WP/15/156

IMF Working Paper

The Dog That Didn't Bark: The Strange Case of Domestic Policy Cooperation in the "New Normal"

by Tamim Bayoumi

INTERNATIONAL MONETARY FUND

 WP/15/156

IMF Working Paper

Strategy, Policy, and Review Department

The Dog That Didn't Bark: The Strange Case of Domestic Policy Cooperation in the "New Normal"

Prepared by Tamim Bayoumi

July 2015

Abstract

This paper examines domestic policy cooperation, a curiously neglected issue. Both international and domestic cooperation were live issues in the 1970s when the IS/LM model predicted very different external outcomes from monetary and fiscal policies. Interest in domestic policy cooperation has since fallen on hard intellectual times—with knock-ons to international cooperation—as macroeconomic policy roles became highly compartmentalized. I first discuss the intellectual and policy making undercurrents behind this neglect, and explain why they are less relevant after the global crisis. This is followed by a discussion of: macroeconomic policy cooperation in a world of more fiscal activism; coordination across financial agencies and with macroeconomic policies; and how structural policies fit into this. The paper concludes with a proposal for a "grand bargain" across principle players to create a "new domestic cooperation."

JEL Classification Numbers: H11, H12, C70

Keywords: Domestic Policy Cooperation, Central Bank Independence, Macroprudential Policy

Author's E-Mail Address: tbayoumi@imf.org

I. INTRODUCTION

This paper examines a relatively forgotten aspect of policy coordination, namely domestic policy cooperation.[1] Most of the modern policy coordination literature has focused on the international dimensions, generally with an implicit assumption that cooperation should occur across similar policy tools—monetary policy makers compare notes with other monetary policy makers, fiscal decisions are made in unison, structural plans are made in unison, etc. Occasionally, more than one policy is involved in the analysis—monetary and fiscal policies, for example. But rarely is the focus on cooperation across a range of different types of policies, the issues at the very heart of domestic policy cooperation.

Domestic cooperation was not always so neglected. For example, in the 1970s the domestic policy mix was central to any discussion of cooperation as the focus was on simultaneously achieving internal and external balance. The IS-LM-BoP model—then the work-horse of international macroeconomic analysis—predicted very different mixes of domestic and external demand from different macroeconomic policies. Monetary policy expansion via a lower domestic interest rate would encourage domestic demand but also involve a more depreciated exchange rate and hence higher external demand from the rest of the world while a fiscal expansion would have the opposite impact on the exchange rate and foreign demand as it boosted domestic demand through different channels.[2] The choice of instrument was thus crucial to simultaneously achieving domestic and external balance. The importance of different domestic policy instruments was a crucial aspect for several international policy agreements, including the Plaza (1985) and Louvre (1987) Accords.[3]

The G-20 process is a good example of the loss of interest in linking domestic policies to international policy cooperation, but rather focusing on cooperation within specific policy areas. On the macroeconomic side, the most visible outcome was the coordinated fiscal boost achieved in 2009 and 2010 in the aftermath of the crisis.[4] The focus here was very much on uniformity—a 2 percent of GDP fiscal boost across the G-20. On the structural side, the main push was for an internationally coordinated tightening of financial regulation including, but by no means limited to, the uniform adoption of regulations suggested by the Basel committee. By contrast, the more wide-ranging G-20 Mutual Assessment Process initiative that combined a broader range of policy options and potential trade-offs failed to gain much traction, and was subsequently adapted to be mainly focused on national structural measures to achieve a globally-agreed target to boost GDP by 2 percentage points.[5] Even more strikingly, the G-20 process does not seem to have branched out into asking whether outcomes could also be improved by better domestic policy cooperation.

---

[1] I prefer cooperation to coordination as it implies a less formal process.

[2] The IS-LM-BoP was developed in Flemming (1962) and Mundell (1963).

[3] See University of Toronto G8 Information Center for texts of the accords.

[4] See Bayoumi (2014) for the history of this and other G-20 initiatives. The impact of the fiscal initiative is analyzed in Horton, Kumar, and Mauro (2009) and, IMF (2009a, b).

[5] See G-20 (2014).

On an intellectual level, it is curious that domestic policy cooperation has been so neglected. For example, international cooperation faces the hurdle of uncertainty about the size and sometimes even the sign of spillovers across countries (is US monetary policy normalization good or bad for the rest of the world?).[6] This uncertainty about spillovers is surely less of an issue for domestic policy cooperation given that the domestic economic impacts of policy initiatives, and the distributional consequences, are generally much better understood than the impact on other countries.[7]

The next section discusses the reasons why interest in domestic policy cooperation waned, noting in particular the central role played by the compartmentalization of policy assignments. The financial crisis, however, illustrated that such a neat policy assignment was no longer viable. The rest this paper then examines the policy issues created by this intellectual sea change in views on the interrelations between various domestic policies. I first consider the issue of macroeconomic policy cooperation in a world in which fiscal activism is more accepted and monetary policy decisions are potentially complicated by new financial stability mandates. This is followed by a discussion of how to coordinate financial policies both across micro- and macro-prudential agencies and with macroeconomic policies. Next there is a section on where structural policies fit into the evolving edifice. The paper concludes with a proposal on how the “new domestic cooperation” could be organized.

II. Why Did Interest In Domestic Policy Cooperation Wane?

The loss of interest in domestic policy cooperation over the 1990s and 2000s seems to have reflected a series of economic and institutional trends. Four stand out in particular. *The rapid movement toward independent central banks* institutionally separated monetary policy decisions from fiscal ones—assigning monetary decisions to central banks that jealously guarded their independence from the political process, and hence with little practical or intellectual interest in pursuing the potential benefits of domestic policy cooperation.[8] At the same time, *the decline in belief that fiscal activism* was an effective tool for business cycle management further lowered the perceived benefits of domestic cooperation across macroeconomic policies. The *opening of international capital markets* eroded concerns about external financing and with it the importance of aiming for external balance. Finally, intellectually, the growing *separation of the analysis of growth cycles from the analysis of structural issues such as growth trends and financial stability* and the associated decline in interest in more holistic models such as creative destruction limited the interest in cooperation between macroeconomic and structural policies.

---

[6] See, for example, IMF Spillover Reports (IMF 2013, 2014a).

[7] Bayoumi and Vitek (2013)

[8] See Debelle and Fischer (1994) and Fischer (1995) for early analysis of independent central banks. The move to inflation targeting was linked to the realization that monetary stimulus was time inconsistent in the face of a vertical long-run Phillips curve (Rogoff, 1985) and principal agent models originated by Coase (1937). The first inflation targeting central bank was New Zealand in 1990.

The outcome was a highly compartmentalized policy assignment in which macroeconomic balance (stable inflation and full employment) was essentially the preserve of central banks, the fiscal authorities largely worried about debt management and fiscal sustainability, structural policies to boost growth were in general the preserve of other agencies and financial stability was focused on regulation and supervision of individual institutions. The design of the euro area—planned in the 1990s and executed in 1999—is a case in point. The European Central Bank was given the assignment of maintaining price stability (which it defined as inflation at "below but close to 2 percent"). Under the Stability and Growth pact, all the individual national fiscal authorities were supposed to aim for a balanced budget, limit deficits to below 3 per cent of GDP, and to ensure that debt was below 60 percent of GDP. Structural policies, on the other hand, were left to a much vaguer inter-governmental process designed at boosting growth, and financial stability was left to specialized national regulators and supervisors.[9]

This domestic policy assignment also had a major impact on international policy cooperation. Independent central banks not only reacted against being pushed into discussions with other domestic agencies, they also guarded their independence of action in the international context. The result was the doctrine of "benign neglect"—that cooperation was unnecessary as focusing solely on domestic stability would ensure a good outcome. This was linked to analysis suggesting that international spillovers were limited (although how this linked with a marked global business cycle was never well explained). In particular, results from large econometric models that focused on international trade links and largely ignored substantial international asset price links found small spillovers as direct trade is limited (at least across major economies with geographically diversified trade).[10]

The 2008 crisis changed the intellectual structure on which this edifice was built.[11] With interest rates in most major countries stuck at the zero lower bound, fiscal policies are again seen as a legitimate cyclical tool. In addition, bloated central bank balance sheets are also blurring the divide between monetary and fiscal policies as central banks have moved into portfolio management and have accepted significant balance sheet risk. Even more importantly, financial stability is no longer seen as a mainly microeconomic issue—as exemplified by adoption of the term "macro-prudential policies." And the elevation of financial stability raises issues of coordination between macro-prudential and monetary policies. In this connection, the role of large US external imbalance in the initial global crisis and of imbalances in the periphery versus the core in the euro area crisis has brought the issue of external balance back into focus. This is epitomized by the G-20 objective of sustainable and *balanced* growth. Finally, fears of a "new mediocre" growth path, and the risk of "lost decades," have lifted structural policies from a backwater to a major policy issue.

[9] The European Commission website is a useful reference.

[10] Bayoumi and Vitek (2013).

[11] Krugman (2009) is a characteristically insightful and entertaining exploration.

III. MACROECONOMIC POLICY COOPERATION IN AN AGE OF INDEPENDENT CENTRAL BANKS

The twenty years before the crisis were a golden time for the theory and practice of monetary policy. On the theoretical side, the new Keynesian model seemed to indicate a "divine coincidence" in which the pursuit of low and stable inflation was sufficient to effectively dampen the business cycle.[12] On the empirical side, numerous exercises looked at the impact of monetary policy on output and inflation and also on the underlying policy reaction functions of central banks—so called Taylor rules. On the policy side, there was a gradual shift from monetary policies based on instruments—such as monetary aggregates, or the exchange rate—to policies based on targeting future inflation. This shift came with increasingly sophisticated communication tools—such as *Inflation Reports* in which the central bank justified its current policy stance on the basis of the expected future path of inflation.

The ascendancy of monetary policy analysis was accompanied by a general loss of interest in the role of fiscal policy as a demand management tool. Fiscal multipliers were seen as small, in part reflecting the widespread acceptance of the Ricardian equivalence hypothesis that held that private sector actions would offset the impact of government policies.[13] In addition, as financial deregulation proceeded, regulators and finance ministries stopped fiddling with access to finance through rules that constrained loans by requiring minimum deposits, maximum loan-to-value ratios and the like. Increasingly, fiscal policies were focused on appropriate debt levels, such as the Maastricht criterion of a maximum of 60 percent of GDP, or on budget rules, such as the modified golden rule in the UK that aimed to allow borrowing only for investment purposes over the cycle.[14] Cyclical support was seen as coming from automatic stabilizers that automatically and predictably increased deficits in recessions and lowered deficits in booms.[15]

Of course, these ideals were not always followed in practice. Inflation targeting countries worried about output (in part because of the feedback to future inflation via output gaps), and the US Federal Reserve, for instance, had a dual mandate involving both inflation and employment. Many emerging markets that practiced inflation targeting in theory also took account of the value of the exchange rate, given its impact on inflation, output, capital flows, and financial stability, where changing financial regulations also played a role. At the same time, fiscal policy was used actively in many countries. This included the United States, where the limited size of federal government and balanced budget rules at the state level implied relatively small automatic stabilizers. Many emerging markets also used fiscal policy relatively aggressively. The most important exception, however, was Japan, which used

[12] Blanchard and Gali (2005).

[13] Barro (1974). Indeed, for a time there was a lively on "expansionary fiscal contractions" where the supply-side benefits of tighter fiscal policies more than fully offset the impact on demand. See Giavazzi and Pagano (1990) and Alesina and Ardagna (2009).

[14] Wyplosz (2012) discusses the theory and history of such rules.

[15] IMF (2015a) discusses automatic stabilizers.

fiscal policy to bolster an economy where monetary policy was constrained by the zero lower bound on interest rates.[16] Opinions on the success of this approach are mixed, with some arguing it was ineffective and piled up debt, and others that it saved Japan from a bigger recession.

The Japanese experience that hitting the zero lower bound creating renewed interest in fiscal stimulus was repeated in other countries after the great recession. With most major advanced economies moving to near-zero policy rates, governments turned to fiscal stimulus in 2009 and 2010 as the G-20 countries committed to a joint stimulus of 2 percent of GDP—an objective that was approximately achieved (Bayoumi, 2014). Importantly, joint stimulus was adopted to minimize "leakage" of stimulus from domestic to other countries, and to maximize the effects. Subsequently, against a backdrop to high government debt and fiscal deficits (particularly in advanced, but also in emerging markets) the focus has moved to consolidating bloated fiscal deficits, but slowly enough to avoid derailing the recovery.[17] The largest controversies in this regard have been in the Euro area, where the pace of consolidation has been speeded in some cases by the requirements of the Stability and Growth pact, involving a vociferous intellectual and political debate about the responsibilities of surplus and deficit countries.[18]

Fiscal policy activism has also been bolstered by a view that fiscal multipliers are larger than previously assumed.[19] Part of this clearly reflects current circumstances. With extensive slack, low real interest rates, and continuing financial market jitters there is more scope for fiscal policy to influence output. Slack increases the likelihood that a boost to demand is reflected in real activity rather than inflation; low real interest rates limit the cost to the government of new debt; and market jitters limit the degree to which government borrowing can be undone by offsetting private sector saving (the essence of the Ricardian equivalence argument).[20] Since these conditions are likely to last for some time, there are reasons to think that fiscal policy will continue to be regarded as an effective macroeconomic option. What is less clear is whether this will represent a permanent change in views about the value of fiscal policy as a counter-cyclical tool, and will remain once the global economy fully recovers from the 2008 crisis and its aftershocks.

At the same time, monetary decision makers in the "new normal" may well find they need to consider new concerns that lessen the pre-crisis focus on inflation (and often activity). In

[16] Muhleisen (2000).

[17] IMF (2015a).

[18] The most dramatic version of this debate is the refusal by the Greek government elected in late 2014 to accept the austerity plan agreed between the previous government and the troika (European Central Bank, European Commission, and the International Monetary Fund).

[19] Alesina and Giavazzi (2013) discusses a wide range of post-crisis fiscal issues.

[20] More generally, there can be an inverse relationship between the effectiveness of monetary and fiscal policy. Monetary policy is most effective when financial markets are acting smoothly since it relies on asset prices to boost demand. For fiscal policy, on the other hand, financial market responses tend to diminish the impact from the direct boost to demand (Bayoumi and Sgherri, 2009).

particular, it is very possible that monetary policy may be asked to play a role in avoiding the build-up of systemic financial risks ("lean against the wind"). Indeed, such calls have already been made—for example, by the Bank for International Settlements who in their 2014 Annual Report recommended that central banks raise rates to offset financial excesses.[21] Were monetary policy to embrace a wider mandate and, accordingly, a wider set of targets—such as domestic asset prices and lending—this would increase the potential value of having fiscal options as an alternative policy instrument in responding to the business cycle.

Under such circumstances it would seem sensible to have some form of organized dialogue to allow cooperation between central banks and fiscal policy makers. This is particularly true since, as discussed earlier, fiscal and monetary policies have quite different effects on interest rates and the external balance (potentially important for financial stability, amongst other objectives) as well as national saving (important for longer-term structural objectives and the external balance). Indeed, it is for these reasons that policy analysis and advice is often specific about which macroeconomic policies to use, particularly in the case of emerging markets subject to large and volatile capital flows.[22] Cooperation between different arms of domestic policy would allow national policies to be executed in a more coherent manner.

Central banks have, however, shown little interest in a formal dialogue on the macroeconomic policy mix. Partly this reflects legitimate concerns on both a technical level and on a policy level. On the technical side, the lead time for fiscal policy is generally much longer than for monetary policy. Budgets are generally passed once a year and planned quite a long way before hand. By contrast, monetary policy committees typically meet every 1-2 months. The danger is that cooperation meetings would focus largely on the more agile monetary response, leading to a dilution of the role of the central bank in making monetary decisions without a countervailing increase in influence in fiscal decisions. In addition, there is an understandable reluctance by central banks to engage with the highly politicized fiscal process. Central bank independence was aimed at removing monetary policy from the hurly-burly of politics. Instead, it is often argued that informal contacts including confidential meetings between heads of agencies provide an adequate degree of cooperation.

Further scrutiny of these arguments, however, suggests that they may be less water tight than they first appear. On the technical side, it is true that implementation of fiscal policy is generally slower than implementation of monetary policy, even though supplementary budgets and the like can provide more flexibility on timing than an annual cycle. Against this, however, the speed with which fiscal policies impact the real economy is faster than monetary policies. Fiscal instruments directly affect spending or incomes, while monetary policies rely on a less direct transmission through asset prices—the main impact of a policy change is generally thought to seep through to spending a year or so into the future. Hence, it is not clear that the full delay from policy initiation to economic impact differs much across the two options.

[21] BIS (2014).

[22] IMF (2012).

On the policy side, the risk of politicization of the monetary policy process has also to be put into perspective. First, unconventional monetary policies have inevitably led to more politicization of monetary actions, whether it be questioning liquidity provisions to major banks or the view that quantitative easing boosted asset prices and increased inequality.[23] Second, as discussed in the final section of this paper, it may be better for central bankers to have discussions with technical representatives on the fiscal side rather than the politicians who make the final decision. Finally, and most importantly, central bank independence does not mean complete separation from the rest of the policy process—indeed, such a separation seems artificial and could involve significant costs in its own right.

The potential cost of central banks from not cooperating with the fiscal authorities is that monetary policy makers get cornered and manipulated. Indeed, this effect has been evident in the period since the great recession. With fiscal authorities making the first move, central banks have ended up playing Stackelberg followers in macroeconomic policies. The result has been a perception in many quarters that, with fiscal policy makers focused on their own needs, central banks have become overburdened with their attempts to support demand, to the point where the enormous injection of liquidity could be creating financial risks.[24] While to some extent this outcome may have been inevitable given high levels of fiscal deficits and government debt as a result of the crisis, the important insight is that *not* engaging in a dialogue about the appropriate macroeconomic policy mix may have led to an inferior policy mix with its own significant costs for central banks as well as too much reliance on external demand to revive economies—at a cost of excessive outflows to the rest of the world and the accompanying threat to financial stability.

Nor is it clear that informal discussions between (say) the head of the central bank and the finance ministry are a particularly useful way of creating effective cooperation. In particular, these meetings do not guarantee an organized and thorough discussion of the underlying issues or a debate about the policy options that engages the broader public. While such meetings provide exciting "war stories" for memoires, they can have significant disadvantages from the point of view of determining the best policy mix.

Finally, although not the focus of this paper, there is also an element to which easing by one central bank has provided incentives for easing elsewhere, thereby increasing the risk of monetary policy becoming overburdened. This is because easing in one country tends to cause exchange rate depreciation at home and appreciations elsewhere, thereby increasing the incentives for other central banks to loosen.

IV. Financial Policy Coordination in an Age of Financial Instability

Before the crisis advanced country policy makers' general view was that financial globalization was making crises ever more unlikely, and that if they did occur the fallout could be limited by adroit policy moves. For example, as late as 2008 the Federal Reserve

[23] Buttonwood (2014) discusses the latter issue.

[24] BIS (2014).

appears to have been of the opinion that it should not react to asset bubbles and that it could deal with the fallout in the event that US financial conditions worsened.[25] The basic view seems to have been that financial crises occurred in emerging markets, but not in advanced countries with sophisticated micro-prudential supervision. Financial regulation could be delegated to specialized micro-prudential regulators, rather than being tied in to the rest of the policy process.

The deep domestic costs and international repercussions of the financial crisis have made it clear that this compartmentalization of policies is no longer tenable. Given the havoc wrought on output, employment and public finances, it has become apparent that financial stability needs to be included as one of the major economic objectives of every country. This leads to three key issues: How to coordinate policies across various financial regulators tasked with specific sectors (banks, insurance, asset management, etc.); how to mesh the broader objective of financial stability with the narrower objective of ensuring the stability of individual institutions (what has become the discussion of the roles of macro- and micro-prudential policies); and assessing the appropriate role of macro-prudential policies and macroeconomic policies in attaining financial stability. This section will deal with these issues in turn.

The major post-crisis focus in the financial field has been on tightening financial regulation, particularly as regards banks and trading of derivative products. Basel rules on bank capital have been strengthened and new rules on liquidity have been added. While there is inevitably a range of views on the effectiveness of this effort, it is clear that banks are now better capitalized and hold more liquid assets than before the crisis. Another result of tighter bank regulation, and hence higher costs for banks, has been a migration of some activities from banks to nonbanks, either to asset managers as firms borrow directly on markets through bonds or equities or through lightly regulated shadow banks such as money market mutual funds. Indeed, with monetary policy extremely expansive, there are concerns that financial excesses are building up in non-regulated sectors.[26]

Another focus of post-crisis financial policies has been an increasing interest in macro-prudential policies as a way of preserving financial stability. While the exact definition of macro-prudential policies remains somewhat elusive, it is clear that they include system-wide limits designed to avoid generalized financial excesses. So, for example, loan-to-value limits can be used to dampen excess mortgage lending in the housing market that otherwise could help drive house prices to unsustainable levels. In what follows, I use the IMF approach that macro-prudential policies are aimed at limiting potential financial excesses rather than operating over the entire business or financial cycle.[27] Hence, for example, it would not include pro-cyclical capital buffers that operate mechanically over the entire cycle that others might include.

[25] Bernanke (2008) and Mishkin (2008).

[26] IMF (2015b).

[27] IMF (2014b).

A striking feature of the current experience with macro-prudential policies is that the vast majority of them are directed at the banking sector.[28] With risks potentially building in the much less closely regulated non-bank sector—i.e., shadow banking—an important area for future exploration is whether macro-prudential policies can be designed so as to effectively limit risks in other sectors. For example, there is widespread concern that the search for yield may be inducing excess demand for risky debt products, resulting in a narrowing in spreads on such products below the level that could be justified by fundamentals. It is unclear, however, what macro-prudential options are available to limit such risks. A similar comment could be made about non-bank intermediaries, such as hedge funds or private equity funds.

The migration of risks beyond the regulated sector also complicates the coordination of financial regulation. In most countries the micro-prudential regulation of individual entities within sectors is well defined, although the complex US regulatory system, which features both overlaps and gaps in institutional coverage, is a major exception. As long as the focus is on micro-prudential regulation—in other words, the safe regulation of individual enterprises—there is no real reason or need for regulators of different groups of institutions to cooperate. After all, there would be little to be gained from systemic dialogues between the supervisor of a bank and (say) a supervisor of an asset management company, except possibly in the realm of connected lending.

When considering *macro*-prudential regulation, however, the gains from cooperation are much clearer. Macro-prudential regulation involves choosing broad policies to avoid systemic financial risks. Actions may be needed on several fronts to curb (say) excess leverage building up in the financial system, as it can come from several sources. For example, in the US housing boom that led up to the great recession, subprime mortgages were often originated by nonbanks specializing in such loans (such as Countrywide), sold on to special purpose vehicles that were subsidiaries of commercial banks (such as Bank of America) where they were repackaged into securitized assets with the help of broker dealers (such as Lehman Brothers), rated by ratings agencies (such as Standard and Poors), and finally sold to investors such as the American Insurance Group or European banks. With so many links in the securitization chain, actions by any one regulator would probably have been muted

Various approaches have been taken to organize domestic macro-prudential regulation.[29] Two effective models are: centralizing such decisions in the central bank (e.g., Czech Republic, Ireland, and New Zealand); and assigning decisions to a committee either within the central bank but including other agencies (e.g., Malaysia and the UK) or an external committee including the central bank (e.g., Australia, France, and the US). The first arrangement implies the central bank has control over all financial sector decisions, which obviates coordination problems but at the cost of limited participation and hence the possibility of conflicts or interest and blind spots.

---

[28] European Systemic Risk Board (2014) is a case in point.

[29] Nier and others (2011), IMF (2014b), and Goodhart (2011). For more background on actual arrangements, see Jacome and others (2012), Lim and others (2013), and Arvai and others (2014).

The committee arrangement reduces this risk of tunnel vision, while still using the expertise of the central bank.[30] The main issue in this model is ensuring that the committee has sufficient powers to obtain a full view of the financial sector as well as the ability to get other institutions to take action on its recommendations. This can involve a combination of formal enforcement powers over some instruments and persuasion (including, possibly, "enforce or explain" powers). While wider membership of the core committee risks slowing the response to building risks, it also helps in wider ways, such as buy-in by independent agencies. Finally, it generally makes sense to have separate arrangements for financial emergencies involving a major role for the Ministry of Finance.

Another coordination issue involves the relative roles of macro-prudential policy and monetary policy in reducing financial sector risks.[31] This is an active area of discussion, with major players taking very different positions. In particular, Chairperson Yellen has argued that the principal defense against financial instability should be macro-prudential policies, although her definition of such policies appears somewhat different from the definition given above (of active policies deliberately aimed at staving off financial instability). Her focus, rather, seems to be on tighter regulation of the financial system throughout the cycle. Hence, the Fed's focus seems to be on creating banks that are safer all of the time, even at the cost of some reduction in efficiency.[32]

By contrast, the Bank for International Settlements in its 2014 *Annual Report* took a much less positive view of the potential role of macro-prudential policies and instead argued for tighter monetary policy (BIS, 2014). This seems to reflect a more guarded assessment of the ability of macro-prudential policies to reduce financial risks caused by the financial cycle. In the view of the Bank for International Settlements, these financial cycles generally have a longer duration than the business cycles macroeconomists are used to studying, and peaks in these cycles are good predictors of financial instability. With macro-prudential policies not up to the task of significantly affecting the financial cycle, the Annual Report suggested that reducing the financial risks caused by exceptionally low interest rates, particularly in the richer countries, should involve tighter monetary policy

Any consensus on this topic is likely to be many years away. As is the case with most controversies, the final outcome will presumably be somewhere between these two extreme views. It seems unlikely that further analysis will eventually conclude that macro-prudential policies are as effective or ineffective as suggested (respectively) by the Fed and Bank for International Settlements. In this case, the interaction and cooperation between monetary and macro-prudential policymakers will remain an important issue.

[30] The choice of the loation of the committee in or out of the central bank largely depends on the relative importance of the central bank in financial regulation and supervision.

[31] See BIS (2011), Checchetti and Kohler (2012), and Blanchard and others (2013).

[32] Yellen (2014).

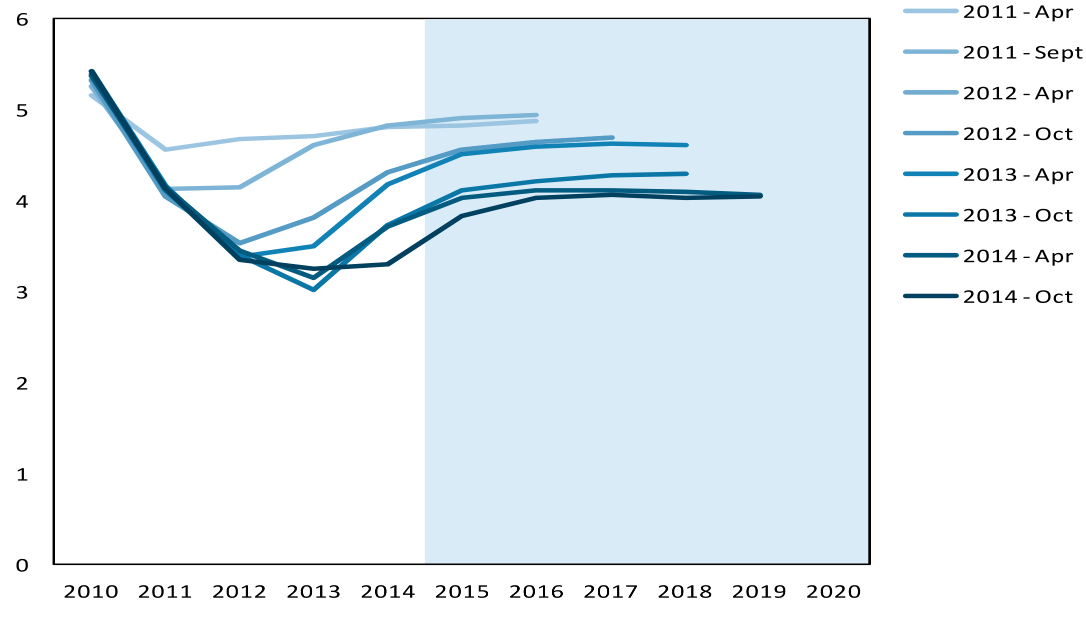
V. Structural Policy Coordination in an Age of Diminished Expectations

There has also been a renewed emphasis on the importance of structural policies to improve growth in the longer term. This reflects consistent disappointments on the growth front since the crisis. For example, as can be seen in Figure 1, IMF global growth forecasts have been consistently revised downwards since 2010, not simply in the short-term but also over the full five-year projection period. This basic pattern holds for both advanced and emerging markets, although encouragingly growth has held up much better for low income countries. Persistently low growth has left many policy-makers concerned that the world may be entering a "new mediocre" of low growth and high unemployment.

The most visible response to this concern has been in the international sphere, where at the Brisbane summit in November 2014 the G-20 leaders coalesced around mutually agreed "individual and collective" structural policy plans. Plans proposed by each government, and vetted by the other G-20 countries and international organizations in the context of the Mutual Assessment Process, are estimated to "lift the G20's growth by at least two per cent by 2018."[33] They reflect a diverse mixture of proposals, principally investment (including infrastructure), competition, trade, and employment initiatives.

Figure 1: World Growth Rate

(IMF projections)



This represents a gradual evolution of the Mutual Assessment Process away from focusing on the gamut of economic policies and their trade-offs to focusing on the narrower issue of structural policies and boosting supply (see Faruqee and Srinivasan, 2013, for a description of the early days of the Mutual Assessment Program). On one level, it is much less ambitious

[33] The communiqué is available at http://www.mofa.go.jp/files/000059841.pdf.

as it involves a narrower and less controversial set of policies (who can oppose boosting growth?). On the other hand, the explicit focus on structural policies is interesting as these policies have been seen in the past much more as a domestic imperative. Indeed, the driving force for past wide-ranging structural reform agendas that generated new economic dynamism in countries such as China, the United Kingdom, and Chile came from within, not from international agreements.

As these examples illustrate, cooperation is important in the domestic sphere. Areas of structural reform such as labor market rules, product market regulation, trade policy, infrastructure spending, privatization, and agricultural policy are typically distributed across a range of ministries and hence ministers. This fragmentation, as well as the fact that structural policies almost always have distinct winners and losers (marginally attached workers/firms versus protected ones, export industries versus firms focused on the domestic market), means such initiatives require considerable political agreement that "there is no alternative" to these policies, to use Margaret Thatcher's phrase.

Structural policies thus suffer the same fragmentation issue as financial policies, but in a more virulent form. While the sub-agencies involved in financial regulation tend to be relatively obscure and technical, structural policies generally involve powerful ministries—labor, commerce, finance, agriculture, etc—and lobby groups. Hence, while financial policy coordination can often be led at the level of the central bank or the finance ministry, structural policies generally involve the commitment of the political leader. A recent example of this is the close identification with Prime Minister Abe of the effort to revive the Japanese economy—Abenomics, one of whose three arrows is structural reform. Indeed, the choice of whether to use "shock treatment" to revive the economy is often the focal issue of political campaigns; think not just of Abenomics but also of Reaganomics and Thatcherism.

The implication is that structural policies need a strong leader and broad agreement across a wide swath of opinion makers about the need to reinvigorate the economy. This is an instance in which domestic policy coordination crucially depends on a deep political commitment rather than on more organizational aspects, such as the defining a dialogue and a decision structure across interested parties. This is not to say the latter is unimportant. Rather, the point is that at such politically charged levels of policy making such structures for decisions are already embedded in the political process.

Finally, there is a case for coordinating supply-side and macroeconomic policies by offsetting any short-term disruptions to output from structural policies with demand stimulus. Many structural reforms are thought to have negative consequences for the economy in short-term even if they are positive over a longer period. This is particularly true of policies that are aimed at a more efficient allocation of workers or capital—labor and product market reforms. The longer-term consequences of (say) successfully opening up a previously relatively uncompetitive industry to competition are positive as more efficient firms come in and produce more output using fewer inputs (at least per unit of production). But the short-term impact can be disruptive. The inefficient firms will likely fire workers before the new firms hire them. Furthermore, there are likely to be teething problems as the new firms go through a period of "learning by doing." Finally, the new structure will disrupt previous relationships across buyers and sellers and it will take a while for new ones to be formed.

Coordinating the use of structural policies with short-term monetary or fiscal stimulus, however, involves its own analytic and organizational complications. On the intellectual side, a major issue is that any offsetting demand stimulus will generally be agreed and possibly implemented before the structural policies have taken effect.[34] In other words, the request for a short-term boost to the economy will be based on the promise of difficult economic decisions rather than their implementation. There is an inevitable risk that the government will reverse the difficult policies, leading to an economy that is over stimulated.

The main analytic issue is the interaction between demand policies and the incentives to implement structural reforms. The basic conundrum, which has become particularly pertinent in the wake of the recent global crisis, is whether demand stimulus increases or decreases the desire to tackle structural issues at a time when demand is already weak. The argument that it increases the incentives comes from the notion that favorable economic conditions provide a better environment to tackle difficult reforms. In other words, that if a government really wants to implement such reforms macroeconomic stimulus can support the effort. The opposite hypothesis that macroeconomic stimulus reduces incentives to carry out structural reforms is the familiar moral hazard argument. If a government is only agreeing to structural reforms because of a dire economic situation, then providing a demand stimulus will allow the difficult decisions to be postponed.

One solution to this conundrum is to make the stimulus dependent on structural actions. IMF programs are an example of such a mechanism at work, albeit in the context of external financing rather than macroeconomic stimulus. In a standard IMF program, external financing is provided steadily over time on the basis of an agreed program of measures, with prior actions being specified before each disbursement. Such an approach works well in the case of external financing, where the enforcement mechanism is strong as the cutting off the flow of foreign currency will have immediate and likely deleterious effects on the domestic economy. It works less well, however, in cases where stimulus affects the economy with a lag and where a formal arrangement is difficult to put in place given the underlying institutional environment. In this case, there is a greater risk of getting stuck in a time inconsistent outcome where stimulus is provided on the basis of promised good behavior that does not materialize.

The alternative is to appoint people who are prepared to stick with the plans even in the face of temptation to deviate. This is the solution proposed by Rogoff (1985) in his paper on the time inconsistency of attempting to exploit the short-run Phillips curve. If the policy maker either sees through the time inconsistency or simply does not acknowledge that the worse option exists then the issue of deviating from the better long-term strategy for short-term "gain" is clearly moot.

All of this basically comes down to saying that the decision as to whether and how to provide demand support or not comes down to an assessment of intentions of those promising structural reforms. If the policymakers' support for structural reforms is lukewarm, then the prudent approach is to line up incentives by providing demand support gradually and making

[34] Monetary stimulus takes time to take effect while fiscal stimulus generally requires political approval.

it contingent on specific actions, even if this risks support being provided somewhat later than would be ideal. On the other hand, if policymakers are fully committed to the policy, then the issue of incentives may be less important, and the focus should be on providing the support at the most effective moment.

The organizational complication has to do with making agreements between the government and independent agencies, most usually in this case an independent central bank. This issue has already been discussed earlier in the context of the coordination of monetary and fiscal policies. The sensible approach is to allow a structured and wide-ranging dialogue, but avoid binding rules that can be used to force the hand of independent agencies.

It should be emphasized that these issues have played out very differently across different countries in the wake of the great recession. In the case of monetary policy, in the United States and Japan independent central banks committed to major monetary stimulus on the assumption that needed structural reforms would follow. In the Euro area, by contrast, the central bank has been reluctant to commit to such a major monetary stimulus in part because of concerns that it will lower the incentives for member governments to embark on structural reforms. Similarly, on the fiscal front, after the initial G-20-led stimulus in 2009, the European Commission, strongly backed by Germany, has taken a rules based approach to fiscal consolidation, while in the United States and Japan there has been more focus on the risk that rapid consolidation could undermine the recovery. As this last case illustrates, this may in part reflect the fact that fiscal and structural reform in the Euro area is the responsibility of member governments, and is hence a more decentralized process than in the United States and Japan. In a monetary union comprising many different national governments "free rider" concerns are presumably greater as spillovers and leakages of such policies onto other countries are larger.[35]

VI. THE GRAND BARGAIN

The global crisis and its aftermath have illustrated the need for domestic policy cooperation as a supplement to international cooperation. The crisis and its enormous costs can be partly attributed to the compartmentalization of policies, which led the Fed, the Bank of England, and the European Central bank to miss or excessively discount rising financial strains. The response to the crisis has involved a policy mix with large amounts of monetary stimulus, less fiscal support than might have been ideal, and very limited structural reforms. Indeed, there may also have been some central bank "self-exploitation" as monetary stimulus in one region has lowered domestic exchange rates, making conditions more difficult elsewhere, and promoting monetary expansion elsewhere to restore competitiveness. The outcome was an enormous recession, a prolonged period of weak growth, and rising risks of getting stuck in a low-growth outcome—a "new mediocre."

The issue now is how better domestic policy cooperation could be organized. This section proposes a regular and organized discussion of the domestic policy mix that allows all of the

[35] The concern that profligate fiscal policy could pose a burden on other members of the monetary union was the initial logic of the fiscal rules set up on the Maastricht Treaty forming European Monetary Union.

relevant policy makers to engage on the overall direction of policy. As long as there is no coercion (i.e., no overriding of mandates) such an approach can deepen the engagement on domestic policies both across policy makers and with other analysts while preserving the different roles and independence of participants. It is akin to the increase in cooperation across financial policy makers once the need for macro-prudential policies was recognized.

As in the case of macro-prudential policies, this approach recognizes the importance of cooperation given interlinkages and spillovers across policies. While allowing fiscal policy to exclusively focus on the level of debt, monetary policy on inflation, and macro-prudential policy on financial stability has a certain intellectual appeal given its tidiness, the main insight from the global crisis is that such explicit assignments cannot do justice to the level of complexity and interaction between policy instruments in the real world. Indeed, it is this complexity that provides the underlying rationale for policy cooperation. As already noted, the advantage about thinking of cooperation in the domestic context is that more is known about the nature and size of domestic policy spillovers than of international ones. It reflects a return to the focus on external and domestic balance epitomized by the IS-LM-BoP model—suitably amended to include issues of financial stability and improving potential growth. More coherent domestic policy cooperation would also lead to more fruitful international discussions as it would open up trade-offs across different policy tools, as was done in the Louvre and Plaza Accords.

The approach advocated here recognizes that many economic issues will ideally involve a combination of policy responses. For example, if the financial cycle is on an upswing that is boosting activity but creating concerns about future financial vulnerabilities coming from excessive leverage from inflated asset prices, the response will likely involve a combination of macro-prudential measures to curb the rise in leverage with some tightening of monetary policy to cool the real economy and (possibly) some fiscal tightening to reduce the impact on the exchange rate. This is an outcome that would be unlikely to come about if the macro-prudential agencies, central bank, and fiscal authorities acted independently.

I suggest organizing regular meetings of "economic allstars"—the main policy makers responsible for monetary, fiscal, macro-prudential, and structural policies (i.e., the heads of the Finance Ministry, Central Bank, Ministry of Commerce, Ministry of Labor, etc.). It would also be sensible to consider any independent fiscal agencies and think tanks that are seen as largely above the political fray. Each agency would be expected to come to the meeting with an explicit view about the desired policy mix, spillovers, and how the policy areas fit into the overall pattern. The meetings would be private, but its existence would be public and a summary record of the discussion would be provided (very much like best practice for central banks or for financial authorities). Any decisions would be announced, but there would be no formal voting rules. In other words, all decisions would be voluntary. The objective is to create a forum for discussion and moral suasion, not a binding mechanism to force policy changes.

Given that many of the policies involved are slow moving, I would suggest that the allstars meet something like every six months. More frequent meetings risk little change in the economic situation, which would devalue the policy discussions and reduce the incentives to produce innovative analysis. While there is a case for annual meetings (after all, most budget cycles are annual) the risk is that annual meetings could miss important economic turning points. In addition, I would propose that ad hoc meetings could be arranged if enough participants agreed that the economic situation had changed sufficiently to make a reconsideration of the policy mix useful.

Why go to so much trouble to discuss the domestic policy mix? This reflects the manifest failure of decentralized and uncooperative decision making in the post-crisis period. After a period of fiscal expansion, consolidation has been pursued as different paces and different results. Meanwhile, in advanced economies facing sluggish growth and debt overhang, monetary policy has often been seen as overburdened, leading to excessive central balance sheets and excess downward pressures on exchange rates with collateral damage in terms of fears of "currency wars." In emerging markets, massive capital inflows and excessive optimism about potential growth led to unsustainable booms. Everywhere, politically difficult structural policies have lagged (see IMF, 2014c). In short, decentralization has led to a mediocre policy mix that has reflected political expediency—the exact outcome that independence across agencies was designed to avoid. Against this background of failure, who would not want to innovate?

References

Alesina, Alberto and Silvia Ardagna, 2009, "Large Changes in Fiscal Policy: Taxes Versus Spending," NBER Working Paper No. 15438 (Cambridge, Massachusetts: National Bureau of Economic Research).

Alesina, Alberto and Francesco Giavazzi, ed., 2013, Fiscal Policy after the Financial Crisis, (NBER: University of ChicagoPress).

Arvai, Zsofia, Ananthakrishnan Prasad, and Kentaro Katayama, 2014, "Macroprudential Policies in the GCC Countries," IMF Staff Discussion Note No. 14/01 (Washington: International Monetary Fund).

Bank of International Settlements (BIS), 2011, "Central Bank Governance and Financial Stability: a Report by a Study Group," May.

Bank for International Settlements, 2014, 84th Annual Report Basel, 29 June 2014

Barro, Robert J., 1974, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, Vol. 82 (6), pp.1095–1117.

Bayoumi, Tamim, 2014 "After the Fall: Lessons for Policy Cooperation from the Crisis," IMF Working Paper 14/97 (Washington: International Monetary Fund).

Bayoumi, Tamim, and Francis Vitek, 2013, "Macroeconomic Model Spillovers and Their Discontents," IMF Working Paper 13/4 (Washington: International Monetary Fund).

Bayoumi, Tamim, and Silvia Sgherri, 2009, "On Impatience and Policy Effectiveness," IMF Working Paper 09/18 (Washington: International Monetary Fund).

Bernanke, Ben, 2008, "Financial Markets, the Economic Outlook, and Monetary Policy," speech delivered at the "Women in Housing and Finance and Exchequer Club" Joint Luncheon, Washington, January 10, 2008

Blanchard, Olivier, and Jodi Gali, 2005, "Real Wage Rigidities and the New Keynesian Model," NBER Working Paper 11806 15438 (Cambridge, Massachusetts: National Bureau of Economic Research).

——, Giovanni Dell'Ariccia, and Paolo Mauro, 2013. "Rethinking Macro Policy II. Getting Granular," IMF Staff Discussion Note No. 13/03 (Washington: International Monetary Fund).

Buttonwood, 2014, "The Rich Are Different," The Economist, March 19.

Cecchetti, Stephen G., and Marion Kohler, 2012, "When Capital Adequacy and Interest Rate Policy are Substitutes (And When They Are Not)," BIS Working Paper 379 (Basel: Bank for International Settlements).

Crowe, Christopher, Giovanni Dell'Ariccia, Deniz Igan, and Pau Rabanal, 2013, "How to Deal with Real Estate Booms: Lessons from Country Experiences," *Journal of Financial Stability*, Vol. 9, pp. 300–319.

Coase, R. H., 1937, "The Nature of the Firm" Economica, Volume 4, Issue 16, pages 386–405, November.

Debelle, Guy, and Stanley Fischer, 1994, "How Independent Should a Central Bank Be?" In Goals, Guidelines and Constraints Facing Monetary Policymakers, ed. by Fuhrer. Boston: Conference Series No. 38, Federal Reserve Bank of Boston, pp. 195–221.

European Systemic Risk Board, 2014, "The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector," European System of Financial Supervision, March.

Faruqee, Hamid, and Krishna Srinivasan, 2013, "The G-20 Mutual Assessment Process—a Perspective from IMF Staff," Oxford Review of Economic Policy, Vol. 28, Number 3, September 26, 2013, pp. 493–511(19).

Fischer, Stanley, 1995, "Modern Central Banking," In The Future of Central Banking: The Tercentenary Symposium of the Bank of England, Cambridge University Press, pp. 262–308.

Fleming, J. Marcus, 1962, "Domestic financial policies under fixed and floating exchange rates," *Staff Papers*, International Monetary Fund, Vol. 9, pp. 369–379.

G-20, 2014, "Leaders' Communiqué: Brisbane Summit November 15–16, 2014" available at http://g20watch.edu.au/g20-leaders-communiqu%C3%A9-brisbane-summit-november-2014.

Giavazzi, Francesco, and Marco Pagano, 1990, "Can Severe Fiscal Contractions be Expansionary? Tales of Two Small European Countries," London, Centre for Economic Policy Research.

Goodhart, Charles A. E., 2011, "The Macroprudential Authority: Powers, Scope, and Accountability," *OECD Journal: Financial Market Trends*, Vol. 2011, No. 2.

Horton, Mark, Manmohan Kumar, and Paolo Mauro, 2009, "The State of Public Finances: A Cross-Country Monitor," IMF Staff Position Note 09/21, (Washington: International Monetary Fund).

International Monetary Fund, 2009a, "The State of Public Finances—Outlook and Medium-Term Policies After the 2008 Crisis," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2009/030609.pdf

———, 2009b, "Companion Paper: The State of Public Finances—Outlook and Medium-Term Policies After the 2008 Crisis," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2009/030609a.pdf

———, 2012, "The Liberalization and Management of Capital Flows: An Institutional View," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2012/111412.pdf

———, 2013, "Spillover Report, IMF Multilateral Issues Report," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2013/070213.pdf

———, 2014a, "Spillover Report, IMF Multilateral Issues Report," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2014/062514.pdf

———, 2014b, "Staff Guidance Note on Macroprudential Policy," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2014/110614.pdf

———, 2014c, "The Managing Director's Global Policy Agenda," October, IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2014/100314.pdf

———, 2015a, "Fiscal Monitor: Now Is the Time: Fiscal Policies for Sustainable Growth," April, IMF Policy Paper (Washington). http://www.imf.org/external/pubs/ft/fm/2015/01/pdf/fm1501.pdf

———, 2015b, "Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks," April, IMF Policy Paper (Washington). http://www.imf.org/external/pubs/ft/gfsr/2015/01/index.htm

Jacome, Luis, Erlend W. Nier, and Patrick Imam, 2012, "Building Blocks for Effective Macroprudential Policies in Latin America: Institutional Considerations," IMF Working Paper No. 12/83, (Washington: International Monetary Fund).

Krugman, Paul, 2009, "How Did Economists Get It So Wrong," New York Times Magazine, September 2, available at http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?_r=1&

Lim, Cheng Hoon, Rishi Ramchand, Hong Wang and Xiaoyong Wu, 2013, "Institutional Arrangements for Macroprudential Policy in Asia," IMF Working Paper 13/165, (Washington: International Monetary Fund).

Mishkin, Frederic S., 2008, "How Should We Respond to Asset Price Bubbles?" speech delivered at the "Wharton Financial Institutions Center and Oliver Wyman Institute's Annual Financial Risk Roundtable," Philadelphia, Pennsylvania, May 15.

Muhleisen, Martin, 2000, "Too much of a Good Thing? The Effectiveness of Fiscal Stimulus," in *Post-Bubble Blues: How Japan Responded to Asset Price Collapse*, ed. by Bayoumi and Collyns (Washington: International Monetary Fund).

Mundell, Robert A., 1963, "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates," *Canadian Journal of Economic and Political Science*, Vol. 29 (4), pp. 475–485.

Nier, Erlend W., Jacek Osiński, Luis I. Jácome, and Pamela Madrid, 2011, "Institutional Models for Macroprudential Policy," IMF Staff Discussion Note No. 11/18 and IMF Working Paper No. 11/250 (Washington: International Monetary Fund).

Rogoff, Kenneth, 1985, "The Optimal Degree of Commitment to an Intermediate Monetary Target," *The Quarterly Journal of Economics*, Vol. 100, No. 4 (November), pp. 1169–1189.

Wyplosz, Charles, 2012, "Fiscal Rules: Theoretical Issues and Historical Experiences," NBER Working Paper No. 17884, (Cambridge, Massachusetts: National Bureau of Economic Research).

Yellen, Janet, 2014, "Monetary Policy and Financial Stability," speech delivered at "Inaugural Michel Camdessus Central Banking Lecture," International Monetary Fund, Washington, July 2.