

A MACROECONOMIC REGIME FOR THE 21ST CENTURY

The book aims to give non-economists a detailed understanding of how macroeconomic policy works in modern economies, and the issues it faces. The world has recently been through a huge economic crisis and thinking people everywhere have reason to wonder whether something is not seriously wrong with the policy regimes underlying these dramatic events in the major economies, and whether changes should be made. The author reviews the history of the successive regimes tried and found wanting in the second half of the last century and proposes a set of reforms designed to convert the flawed neo-liberal consensus of the 1990s into a durable regime for the present century.

Drawing on his personal experience as a senior economist at the Bank of England for much of the time, the author traces the decline and fall of Keynesian management in the 1970s and the failure of the monetarist experiment that largely succeeded it in the 1980s. The story culminates in the '1990s synthesis' – the consensus on macro-policy reached in the early 1990s, which combined the best elements from previous approaches – which although promising a workable solution also proved to contain serious flaws, as the crash of 2007–8 showed. The second half of the book proposes important changes to address these flaws, including a new role and institutions for fiscal policy, a broadening of monetary policy, and a revival of systematic exchange-rate stabilisation in the cooperative spirit of Bretton Woods. More speculatively he floats the possibility of crowning these reforms by merging the dollar and the euro in a North Atlantic Monetary Union around the middle of the century.

This makes for a stimulating volume which should equip readers to enjoy a greater understanding of the topic area.

Christopher Taylor wrote the book while he was a Visiting Fellow at the National Institute of Economic and Social Research, London. He previously worked as an economist at the Bank of England for 20 years until 1994, including a secondment as UK Alternate Executive Director at the International Monetary Fund, Washington DC, 1981–3. Since 2008 he has been a lecturer and tutor for the MBA elective course on International Macroeconomics at the Judge Business School, Cambridge, where he is a Teaching Fellow.

'At last a book that recognises that different policy mixes are appropriate for different circumstances. Christopher Taylor's illuminating book presents macroeconomics as policy choices, rather than a menu of economic models. This gives his analysis a vitality largely lacking in more academic textbooks. No other book explains the complex macroeconomic policy choices faced by governments after the recent financial crisis in such a direct and accessible way'.

Dr. Jan Toporowski, SOAS, UK.

'The book provides both a valuable outline of the evolution of macroeconomic policy and a discussion of potential policy options for the future. This is a timely book, given the failure of contemporary economic orthodoxy to anticipate and prevent a financial crisis and global recession. Consequently, it can make a useful contribution to the debate on understanding past mistakes and how economic policy should evolve to meet the needs of the future'.

Prof. Philip Whyman, University of Central Lancashire, UK.

Foi	r my grand	dsons Char	lie and Eth	an	
Pol	i my grand	asons Chai	ne and Em	aii	

PREFACE

This book is about macroeconomic policy; that is to say, policy for the economy as a whole. It tries to observe the conventional distinction between macroeconomics, which deals with aggregate or collective behaviour in an economy and its broad sectors, and microeconomics, which is concerned with individual agents households, firms, etc. Thus its main subjects will be the institutions, instruments and modalities of monetary and fiscal policy, which are the chief modes of policy used nowadays in modern market economies. This choice of focus does not of course mean that microeconomics can be ignored: collective behaviour cannot be understood without reference to individual motivations, and discussion of the macroeconomic regime would miss a lot if it ignored them. Indeed the dramatic economic events of the past few years make it essential to look beyond the usual subject matter of macro policy. When leading international banks go down like nine-pins or exchange rates and asset prices gyrate, we have to ask whether macroeconomic measures are not called for. What seems clear is that these events have brought macroeconomic policy back to the centre of attention with a vengeance: any notion that the policy consensus reached towards the end of the last century heralded the end of macroeconomics has been shown to be premature.

The purpose of the book is to devise the best possible macroeconomic regime for liberal democracies – the so-called developed economies – in the 21st century, or at least suggest the kind of regime towards which they should be moving. Although much of the discussion will address policy at the national level, the international dimension will also be prominent. In a world becoming ever more interdependent in economic as in other respects, the external aspects of policy are increasingly dominant: macroeconomic policies and institutions must nowadays be considered in an international context, and the links with developing and emerging-market economies taken into account.

The book was conceived well before the onset of the recent global financial turmoil, at a time when the economic climate seemed set relatively fair, though clouds were visible on the horizon. The breakneck speed of events in the past three years has complicated the author's task by making it impossible to ignore questions of crisis management and short-term recovery. Nevertheless, as the task nears completion (spring 2010), policymakers are naturally still preoccupied with the present troubles, the book aims to look beyond them to address more fundamental questions of policy design. That will naturally mean considering how far the upsets of the past few years can be traced to weaknesses in the existing regime, among other causes.

The author's interest in macroeconomic policy stems from a career of over 40 years as a professional economist, starting with nearly ten years as a Research Officer at the Department of Applied Economics at Cambridge, where he was a founder member of the Cambridge Economic Policy Group; then 20 years as an economic adviser at the Bank of England; then a short spell as a research fellow at the Royal Institute of International Affairs, and since then as a visiting fellow at the National Institute of Economic and Social Research, and latterly at the Judge Business School, Cambridge. He has worked in a variety of fields, including international direct investment, the patent system, macroeconomic forecasting, the operation of monetary and fiscal policy, monetary integration in Europe, and several recent ventures into the teaching of economics. Throughout, macroeconomic policy has been a favourite theme, as this book aims to show in a synoptic and forward-looking way.

In the belief that economic policy is too important to be left to economists, the book is addressed mainly to non-professionals, or those who may have forgotten much of the economics they once learned. For that reason, technical analysis is mostly avoided or segregated in text boxes, annexes or footnotes which may be skipped by those prepared to take the arguments on faith. But professional colleagues may find something to interest them in the policy recommendations later on.

With luck the book will also engage readers in the wider world. It aims to avoid being too UK-centric, and many of its policy recommendations apply to developed economies generally. Indeed it will have missed an important target if the suggestions for a new economic order in later chapters fail to interest those concerned with global issues.

Acknowledgements

The immediate stimulus for the book came from reading Andrew Britton's study, Monetary Regimes of the Twentieth Century (Britton 2001). While finding much to agree with there, I felt his message about the failures in policy design in the last century unduly pessimistic. At any rate his conclusions posed a challenge to find a more optimistic answer. The global crisis of the past few years has of course given that challenge extra point, while ensuring that it is indeed a challenge.

Much of the guidance I received in the formative phases of my career came from my mentors at the Department of Applied Economics, Cambridge – its directors Brian Reddaway and Wynne Godley. Later, while engaged on policy analysis at the Bank of England over the next 20 years, I benefited greatly from working to the Bank's chief economists of the time, successively Christopher Dow and John Flemming, both of whom taught me much in their different and inimitable ways. More recently, my association with the National Institute of Economic and Social Research has been a constant source of support and instruction and I am grateful to its director Martin Weale for providing a congenial haven for work on this book among other themes. I have been fortunate in being able to use the National Institute's facilities, including online access to OECD statistics for many of the charts and tables, although of course their presentation and interpretation are entirely my responsibility.

Among others to whom I owe special thanks are my friend and colleague Jochen Runde, Director of the MBA at the Judge Business School, who has been a frequent source of help, including arranging for me to teach courses on international macroeconomics there for the past three years; and my thanks are due to students on these courses for acting as involuntary guinea pigs for some of the book's ideas. Lastly but not least, my heartfelt thanks go to my wife Leslie for putting up with long silences while I have been wrestling with these ideas. Without her encouragement and patience the task would never have been finished.

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INTRODUCTION

To Utopia and back

An important lesson to emerge from the economic history of the last century is that although a number of different macroeconomic regimes were tried at various times and in various countries, none emerged as superior for all times and countries. This was the main conclusion of Andrew Britton's illuminating historical study some years ago (Britton 2001), which found that different regimes suit different circumstances so that, in a diverse and changing world, no single regime can claim primacy, and no macroeconomic policy can be right for all time. Much depended on the accompanying institutional environment – the political and social institutions, economic structures and behaviour patterns – that confronted policymakers in the 20th century, which also varied greatly through time and across countries, as Britton reminds us (should a reminder be needed).

Change may occur in the institutional environment quite independently of the macroeconomic regime in place. In some cases extraneous institutional change may strengthen the prevailing policy regime, but its effect is more likely to be adverse, creating problems in due course and putting the regime's survival to severe test. This is because macroeconomic regimes tend to be rather specific to their institutional environment, major changes in which are likely to create tensions sooner or later. Thus a regime that succeeds in one era may fail in another. Even if defined rather broadly, no 20th-century regime appears to have lasted more than about 35 years (according to Skidelsky 1998, cited in Britton 2001: 3). On a narrower definition, few regimes have lasted more than 20 years or so, exceptions being the Gold Standard (which however dated from the late 19th century), and the centrally planned regimes of Communist countries.

History also shows that macro regimes tend to *induce* significant changes in their behavioural or institutional environments sooner or later, which therefore cannot be regarded as regime-independent. This property of regimes received famous theoretical recognition in the form of the 'Lucas critique' towards the end of the

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Keynesian era (see Lucas 1976 and 1987), which argued that basic macroeconomic behavioural relationships (like the consumption function – the generally stable link between personal consumption and disposable income) are likely to be affected by government policies through their effects on economic agents' expectations. In some cases the induced effects on agents' behaviour may help the regime, as for example when a successful commitment to output stabilisation creates expectations of steady growth which generate high investment and thence become self-fulfilling. But in others they may be unhelpful, as when a commitment to full employment encourages labour–market rigidities (inflexible wage differentials or job-demarcation rules) that make high employment harder to sustain.

This interdependence between regimes and institutional environments might seem to imply that the choice of regime ultimately does not matter, for almost any regime may succeed if it induces supportive environmental change, or fail if it induces disruptive change. It might then be concluded that conscious efforts at 'intelligent design' to create the best policy regime are likely to be fruitless, whereas Darwinian competition between regimes is more likely to throw up the best one for a particular time and place sooner or later. Britton (2001) does not push his argument quite that far, but he does come close to suggesting that all regimes are fatally flawed, in the sense of containing the seeds of their own eventual destruction. Thus his theme is that the 20th century witnessed a grand oscillation between 'laissez-faire' and interventionism - a journey 'to Utopia and back' in policies and theories, which left policymakers at the century's end with no better macroeconomic prescriptions than were available at its start, and economists with no better understanding of how the economy works, apart from some technical improvements in data and analysis. Britton seems to have taken the idea of Utopia from Friedrich von Hayek, who characterised what he held to be the unrealistic goals of socialism as the 'Great Utopia' in The Road to Serfdom (Hayek 1944: ch. 2).

Such a pessimistic conclusion, if true, would imply that the mistakes of economic history are bound to be repeated. Although the biggest shocks to the institutional environment during the last century – the two world wars – seem unlikely to recur, at least in the sense of continent-wide conflicts between powerful groups of countries armed to the teeth with conventional weapons, adverse events or tendencies affecting numbers of countries seem bound to happen, and to be very upsetting for those affected. A list of possibilities is painfully self-evident. At the top must come the prospect that systematic climate change, unless mitigated by action to reduce carbon emissions, will bring environmental degradation, with all the implied disastrous consequences: perhaps massive regional impoverishment and conflict. Conflict may also arise from perceived incompatibilities between the main faiths and ideologies, leading to serious political and social disturbances, regional if not global. Given the power of modern technology, the most sophisticated economies seem the most vulnerable to new, organised forms of terrorism, as exemplified by the events of 9/11.

Of more immediate relevance for macroeconomic policy, major political realignments like the formation of the European Union or the collapse of the Soviet

empire may occur, calling for the creation (in the former case) or dissolution (in the latter case) of supra-national economic institutions with special regime requirements. Powerful new economic players are now clearly emerging among the developing economies, principally China and India and the thrusting market economies of South East Asia; and others seem bound to emerge in due course among the 'transition' economies of Eastern Europe, principally Russia itself; and these will doubtless create new alignments or new problems for the existing players. The soaring demands for energy, industrial materials and foodstuffs from the emerging giants, whose implications for commodity prices are now becoming painfully apparent, are just one of the more obvious manifestations of such problems. Even the more predictable types of long-run structural change, like the ageing of populations in developed economies, seem likely to add to social tensions and pressure on resources, and clearly have important implications for fiscal-policy objectives and modalities. In the past few years an outbreak of rampant instability in the financial markets has added to these woes. The menu of such possibilities is large and the range of uncertainty about their potential economic implications, unfortunately, verv wide.

If macroeconomic policymakers respond to future economic shocks and adverse trends in ways entirely reminiscent of the last century, clinging to regimes tried and then found wanting, or lurching between the extremes of laissez-faire and interventionism in the manner depicted by Britton, they seem condemned to repeat the errors of that century. If this is the prospect, economics will indeed deserve the label of the 'dismal science' it acquired in the time of Malthus and Ricardo.

This book tries to take a more optimistic, if no less speculative, tack. While accepting that no single macroeconomic regime, and no single school of macro theory, has proved universally superior in modern times, it argues that important lessons can be learned from the experience of the main regimes tried in the past century. If these lessons are absorbed and built upon, it should be possible to arrive at a new regime that will be more effective and resilient than any seen previously. In the last decade of the 20th century economists of different persuasions reached a consensus on the key elements of a more durable regime. The denouement was especially prominent in Western Europe, as policymakers striving to achieve monetary union there stumbled upon a new synthesis that held promise for the future. The rapprochement between competing macro-policy doctrines in the 1990s has been called the 'neo-liberal consensus', though that name hardly does it justice. It certainly contains substantial free-market elements, comparable to those that held sway about a century previously; and the associated consensus in macroeconomic theory - which will be reviewed in Chapter 4 - embodies much of the neoclassical thinking of that earlier time. But, as we will argue in more detail later, the 1990s policy settlement also includes elements of the 'new economics' that emerged in the 1930s and gained wide acceptance after the Second World War, including some of the Keynesian apparatus and even the policy activism that Britton dismisses, regretfully but firmly, in his book. In short, the 1990s policy consensus was a genuine compromise between the two main competing macroeconomic philosophies

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that prevailed at different times and places in the preceding century. That in itself seems an achievement worthy of respect and even some optimism. We may not yet have reached the end of economic ideology, but economists are learning that a mix of ideologies seems to work better.

Nevertheless it is clear from the economic traumas witnessed since 2007 that regimes built on the 1990s synthesis also embody important weaknesses, and further reforms will be necessary if they are to survive and cope well with the threats that seem bound to grow in the present century. One such weakness is the phenomenon of unbridled 'globalisation' - the sweeping removal of barriers to cross-border trade and investment, perhaps the single most powerful and pervasive policy innovation of the second half of the 20th century (though not much mentioned by Britton). Globalisation has brought a near-universal openingup of economies large and small, developed and undeveloped, to market forces, and with that has come a huge expansion of international trade and investment. Neoclassical economists have hailed it as a triumph of free-market capitalism over interventionist and centrally planned approaches. But several painful episodes have shown that globalisation can bring serious problems if it proceeds indiscriminately and without firm regulation, notably the East Asian financial crisis of the late 1990s and most recently the 'Crash of 2007-8' and the ensuing global credit crunch.

The principal task in what follows will be to identify these key weaknesses and suggest how they might be remedied. This is admittedly a tall order for a rather short book; it calls for more generalisation than the author would like, and considerable selectivity in the range of problems and solutions covered. But if it provokes others to reflect on policy design for the longer term, he will be more than satisfied.

Plan of the book

The first half of the book reviews the policy experience of the later 20th century as a prelude to suggesting what should be done to create a durable regime for the present century. It starts by drawing lessons from the abandonment of Keynesian economic management in the mid-1970s (Chapter 2), and from the experiment in monetarism that largely superseded it in the 1980s (Chapter 3). Chapter 4 describes the '1990s synthesis' – the policy consensus which emerged in the 1990s from the confusion following the successive failure of Keynesian and monetarist approaches; as part of that task it reviews the theoretical model known as the 'New Consensus in Macroeconomics', developed in rationalisation of the 1990s settlement. Chapter 5 explores the weaknesses inherent in the new consensus and the problems it has encountered, with special reference to economic stagnation in Japan and the appearance of China on the world scene. Finally Chapter 6 describes the financial crisis that broke in 2007 and the lessons to be learned from it.

Throughout these chapters detailed consideration will be given to the objectives and methods of monetary policy, reflecting the primacy accorded to it in