The New Macroeconomic Paradigm: Pandemic Lessons and Policy Needs

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Overview

- New macroeconomic paradigm: going from “plenty” to “shortages”.
- Pandemic lessons: past macro stimulus now constrains policy options
- Policy needs: only hard choices but still the lure of “easy” options.
- And high stakes: economic difficulties threaten other fragile systems

From an “era of plenty” to an “era of shortages” (1)

- Supply shocks contributed to peak inflation
- But so too did excess macro stimulus of demand
- Policy has tightened, belatedly, and inflation is declining
- But enough to hit 2% inflation targets?
- If not, will further increases in unemployment be needed?
- If so, must macro policy tighten further?
- And China reopening poses further inflationary risks

From an “era of plenty” to an “era of shortages” (2)

- Supply shocks from the past: hysteresis and “malinvestments.”
- Supply shocks in the future: workers, climate change, commodities.
- Global supply chain restructuring aggravated by geopolitics
- Need for huge capital investment to cope with future supply shocks.
- With heavy demands on government spending
- Possibly aggravated by military buildups?
- A recipe for higher inflation and higher real rates?

Past macro stimulus now constrains policy options (1)

- Tighter monetary policy constrained by fear of **financial instability**
- Financial instability fuelled by decades of ultra-easy monetary policy
- Record high debt levels of decreasing quality
- Asset prices falling but still high
- Stability of some financial institutions (especially NBFI) questionable
- Markets functioning badly (flash crashes and anomalies)
- Even US Treasuries under stress (Sept.2019, March 2020)
- Systemic interactions more evident in light of “gilts” debacle.

Past macro stimulus now constrains policy options (2)

- Tighter monetary policy constrained by fear of **fiscal instability**
- Fiscal instability fuelled by decades of asymmetric fiscal policy
- Sovereign debt ratios swollen by covid and energy price shocks
- Higher rates raise debt service more quickly because of QE
- QE can easily be seen as central bank financing of fiscal deficits
- Massive central bank losses “inconsequential” but also bad optics
- “Gilts” debacle only a warmup for JGBs and other sovereigns?

Past macro stimulus now constrains policy options (3)

- Tighter monetary policy impeded by fear of **exchange rate instability**
- Easy money in US led to lower dollar and “currency wars”
- Other countries resisted appreciation and loss of “competitiveness”
- AMEs also eased monetary policy while EMEs used FX intervention.
- With fixed rates, fears of financial and fiscal instability became global.
- Tighter US policy could trigger a dollar liquidity or debt service crisis.

Now only hard choices but still the lure of easy options (1).

- Given continuing negative supply shocks, macro policy must tighten
- But tighter monetary policy threatens to trigger instabilities
- Orderly debt restructuring could reduce that threat
- Fiscal restraint is also needed, even if public spending must rise
- Only measures to cut private consumption can “square the circle”
- But this will be very hard to sell politically

Now only hard choices but still the lure of easy options (2).

- Citizens, the powerful and politicians likely to choose the easy answer
- One possibility is denial: continue to just “spend and print”
- But higher debt service ends in either debt/deflation or inflation?
- More likely is “financial repression” to try to keep interest rates down
- This worked after World War II, but could it work today?

High stakes: economic difficulties threaten other fragile systems

- Stressed **environmental** systems need massive investments.
- Stressed **political** systems need more inclusive growth.
- Stressed **health** systems need restructuring and more resources.
- Another economic crisis would threaten these vital needs.
- **The stakes are high indeed!**

GOOD LUCK: YOU MIGHT JUST NEED IT