

## Olivier Blanchard on Global Stability

By Dan Richards

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Olivier Blanchard

*Olivier Blanchard is the chief economist at the International Monetary Fund, a position he has held since September 1, 2008. He is on leave from his position as the Class of 1941 Professor of Economics at MIT. He is also an advisor to the Federal Reserve Banks of New York and Boston.*

*Dan Richards interviewed Blanchard on January 4 at the annual meeting of the American Economic Association in Atlanta, GA. This interview is one of a series that Dan conducted at that conference, and we will provide links to videos of his other interviews. He is president of Toronto-*

*based Strategic Imperatives.*

**I want to focus on where we are today and where challenges lie ahead. What is your assessment of where the world stands today in the wake of the financial crisis?**

The most acute part is almost surely behind us. We have turned the corner. Now there are issues we have to deal with to make sure the recovery continues. There are new challenges that are quite different from those we faced a year or so ago.

**Let's talk about some of those new challenges.**

The first one is to make sure that growth actually continues. Growth is now positive in most of the countries of the world, but not all of them.

But at this stage, that growth is from steroids – from drugs. It comes partly from the fiscal impulse, from low interest rates, and from what we call the “inventory cycle.” This is when companies rebuild their inventories that have been depleted. All this is useful, because it creates growth. But we can't rely on it. It won't go on forever. When it ends depends on the country - maybe six months or a year. After this, something else has to come.

Consumption, investment and private demand have to go up. How that happens is much less obvious. We don't know how traumatized things are.



**The sustainability of government spending and low interest rates is in question and one issue is the exit strategy. When he spoke yesterday, Chairman Bernanke assured the audience that he is confident that the Fed will be able to execute an effective exit strategy in the US. What is your take on the challenges globally in defining that strategy?**

For the reasons I discussed, it's not yet the time to execute this exit strategy, but to think about how to do this and be ready to do this. Until private demand is there, if we increase interest rates and decrease the deficit, growth will stop and there will be trouble.

So we have to think about how to exit, but we shouldn't exit now. We should be ready in a year.

I think there is an asymmetry between monetary policy and fiscal policy. Exiting from monetary policy is not very hard. First, it is not a catastrophe to continue to keep rates low for a long period of time. That's not a real issue.

The increase in the balance sheets of the central banks is largely to going to affect investors who want to hold this stuff. To the extent that investors come back to the market, it's fairly easy for most central banks to decrease the size of their balance sheets.

There are some issues, for example, with the mortgage purchase program of the Fed: what happens when it stops, which is going to happen this year? But these are minor issues. For monetary policy, the course is low interest rates for as long as necessary, and then slowly increase them.

On the fiscal side, it is much harder. In many countries there are high levels of debt and deficits are enormous. That had to be. So, now, how we actually get out of the hole is not obvious. It's going to depend on the country, but it's going to be very difficult.

**In December of 2008, shortly after you took your post at the IMF, you wrote an article, *Planning for the Post-Crisis Environment*. That was a very brave title, because it wasn't clear that there would ever be a post-crisis period. But things have stabilized. Let me ask you to highlight some of the issues you considered.**

At the time we feared we were still in fighting mode. So the priority was to get out of the crisis. But even then, we already thinking about what would happen after the crisis.



One of the big decisions was to have much larger fiscal deficits because it was feared that private demand was low and states would have to help.

Larger spending or lower taxes was called for – whatever it took to basically push people to buy or buy indirectly. It was needed but at the same time the numbers were scary. We had to think about fiscal deficits.

The same thing was true on the monetary front. The central banks by then had decreased interest rates to zero. They were buying assets, accepting all kinds of things as collateral and doing all sorts of crazy things by normal standards. Again, that was needed. But we had to think about, when times became quieter, how we could go back to normal monetary policy. What is it going to be?

On the financial side, we were trying to save all kinds of financial institutions, having understood the consequences of Lehman Brothers' failure.

These were the three dimensions on which we had to start thinking, and we are still thinking. The time at which we are going to do these things is getting closer. When, exactly, we don't know. But we had to start thinking about them.

**There does seem to be a consensus about the need for greater coordination and regulation among global institutions. What kinds of things do you see happening in that respect?**

At this stage, it is taking longer than people would want. But it's an incredibly complex set of issues. So there is a lot of technical work behind this.

Not all countries have to have the same kind of regulation. There can be differences. But there are dimensions on which it is absolutely essential that they be common and consistent.

For example, if you take rights and guarantees on certain forms of debt. You cannot have it in one country and not the other. On issues of capital regulation – how much capital the banks must have – the rules are very different in most countries.

There has to be some form of coordination along these dimensions. That's the set of technical problems we are working on.



**One of the causes of concern is that some governments are already facing high debt levels. As a result of their spending, their debt has become particularly worrisome. In Europe, there are number of countries – Portugal, Ireland, Italy, Greece and Spain – not positively referred to as the “PIIGS.” Greece’s debt recently was downgraded. To what extent are you concerned about the fiscal stability of these countries?**

I think the fiscal issues are the big issues. It’s going to be an issue nearly everywhere. You’ve chosen countries that started from a weak position and therefore are affected first. But it’s going to be a general issue.

I think that there is a good chance that, in some countries, the financial markets are going to look at it and say that it doesn’t look so good and take their ratings down and start asking for a premium on their debt. And governments will have to take tough countermeasures. Some of the measures that were taken during the crisis can be taken off easily, but others can’t.

In the end, you will have more debt. You will have the aging problem that was there before the crisis and is still there after the crisis. You will have the health care problem, which in many countries was there before the crisis and will be there after the crisis.

It’s fairly obvious to us that you will have to do a lot of spending, such as on health care, and you will have to do something on taxes.

How is it going to happen? Well, the ideal situation is that governments are responsible. But sometimes it takes a push.

I think when financial markets indicate that they are unhappy, governments can’t ignore that. It is essential that governments and parliaments act.

We may go through a number of these crises and Greece will be the first.

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