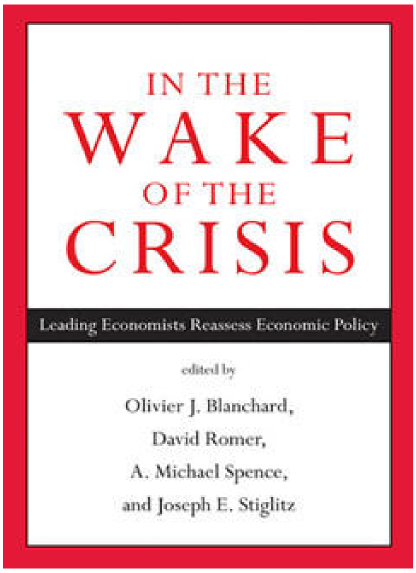
Book Review: In the Wake of the Financial Crisis: Leading Economists Reassess Economic Policy

by Blog Admin

November 22, 2012

In 2011, the International Monetary Fund invited prominent economists and economic policy makers to consider the brave new world of the post-crisis global economy. The result is a book that captures the state of macroeconomic thinking at a transformational moment. Among the new realities they consider are the swing towards regulation, the need to incorporate behavioural economics, and the importance for macroeconomic policy to target financial stability. ***Natacha Postel-Vinay*** *finds it an absolute must-read.*

In the Wake of the Financial Crisis: Leading Economists Reassess Economic Policy. Joseph E. Stiglitz, Michael Spence, David Romer, Olivier J. Blanchard. MIT Press. March 2012



On March 7-8 2011, Olivier Blanchard, a famous economist recently appointed Director of the Research Department at the IMF, convened other famous economists to speak at a conference with a rather unusual aim. The purpose was not for these researchers to present their latest academic paper on a precise topic in economics, but rather to give their opinion on the state of economic thought after the crisis. *In the Wake of the Crisis*, which gathers all twenty-three viewpoints in one volume, should therefore at the very least be rewarded simply for asking somewhat taboo questions such as "What did we think we knew in economics before?," "What do we know now?," and even "How deep is our confusion?." These questions are of utmost importance for the economics profession, and have strong implications for what policy-makers may claim to know about what is good for the economic system. The volume is also remarkable for the humility with which the authors admit the limits of their knowledge.

The book is divided into six different parts, each dealing with such broad areas of inquiry as monetary policy, fiscal policy, financial regulation, and capital-account management for emerging countries. The short introductory sections at the beginning of each part are a rare species in the field of economics, and as such may be regarded as little academic jewels: they summarise the "pre-crisis consensus" on a topic and then state the issues that should be raised in relation to this consensus, all this in bullet point format. For example, in the field of fiscal policy, the pre-crisis consensus was that "monetary policy should be the primary tool of stabilization policy and that fiscal policy should play little role (…)," and some of the questions asked are "should fiscal policy become a regular part of the stabilization toolkit?" and "to what extent do long-run fiscal outlooks constrain the short-run response to the crisis?"

In the most plain-spoken and direct prose — Blanchard explicitly asked for non-formal papers – each conference guest attempts to answer these questions, quite expectedly sometimes coming up with different conclusions. On the monetary policy side, however, one idea seems to emerge from the five different papers: it is that mainstream macroeconomics failed to include an analysis of credit markets through its obsession with inflation-targeting. As Joseph Stiglitz puts it, "What is especially remarkable is that central banks had models in which banking did not play an important role." He remarks that the interest rate also influences credit availability, and that in general different policy instruments cross-influence different areas of the economy in ways that need to be much better researched.

On the fiscal policy side, there is broad agreement that more questions should be asked concerning the usefulness and timeliness of fiscal stimulus during a crisis, rather than assuming from the start (as was the case pre-crisis) that it should only be used as a last resort. The reason, according to David Romer, is that the crisis showed that the zero lower bound on nominal interest rates was much more constraining than initially thought. Here ends the agreement, though, as some argue for or against large fiscal stimuli, for reasons that unfortunately are not always well stated. Regarding financial regulation, the authors call for more attention to be paid on tools other than large shock absorbers and general supervision, such as greater roles for shareholders and boards of directors, transaction taxes and taxes on leverage and debt. Some call for a reconsideration of the use of rules rather than discretion, offering the regulation of U.S. aviation as a promising instance of the latter.

Collections of informal essays such as this one inevitably suffer from a lack of consistency (which can be interesting in itself) and, perhaps more importantly, from excessive vagueness. This collection is no exception, and the lack of argumentative precision comes out especially in the last parts of the book on capital flows in developed and emerging economies. Nevertheless, even in these sections the call for crisis-driven academic humility and deeper research is noticeable, as epitomised by this statement by Rakesh Mohan on the importance of capital flow oversight for emerging countries: "Even the most sophisticated, diversified, and deep financial market in the (…) world [ie. the U.S.] had weaknesses that inhibited it from absorbing large capital [in]flows prior to the crisis. Stronger financial regulation and macro-prudential oversight is required, [which] applies to emerging markets even more strongly." This book is thus an absolute must-read for anyone wondering how much we do and do not know about economic policy.

———————————————————————————————-

Natacha Postel-Vinay is a third-year PhD student in the Department of Economic History at the LSE. She has an undergraduate degree in economics and political science and an MSc in economic history from LSE. She specialises in financial history, and her PhD thesis concentrates on the causes of bank failures in the U.S Great Depression with an emphasis on their behaviour in the 1920s. She also has a particular interest for political and economic philosophy, economic development, and statistical tools for economic investigation. Read reviews by Natacha.

Related posts:

1. Book Review: Financial Crisis and Institutional Change in East Asia (14.7)
2. Book Review: The End of Modernity: What The Financial and Environmental Crisis is Really Telling Us, by Stuart Sim (13.2)
3. Book Review: Casino Capitalism: How the Financial Crisis Came About and What Needs to be Done Now (12.5)
4. Book Review: The Crisis of the European Union: A Response by Jürgen Habermas (11.8)
5. Book Review: The Rise and Fall of an Economic Empire, With Lessons for Aspiring Economies, by Colin Read (10.5)