# OLIVIER BLANCHARD INTERVIEW WITH WEBPONDO

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**Webpondo:** People have recently criticized the so called "Washington Consensus" arguing that it has proved to be a failure at least in Latin America. You and Dani Rodrick among others have recently contributed to another consensus, the "Barcelona Consensus". Could you please explain to us the main differences between the two?

**Olivier Blanchard:** The original Washington Consensus was a set of propositions written by John Williamson, summarizing what he saw as the consensus among policy makers and economists at the time. If you look at the set of propositions, I am sure you will agree with most of them: You have to have fiscal control; low inflation is probably better than high inflation; and so on. What people and the press started to refer later on to as the Washington Consensus was something very different: Free markets all the way, reduce the role of the state, etc. So you always have the issue of which version you talking about. The Washington Consensus as John Williamson wrote it down is perfectly fine, but the better known caricature is unacceptable.

Our purpose in writing the Barcelona consensus was largely to restate the original Williamson version of the Washington consensus (John Williamson signed the Barcelona consensus as well), and extend it to take into account what we have learned over the past two decades, from the implications of sudden stops for the way we think about capital flows, to the painful transitional effects of many reforms, to the realization that, when it comes to putting in place or reforming institutions, one size (of institutions) does not fit all.

**W.P:** Talking about institutions, what is your opinion of the work of Acemoglu, Robinson and Johnson. They have put a lot of emphasis on institutions as the ultimate cause of development. What practical implications do you think this view has? Some people, in particular in policy environments, argue that it is a pessimistic view of development. What are the positive and normative implications of this view?

**O:B**: I can't think of the work of any of my colleagues as anything else than brilliant… On a more serious note: I think it is indeed very important work.

The first step is to note that differences in income per capita across countries come mostly from differences in productivity levels. At the same time, it is a fact that most of the countries have access to most of the world technology. This suggests that the source of difference in productivity levels must be differences in institutions. Institutions determine what technology can be used, and how efficiently it is used.

The second step is then to ask why institutions are the way they are. Let me state two extreme views here. One is the predetermination view: Something happened in the 1500s or some other century, when the country was invaded by the wrong guys. Call this the original sin theory. The second is that, in fact institutions are very much the result from accidents of nature and history, the history of labor relations, etc. and there is no predetermination.

I see the work by Acemoglu et al as trying to find out to what extent predetermination plays a role and how much it explains. My view is that the systems countries adopted

long ago may well play a big role in the differences in outcomes today. But when you get down to the specifics of a particular institution and go away from the general meta-institutions like the "rule of law", you realize that not all is predetermination.

Let me give you an example from the French labor market—something I know well. Thirty years ago, the French government decided that if workers were laid off for economic reasons, they should get slightly more generous unemployment benefits than if they were laid off for other reasons. After the government put this in place, not surprisingly, the proportion of layoffs classified by firms as being for economic reasons increased substantially: Why pass on a good thing? To try to stop the abuse, the reaction of the government was then to delegate to judges the responsibility of assessing whether a layoff was indeed for economic or for other reasons. Over time, this mandate was interpreted by judges as giving them the right to assess whether a layoff was justified on economic grounds---a very different question of whether a layoff is justified for economic reasons or other reasons. Today, differential payments of unemployment benefits based on the nature of the layoff are long gone. But the role of judges in assessing whether a layoff is justified or not is now central to the system of employment protection. And the costs of the system in place can be quite substantial. Let me take an example.

In 1997, the Michelin Company decided that one of their plants was not profitable and closed it. This is one plant out of many, and Michelin as a company was still making profit. Workers went to labor court, saying Michelin should not close the plant because it was making money overall. Over the last five years, the case has gone from court to court. Three days ago, the highest labor court confirmed an earlier lower court ruling, that Michelin did not have the right to lay off the workers at the plant. The argument given by the labor judges: It is ok for a firm to layoff workers if it is to maintain its profitability; it is not ok for a firm to layoff workers if it is to increase its profitability (By the way, the plant is long gone, so workers will not get their jobs back) Here we are with a very inefficient institution: judges clearly do not have the competence to second guess the decisions of firms, and the distinction between maintaining and increasing profitability is meaningless. Was it anybody's intent to put that power in the hands of labor judges? No. For the most part, it was largely the result of a series of accidents.

Let me put my thoughts together. There are both deep forces shaping the institutions, and a lot of accidents along the way. If we want to change institutions, we need to understand the role of each one, the fundamentals and the accidents.

**W.P:** In an essay, by invitation, of Keneth Rogoff to the Economist[1], he argued that the World Bank and the IMF are not in good shape and that the IMF, and in particular the World Bank, should close some of his lending windows like the IBRD and IFC. They shouldn't make loans; they should give grants. What views you have on this and what's the role that the IMF and the World Bank play in the world economy.

**O.B:** Both are extremely useful institutions. The IMF is a precious institution, giving useful advice to countries, and helping them do what they want and need to do.

[1] [1] The Economist, July 24-30th, 2004. Page 63.

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Does this means that the advice that the IMF in particular gives is always right? No, it reflects both the state of knowledge and the fashion in macroeconomics at the time. Also, (and this goes back to my earlier discussion of the Barcelona consensus) it would often be better if the advice was better tailored to the particular characteristics of each country. The IMF probably doesn't do enough of that. Why? I think it is in the nature of any large organization that there has to be a clear set of rules, here a set of standards regarding fiscal policy, monetary policy, exchange rate policy, etc. Fund economists need a framework they take with them when they go on a country mission; if they were totally free to improvise, the outcome would likely be chaos. Let me take an example here. When Joe Stiglitz, then at the World Bank, was going to Eastern Europe in the 1990s, what he said was often quite interesting and provocative, but also quite unrelated to the official views of the World Bank or the IMF. And the result was more often than not catastrophic. The reason was not that Joe was necessarily wrong. It was that his positions were often used by people who hated privatization or transition in general. They would appropriate some comments by Stiglitz about the limits of privatization, and use it to keep the status quo—not a good outcome.

To put it simply: These two organizations have to have a coherent message; to some extent, any coherent and simple message has to be a bit of a caricature. When you take this constraint into account, and the changing state of knowledge in macro, they are doing a pretty good job.

On the specific proposal by Ken you mentioned in your question, my view is that is too restrictive. The IMF should be in the position of being able to use carrots and sticks. If a government commits to a good program, the IMF should stand ready to help contingent on implementation. We know that ex-post when things don't go well, there are time inconsistency issues, and there is a tremendous pressure to lend more, which ex-ante is not so good. I think that tension cannot be avoided. I still like the idea of the IMF being in the position of saying to the governments: If you do what we think is right, we will be standing by, ready to help you. This is probably a better way of doing it rather than just give money.

**W.P:** Do you think that moral hazard is a minor point?

**O.B:** No it's not a minor point. Ex post, there is a very strong incentive to help the country which maybe did everything right but was unlucky, or didn't do it quite right. And once you've done it for one country, then next time you go in and you say we shall not bail you out, other countries are going to be more skeptical. I do not think the moral hazard argument is overwhelming: In the end, it is very costly for a country to misbehave, even if debts are partly forgiven.

**W.P:** On your document *Comments on "Inflation targeting in transition economies; Experience and prospects", by Jiri Jonas and Frederic Mishkin* you say that, as it is likely, there are nominal rigidities in both price and wage setting, then the central bank should target a combination of price and wage inflation, because targeting either just price inflation, or just wage inflation, may lead to a very inefficient policy. Do you think that our central bank should target wage inflation? Which is the argument and how would you set a target?

**O.B:** I don't know what your central bank should do but I know what you should try to look at in order to help the central bank decide what it should do.

Let me step back. In new Keynesian models---which I take to be a decent representation of the world for purposes of this discussion---, there is typically a relation between inflation, expected inflation and the output gap. These models also typically deliver something I have called elsewhere a ``divine coincidence'': Maintaining constant inflation implies achieving a zero output gap, a zero deviation between output and the natural level of output. In other words, you can have your cake and eat it too: Constant inflation and no output gap.

The question is then what rate of inflation enters the equation, and thus what inflation rate should be stabilized. If for example, if stickiness comes on wages then our models say it is wage inflation which should be stabilized. If instead, it is prices which are sticky, our models say it is price inflation which should be stabilized. So, if you care about the output gap—which you should---which inflation rate you should try to stabilize is an empirical question, depending on the relative degrees of wage and price stickiness. In the US, targeting wage or price inflation does not make an enormous amount of difference, because wage inflation and price inflation move pretty much together. But in countries like Poland or Hungary, there were years in the late 1990s for which for which price inflation was 7% and wage inflation was, say, -2%. Then, which inflation rate you target is going to make a gigantic amount of difference.

**W.P:** Doesn't this depend on the type of shocks?

**O.B:** To a first approximation, the answer is no. I'm going to get a bit technical here. Take the Calvo model, in the sense that prices are set in staggered fashion a la Calvo (but the point is more general). In this case, there is an exact relation, i.e. a relation with no error term, between price inflation, expected price inflation and the output gap. So if you want to stabilize the output gap, you should stabilize price inflation, no matter the shocks, be they oil or productivity shocks for example. This is a very strong result. Should we believe it? The assumptions of the Calvo model may well be wrong, and so may the result. But we have to understand why.

**W.P:** You have been critical of the idea of bringing down inflation to very low levels. You have also argued that a sustained increase in real interest rates leads first to an increase in the actual unemployment rate and later, as capital accumulation decreases, to an increase in the natural rate itself. Does this mean that you are against inflation targeting?

**O.B:** No. I believe in inflation targeting. I believe in following something like a Taylor rule. My criticisms are of (important) details.

On the inflation rate. I believe deflation brings a serious danger, the danger of a deflationary spiral. Low steady state inflation imply low steady state nominal interest rates. Low steady state nominal interest rates imply a low margin for reducing nominal interest rates if needed: nominal interest rates cannot go below zero. This margin may not be enough when faced with a strong adverse shock in demand. In this case, the

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outcome may be, even when nominal interest rates have been decreased to zero, low activity and deflation. Deflation means higher real interest rates, higher real rates mean lower activity, lower activity leads to more deflation, and so on. The argument is old and well known. Japan has reminded us that this is not just a construction of the mind. It can happen.

This leads me to think that we should not aim at too low a target inflation rate, and by implication, too low a normal level of nominal interest rates. I want the central bank to have room to act strongly in case of recession. If average inflation is, say, 4\%, the average real rate 2\%, and so nominal interest rates 6\%, this gives 600 basis points of margin to play with. Much better than if we start with, say, 0\% inflation, a real rate of 2\%, and nominal rates of 2\%.

I realize it sounds strange to say that one wants enough steady state inflation because this is the only way to get a higher steady state nominal rate, and thus a larger margin for monetary policy to act when needed. But I see no way out of this argument. It has a number of implications. Let me point one. The larger the variance of the shocks confronting the country (think Colombia), the more room the central bank will want to have, the higher should be the target rate of inflation.

Regarding the effect of monetary policy on capital accumulation and unemployment, I do indeed think that if you have tight monetary policy for a long time time, then you will have effects on the supply side of the economy. And my reading of disinflation in Europe is that this effect was indeed very much in play then and there.

**W.P:** There is a huge debate in Colombia regarding exchange rate intervention. In particular, some exporters argue that is hard to compete with hardly any devaluation, especially when we are close to sign an important trade agreement with the U.S.

**O.B:** Let me again stay away from Colombian particulars, and answer in steps.

Step one. If you have inflation targeting, if you care about inflation and the output gap, and if you use a nominal interest rule, explicit or implicit, then you will respond indirectly to the exchange rate. The reason is that an appreciation leads to lower inflation, and lower output. Both should lead to a decrease in the nominal interest rate.

Step two. Should you care directly about the exchange rate, that is care explicitly about inflation, the output gap, and the exchange rate? Maybe. Again, go back to theory. Why do we have inflation (or the deviation of inflation from some target) on the right hand side of the interest rate rule? Because we dislike inflation. Why do we have the output gap? Because we care about aggregate activity. Are these the only two things we care about? Surely not. If you write down a model with two sectors then you will start thinking about sectoral distribution. Then, one of the variables that will come in will be the real exchange rate. So in economies in which the exchange rate has a big impact on the sectoral composition, then there is a good argument for having the exchange rate in the rule, again be it implicit or explicit (this is a different issue).

Step three. Suppose that, for the reasons I just given, the central bank cares also about the exchange rate. Should it use intervention? Should it just affect the exchange rate through the nominal interest, and the uncovered interest rate parity relation? The general answer is: Both. In a world of imperfect capital mobility, such as is the case in Colombia, it should use its two instruments, sterilized intervention and the nominal interest rate, to achieve its preferred outcome for inflation, the output gap, and the exchange rate. Conceptually it's quite simple. It all boils down to really understanding the transmission mechanisms. Research at the central bank should focus on these issues.

**W.P:** Having touched on unemployment issues, could you synthesize your main ideas regarding the optimal design of labor market institutions?

**O.B:** There is a wide feeling among economists that existing labor market institutions are not best, either in Western Europe or in Latin America. But there is no clear view as to what optimal, or simply good, labor market institutions should be. This has led Jean Tirole and I to embark on a research project, aimed at exploring the contours of optimal institutions. (Our research was actually triggered by a request from the French government to explore reforms of the employment protection system. We started with an applied paper, then went back to theory, and have been going back and forth since then.) If I were to summarize our basic conclusions at this point, it would go something like that:

First: Unemployment insurance will not be provided by private markets efficiently. There is a role for the state to provide unemployment insurance, and the state should do that in the best possible way.

Second: When laying off workers, firms should take into account the social cost of the layoff. This implies that they should pay something like a layoff tax. Or put another way, unemployment benefits should be financed by contributions paid by firms in proportion to their layoff behavior, rather than through a payroll tax.

Third: Layoff taxes should be the main form of employment protection. There may be a case for some severance payments in addition, related to seniority. Legal and administrative restrictions should be much lighter than they are today. The role of judges should be limited to judging process, not cause.

Fourth: For Latin American countries, the challenge is to move from a system organized mainly around severance payments---which one can think of as a simple but primitive form of insurance--to a system of state provided unemployment insurance, financed at least in part through layoff taxes. Individual accounts are probably not the way to go.

**W.P:** Let's talk about the current and future state of the art of economic theory: The Nobel prizes of this year, that went to Finn Kydland and Ed Prescott, have called our attention on the enormous influence of Dynamic Stochastic General Equilibrium Models for the study of dynamic economies, not to say anything about the importance of the idea of time inconsistency of optimal policies. You mentioned in one of your papers that since 1980, macroeconomics has explored and focused on combining general equilibrium models with nominal rigidities for a better understanding of the role

of imperfections in macroeconomics. However, in recent years, another important part of macroeconomic studies has focused on the interrelations of economics with other social sciences as psychology. Nowadays it seems to be that there are two kinds of macroeconomics "profiles". Do you see it that way?

**O.B:** I think that we are at a state at which many people explore many things.

Prescott, Lucas and others have been very influential. They have made a convincing case for forcing people like me to be more explicit about imperfections, their justification, and their role in fluctuations. This has happened. Many models now have an RBC frame but embody a number of imperfections that the researcher sees as central to the issue at hand. To take example, to study the implications of market incompleteness, the origins of sudden stops and so on. This is exciting stuff.

At the same time, there are researchers who think that our typical assumptions about utility are convenient, but misleading. In dynamic contexts, or under uncertainty, they argue that people behave in ways which are systematically different from the separable additive Von Neuman Morgenstern case. And their argumentation is quite convincing. Some researchers are simply exploring, sometimes through experiments. Some are formalizing, for example David Laibson, in his work on hyperbolic discounting. Some, again for example David, are introducing these formalizations in otherwise standard dynamic GE models, with or without imperfections. When I think about the field, metaphors come to mind: Let a hundred flowers bloom. Mix and match. The field is fun, and these interactions are exciting.

**W.P**: In an interview that you made to Stanley Fischer he said that when he was at MIT, Don Patinkin was one of his heroes. Speaking about economic heroes, do you have any economic heroes ? People that inspired you in your work?

**O.B:** A lot of people have. I don't think that there is anybody that I can call my intellectual father. My two advisers at MIT were Robert Solow and Stanley Fischer. I admire both of them, and I suspect I have tried to imitate them in my research. Both take important issues, think really hard, and write something really simple in the end. There is no intellectual pretense, no macho technical game, no obfuscation. Their techniques are never more that what is needed, and the answers are always insightful .

**W.P:** We read in an interview you gave that you left France because you wanted to rebuild Marx's Capital.

I never said that, but that was the spirit. In 1968, I was a student in Nanterre, a University just outside of Paris, where the events of May 1968 started. I became passionate about social change, and about the role of economics in general. I went to MIT with a simple and modest goal, that of integrating Marxist economics, which is what I had learned, with neo classical economics, which is what I was coming to the US to learn. After two weeks of courses at MIT, I gave up on the goal… I was not quite up to the task. My commitment to social change has remained. The purpose of economics is to make the world a better place.

**W.P:** Thank you very much.