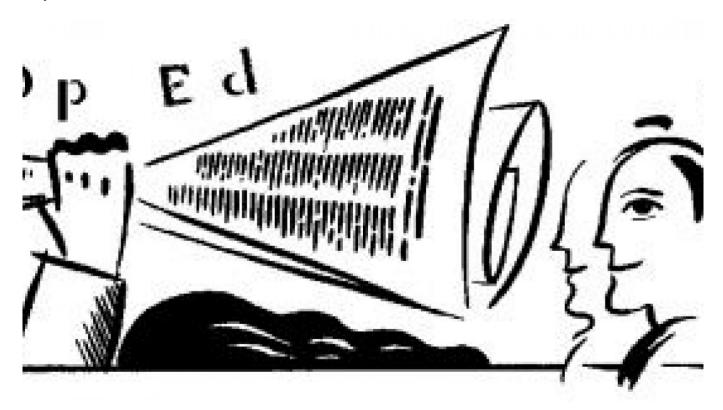


2 Prescriptions to Help Resolve the Global Crisis

By Kaushik Basu

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One thing that experts know, and that non-experts do not, is that they know less than non-experts think they do. This much was evident at the just-completed Spring Meetings of the International Monetary Fund and the World Bank Group. They were three intense days of talks that brought together finance ministers, central bankers and other policymakers.

Our economic expertise is limited in fundamental ways. Consider monetary and fiscal policies. Despite decades of careful data collection and mathematical and statistical research, on many large questions we have little more than rules of thumb. For example, we know that we should lower interest rates and inject liquidity to fight stagnation and that we should raise policy rates and banks' cash-reserve ratios to stifle inflation. Sometimes we rely on our judgment in combining interest rate action with open-market operations. But the fact remains that our understanding of these policies' mechanics is rudimentary.

These rules of thumb work as a result of evolution. Over time, the wrong moves are penalized, and their users either learn by watching others or disappear. We get our monetary and fiscal

policies right the same way that birds build their nests right.

As with all behaviors shaped by evolution, when the environment changes, there is a risk that existing adaptations become dysfunctional. This has been the fate of some of our standard macroeconomic policies. The formation of the eurozone and a half-century of relentless globalization have altered the global economic landscape, rendering once-proven policies ineffective.

When Sweden's Riksbank was founded in 1668, followed by the Bank of England in 1694, the motivation was that a single economy should have a single central bank. Over the next three centuries, as the benefits of instituting a monopoly over money creation became more widely recognized, a slew of central banks were established, one for each politically bounded economy.

What was not anticipated was that globalization would erode these boundaries. As a result, we have returned to a past from which we tried to escape: a single economy with multiple money-creating authorities.

This is clearly maladaptive, and it explains why the massive injections of liquidity by advanced-country central banks are failing to jump-start economies and create more jobs. After all, in a globalized economy, much of this liquidity spills across political boundaries, giving rise to inflationary pressures in distant lands and precipitating the risk of currency wars, while unemployment at home remains dangerously high, threatening to erode workers' skills. The long-run damage could be devastating.

What was evident at the World Bank and IMF Spring Meetings was that virtually all policymakers are distressed, and no one has a complete answer. Neither do I. But here are two simple ideas that could help to mitigate the crisis.

First, in the absence of a single global central-banking authority, a modicum of monetary-policy coordination among major economies is required. We need a group of the major economies — call it "G Major" — that announces monetary policies in a coordinated fashion.

To see why, consider the case of Japan. Japanese policymakers have good reason to try to promote some inflation and even correct some of the yen's secular appreciation over the last six or seven years. But in today's unilateral world, other central banks would soon respond by injecting liquidity, prompting the Bank of Japan to act again. These actions are usually justified as policies for boosting domestic demand, but they end up fueling a surrogate, low-grade currency war.

If, however, the G Major economies issued quarterly announcements of significant upcoming policy changes — for example, a small round of quantitative easing by country X, a larger liquidity injection by countries Y and Z, and so on — markets would be reassured that a currency war was not being fought. Exchange-rate movements would be minimal and only as intended, and volatility would be contained because tit-for-tat injections would no longer occur and speculation would wane. Moreover, liquidity injections would be likely to have a greater impact on demand because synchronization would reduce leakage across national boundaries.

The second recommendation pertains to the mechanics of liquidity injection, much of which takes place nowadays — in Europe, Japan and elsewhere — through asset purchases. The U.S. Federal Reserve, for example, is currently purchasing assets, many of them mortgagebacked, worth \$85 billion each month.

Liquidity injections and low interest rates have a microeconomic effect that has received little attention. They lower the cost of capital vis-a-vis the cost of labor, which causes a relative decline in demand for labor. This is very likely exacerbating the unemployment problem. In any case, it is certainly not mitigating it.

One solution is to channel part of the liquidity injections toward countering this factor-cost asymmetry. Thus, for every \$100 of new liquidity we could use \$60 to purchase assets and the remainder to give firms a marginal job-creation subsidy, which could be especially effective in economies with flexible labor markets that enable short-term hiring.

Even if the employment subsidy were offered only for, say, one year, firms would be tempted to use more labor during this time. Since the current bout of high unemployment is self-reinforcing, once the equilibrium is broken for a while, the economy could move to a higher-employment equilibrium permanently without the need for any further government support.

This prescription has one problem. Asset purchases have no balance-sheet effect because assets replace money. Subsidizing labor, by contrast, is a pure injection of liquidity. But for precisely that reason, an employment subsidy is likely to be more effective in boosting demand, which implies that a smaller injection of this kind is likely to boost demand as much as a larger asset purchase would.

Among the few certainties in crafting economic policy is the need to adapt to external change. Our challenge is like that of Industrial Revolution-era moths, which adapted to their new soot-laden environment by becoming darker and thus better able to hide from predators. In a globalized economy, national policymakers should not be left circling light bulbs.

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