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BOOK REVIEW

"IN THE WAKE OF THE CRISIS: LEADING ECONOMISTS REASSESS ECONOMIC POLICY" EDITED BY OLIVIER BLANCHARD, DAVID ROMER, MICHAEL SPENCE, AND JOSEPH STIGLITZ

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ABSTRACT To understand the issues raised by the recent global crisis, IMF organized a conference on March 7-8, 2011, around six themes: monetary policy, fiscal policy, financial intermediation and regulation, capital account management, growth strategies, and the international monetary system. The conference proceedings are published in a book, *In the Wake of the Crisis: Leading Economists Reassess Economic Policy*. This review presents a summary of the book and provides its implications for research and policy. The book contains 23 chapters, editors' sets of questions and notes for each of the six areas; and concluding remarks by Olivier Blanchard. Each essay is about 4 to 13 pages in length; and provides concise, lucid descriptions, in non-technical language, of the recent crisis. Missing from the book is the adequate analysis of the increase in measures of aggregate productivity concurrent with strong contractions in output and employment; and the role of income inequality on the crisis.
JEL E58, E60, F01, F42, G01, G20
Keywords Economic policy, Financial crises, Book review

ÖZ Uluslararası Para Fonu (International Monetary Fund, IMF) 7–8 Mart 2011 tarihinde, son küresel ekonomik kriz ve sonrasına ilişkin olarak para politikası, maliye politikası, finansal düzenlemeler, sermaye hesapları yönetimi, büyüme stratejileri ve uluslararası parasal sistem olmak üzere altı tema çerçevesinde bir konferans düzenlemiştir. Konferans tebliğleri, *In the Wake of the Crisis: Leading Economists Reassess Economic Policy* başlığını taşıyan bir kitapta basılmıştır. Bu eleştiride, söz konusu kitabın bir özeti sunulmakta ve araştırma ile politikalar açısından etkileri tartışılmaktadır. Kitap, 23 makalenin yer aldığı toplam 6 bölümden oluşmaktadır. Her bölümden önce editörlerin o bölümle ilgili kısa notlarının ve sorularının yer aldığı kitap, Olivier Blanchard'ın kapanış yazısı ile sonlanmaktadır. Her bir makale 4 ile 13 sayfa arasında değişen uzunlukta olup son krizin teknik olmayan bir dilde yorumlandığı yazılardır. Çıktı ve istihdam daralmalarına karşılık artan genel verimlilik göstergeleri, gelir eşitsizliği gibi önemli konulara ilişkin ayrıntılı tartışmalar kitapta yer almamaktadır.
"IN THE WAKE OF THE CRISIS: LEADING ECONOMISTS REASSESS ECONOMIC POLICY" ÜZERİNE BİR ELEŞTİRİ
JEL E58, E60, F01, F42, G01, G20
Anahtar Kelimeler Ekonomi politikaları, Finansal krizler, Kitap eleştirisi

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"For me, policy analysis and basic research are mutually supportive. Policy discussions have alerted me to interesting research questions that had not received adequate analysis. And my policy analysis draws heavily on my understanding of economic theory and reading in the empirical literature. Indeed, without being based on real understanding of how policies could accomplish good ends, making policy recommendations seems very hit or miss."

- Peter A. Diamond[1]

1. Introduction

The Great Recession of 2008–2009 generated substantial discussion and debate about economic policy and economic research. Many discussions are centered on the questions of what caused the financial and economic problems that culminated in the crash of 2008, what policies might have prevented it, or what might help us in the future. A diverse set of books are written by academics, journalists, and the commentators specializing in economics, finance, and business to deepen our knowledge of the key areas surrounding the global financial crisis.[2]

To understand the issues raised by the recent global crisis, IMF organized a conference, on March 7-8, 2011, around six key areas: monetary policy, fiscal policy, financial intermediation and regulation, capital-account management, growth strategies, and the international monetary system.[3] The conference proceedings are published in a book, *In the Wake of the Crisis: Leading Economists Reassess Economic Policy*. This book has 23 essays written by Nobel laureates, prominent academics, and policymakers. The book aims to explain things to interested parties providing insights; and all of the essays provide concise, lucid descriptions, in non-technical language, of the recent crisis regarding the six themes mentioned above. Each essay is about 4 to 13 pages in length and none of them has any formal models. Instead, the contributors provide their views on the themes. For each one of the six themes, Olivier Blanchard and David Romer add short notes with some questions. Finally, the book ends with the concluding remarks of Olivier Blanchard.

In the Wake of the Crisis provides many questions seeking both academic and practical answers. The editors introduce each part by listing questions that should be addressed in the post-crisis world. For example, *Should interest rate policy respond to asset prices? Can immediate fiscal*

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[1] http://www.nobelprize.org/nobel_prizes/economics/laureates/2010/diamond.html

[2] See, for example, Akerlof and Shiller (2009), Gorton (2010), Rajan (2010), Reinhart and Rogoff (2009), Shiller (2008), and Sorkin (2009). Lo (2012) reviews twenty-one books on the crisis, eleven written by academics, ten written by journalists, and one former Treasury Secretary.

[3] The conference program and the presentations are available at the following address: http://www.imf.org/external/np/seminars/eng/2011/res/

consolidation be expansionary in the short run? What is the social value of the financial sector? What is the right macroprudential response to high capital flows? Should we revisit the benefits and costs of financial liberalization and of financial openness for growth? Should there be rules on reserve accumulation and on capital controls? These are surely very important and tough questions. Unfortunately, the essays do not provide (satisfactory) answers for the questions listed by the editors. The contributors do not provide an analytical or a quantitative framework to integrate the crisis into macroeconomics. Instead, they provide some guidance on the possible ingredients for such frameworks. For example, Otmar Issing, in Chapter 3, states that combining money and credit quantities within the inflation-targeting framework is worth for a Nobel Prize.

The recent crisis highlighted the importance of banks and other financial institutions in the origination and transmission of exogenous shocks. One of the messages that can be extracted from this book is that economists at central banks and academic institutions should devote further attention to (i) analytical and empirical analysis of the behavior of financial markets, and (ii) the interaction between financial sector and real economy. This book also highlights that there are more instruments available for central banks than the pre-crisis view on monetary policy suggested by its focus on pure interest rate policy.[4] Another point stressed is that risk is endogenous and macroprudential tools can address systemic weakness.[5] Policies should be judged according to their objectives and development of resilient domestic financial markets is needed. There is consensus on the need for reform of the financial sector. To establish these reforms in international monetary system the importance of the globalization of governance is emphasized as well.[6] The book also touches on the questions related to lessons of the crisis about drawbacks of the current international monetary and financial system. One message is that international cooperation should be strengthened in terms of financial regulation.

This edited volume is not just about the crisis in the developed world. It is also mentioned in different chapters that emerging markets have generally done better than advanced countries in the last crisis.[7] Some remarks on developing countries are in the book. This is an important issue that since over the past two-three decades the global economy has been reshaped by the rise of the emerging markets, most notably China; and the rising

[4] See the first four chapters.
[5] See, for example, Chapter 14.
[6] See the last four chapters.
[7] See, for example, Chapter 2.

importance of emerging market economies in global economic affairs is one of the central topics of the current research in international macroeconomics.[8]

In the Wake of the Crisis should not be viewed as a comprehensive analysis of the recent crisis, but, rather, should be seen as a very interesting discussion of particular issues by several economists and policy makers. There are some important topics, such as productivity and income inequality that deserve serious discussions, but they are not analyzed or discussed in depth. The primary readers of this book are economists and users of economic research in governments, central banks, international organizations, academia, and private sector. This book also provides many important questions for graduate students who are looking for dissertation topics.

This review is organized as follows. Section 2 provides a summary of the book with the main points of each essay. Section 3 offers a discussion for two neglected topics in the book and adds remarks about the state of macroeconomics in the light of the recent discussions. Section 4 concludes.

2. What Is This Book About?

Section I of the book, *on monetary policy*, contains chapters by Olivier Blanchard, Guillermo Ortiz, Otmar Issing, and Joseph Stiglitz. These four chapters have common point that the recent crisis has challenged several aspects of the conventional monetary policy. For example, Blanchard's piece is about the new era, in which we need to think about monetary policy with many targets and many instruments. There was one target before the crisis, *stable inflation*, and there was one instrument, *the policy-rate rule*.[9] However, after the crisis, many realized that there are additional targets (such as financial stability) and additional instruments (such as macroprudential tools).

Ortiz, Governor of the Bank of Mexico during 1998-2009, adds that the upshot of the crisis for central bankers is that price stability is not enough to maintain financial stability. He argues that central banks need to have a bank supervisory responsibility and this role should not interfere with their independence in conducting monetary policy.[10] Otmar Issing has comments on the understanding of the inflation-targeting framework. Issing accepts that the inflation-targeting framework was effective in bringing down

[8] See Kose and Prasad (2010).

[9] Tinbergen (1952) demonstrates that to achieve policy objectives, governments must have policy instruments equal in number to the objectives. According to what is known as the Tinbergen rule, a government cannot achieve two objectives with just one instrument.

[10] See also Miller (2012) on this point of Ortiz's chapter.

inflation, particularly in emerging markets. On the other hand, Issing argues that money/credit should play active roles for policy since nearly all bubbles in history have been accompanied or preceded by strong growth in credits. Stiglitz, co-recipient of the 2001 Nobel Prize in economics, makes a similar argument on the importance of the credit markets for recessions.[11] Stiglitz criticizes economists and claims that inadequate modeling of credit markets plays a crucial role for the failure of such economic models. Stiglitz also discusses the possible assignment problems of instruments to specific objectives arguing that all instruments have to be coordinated, since in the presence of uncertainty, even with a single target, it may be desirable to use multiple instruments.

Section II of the book, *on fiscal policy*, contains chapters by Parthasarathi Shome, David Romer, Sri Mulyani Indrawati, and Robert Solow. Parthasarathi Shome, from the Indian Council for Research on International Economic Relations, reviews fiscal policy experiences of India and the United Kingdom. Shome's main message is that the policymakers should be aware of that the size of the fiscal multipliers varies across countries, suggesting that fiscal deficit per GDP of each country produces a different stimulus. David Romer focuses on four lessons about fiscal policy that can be learned from the crisis: (i) there is a need of fiscal tools for short-run stabilization; (ii) fiscal policy is effective; (iii) fiscal space is valuable; and (iv) political economy considerations are extremely important.[12]

Indrawati, the Minister of Finance of Indonesia between 2005 and 2010, shares her experiences as a policymaker in an emerging market country. She conveys one specific policy message that the fiscal stimulus programs for developing countries during the crises should target the social sectors and infrastructure, which stimulates their employment and growth prospects. Solow, recipient of the 1987 Nobel Prize in Economics, comments on the size of the government spending multiplier, since there is substantial disagreement about the size of the government spending multiplier.[13] Solow suggests that new estimates are needed to narrow the range of expected multiplier effects.

Section III of the book, *on financial intermediation and regulation*, contains chapters by Y. V. Reddy, Hyun Song Shin, Adair Turner, and Paul

[11] Bernanke (1983) presents the view that the breakdown of the credit system was the critical feature of the Great Depression.

[12] The fact that nominal interest rates cannot be negative implies that alternative policies should be considered at the zero bound to provide stimulus. Correia et al. (forthcoming) show how fiscal policy should be designed to replicate the efficient allocation when the zero lower bound on nominal interest rates binds. They argue that there is no need to use inefficient policies such as wasteful public spending or future commitments to low interest rates.

[13] See Christiano et al. (2011), Woodford (2011) and the references therein.

Romer. Reddy, Governor of the Reserve Bank of India during 2003-2008, lists a set of questions to develop further understanding of the social value of the financial sector as well as designing financial institutions. Shin, in Chapter 10, notes the importance of the US dollar for the global banking system. The United States is a substantial *net creditor* in the global banking system, although it is the largest *net debtor* in the world. In Chapter 11, Adair Turner argues that one shall not take for granted that increasing financial intensity produces valuable allocative efficiency benefits; and questions should be asked on the level of optimal financial intermediation.

One of the most intellectually stimulating (and one of the longest) piece of *In the Wake of the Crisis* is written by Paul Romer, a prominent growth theorist currently working on the establishment of city-scale special administrative zones. His essay starts with his views on the power of ideas. Then, he continues that there is an urgent need for the discovery and implementation of new rules, of new ideas about how people interact. Moreover, these rules, according to Romer, have to evolve in response to (i) new technologies, (ii) increases in the scale of social interaction, and (iii) opportunistic attempts at evasion. He provides persuasive examples from the Internet, the financial markets, and different institutions from the US to develop an understanding of the dynamics of technologies and the dynamics of rules.

Section IV of the book, *on capital account management*, contains chapters by Ricardo Caballero, Arminio Fraga, Rakesh Mohan, and José Antonio Ocampo. Caballero has comments for capital inflows and global equilibrium issues and states that emerging markets should focus on the development of domestic financial markets and foreign exchange derivatives. In Chapter 14, Fraga argues that the regulation of capital flows can be a second best response and capital controls should not be seen as a permanent solution to international finance problems. Rakesh Mohan, former Deputy Governor of Reserve Bank of India, notes on the so-called *the impossible trinity*. This macroeconomic policy trilemma for open economies states that a country simultaneously may choose at most two of the following three goals: monetary independence, exchange rate stability, and capital account openness. Mohan states that there is no need to be at the corners of the trinity and gives examples from the emerging market economies in Latin America and Asia. The recipe is that an independent monetary policy can be practiced with a certain degree of management of the capital account and of the exchange rate. José Antonio Ocampo, who served in a number of positions in the United Nations and the Government of Colombia, adds further insights to the perspective of Mohan on the impossible trinity; and states that *all interesting things happen inside the impossible trinity*.

Section V of the book, *on growth strategies*, consists of contributions by Dani Rodrik, Andrew Sheng, and Michael Spence. Rodrik has important comments on growth policies and convergence experiences. For example, he shares his observation on Latin America: the convergence gap between the average income levels in Latin America and in rich countries is wider now than what it has been since the 1970s. Both Rodrik and Spence touch on a very important topic in economic growth and development. Part of their essays focuses on structural transformation and the reallocation of resources across sectors in economies. They offer insights into issues related to the promotion of policies, to raise productivity in the low productive sectors, in the pursuit of sustainable growth and catch-up strategies.

Andrew Sheng writes about the Asian growth model with some particular aspects of the Chinese model. Economic reforms, started in 1978, have driven a rapid transition from central planning toward a market-oriented system integrating with the world economy. The Chinese economy, today the second largest in the world, has maintained high and steady growth rates for over two decades. Sheng argues that the growth process of China is about experimentation and a pragmatic, adaptive system, i.e. adopting global experience and practicing to local conditions.

The final section of the book, *on the international monetary system*, contains chapters by Már Guðmundsson, Olivier Jeanne, Charles Collyns, and Maurice Obstfeld. Már Guðmundsson, who was appointed Governor of the Central Bank of Iceland in 2009, argues that the international financial system needs a change in a way that countries should adopt measures to deal with risks. Placing prudential limits on currency mismatches is one of them. He also discusses the argument that the IMF should be strengthened as an international lender of last resort.

Olivier Jeanne focuses on global imbalances and reminds us the predictions in the World Economic Outlook that China accounts for more than 60% of the global surplus, excluding oil exporters. Charles Collyns, who serves as the US Department of the Treasury's assistant secretary for international finance, states that international monetary system needs a reform. As an example, all major economies should have flexible exchange rates and volatility of capital flows should be reduced via consensus around a coherent policy framework. Maurice Obstfeld also notes that the globalization of capital markets has facilitated larger current account imbalances and he suggests that financial supervision and similar issues should be considered in the related institutional arrangements for the globalization of governance.[14]

3. Some Remarks

This section argues that there are two important issues, which are not covered or discussed in depth in the book. The first one is the discussion of productivity. Başçı (2012), Governor of the Turkish Central Bank, argues that there are three essential factors that determine the growth potential of a country: (i) *price stability*, (ii) *financial stability,* and (iii) *productivity*. Any weakness in any of these three factors may cause considerable harm to growth prospects. Therefore, studies on productivity and crises are informative. A provoking study on the importance of productivity for economic crises is the edited volume by Kehoe and Prescott (2007). The papers in that volume study sixteen depressions – both from the interwar period in Europe and America and from more recent times in Japan and Latin America. Collectively, the papers in Kehoe and Prescott (2007) volume argue that government policies that affect total factor productivity (TFP) and hours per working-age person are the crucial determinants of the great depressions of the 20th century.[15] What can one say about the productivity developments during the recent crisis? When faced with such a question, *In the Wake of the Crisis* is silent.

In the downturn of 2008–2009, labor productivity actually rose as GDP plummeted (McGrattan and Prescott, 2012); and the financial crisis of 2008 was followed by sharp contractions in aggregate output and employment and an unusual increase in aggregate TFP (Petrosky-Nadeau, *forthcoming*). There is no particular discussion on productivity in *In the Wake of the Crisis*. This is an important missing issue since productivity is one of the ingredients that determine the growth potential of countries.

The second topic that is not touched in the book is about the role of income inequality that may have contributed to the emergence of the financial crisis. The editors put note on the income distribution and growth in the opening paragraphs of Section V. However, there is no satisfactory discussion. There is an ongoing debate and some researchers argue that rising inequality led to a credit boom and eventually to a financial crisis (Kumhof and Rancière, 2010; Rajan, 2010). For example, Raghuram Rajan in his book, *Fault Lines*, argues that growing income inequality in the last

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[14] Farhi et al. (2011) argue that failures in the international monetary system are the root cause of the global crisis. They propose a number of reforms of the international monetary system focusing on liquidity provision, and emphasize that the optimal provision of global liquidity is a central feature of any well-functioning international monetary system.

[15] See Kehoe and Prescott (2007, pp. 8-11) for their definition of a great depression.

part of the 20th century created the push for higher home ownership rates and led to the distortions of the housing market that in turn led to excessive risk-taking in the financial market.[16] On the other hand, some other researchers argue that there is very little evidence linking credit booms and financial crises to rising inequality (Bordo and Meissner, 2012). *In the Wake of the Crisis* does not touch upon this subject.

One final remark is that the recent crisis has suggested that economists need to build up better analytical and quantitative tools with a nontrivial financial sector for understanding interactions between the real sector and the financial system.[17] Stiglitz criticizes the mainstream macroeconomics arguing that the so-called standard models do not incorporate the microeconomic tradition that was derived from the economics of information, with a focus on credit markets.[18] Although he states that there are good models of banking, credit bubbles, and agency problems, Stiglitz does not mention related literature in macroeconomics. For example, starting with Bernanke and Gertler (1989) and Kiyotaki and Moore (1997), a literature has studied dynamic macroeconomic models that embed financial market phenomena. In addition, Diamond and Dybvig (1983) and Kareken and Wallace (1978) offer important insights for financial crises.[19]

4. Conclusion

Many argue that the financial crisis of 2008 resembled the Great Depression of 1929 far more closely than it did any of the postwar recessions (Ohanian, 2011). The policy discussions surrounding the recent financial turmoil highlight need for more solid work on the impact of financial development on growth, banking and financial crises, and governance. Developing novel empirical and theoretical approaches with significant policy implications will be at the core of the macroeconomic research as they always have been. For example, Thomas J. Sargent, co-recipient of the 2011 Nobel Prize in Economics, states in an interview

[16] Barlas (2012) provides a recent review of Rajan's book.

[17] For example, Woodford (2010) sketches the basic elements of an approach that allows financial intermediation and credit frictions to be integrated into macroeconomic analysis.

[18] One argument that has been often used against modern macroeconomics is that much of modern macroeconomics is not very helpful in understanding the crisis [see Caballero (2010) for a comprehensive essay]. For example, Kocherlakota (2009) says that "*I believe that during the last financial crisis, macroeconomists (and I include myself among them) failed the country, and indeed the world*." Krugman (2009) even goes further and almost argues that modern macroeconomics in general has not been valuable [see Paul Krugman's New York Times article, "How Did Economists Get It So Wrong?" and the responses of Levine (2009) and Cochrane (2011) to Krugman]. On the other hand, there are some economists arguing that the recent crisis gives no reason to abandon the core models. For example, Taylor (2011) states that "*The rules were provided. Policy makers took a different more discretionary approach*."

[19] See Thomas J. Sargent's interview at the Minneapolis Fed for a detailed discussion on the importance of these works (Region, 2010).

(Region, 2010) that "*...for policymakers to know whether and how they can moderate bubbles, we need to have well-confirmed quantitative versions of such models up and running. We don't yet, but we are working on it*."

In addition, new organizational arrangements involving financial institutions, regulators, rating agencies, and international organizations will be at the center of many policy related discussions, such as objectives and instruments of financial stability, economic outlook and risks. In response to the recent financial crisis, many central banks are becoming involved in macroprudential supervision. Central bank communication will constitute a central policy tool for that purpose. The presence of nominal and real rigidities and the explicit consideration of the zero lower bound on the nominal interest rate will be crucial elements of academic and policy research.

Are we going to face another crisis sometime in the next several decades? David Romer argues that the Great Depression of 1929 led to institutional changes, such as deposit insurance, financial regulation, and attention to stabilization policy. On the other hand, he is not optimistic as he states that *"nothing as significant appears to be coming out of the current crisis"*. Olivier Blanchard, in his concluding remarks, states that *"we need to be modest in our hopes"*. The answer to the question of facing another crisis soon would be clearer after a period of time as it is summarized in the closing sentence of the book: *Time will tell where it takes us*.

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