

# **Reform the macroeconomic policy framework, don't abandon it**

There is much to learn from recent events, but policymakers should build on the framework that already exists.

EXPERT COMMENT

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**Creon Butler**

Director, Global Economy and Finance Programme



It now looks likely that the cost – in terms of lost output and jobs – of bringing inflation back to target will be lower in most advanced countries than previously feared. But even as the immediate crisis subsides, there is a growing debate over the policy lessons to be learnt, not just from the inflation shock and the economic handling of the pandemic, but from the entire period since the 2008-9 global financial crisis (GFC).

This reflects advanced countries' poor economic record over that period, with low and volatile growth accompanied by very low investment and anaemic productivity growth, rising public debt and weak trade growth.

## **A consensus framework**

The thirty years preceding the pandemic saw a consensus emerge that the best framework for operating macroeconomic policy comprised independent central banks pursuing inflation targets, transparent fiscal authorities following long-term rules on the size of deficits and level of public debt, and strong regulators tasked with maintaining competition and financial stability.

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These institutions were then supported by international organizations – notably the IMF, Financial Stability Board (FSB) and WTO – dedicated to upholding free trade and capital flows and responding to global economic shocks.

Meanwhile government intervention was focused on public goods such as boosting skills, undertaking basic scientific research, ensuring provision of core infrastructure and providing a social safety net.

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**Critique of the consensus**

Some commentators focus on the framework's implementation, arguing, for example, that monetary policy was kept too loose for too long following the GFC, and that central banks were insufficiently risk averse about the possibility that the energy price shock triggered by Russia's invasion of Ukraine would feed through into core inflation expectations.

Another view is that the framework is not equipped to deal with what is coming down the tracks – in terms of geopolitical tensions, global market fragmentation, extreme weather, biodiversity loss and health shocks, the requirements of the net zero transition and the impact of transformative technologies. Critically, these factors mean that the way economies operated in the past will be a poor indicator of the way they will operate in the future.

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The starkest view is that the whole consensus framework is to blame for historic poor performance and needs to be replaced with something fundamentally different. This view argues that the West's growing concern about political and economic competition from China provides an opportunity to bring about the required transformation of the framework.

Under this approach, national industrial strategies, implemented through direct public spending, fiscal incentives and economic regulation, would be at the heart of economic policy.

Monetary, fiscal and competition policies would be reshaped to accommodate this, both domestically and internationally. The US Inflation Reduction Act, the EU's 'Green Deal' and China's 'Made in China 2025' point the way, with a step increase in productive investment being one of the key benefits.

## **Problems with abandoning the framework**

There is clearly a problem with long-term economic performance in advanced economies, an increasing fracturing in the consensus approach to economic management (particularly in the US under the Trump presidency), and a strong case for reform.

But it would be a serious mistake to abandon the current macroeconomic framework in favour of something entirely new, particularly one with government direction at its core. There are three reasons for this:

First, the fundamental importance of preserving private enterprise and competition as the core organizing principle for any country's domestic and international economic relations should not be underestimated.

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Large scale government intervention may well be needed to correct for externalities (particularly costs to the environment). And the world may have to live with major distortions that have no economic justification, such as the \$7 trillion a year currently spent globally on hydrocarbon subsidies. But the outcomes from a private sector-based model, however imperfect, will be fundamentally better than any other kind of model.

Second, it is far from clear where the current push to enhance western national security and economic resilience through economic security measures will end up. And so it would be very risky to use it as the basis for a new macroeconomic framework.

The Biden administration is aware of the fundamental conflict between such measures and the free flow of goods, services and capital and so has argued for a ‘small yard, high fence’ approach to economic security.

But it may prove impossible to restrain government intervention – particularly in the current US political context – with pursuit of this approach resulting in considerable economic losses for both the US and its allies, with little gain to US national security or economic leverage<sup>27</sup>.

For example, China’s BYD is now the largest producer of electric vehicles globally and a technology leader in solid state batteries. Closing western markets to BYD’s current or future products, or attempting to recreate what BYD has already achieved, would be enormously costly.

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**Global institutions are critical to upholding rules, standards and safety nets for global markets.**

Third, global institutions are critical to upholding rules, standards and safety nets for global markets. Several of these institutions face enormous challenges today, reflecting both US–China tensions and the debate between advanced and developing countries over the provision of development finance.

But these institutions have the fundamental advantage of being founded on international laws which are still respected, even if imperfectly, by all major players. It would be impossible to recreate this consensus if starting from scratch, particularly in the present circumstances.

The only practical way forward is therefore patient and incremental international reform. The scope for this still to make a real difference should not be underestimated.

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For example, the WTO's effectiveness has been greatly weakened by the US move to de facto paralyse the dispute settlement system. But recent discussions among leading WTO members on this issue have been among the most positive for a long time.

This raises the prospect of a replacement which may not have the same scope and independence as the 1994 model, but would nonetheless re-activate this key part of the WTO's role.

## **The way forward**

While there is no choice but to proceed incrementally and build on the existing framework, reform is nonetheless urgent and needs to be sustained.

The top priorities are to understand and respond to lessons on implementation arising from the inflation shock and GFC (for example, by changing how central banks address risk and uncertainty); to work out how better to anticipate future changes in the global economy in today's macroeconomic framework (for example, through use of scenarios and, if necessary, by adapting the mandates of central banks and design of fiscal rules); and to build on existing domestic and international institutions to fix the most pressing shortcomings, including WTO dispute settlement, and by strengthening the architecture for consensus building.