Preface by Olivier Blanchard, MIT and IMF

“This book is a book I would have loved to write. Indeed this is a book I long wanted to write. I wanted to do it out of guilt. For a long time, I have felt that my graduate textbook with Stan Fischer sent a wrong message. We had made the choice to present models and their logic, rather than their applications. The justification was a perfectly good one, namely that we wanted to show the intellectual structure of macroeconomic theory first. But, de facto, the lack of serious empirics sent another message: that theory was largely divorced from practice, and from facts. That message is wrong: theory without facts is much too easy to do, and of very little use. I wanted to do it also out of a desire to share with students my excitement about moving between theory, facts, and policy. It is traditional to do so in undergraduate textbooks, at least in the United States. Those textbooks are full of discussions about policy debates, about the effects of policy choices on the economy. I thought it would be even more fun to do so with graduate students, who have more tools, both theoretical and econometric, at their disposal.

Agnès Bénassy-Quéré, Benoît Coeuré, Pierre Jacquet, and Jean Pisani-Ferry have beaten me to it. I am happy they did, because they have done a better job than I could have hoped to do.

To give a sense of what they do, I shall take one example, the creation or reform of fiscal frameworks like the European Stability and Growth Pact (SGP). To come to an intelligent set of recommendations, think of all the elements you need to put together:

- You need to understand what sustainability means in theory and in practice, what the costs of not abiding by it are, and how to assess it. When does a debt-to-GDP ratio become truly excessive? What happens then? How fast can you reach that threshold? How fast can you move away from it?

- You need to understand the long-term effects of deficits and debt on output and its composition. How do deficits and debt affect output in the medium and the long run? How do they affect the interest rate, the net foreign debt position, the capital stock? What is the cost in terms of lost consumption in the future? Which generations gain, which generations lose?
You need to understand the short-term effects of deficits, and how counter-cyclical fiscal policy can help in the short run. Do deficits affect activity in the same way, whether they come from tax cuts or spending increases? How important are expectation effects? Can the anticipation of large deficits in the future lead to a decrease in consumption and investment, and a decrease in output today? When is this more likely to happen?

You need to understand the macroeconomic costs of decreased policy flexibility. Are constraints on deficits and debt consistent with an appropriate response of fiscal policy to shocks? What explains sustained divergences within the euro area during the first ten years? Were such divergences avoidable? Then you should determine whether and to what extent fiscal policy is the right tool to deal with country-specific shocks and to what extent it can (should) substitute for the lack of an independent monetary policy. Finally, you need to figure out how much policy space is left to governments after they have fought the great recession and rescued their banks.

You need to think about how to define the rules in practice. How should debt be defined? How should implicit liabilities, coming from social security and other promises to future generations, be treated? If rules are defined in terms of deficits and debt, what are the most appropriate definitions of the two concepts for the question at hand? How should rules deal with privatization revenues? Should rules apply to gross debt or to net debt? Should the budget be separated between a current account and a capital account? Should the deficit rules apply only to the government current account? Can rules be enforced by politicians or do we need to set up independent committees?

You need to think about political economy issues. Why are rules needed in the first place? To protect people from their governments, or to protect the governments from themselves? How can a particular set of rules be manipulated or distorted by a national government? How will sanctions against a misbehaving government be imposed? Will these sanctions be credible ex ante? Is international coordination, such as in the G-20 framework, an asset or a diversion from every government’s duties?

To answer these questions, you need many conceptual tools. Among them: a dynamic general equilibrium model with overlapping generations; a model of short-run fluctuations with careful treatment of expectations; political economy models to think about the case for rules; agency models to help you think about the design of specific rules. In each case, with the
guidance of theory, you need to look at the evidence, so as to get a sense of which theoretical arguments are more relevant. This is not easy to do. Courses will typically give you the theoretical tools, without much motivation, and let you use them on your own, without much practical training. This is not what this book does. It motivates the use of the tools, gives you the tools, and shows you how they can be used.

Last but not least, this book is among the very first ones that offer students a rigorous and comprehensive treatment of the financial crisis and the great recession that followed. The authors do not try to cast a veil over the conceptual difficulties economists face when they reflect on the causes of the crisis, on the limitations of traditional approaches that the crisis has uncovered and maybe the excessive faith in theory, and on the need for more theoretical work to be done to understand better the crisis and make sure it does not happen again. But they do not throw the baby out with the bath water and claim that economists have “mistaken beauty for truth”, as was suggested by Paul Krugman. On the contrary, they show how existing theories can be used, cross-fertilized, and replaced in a historical context to understand the crisis better. This is the way forward.

In short, this book trains you to be a good macroeconomist—a good economist. It instills the right attitude, and gives you the right methodology: the need to build solidly on theory, to use the theory to look at the data, and then to go back and forth between the two until a coherent picture forms. As I was reading it, I felt again the excitement which comes with doing research on macroeconomics. I hope this excitement is contagious and I wish you a very good read.”

Olivier Blanchard, May 2010.