial: Long tem commitment

Fiscal Austerity today will be counter-productive if it increases probability for policy reversal (change in government)

Key challenge: How to establish long term credibility?
Raising retirement age; tackle health care cost

Endogenize risk premia → Multiple equilibria prevailing (Calvo)

Role of confidence crucial for policy design of adequate institutions

DSGE model not helpful for addressing these issues!