Peterson Institute for International Economics

Lessons from the crisis, and challenges to macroeconomic theory

Discussion of ``Rebuilding Macroeconomic Theory”, by David Vines

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Olivier Blanchard

1. Challenges

The easy part:

- Reflect the importance of own funds for decisions. Be it funds on hand, collateral, and ability to borrow for firms and households, capital ratios and leverage for intermediaries.

The not so easy part:

- The need to depart from rational expectations. In two ways. Bounded rationality. And extrapolative expectations (Minsky like).

Challenges (continued)

The very hard, perhaps impossible part:

- The existence of non linearities, and multiple equilibria. Not quite the same, but close.

Example of first: Doom loops between sovereign and financial. Zero lower bound.

Example of second: Liquidity runs (used to be bank runs, but more general). Can hope to capture prob that they happen. But very fuzzy.

- The need to know the plumbing. Granularity.

Complex interactions between individual entities. Financial: Direct, indirect through asset sales.

Another example from outside finance: Korea and global supply chains.

- If central, existential challenge to macro.

2. Models: The need for a panoply

- Forecasting. No need for theory, unless helps. Analogy to AI approach to translation/chess.
- Descriptive. First step towards theory. Organized data description. Structural VARs.
- More formal. DSGE. Staying close to theory, so taking some liberty from the facts
- Less formal. SEM. Taking some liberty from theory, to stay closer to the facts.
- Pedagogical. Toy models. (Ramsey, OLG, ISLM, MF, NK, Mehra-Prescott ,…)
- All linked/all needed. Just have to make them all legal and more widely accepted.