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Macroeconomic Policy after the Global Financial Crisis

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ABSTRACT

This chapter describes the ideology of market liberalism, the macroeconomic policies and institutions it produced, and the failure of those policies and institutions that produced the GFC and the subsequent deep recession in most developed countries. Although it is impossible to prescribe a fully-developed alternative policy framework at this point, new directions in macroeconomic policy are sketched out, including countercyclical fiscal policy, the need for an increase in public sector revenue and expenditure, and new approaches to monetary policy and financial regulation.

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Macroeconomic policy after the Global Financial Crisis

Introduction

Since the mid-1970s, Australian economic policy has been driven by a set of ideas based on the claim that a market economy, with minimal government regulation will outperform any alternative. The central goal of policy has been to reduce the scope and extent of government activity, with the aim of promoting productivity growth. The dominance of these ideas may be seen in the very names of government departments like the Department of Finance and Deregulation and institutions such as the Productivity Commission.

The same set of ideas, with variations, has been dominant throughout the world, beginning in the economic turmoil of the 1970s and reaching its peak of confidence in the 1990s. The ideology that unifies them has been given various names: "Thatcherism" in the United Kingdom, "Reaganism" in the United States, "economic rationalism" in Australia, the "Washington Consensus" in the developing world, and "neoliberalism" in academic discussions. Most of these terms are pejorative, reflecting the fact that it is mostly critics of an ideological framework who feel the need to define it and analyse it. Politically dominant elites don't see themselves as acting ideologically and react with hostility when ideological labels are pinned on them. From the inside, ideology usually looks like common sense. The most neutral term I can find for the set of ideas described by these pejoratives is market liberalism, and this is the term that will be used in this chapter.

Market liberalism created the preconditions for the Global Financial Crisis (GFC) and, repackaged as 'austerity', ensured that the crisis became a sustained depression engulfing most of the developed world. The failure of austerity is now widely recognised within the economics profession, even by bodies like the International Monetary Fund, which has traditionally had the role of enforcing painful adjustments on indebted governments.

Australia avoided recession during the GFC, in large measure because of policies of fiscal stimulus adopted both here and in China, our most important export market.

However, the Labor government failed to defend the stimulus policy against conservative attacks, instead focusing its efforts on defusing the issue through a rapid return to budget surplus. At the same time, and despite some promising initial responses, the crisis provoked no rethinking of the dogmatic commitment to small government, adopted in response to the perceived need to be seen as 'economically conservative'. However, the failure of the microeconomic part of the market liberal agenda produced pressing needs for more government expenditure on health, education, environmental and infrastructure services. The resulting contradictions have produced an atmosphere of crisis, despite the strong performance of the economy as a whole.

This chapter describes the ideology of market liberalism, the macroeconomic policies and institutions it produced, and the failure of those policies and institutions that produced the GFC and the subsequent deep recession in most developed countries. Although it is impossible to prescribe a fully-developed alternative policy framework at this point, new directions in macroeconomic policy are sketched out, including countercyclical fiscal policy, the need for an increase in public sector revenue and expenditure, and new approaches to monetary policy and financial regulation.

Market liberalism

In *Zombie Economics: How Dead Ideas Walk Among Us*, (Quiggin, 2012)[2] I describe the resurgence of market liberalism in the 1970s, and the displacement of the post-war economic consensus built on Keynesian macroeconomic policy, the social-democratic welfare state and the mixed economy. The central ideas of market liberalism as it developed in the years leading up to the GFC are:

* The Great Moderation: the idea that the period beginning in 1985 was one of unparalleled macroeconomic stability;

* The Efficient Markets Hypothesis: the idea that the prices generated by financial markets represent the best possible estimate of the value of any investment;

* Dynamic Stochastic General Equilibrium: the idea that macro-economic analysis should not concern itself with economic aggregates like trade balances or debt levels, but should be rigorously derived from microeconomic models of individual behaviour;

[2] This is the Australian edition, in which the chapter on austerity is replaced with a discussion of economic rationalism (that is, market liberalism) in Australia.

* Trickle--down economics: the idea that policies that benefit the well-off will ultimately help everybody;

* Privatisation: the idea that any function now undertaken by government could be done better by private firms; and

* Austerity: the belief that the best response to a crisis like that of the present is for governments to balance their own books, and wait for the private sector to recover.

Taken together, these ideas supported the vision of an 'ownership society' in which individuals and families managed their assets to achieve the best possible outcomes for themselves. The ideal type of ownership was the ownership of equity capital, traded in sophisticated financial markets. More mundane assets, such as houses, and the associated mortgages, should ideally be securitised, through devices such as home equity loans and associated derivatives, to unlock the capital value they represented. The most important of assets for most people, the 'human capital' embodied in their labour power was to be commodified in the same way, and marketed, in Tom Peters' phrase, as 'The Brand Called You'. (Peters, 1997)

The role of government, in the market liberal view, should be limited to a few basic tasks: providing a legal framework, along with the police and defence forces necessary to maintain that framework, correcting a limited range of 'market failures' and providing a basic 'safety net' for those unable, through bad luck or disability, to provide for themselves. The associated program of microeconomic reform was one reducing the role of direct intervention by governments and increasing the role of markets and market-based policy instruments. In macroeconomic policy, the defining feature of market liberalism is a rejection of Keynesian economic theory and the associated policy of macroeconomic stabilization through policies of fiscal stimulus during recessions and depressions. The macroeconomic policy prescribed by market liberalism is one that relies exclusively on monetary policy, and in which a low and stable rate of inflation is the primary target. Fiscal policy is aimed at maintaining balance between revenue and expenditure, and at constraining the total share of resources allocated to public expenditure.

In Australia, market liberalism is most commonly called 'economic rationalism'. The most distinctive feature of Australian economic rationalism, compared to the versions of

market liberalism found in other countries, is its relentless focus on 'productivity', sought largely through labour market 'reforms' such as those embodied in the Howard government's *Workchoices* package. The 'recession we had to have' in 1989-91, deeper and more sustained than contemporaneous slowdowns in the United States and elsewhere did much to discredit the macroeconomic ideas associated with economic rationalism. Only after the adoption of the Keynesian *Working Nation* package in 1994 (Commonwealth of Australia, 1994) did the labour market begin to recover from the recession. Arguably, this experience contributed to the greater willingness of Australian policymakers to embrace Keynesian stimulus as an immediate reaction to the GFC.

Macroeconomic policy under market liberalism

During the 1990s, the experiments of the 1980s coalesced into a more-or-less standard approach to macroeconomic policy, followed with minor variations in most developed countries. The central element was the primacy of monetary policy, based on the use of interest rates as the sole policy instrument and inflation rates as the primary target. The use of fiscal policy for macroeconomic stabilisation, the hallmark of the Keynesian era, was abandoned or discouraged. Instead the primary goal of fiscal policy was to maintain the government budget balance at levels consistent with stable ratios to debt to national income. Prudential policy, that is the management of risk in the financial sector, was separated from monetary policy and treated as a regulatory function, to be undertaken in as 'light-handed' a manner as possible.

There were some variations in the approach. For example, the US Federal Reserve did not adopt a formal target range for inflation until 2012, although it was generally known that policy was based on a 'comfort zone' of 1 to 2 per cent for the Fed's preferred inflation measure. In the eurozone, the separation between monetary policy, operated by the European Central Bank and targeted solely at inflation, and fiscal policy, operated by national governments, was sharper than elsewhere, with the result that the austerity policies adopted after the GFC have been harsher and more damaging.

Even under a system of inflation targeting, central banks did not ignore the real economy entirely. Booming conditions in the real economy were seen as raising the danger of high inflation in the future, while depressed conditions implied that this risk

was low. Hence, an inflation target could be implemented using what is known as a 'Taylor rule', in which the central bank sought to keep both the current inflation rate and the rate of growth of output (seen as an indicator of future inflation) near their long-run target levels. The result was that both the inflation rate and the rate of growth of real output could be stabilised.

This worked well as long as economic fluctuations were modest, so that, in the event of a recession or slowdown, a cut in interest rates was usually sufficient to restore growth. However, the sustained slump that has followed the GFC in North America and Europe has shown up the inadequacy of this policy. Although most OECD economies have high levels of unemployment and underemployment, inflation has remained at or close to its target level. This outcome led the former chairman of the European Central Bank, Jean-Claude Trichet, to describe his own performance as 'impeccable'(Trichet, 2011), at a time when most of the economies in Europe were severely depressed, and when the complete collapse of the euro as a common currency appeared likely.

The GFC and Australia's escape

The apparent triumph of market liberalism collapsed with surprising rapidity during the GFC. Nevertheless, although the ideas supporting market liberalism have been refuted by experience they continue to dominate the thinking of policymakers and opinion leaders, particularly as regards macroeconomic policy and have ensured that there has been no effective macroeconomic response to the crisis. The financial phase of the crisis was surprisingly short-lived. The major banks were bailed out on generous terms. They rapidly returned to profitability, and resumed their old practices of market manipulation, insider trading and massive bonus payments. Recent scandals include major tax frauds, rigging of commodity markets and of the London Interbank Offered Rate, known as LIBOR, which forms the basis of global bond markets (House of Commons Treasury Select Committee, 2012), and multi-million dollar payments to bankers whose incompetence is obvious to all. By contrast, the real economy in the US and Europe has yet to recover the ground lost in 2008 and 2009. The problems of the eurozone are even worse than in the US because the institutional structure, combined with the rigid ideological positions taken by key officials, has prevented any effective response to a depression that is now more than three years old, and shows no sign of ending.

The crisis has invalidated most of the popular explanations for the Great Moderation. The idea that improvements in monetary policy, administered by central bankers such as Alan Greenspan, have been a force for economic stabilization looks rather silly now. A crisis generated within the financial system has brought about a crisis against which the standard tools of monetary policy, based on adjustments to interest rates, have proved ineffective. If the pretensions of central banks have been shaken, those of financial markets have been utterly discredited. There is now no reason to accept the claim that financial markets provide individuals and households with effective tools for risk management. Rather, the unrestrained growth of financial markets has proved, as on many past occasions, to be a source of instability. The collapse of the Great Moderation has destroyed the pragmatic justification that, whatever the inequities and inefficiencies involved in the process, the shift to market liberalism since the 1970s delivered sustained prosperity. If anything can be salvaged from the current mess, it will be in spite of the policies of recent decades, and not because of them.

Australia's escape

Australia stands almost alone in the developed world both in the vigour with which Keynesian policies of fiscal stimulus were used during the GFC and in the success of our macroeconomic outcomes. As the crisis emerged in the US, the first Rudd government undertook a highly effective fiscal stimulus, co-ordinated its fiscal policy with the monetary policy of the Reserve Bank and fixed major vulnerabilities in the system of prudential regulation, most notably the absence of a deposit guarantee.

The results speak for themselves. Almost alone in the Organisation for Economic Co-operation and Development [OECD], Australia escaped recession, whether this is judged on the “two quarters of negative growth” rule of thumb or a more general assessment of economic performance. Inflation has remained quiescent, sitting right in the middle of the Reserve Bank’s target range. Unemployment remains near its 30-year low. Despite unfavourable demographic trends associated with the ageing of the baby boomers, the employment-population ratio is near an all-time high. At the same time, and despite the global crisis, some of the chronic imbalances that threatened the Australian economy when Labor came to office have abated. The bubble in house prices that emerged in the early 2000s has deflated gradually, in marked contrast with the

disastrous bursting of such bubbles in many other countries. Household savings rates, negative in the last years of the Howard government, have recovered strongly to levels not seen since the 1980s. The ratio of foreign debt to national income has declined, and debt has been redirected from financing consumption (including consumption of housing services) to financing investment, primarily in the mining sector. It is also possible that a Coalition government, faced with strong advice from Treasury in favour of fiscal stimulus, would have abandoned the focus on headline measures of budget balance that characterised the Howard-Costello era. Under the actual circumstances of the crisis, however, the opposition, then led by Malcolm Turnbull and Julie Bishop, with Joe Hockey as shadow treasurer, opposed the stimulus and proposed instead to pursue permanent tax cuts.

It is, of course, possible to argue about the appropriate division of credit between the Rudd/Gillard governments, their predecessors, the success of monetary policy under the Reserve Bank, and the favourable external circumstances of the mining boom. But on the most important question of how we managed to avoid the effects of the GFC, there can be little doubt that it was government policy that was responsible. The close co-ordination between fiscal and monetary policy means that there is no sense in separating the credit due to the Reserve Bank from that due to the government. In retrospect it has been claimed that demand from China, and the mining boom more generally, meant that stimulus was unnecessary. This claim is nonsense for at least three reasons. First, minerals prices fell sharply in the immediate aftermath of the crisis, making Australia more, rather than less, vulnerable. Second, the rapid Chinese recovery was due to the policies of fiscal stimulus very similar to those adopted in Australia. Finally, the failure of economic recovery in other countries that turned rapidly to austerity once the immediate crisis was past is a further demonstration of the validity of the Keynesian analysis.

Despite this relative success, our current policy debate, focused almost entirely on the idea of budget surplus and on public debt, reflects neither the success of Keynesian policies in Australia nor the global failure of the austerity policies that drive the politic rhetoric of the conservative parties. Much of the blame for this fiasco must go to former treasurer Wayne Swan. Whatever the substantive merits of the policies he oversaw, Swan failed to show any conviction in defending them. The huge success of Keynesian

stimulus should have resulted in a fundamental reconsideration of the ‘fiscal conservatism’ inherited from Howard and Costello. Instead of pursuing a target of balance or small surplus every year, Keynesian theory prescribes a counter-cyclical policy of deficits in recession and surpluses in booms. While occasionally paying lip service to this idea, Swan’s public rhetoric mostly treated the GFC as an embarrassing departure from reality and the return to budget surplus as a holy grail. His oft-repeated promise to return the budget to surplus by 2012-13 was, of course, a disastrous failure in practice. Even worse was the rhetorical gift to the spurious economic analysis propounded by then Opposition Leader Tony Abbott, in which budget surplus is the sole goal of fiscal policy.

The current situation

The failure of the Great Moderation calls for a rethinking of the macroeconomic experience of the twentieth century, and in particular, the crisis of the 1970s. Considered as a whole, the performance of developed economies in the era of market liberalism looks considerably less impressive than that of the post-war period of Keynesian social democracy. Yet the Keynesian era ended in the chaos and failure of the 1970s. Until the current crisis, that failure was taken as conclusive. Whatever its merits, Keynesian economic management had proved unsustainable in the end, while the methods of market liberalism seemed to promise the continuing stability of the Great Moderation.

Economies can collapse to a point where only large-scale monetary expansion and fiscal stimulus can revive them. But having revived the economy, can Keynesian policies restore and sustain full employment in a system that is inherently prone to crisis? An answer to this question will require radical new directions in macroeconomics. Economists are only beginning to understand the lessons of the GFC and its implications for economic theory and policy. The failure of market liberalism, the Great Moderation, and of supporting economic theories like the Efficient Markets Hypothesis has forced (at least some) policymakers to relearn the basic lessons of Keynesian economics. The GFC has shown, once again, the effectiveness of Keynesian macroeconomic policy, and the failure of fiscal austerity, as responses to recession. In the long term, the GFC must lead to a radical remodelling of economic theory that will

entail the development of new policy instruments for macroeconomic management. In the short term, however, it is necessary to take the institutions and policy instruments of market liberalism as a starting point, and to consider how they can be modified to allow more control over the economy.

Countercyclical fiscal policy

The most important lesson from the crisis is that, when macroeconomic policy really matters, both monetary and fiscal policy are necessary, and they must be used together. The two crucial requirements for Keynesian fiscal policy are that:

* the government budget balance should be countercyclical, with deficits during slumps and surpluses during booms; and
* it should be sustainable over the course of the economic cycle.

A countercyclical budget balance tends to stabilize the economy. When private economic activity is weak, the government can stimulate demand directly, by increasing its purchases of goods and services, or indirectly, by reducing taxes and increasing transfer payments such as pensions and benefits. To some extent the second of these processes happens automatically. When the economy is in recession, tax revenue declines and unemployment increases, leading to higher expenditure on benefits. Conversely, during booms, the budget automatically returns to surplus.

However, the effectiveness of these 'automatic stabilisers' may be undermined if governments are excessively concerned with annual measures of budget balances. Instead of using budget surpluses to build up assets, governments may run the surplus down through tax cuts or popular, but economically dubious, expenditure programs, leaving less room for stimulus when the economy inevitably declines. A far more serious problem, evident in European and US responses to the GFC, is the adoption of 'austerity' policies aimed at restoring budget balance during a sustained recession. Such policies played a major role in exacerbating the Great Depression of the 1930s, and contributed to the rise of Hitler in Germany and the military takeover of politics in Japan (Blyth, 2012; Quiggin, 2011). Reliance on automatic stabilisers is a sensible fiscal policy during periods when economic fluctuations are modest, as they were for the

decade leading up to the GFC. However, more severe shocks such as those of the GFC, or the 1989–91 Australian recession require a more active policy response.

The second requirement of fiscal policy is sustainability, which may broadly be stated as the requirement that the ratio of public sector net worth (the difference between assets and debt) to national income should remain stable over the long term. A policy that allows debt to grow without limit cannot be sustained indefinitely, though there is no clear point at which the debt position becomes untenable. Broadly speaking, debt will increase when the government budget is in deficit and decrease when it is in surplus. So, if stability is to be sustained, deficits and surpluses, appropriately defined, must balance over time.

There are two main measures of the government's net financial position. First, and most important, is the net worth of the public sector, that is, the difference between the value of publicly owned assets and the debt incurred to finance those assets. Historically, these two values have been about equal, so the net worth of the Australian government has been around zero, ranging from 6 per cent of GDP just before the crisis to negative net worth of −6 per cent in 2011-12. Net worth is the most relevant measure of a government's financial position in the long run. The second measure is net financial worth, which excludes non-financial assets such as schools, hospitals, roads and so on, but includes the value of public enterprises such as Australia Post. Investments in non-financial assets generate a flow of services, but no monetary return. Hence, they must be financed over time by tax revenue. In Australia, state governments own most of these types of assets, so the impact on the Commonwealth is modest.

By looking at the results of privatisation and other asset sales one can see clearly the importance of using correct measures. Asset sales improve the government's cash balance in the year they take place, and they reduce 'gross' measures of public debt, which do not take assets into account. Selling income-generating assets will make no difference to the government's financial position, unless the asset is sold for more than its value in continued public ownership. In other words, only if the interest that can be saved, by using the sale proceeds to repay debt, exceeds the value of the flow of dividends and retained earnings from the continued public ownership of the asset will there be a net benefit.

Turning from measures of the government's financial position at a point in time to measures of annual flows, the most useful concept of budget balance, sometimes called primary budget balance, is simply the difference between government revenue and operating expenditure. This measure does not include interest on government debt or income flows from financial assets. Assuming the rate of interest on government debt is equal to the rate of growth of national income, the addition of interest to the existing debt will leave unchanged the ratio of debt to national income. This point may best be illustrated by an example. Suppose public debt is equal to 30 per cent of national income, which is initially one trillion dollars a year, so that debt is $300 billion. Suppose too that the rate of interest on public debt and the rate of growth of national income are both 5 per cent. With a primary balance of zero, public debt will grow by the amount of interest paid, which is 15 billion (5 per cent of $300 billion). But national income will also grow by 5 per cent, to 1.05 trillion. It is easy to check that the ratio of debt to income remains unchanged at 30 per cent, and that this result does not depend on the specific values in the example.

It is, not, however, generally desirable to pursue the goal of primary balance every year. Countercyclical fiscal policy requires governments to run deficits during recessions and surpluses during booms. Sustainability requires that, over the course of the economic cycle, deficits and surpluses must balance out. Although the precise measurement of budget balances and public balance sheets is complex, the central issue is the very simple one raised at the beginning of this section. In the language of economists, fiscal policy satisfies the long-term inter-temporal budget constraint if, and only if, it is consistent with a stable long-term ratio of public debt to national income.

Taxation and expenditure

In macroeconomic analysis of fiscal policy, the primary emphasis is on measures of budget balance, and on the economic impact of deficits and surpluses. In the longer term, however, balance must be maintained one way or other. The crucial questions are how much of national income should be allocated to the public sector as government revenue, and which services should be provided or funded with that revenue. For most of the 20th century, both the size of the public sector, relative to the economy as a whole, and the scope of public sector activity, expanded.

The resurgence of market liberalism from the late 1970s onwards was centred on the belief, that most productive functions performed by the public sector could be better handled by the private sector. This belief was supported by the development of theories of property rights and public choice in which government intervention in the economy was viewed as inefficient and as motivated primarily be a desire to redistribute income. However, the crucial theoretical underpinning of this belief was the idea, inherent in the Efficient Markets Hypothesis, that private capital markets do a better job of allocating investment than can ever be achieved by governments.

Market liberals sought to roll back the growth of the state through privatisation, deregulation, contracting out of public services and scaling back efforts to redistribute income. These efforts achieved substantial success both in cutting back the scope of the public sector and in reversing the egalitarian shift in income distribution that had taken place in the era of Keynesian democracy. By the time of the GFC, the role of the public sector in the provision of infrastructure had been greatly reduced, and substantial shifts towards for-profit provision had taken place in health, education and other services traditionally provided by governments. These efforts stopped the growth in the government share of national income. In Australia, the Commonwealth government's share of national income has remained broadly constant between 20 and 25 per cent since the 1984 'Trilogy' commitment of the Hawke Labor government. This promise, initially made for a single Parliamentary term, required the government to allow no further growth in the revenue and expenditure shares of national income and to reduce the size of the deficit. With the exception of the periods of fiscal stimulus in 1990 and 2009, these commitments have hardened into dogma.

To the disappointment of market liberals, however, all their efforts have been insufficient to reverse the 20th century growth in the government share of national income. There are two main reasons for this. The first is that the sectors of the economy in which government has historically played a crucial role, most notably health and education, are growing in their relative economic importance, while the sectors where market provision works best, most importantly manufacturing, wholesale and retail trade and primary production, are generally declining. The second, more significant factor has been the failure of attempts to introduce for-profit provision of infrastructure

and key services in place of public (or publicly supported non-profit) provision. Examples include:

* Telecommunications: the failure of Telstra (the privatised replacement of the former Telecom Australia) to provide modern broadband services has forced governments to re-enter this field with the creation of the National Broadband Network.

* Roads: the attempt to finance road infrastructure through privately built and financed toll roads on the Public-Private Partnership (PPP) model has almost invariably ended in failure. Either the public has paid far more than the true cost of the infrastructure (the most common outcome in the 1990s) or the private investors have lost their money (most common since 2000). Now that neither party is willing to accept substantial losses, it has proved virtually impossible to induce private investors to tender for road projects on the traditional PPP model.

* Electricity: The introduction of market competition was expected to produce large reductions in prices but has distorted investment decisions and led to massive increases in costs.

* Education: For-profit providers of vocational education and training have repeatedly exploited weaknesses in the pricing system to generate large profits while providing training of little value. Internationally, for-profit education has been a comprehensive failure in the United States at both the school level (Edison Schools) and in the tertiary sector (University of Phoenix).

The catastrophic failure of financial markets in the current crisis represents an even more fundamental failure for the market liberal project. In some circumstances, private operators may do a more efficient job of delivering some kinds of services than their public counterparts, using existing infrastructure. It is now apparent, however, that leaving the provision of new infrastructure to the judgements of financial markets has been a disastrous mistake. This means that, in future partnerships between public and private sectors, the balance in the existing PPP model must be reversed.

The financial crisis also undermines a crucial argument for lower rates of taxation, particularly on high-income earners. Market liberals claimed that the incentive effects of lower tax rates would lead those at the top of the income distribution to devote more effort to productivity activity and less to tax minimization. In reality, both unproductive

financial speculation and aggressive attempts to undermine the tax system have expanded massively during the era of market liberalism. There is no evidence that an increase in the tax burden on high-income earners would have any adverse effects on the performance of the economy as a whole.

The need for an expanded public sector role in infrastructure, health and education services implies that the share of national income allocated to the public sector as government revenue must increase. The current Labor government has made some initial steps in this direction, with the increase in the Medicare levy to partially fund DisabilityCare Australia (the national disability insurance scheme) and a scaling back of tax expenditures such as the Fringe Benefits Tax Exemption for motor vehicles. But these measures are not nearly sufficient to fund the necessary expansion of public provision. The expansion of health, education and infrastructure services will require an additional three to five per cent of national income over the coming decade or so. To fund that it will be necessary either to raise the rate of GST substantially, to 12.5 or 15 per cent, or to raise income tax rates, particularly for high-income earners, as well as extending the kinds of measures that have already been taken. Such measures have been seen as politically impossible until recently. However, the increase in the Medicare levy to fund DisabilityCare Australia went through smoothly, and the Rudd government's recent changes seem to have been received without too much concern raising the possibility that the levy could be increased further in the future.

Monetary policy

Despite its comprehensive failure to prevent the GFC, and the failure of monetary policy to generate a recovery, inflation targeting remains the preferred approach of central banks around the world. The United States Federal Reserve, which previously operated an informal policy of targeting an inflation 'comfort zone', announced an official inflation target of 2.0 per cent in 2012. In many countries, however, the issue is somewhat academic, since interest rates are at or close to zero, so that the conventional version of inflation targeting, based on small adjustments to interest rates is not applicable. Yet, in countries such as Australia, with low but positive interest rates, inflation targeting remains dominant.

The most modest change that could be made is to increase the inflation target, say to a range of 3 to 4 per cent. Changing the inflation target would simply be an adjustment of the parameters of the policy regime that has prevailed since the early 1990s. The IMF suggested this idea in the early stages of the crisis. More recently, and starting from a situation of price deflation the Japanese government has sought to increase the rate of inflation. A more fundamental shift in policy, advocated by economists including Christina Romer and Paul Krugman, would be to target the nominal (current dollar) value of GDP rather than the rate of inflation, a policy called nominal GDP targeting. The key merit of this approach is that it takes account of economic activity as well as inflation, and includes an automatic trade-off between the two.

In periods of strong growth in real activity, policy leans towards controlling inflation, so that the rate of growth in nominal GDP is kept close to the target. By contrast, in recession periods, the nominal value of GDP declines, implying the need for monetary stimulus. The other critical feature of nominal GDP targeting is that, unlike inflation targeting, it does not ignore the past. If the economy is in recession, the aim of nominal GDP targeting is not merely to achieve a return to growth from a low basis but to return to the pre-recession trend of economic activity.

As with fiscal policy, a shift to nominal GDP targeting would not have much effect during periods where economic fluctuations are modest. By contrast, in the severe and sustained recession observed in most developed countries since the GFC, both real and nominal GDP have fallen far below the levels implied by pre-crisis trends, even as inflation has remained close to its target values. In this context, a nominal GDP target implies a far more expansionary monetary policy than an inflation target. More importantly, a nominal GDP target implies a commitment to sustain monetary expansion until growth is restored.

Financial regulation

The most distinctive feature of Australia's policy approach in the years leading up to the GFC was a more cautious and restrictive approach to prudential regulation. In large measure, this reflected the near-collapse of the banking system that occurred in during the 1990 recession, following the deregulation of the 1980s. In addition, the political unpopularity of the major banks meant that restrictions on mergers (the 'Four Pillars'

policy) were retained, and financial innovations were viewed less favourably than elsewhere.

Australia's approach to monetary policy and financial regulation differed only in minor and subtle details from that adopted in other developed countries. The fact that Australia escaped serious problems during the GFC might, perhaps, be due to such subtle details in policy frameworks, but if so, no one has identified yet the crucial differences between our approach and those that failed so badly elsewhere. Alternatively, it might be that those managing our system did a better job than their counterparts elsewhere. That might be a cause for satisfaction, but there is no guarantee that similar skill will be shown the next time the system runs into crisis. Finally, it was largely a matter of luck that Australia escaped the initial impact of the crisis and therefore had time to implement an effective program of fiscal stimulus, expansionary monetary policy and guarantees to financial institutions.

Moreover, the system came closer to collapse than is commonly realised. Both Westpac and NAB secretly borrowed billions from the US Federal Reserve in 2008. If the Fed had not been willing to act as a lender of last resort in this instance, the job would have fallen to the Reserve Bank of Australia that had quietly bailed out Westpac in 1991. The GFC exposed a major regulatory weakness in the absence of a guarantee on bank deposits. Such a guarantee had been resisted by the major banks, which correctly foresaw that they would be made to pay for an explicit guarantee, whereas, in the absence of such a guarantee, they could rely on being bailed out, overtly or covertly. After briefly flirting with the disastrous idea of a guarantee limited to $20,000 per account, which would surely have caused a bank run, the government introduced an unlimited guarantee of deposits in September 2009. This was originally intended to be temporary, but was made permanent in 2011, with a limit of $250 000 per account.

More generally, the crisis exposed fundamental flaws in the reasoning underlying the light-handed regulation introduced in the 1980s, and extended by the Wallis Review in 1996. It was obvious that a new review was needed, even businessman Stan Wallis himself said as much in 2012. But Treasurer Wayne Swan resolutely refused to consider such an inquiry, though the LNP Opposition has proposed one. Even such a simple step

as charging banks for the guarantee introduced in 2008 and made permanent in 2011 was too much for Swan and was left to his successor Chris Bowen.

In the absence of a proper inquiry into the crisis and its management, it is hard to reach firm conclusions about the Australian experience. However, examination of the outcomes in Europe and the US suggests that the policy framework adopted in the 1990s played a major role in generating the crisis and requires radical modification.

Beyond financial capitalism

The policy proposals set out above represent a feasible medium-term response to the failure of market liberalism in the Global Financial Crisis, aimed at achieving sustainable full employment. In the longer term, however, a reform program of this kind would imply radical changes to the economy and society.

In part, these changes would be a reversal of the program of deregulation and privatisation that began in the 1970s. It is obviously impossible, however, to turn the clock back to the 'social democratic moment' of the late 1970s. Social and family structures, life expectations and technology have all changed radically since then.

What, then, would be likely to emerge in the place of the failed structures of financial capitalism? In macroeconomic terms, the most important changes would involve what Keynes (1936) called 'a somewhat comprehensive socialisation of investment'. In part, this would involve governments returning to their traditional role of undertaking large scale investment in infrastructure, particularly at times when private investment is weak.

In a more globalised world, it is important to manage international flows of investment. Measures such as a tax on high-volume financial transactions (Tobin tax) would help to reduce the volume and volatility of short term capital flows. Similarly, experience has shown that controls on capital flows, anathema under market liberalism, can be a useful tool.

Nevertheless, it is impossible to restore the level of control over global capital flows that facilitated the Keynesian boom of the post war era. It is, therefore, necessary to undertake financial regulation at a global level, and to construct what has been called a 'new global financial architecture'. Attempts to do this so far, through the 'Basel process' have only served to facilitate destabilizing financial speculation. A new

approach, in which the primary objective is to tame and constrain the financial system, rather than to set it free, is needed.

Macroeconomic management must also take account of requirements for sustainability, particularly in relation to climate change. For example, periods of slow economic growth should be taken as an opportunity to accelerate investments in renewable energy, and close down old fossil-fuel power plants.

The primary requirement in all of this is the need for governments to take the ultimate responsibility for stabilizing the macroeconomy. During the years of the Great Moderation, this task was left to financial markets and to central banks, which have proved unequal to the task. Both the traditional instruments of fiscal policy and new policy instruments suited to a globalized world need to be deployed.

Concluding comments

Australia's escape from the GFC owes much to the willingness of policymakers to break with the dogmas of market liberalism and intervene decisively to prevent financial collapse and offset the shocks to the real economy arising from the global recession. Unfortunately, they have, for the most part, regarded the GFC as a once-off shock, never to be repeated. Australia's success in managing the crisis has been seen as proof that our macroeconomic policies and institutions are in no need of change, while the catastrophic failures of similar policies and institutions in other developed countries have been largely ignored.

An adequate response to the GFC will require fundamental changes in macroeconomic policy and in the economic theory that guides policy. Unfortunately, there is little evidence of any serious rethinking among policymakers or the majority of academic economists. In this chapter, I have tried to indicate some of the new directions that are needed.

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