Time for an Economic Rethink

By Antonio Fatas , INSEAD Professor of Economics

As the "lowflation" phenomenon continues, is it time to revolutionise how we view the world's economies?

It is coming up to eight years since the US Federal Reserve made the decision to bring its interest rate down to 0%. Other central banks have spent a similar (or in the case of Japan much longer) period stuck at the zero lower bound. Throughout the duration they have used all the tools at their disposal to lift inflation closer to their target and boost growth; with limited success. For eight years GDP gains have been weak or anemic, and there is very little hope that economies will ever go back to their pre-crisis trends.

Some recent movements have challenged the traditional views held by academic economists and policy makers about how an economy works. Very few, for example, would have anticipated:

- The idea that central banks could not lift inflation rates closer to their targets over such a long horizon.
- That a crisis could be so persistent, and cyclical conditions have such large **permanent effects on potential output.**
- Or that the natural tendency of the economy could be so slow (or fail) to adjust by itself to a new equilibrium.

The “lowflation” warning

To be fair, some of these trends are not a complete surprise and correspond well to the description of depressed economies that have hit the zero lower bound level of interest rates due to deflation or "lowflation". We were warned about them by those who studied the Japanese experience: **Krugman** and **Bernanke**, among others. However, at the time they were considered a unique example of incompetence among Japanese policy makers, and my guess is that even those who agreed with Krugman and Bernanke’s reading of the Japanese economy would not have foreseen the same occurrence happening in other advanced economies.

Since then we have learned that, either all central bankers are as incompetent as the Bank of Japan in the 90s or that, the phenomenon is a lot more natural and likely to be repeated in economies with low inflation; more so when natural real interest rates are very low.

If this scenario is likely to recur going forward it might be time to rethink our economic policy framework. Some obvious propositions include raising the inflation target and considering "helicopter money" as a tool for central banks. Although neither of these proposals is getting a lot of traction.

A revolution in economic analysis

My own sense is that the views held by academics and policy makers are not changing fast enough; some are just assuming that this is a one-time phenomenon that will not be repeated in the future (even if we are still not out of the current event!).

The comparison with the 70s, when stagflation produced a considerable adjustment in the way academic and policy makers thought about their models and about the framework for monetary policy, is striking. During those years a high inflation and low growth environment created a revolution among academics (moving away from the simple Phillips Curve) and policy makers (switching to anti-inflationary and independent central banks).

How many more years of zero interest rate will it take to witness a similar change in our economic analysis?

Antonio Fatas *is a Professor of Economics at INSEAD. You can follow him on Twitter at* ***@AntonioFatas****, and read his* ***blog****.*

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About the author(s)

Antonio Fatas is a Professor of Economics at INSEAD. He is also a Research Fellow at the Centre for Economic and Policy Research in London and has worked as an external consultant for the International Monetary Fund, the OECD and the World Bank.