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THE CRISIS: POLICY LESSONS AND POLICY CHALLENGES

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NON-TECHNICAL SUMMARY

Throughout the 2000s, mainstream economists concurred on an 'augmented Washington consensus' which was deemed favorable to rapid, stable, non-inflationary growth: light-touch regulation, limited government intervention, rules-based fiscal and monetary policies. The financial crisis that erupted in the summer of 2007 and turned into a sharp, global economic downturn in the autumn of 2008 led policymakers into transgression. Not only did they engage on unprecedented scale in discretionary monetary and fiscal stimulus, but they also intervened heavy-handedly by bailing out banks and some non-financial industries.

The present paper reviews the main causes of the crisis, recalls how governments around the world had to depart from established policy stances, and reflects on the legacy of the crisis both in terms of future challenges and changes in policy doctrine.

There are three different, non-mutually exclusive lines of explanation to the crisis: wrong incentives in the financial sector, unsustainable macroeconomic outcomes, and misunderstood and mismanaged systemic complexity. These yield different sets of policy recommendations, all of which combine the overhaul of financial regulation, supervisory reform, changes in the monetary policy framework, and some of which also involve reforming the international monetary system and rethinking the remit and governance of international organizations. The G-20, relying on specialized international bodies such as the International Monetary Fund and the Financial Stability Board, as well as on national and regional authorities, has addressed many of these. Crucial themes, however, have been left unaddressed, both on the regulatory and the macro-financial fronts:

- on the *regulatory front*, four issues stand out unresolved: (i) moral hazard, which was magnified when G-7 finance ministers decided not to let financial institutions of systemic significance collapse; (ii) the separation between retail and investment banking; (iii) the desirable size of the financial sector, both in terms of efficient resource allocation and in face of the 'too big to be saved' dilemma; and (iv) the impact of new capital regulations on the cost of capital, which may hamper post-crisis growth;

- on the *macro-financial front*, the crisis has been a reminder that economic policy is not only about targets and rules but also about risk-management, both in the private and in the public sector. On the monetary side, the crisis has questioned the relevance for central banks to target consumer-price inflation and leave aside asset prices, and more generally financial stability. As concerns international coordination, there is no agreement yet as to how much current-account imbalances contributed to financial instability. Historical experience with peer-pressure-based surveillance, including in Europe, allows for low expectations on the newly-created G-20 framework for sustainable growth.

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