DeLisle Worrell: The search for practical economics

Remarks by Dr DeLisle Worrell, Governor of the Central Bank of Barbados, at the International Monetary Fund–Central Bank of Barbados–University of the West Indies (IMF-CBB-UWI) conference, Bridgetown, 27 January 2011.

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I begin this morning with a quote from Eric D. Beinhocker of the McKinsey Global Institute, London, from his 2007 book *The Origin of Wealth*: "As I write this, the field of economics is going through its most profound change in over a hundred years. I believe that this change represents a major shift in the intellectual currents of the world that will have substantial effects on our lives and the lives of generations to come. …just as biology became a true science in the twentieth century, so too will economics come into its own as a science in the twenty first century".[1] I am not as confident as is Beinhocker that change has begun to take root; I scan working papers from all the leading economic research institutes and university departments daily, and they are all comfortably situated in a conventional idiom of economic analysis. However, I do share his conviction that a change that goes to the foundations of our discipline appears to be needed, if economists are to have useful advice for policy makers about improving the performance of modern economies. The longer I stay in this business, the more I am disappointed by the disconnect between what economic analysis would seem to suggest, and what is practical and makes sense.[2]

Clearly a conference such as the one we begin today cannot address the fundamentals of our discipline, but I believe it offers an opportunity which should not be missed, to explore needed changes in our approach to economic analysis. No doubt the revolution in economic thinking will come upon us, when and from what quarter we cannot tell; but in the meanwhile there is much that we can do, as economists, to improve our practices, approaches and techniques, so that we are able to offer usable advice on economic policy. I offer an illustration in this short address, of what might be called "Practical economics", meaning analysis that enlightens the decisions policy makers have to make.

Let me begin with an example of conventional monetary policy analysis and advice in Caribbean. Conventional economics, reflected for example in the IMF Occasional Paper "Monetary policy implementation at different stages of market development",[3] recommends that monetary policy is the tool that should be used to target inflation. How does that work in practice? Say the inflation forecast is 8 percent, and that policy makers, considering this unacceptably high, choose an inflation target of 5 percent maximum. Conventional economics would recommend that the central bank buy treasury bills, with an expectation that the interest rate yield curve will rise over its entire range, the supply of money will decline, aggregate expenditure will contract, and therefore expected inflation will fall.

In practice the central banker needs more precise information. What quantity of additional treasury bills should the central bank buy, to reduce inflation by 3 percentage points? To provide the answer, at a minimum, we need to know:

1. How banks will react to the central bank's purchase of additional T-bills. How much excess liquidity do they have? Would it be profitable for them to source additional liquidity abroad, as domestic interest rates rise? Should they do so, would the

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[1] Beinhocker, Eric D. *The Origin of Wealth: the Radical Remaking of Economics and What it Means for Business and Society*, Harvard Business School Press, 2006, 2007.

[2] See my address to the Barbados Economics Society, "What's wrong with economics", June 30, 2010, www.centralbank.org.bb.

[3] IMF, "Monetary policy implementation at different stages of market development", October 2004, www.imf.org.

exchange rate tend to appreciate? Would banks be inclined to change domestic deposit or loan rates?

2. Whether, when and how will interest rates rise? Will rates rise all along the yield curve? What lag can be expected? Will rates increase on both sides of banks' balance sheets? Will the spread narrow, widen or stay the same?

3. If the T-bill purchases do result in interest rate increases, by how much will banks adjust their holdings of cash and liquid items?

4. Will there be any adjustment in loans, and if so, how large an adjustment?

5. Will there be any cut in aggregate expenditure, as a result either of an increase in loan rates (if they increase) or a reduction in loan supply (if there is a reduction)? If so, what is the elasticity of response?

Unfortunately, we can seldom offer a definitive answer to these questions. As a result, the analysis of monetary policy in central bank reports, and in the economic media, seems curiously incomplete. They describe what has been done with interest rates and open market operations, and what, if anything, has happened to bank liquidity, but they never bring the story to a conclusion, to say what effect policy actions have had on output or inflation, even in the broadest terms. We simply do not have the information we would need to make such an assessment.

Does that mean we are in a hopeless situation, and that we can do nothing to stabilise the economies of small open economies? I do not think so. However, the search for practical advice, advice that a policy maker can actually put into practice and measure its impact, takes us beyond conventional economics. To begin with, the policy objective of choice should be economic stabilisation, not inflation control. Policy makers need to choose as target a variable over which they can have some control. We cannot target inflation at 5 percent if 80 percent of that inflation is imported from abroad, and import prices rise 10 percent. Whatever our policy, domestic prices are going to rise at least 8 percent. A more useful objective, in the open economy, is to stabilise external payments and receipts, and maintain a level of foreign exchange reserves which market agents find to be adequate. That creates a stable environment for business and investment planning, and is therefore the best platform for sustained economic growth. As a result, this is an objective which resonates with the companies and households whose collective decisions will result in the outcome of whatever policy is chosen. Practical policy requires us to start with this objective, and to find the economic policies that may be employed to achieve it.

What might these policies be?

First, are there any policies that might significantly increase foreign exchange earnings in the near term? The answer is, not really. The only way to increase foreign currency inflows in the short run is by borrowing, attracting foreign direct investment, or selling assets to foreigners. Each of these implies higher commitments of foreign payments in the future, which means that the limits on capital inflows are first, the supply of foreign finance and secondly, the capacity for future debt service.

The policy maker's challenge then boils down to this: how can expenditures on imports and other foreign currency spending be brought down to the level of available foreign currency inflows? In economies like the US or Brazil, which produce practically everything domestically, it may be possible to persuade consumers to switch from imported to domestically produced items by depreciating the exchange rate or imposing a tariff. In the Caribbean, that option is not available, because we produce only a handful of consumption items competitively, and most of those would become more expensive with currency depreciation, because of their import content. The Caribbean policy maker has only one option for reducing spending on foreign exchange, and that is to reduce spending on everything. To stabilise these small open economies one has to cut expenditure in the aggregate.

The tools available to reduce aggregate spending are all fiscal, and what is needed, in the end, is a reduction in the fiscal deficit. Most of us, even those who remain wedded to conventional economic analysis, will be in sympathy with this conclusion. However, the conventional story, with its armoury of money supplies, excess liquidity, real effective exchange rates, core and headline inflation, etc, obscures the fundamental link between the fiscal deficit, external balances and foreign reserve adequacy. That linkage is what makes for the success of stabilisation policy. It may be employed to estimate the amount of fiscal adjustment needed for economic stabilisation, and equally importantly, to track the success of the fiscal adjustment measures, as they are reflected in the evolution of foreign exchange reserves.

May I therefore take this opportunity to appeal for a practical approach to economics, one that

1. Is based on careful measurement and observation of actual economic transactions and behaviour, even if that means we must rethink our prior notions;
2. Uses a variety of methodological approaches in the effort to understand better how our economies work;
3. Is sufficiently easy to understand and explain to economic agents whose decisions ultimately determine the success of policy;
4. Provides useable guidance about the magnitude of the policy adjustment that may be necessary.

In a paper on fiscal sustainability that my colleagues Anton Belgrave, Jason LaCorbiniere, Denisa Applewhaite and I will present at this conference, we provide an example economic analysis which we believe is practical in this sense. In the panel discussion tomorrow I hope we can explore this question more fully.