August 2008 | Number 6

Economic Viewpoint

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Macro-economic Policies: Is Consensus Slipping Away?

A quick look at the FT of recent days points out the state of confusion in policy circles about what we think we know about macro-economic policy and what to do about the current mess. Although there is always debate, the degree of discord has increased dramatically since the recent mortgage crisis in the U.S. took the global economy by surprise and the twin supply shocks of higher energy and much higher food prices added to the dilemma. We are now confronted with proponents of easy credit (see Hathaway, August 25), who argues that the expectations model is no longer valid since inflation dynamics have fundamentally changed, and proponents of concerted monetary tightening (see Posen and Subramanian, August 22), who argue that inflation must be tamed at all costs via coordinated credit control. As if that weren't disconcerting enough, there are also big debates about what trade policy should be, ranging from Jagdish Bhagwati (August 19, FT) arguing that the U.S. is dangerously hegemonic to Larry Summers (August 26, FT) seeing the Chinese as the spoilers in the international system. What's left to believe in, one may ask?

On the inflation front, it is probably wise to separate out the dynamics in the U.S. from those in Europe and in emerging markets. In the U.S., it may well be argued that expectations are less important as wages are more flexible, consumption depends as much on asset price (viz., homes and the stock market) as it does on posted inflation data, itself only partially reliable since food and fuel are not headline inflation numbers, and prices do move downward through the use of sales, rebates and discounts. In Europe, where wages and benefits are much more indexed, the ECB has legitimately focused on keeping expectations close to the stated goal of 2 percent to avoid the endogenization of price increases. In emerging markets, where one can legitimately speak about overheating, a more traditionally Keynesian approach may still make sense.

A challenge faces the world's poorer countries, however. Faced with fuel and food price shocks that may well persist, developing countries are seeing inflation rise to double digit levels, and also witnessing households losing significant amounts of real purchasing power. Once a poor household falls below the poverty line it is difficult to reverse, and also cognizant of the damage to children of inadequate nutrition in early years, poor countries are forced into safety net expenditures that they cannot afford. Aid is not only slow when it reflects emergency needs but it is also very intractable with regard to disbursements. The current crisis is one in which increasing amounts of budget support is needed to reverse what the World Bank estimates to be a potential increase of 100 million persons among the ranks of the poor as a result of the food and fuel crises.

Coming back to the inflation-recession dilemma (see Economic Viewpoint #4 on Stagflation), the dilemma in the U.S. is that premature tightening of monetary policy to deal with inflation may well increase chances of further financial distress. The financial bailouts of big mortgage lenders will inevitably raise rates in any event as the fiscal deficit will rise and will be funded via further borrowing. Ways need to be found to offset the inflation of commodities through productivity improvements and to stimulate the economy in ways that will not add to the long-run deficit. One should measure might be to consider an " enhanced mortgage interest deduction scheme" whereby much like accelerated depreciation, the homeowner could deduct more now and pay more later in order to restore asset confidence in housing and promote spending. This could be supplemented with increased investment credits for energy saving technologies, perhaps funded by increased gas surcharges on low performing vehicles. The biggest danger for U.S. economic policy is to see each problem (i.e., inflation, recession, energy switching, housing) independently.

Coming back to the thorny issue of trade, US demand for Chinese exports, the exchange rate, and the resurgence of disguised mercantilism as some have argued, the question is will the U.S. consumer continue to be the world's growth engine. Summers argues that this honor should shift to Chinese consumers, if prices were right and the political economy model of China different. Regardless of who's to blame for the Doha trade round collapse, it is unfortunate that China is seen as siding with those opposing openness (the issue of agricultural subsidies and supports notwithstanding) because China has benefitted most among nations from the openness it was afforded in international, especially American, markets. It is inevitable that China's phenomenal growth will lead to additional consumption and that demand must be open to all. More imports will slow its inflation, add to currently weak global demand, and reduce global imbalances. Accumulating reserves, whether in SWFs or other vehicles, when combined with current exchange rate management, is unfortunately bad not only for trade policy but also for

*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*