Economics focus

(Nearly) nothing to fear but fear itself

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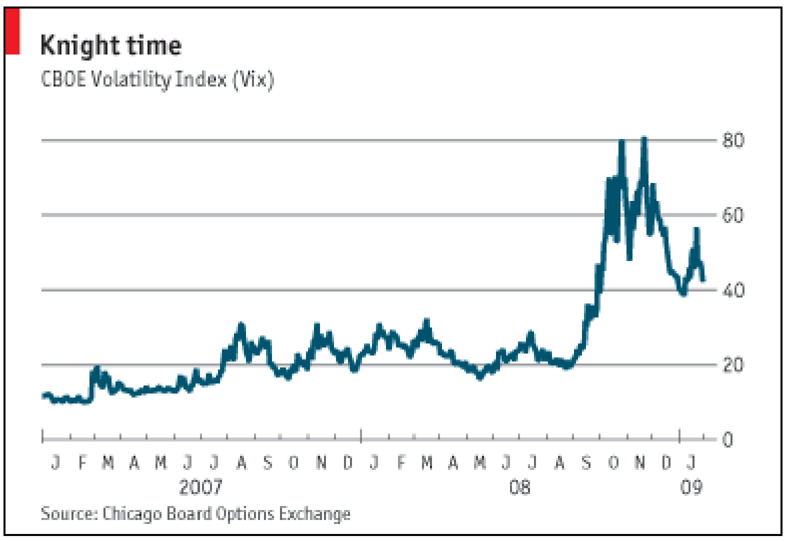
In a guest article, Olivier Blanchard says that policymakers should focus on reducing uncertainty

CRISES feed uncertainty. And uncertainty affects behaviour, which feeds the crisis. Were a magic wand to remove uncertainty, the next few quarters would still be tough (some of the damage cannot be undone), but the crisis would largely go away.



From the Vix index of stockmarket volatility (see chart), to the dispersion of growth forecasts, even to the frequency of the word "uncertain" in the press, all the indicators of uncertainty are at or near all-time highs. What is at work is not only objective, but also subjective uncertainty, or what economists, following Chicago economist Frank Knight's early 20th-century work, call "Knightian uncertainty". Objective uncertainty is about what Donald Rumsfeld (in a different context) referred to as the "known unknowns". Subjective uncertainty is about the "unknown unknowns". When, as today, the unknown unknowns dominate, and the economic environment is so complex as to appear nearly incomprehensible, the result is extreme prudence, if not outright paralysis, on the part of investors, consumers and firms. And this behaviour, in turn, feeds the crisis.

It affects portfolio decisions. It has led to a dramatic shift away from risky assets to riskless assets, or at least assets perceived as riskless. It sometimes looks as if investors around the world only want to hold American Treasury bills. Why? At the start was the realisation that many of the new complex assets were in fact much riskier than they had seemed. This realisation has now morphed into a general worry about nearly all risky assets, and about the balance-sheets of the institutions that hold them. "Better safe than sorry" is the motto. Unfortunately, while the motto may make sense for individual investors, it is having catastrophic macroeconomic consequences for the world. It is triggering enormous spreads on risky assets, a credit crunch in advanced economies, and major capital outflows from emerging countries.

It affects consumption and investment decisions, and is largely behind the dramatic collapse in demand we have observed over the last three months. Sure, consumers have lost a good part of their wealth, and this is reason enough for them to retrench. But there is more at work. If you think that another Depression might be around the corner, better to be careful and save more. Better to wait and see how things turn out. Buying a new house, a new car or a new laptop can surely be delayed a few months. The same goes for firms: given the uncertainty, why build a new plant or introduce a new product now? Better to pause until the smoke clears. This is perfectly understandable behaviour on the part of consumers and firms—but behaviour which has led to a collapse of demand, a collapse of output and the deep recession we are now in.

So what are policymakers to do? First and foremost, reduce uncertainty. Do so by removing tail risks, and the perception of tail risks. On the portfolio side, establish a price, or at least a floor on the price, of the troubled assets. Ring-fence them or take them off bank balance-sheets. On the consumption side, commit to do whatever it will take to avoid a Depression, from fiscal stimulus to quantitative easing. Commit to do more in the future if necessary. Above all, adopt clear policies and act decisively. Do too much rather than too little. Delays in financial packages have cost a lot already. Further rounds of debate will stoke uncertainty and make things worse.

Bloomberg News

Olivier Blanchard is the IMF's chief economist

Second, undo the effects of uncertainty on the portfolio side, and help recycle the funds towards risky assets. The standard advice here is to return the private financial sector to health through recapitalisation. That is absolutely right, but easier said than done. And, while damage is slowly repaired, it makes sense for states to recycle part of the funds themselves. To caricature: if the world loves American Treasury bills but the funds would be more useful elsewhere, then the government should issue the bills, and use the proceeds to channel the funds where they are needed. It should buy some of the riskier assets, and return some of these funds back to emerging-market countries to offset capital outflows. This is indeed close to what America's Federal Reserve is now doing with quantitative easing at home and swap lines to foreign central banks. The only difference is that the Fed issues money rather than treasury bills in exchange for its purchases. It would make more sense for the Treasury to be involved, and to separate more clearly the role of fiscal and monetary policy, but, in the current state of play, this is a minor wrinkle. Either will do.

Retail therapy

Third, undo the effects of the wait-and-see attitudes of consumers and firms on the demand side. Get them to spend more, and have the state do some of the spending itself. Offer incentives to buy now rather than later; for example, temporary subsidies to consumers who turn in a clunker and buy a new car, a measure adopted in France. Increase spending on public infrastructure, a central component of President Barack Obama’s programme. Both types of measures are indeed present in the fiscal programmes more and more countries are putting in place. If tailored and communicated well, these programmes cannot only stimulate and replace private demand, but also convince consumers and firms that they are not in for another Depression. This will ensure that they stop waiting and start spending again.

Coherent financial, fiscal and monetary measures are all needed. All three will have direct effects on demand. But, as importantly, they will help reduce uncertainty, lower risk spreads, and get consumers and firms spending again. If policymakers act decisively, private demand will recover sooner rather than later. And, within a year or less, we can be on the path to recovery.

Economics

Free exchange

Blanchard roundtable: Where economists fear to tread

- Feb 1st 2009, 12:26 by The Economist | DELHI

This discussion can be followed in its entirety here.

OLIVIER BLANCHARD provides a disturbing account of what Knightian uncertainty means for the economy; let me offer a few untutored thoughts about what it means for economics.

Economists do not, in fact, follow Knight's work very much. The discipline shys away from his concept of uncertainty (as distinct from risk), because it is, by definition, so hard to model. If economists could model it, then so could firms and investors. The future would be calculable, if not knowable, and there would be less excuse for bewildered inaction.

Paul Samuelson once went so far as to argue that economics must surrender its pretensions to science if it cannot assume the economy is "ergodic", which is a fancy way of saying that Fortune's wheel will spin tomorrow much as it did today (and that tomorrow's turn of the wheel is independent of today's). To relax that assumption, Mr Samuelson has argued, is to take the subject "out of the realm of science into the realm of genuine history".

The scientific pose has great appeal. But this crisis is reminding us again of its intellectual costs. Knightian uncertainty may be fiendishly hard to fathom, but ignoring it, as economists tend to do, makes other phenomena devilishly hard to explain. The thirst for liquidity—the sudden surge in the propensity to hoard—is one example. If risks are calculable, then investors will place their bets and roll the dice. Only if they are incalculable will they try to take their chips off the table altogether, in a desperate scramble for cash (or near-cash). As Keynes put it, "our desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future."

We journalists make great sport poking fun at the techniques on which financial markets have relied—the value-at-risk models with their normal distributions—much as Keynes scorned all those "pretty polite techniques, made for a well-panelled board room and a nicely regulated market". But as economists (or as friends of economics) we have to fess up that the models that led banks astray are, fundamentally, ours—they spring from the same intellectual tradition. My suspicion, perhaps unfair, is that in recent years too much macroeconomic theory itself became "one of these pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future."

As Mr Blanchard's article makes clear, if you can't explain the propensity to hoard, then you can't explain our current predicament. And a macroeconomics that cannot explain this crisis is hardly worthy of the name.