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Rethinking macroeconomic theory in light of the crisis

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Two views about macro theory today

- 'The crisis was not triggered primarily by macroeconomic policy. In many ways, the general policy framework should remain the same.' (Blanchard, 2010)
- 'Macroeconomics has not done well in recent years…. The models/theories that guided policy were not just innocent bystanders in the crisis that unfolded beginning in 2008. They were critical in the creation of the crisis and in the inadequate responses to it' (Stiglitz 2014).

Outline

- Broad brushes
- Changes from a post-Keynesian perspective:
  - Monetary theory
  - Macroeconomic theory

BROAD BRUSHES

What must go away

- New classical economics or freshwater economics (RBC theory);
- The rational expectation hypothesis;
- The strong or semi-strong version of the efficient market hypothesis;
- The assumption of perfect asset substitutability;
- The unbiased efficiency hypothesis;
- The idea of policy-ineffectiveness
- The idea of expansionary fiscal contraction

What is back into view

- The crucial role of expansionary fiscal policy;
- The favourable effects of controls over foreign capital flows;
- The possibility of direct credit controls;
- The need to integrate into a single economic model the real economy and the financial side of the economy (by going beyond the introduction of the target rate of interest, for instance adding stocks and flows of debt)

MONETARY THEORY

Inflation targeting?

- The standard inflation target (2%) is probably too low.
- Price-level targeting has been put on the backburner.
- Inflation targeting is not necessarily the best thing a central bank can do.
- The stability of the financial system may be a much more important objective.
- And what about full employment?

Central bank independence?

- The crisis has highlighted the fact that a central bank cannot be fully independent.
- After the Lehman Brothers default, a number of central banks purchased private assets and started to run out of Treasury bills that were initially needed to make swaps with commercial banks; central bankers were thus forced to ask the Treasury to issue government securities (even if they were not running deficits), which they purchased, with the proceeds being held by the government as deposits at the central bank.
- Central bank independence is illusory.

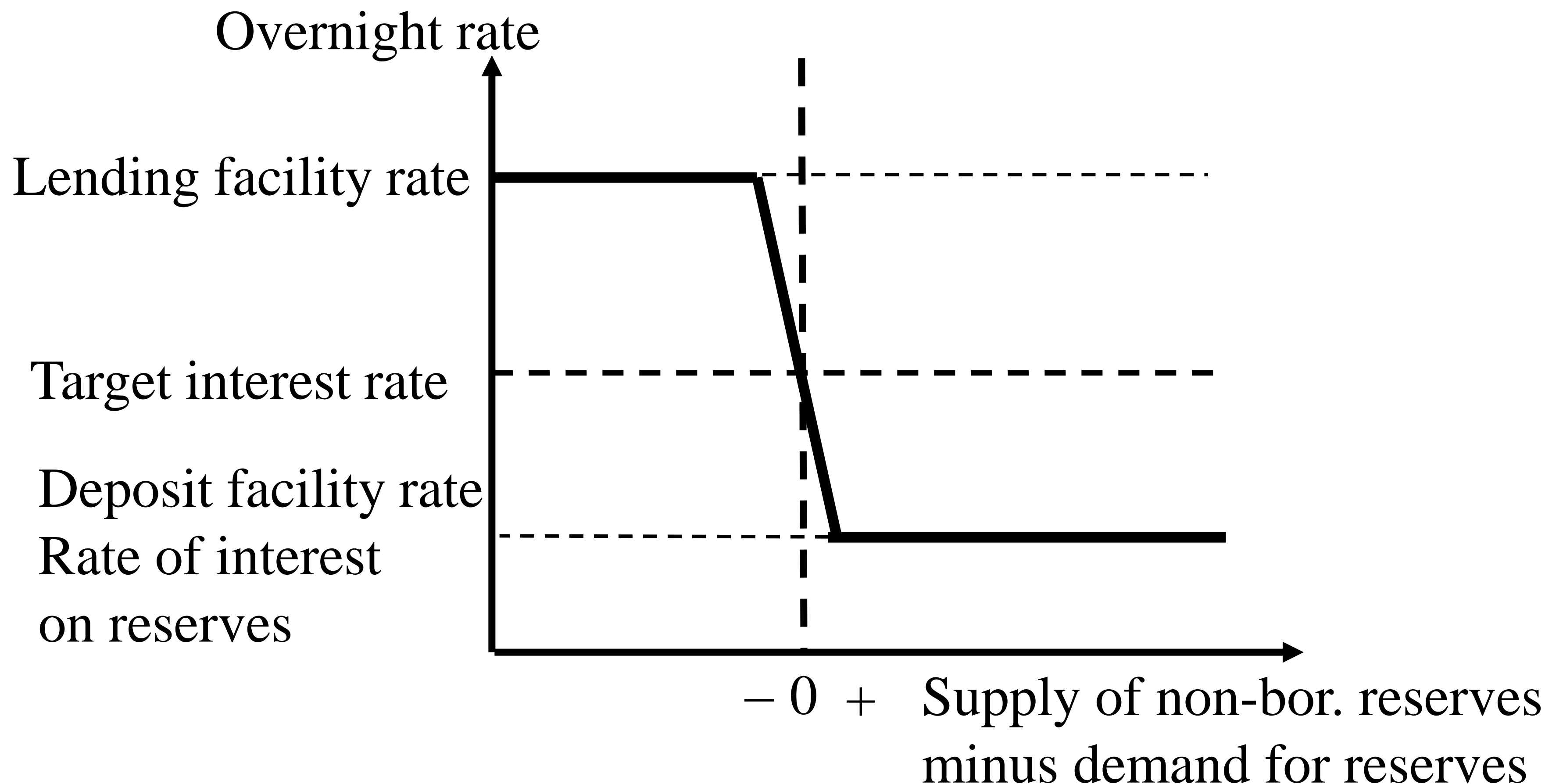
The natural rate of interest?

- Before the crisis, the long-term rate of interest was deemed to be a good proxy of the (nominal) natural rate of interest.
- It was said that a central bank should align its administratively-determined short-term rate to this long-term rate.
- During the crisis, the long-term interest rate shot up; but at the same time (some) economists were arguing that the natural rate of interest had become negative.
- There was a clear contradiction here.
- From a pedagogical point of view, it is clear that we can no longer speak of **the** rate of interest.

Endogenous money

- Post-Keynesians have been arguing for decades that the money supply is endogenous and demand-determined.
- New Consensus models (New neoclassical synthesis) also implicitly endorsed the notion of a demand-led endogenous money supply.
- But the implications of endogenous money were not fully understood.
- The central bank essentially pursues defensive operations, trying to adjust the supply of reserves to the demand for reserves.

The corridor system: a defensive central bank with decoupled interest rates



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The money multiplier?

- Textbooks are still filled with money multiplier stories (reserves at the central bank cause bank lending and the creation of money deposits).
- This is a case of inverse causation: if any relationship exists, it is that of a credit divisor.
- ‘You can’t push on a string’.
- ‘Governments can no more “control” stocks of either bank money or cash than a gardener can control the direction of a hosepipe by grabbing at the water jet’ (Godley, 1996)

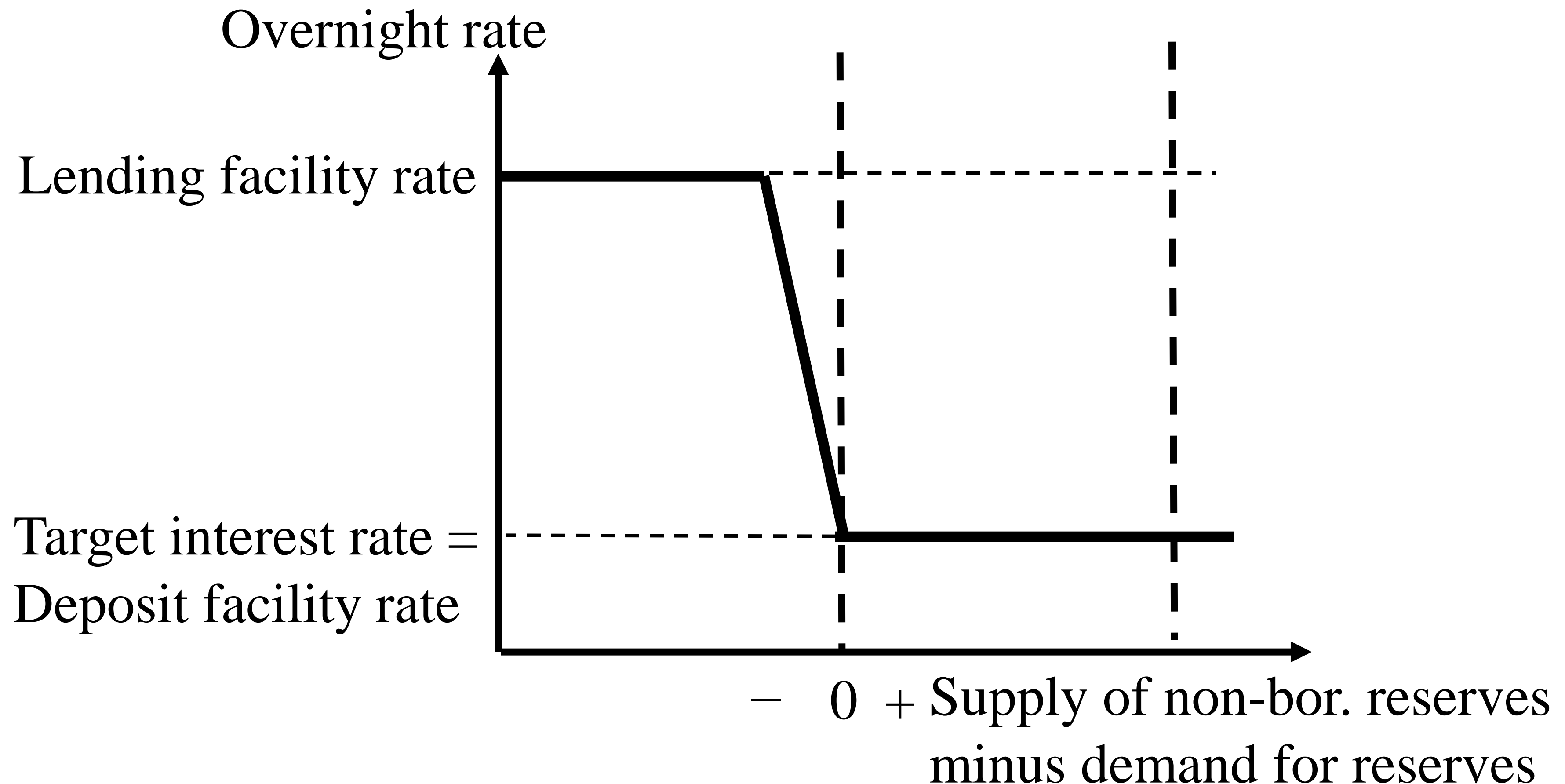
Even the Bank of England agrees!

- ‘Another common misconception is that the central bank determines the quantity of loans and deposits in the economy by controlling the quantity of central bank money – the so-called “money multiplier” approach’. (McLeay et al. 2014: 2)

The money multiplier II

- The crisis has clearly shown that the money multiplier story is false and meaningless (‘not even wrong’!).
- With credit easing and quantitative easing policies, there is no relationship any more between bank reserves and bank loans or bank deposits.
- Indeed, in the USA, the money multiplier is now below one.
- This is due to the adoption of the floor system.

The floor system: a central bank free to pursue quantitative easing while fixing interest rates



Non-conventional monetary policies

- The world of monetary policy is upside down.
- Conventional monetary policy is now interest-rate targeting, as it was at the time of Wicksell and of the Radcliffe committee, and before the advent of Monetarism and Milton Friedman.
- Unconventional monetary policy is now (mostly) quantitative targets.
- Monetary targeting in the 1970s-1980s was used to **reduce** the inflation rate; now it is used to **increase** the inflation rate or the expected inflation rate!

Quantitative easing (QE)

- There is a contradiction.
- Monetary authorities pursue QE because they wish to increase the expected rate of inflation, so as to lower the real interest rate.
- But central bankers are at the same time trying to persuade financial markets that QE can be reversed in the future, so that an inflated balance sheet of the central bank does not mean high future inflation rates, so as to stop long-term interest rates from rising.

Quantitative easing II

- At best, quantitative easing, as pursued, helps to sustain security prices and stock market prices, and may help to depreciate the domestic currency.
- At worse, QE has no effect on output and employment. Those who sell their assets to the central bank use the money to deleverage, paying down their loans.

Excess reserves

- There is a lot of confusion about these.
- Many economists believe that commercial banks refuse to make loans because they are getting interest payments on their reserves at the central bank.
- They don’t seem to understand that in a floor system, the central bank is able to set the amount of excess reserves in the system at whatever level it wants.
- The banks could be making billions of loans and still the central bank could keep excess reserves where they are.

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Repeat After Me: Banks Cannot And Do Not "Lend Out" Reserves

Implications

- Monetary policy has limits.
- The role and power of monetary policy has been exaggerated.
- The role and power of fiscal policy has been overly minimized.
- There needs to be a new emphasis on fiscal policy.

MACROECONOMIC THEORY

The NAIRU

- It was believed that unemployment rates in the US were lower than elsewhere because their labour market was more flexible.
- Now it is realized that unemployment rates are high because aggregate demand is low.
- There is now lots of evidence showing that labour rigidities help employment performance.
- The OECD – the champion of labour flexibility – is now backtracking on its claims and on its systematic calls for labour market reforms.
- There is no such thing as a NAIRU, as became obvious even before the crisis.

Hysteresis and potential output

- Right after the 2008-2009 crisis, all estimates of potential output or growth rates of potential output took a dive.
- This shows that aggregate demand has an impact on potential output. There is hysteresis. The economy is path-dependent.
- This also generates questions about inflation-targeting policies.
- It was claimed that restrictive monetary policies were good because by producing short-term recessions they would generate lower inflation rates and more efficiency, thus achieving higher output per capita; it was always denied that the short-term recession could generate lower long-run potential outputs.

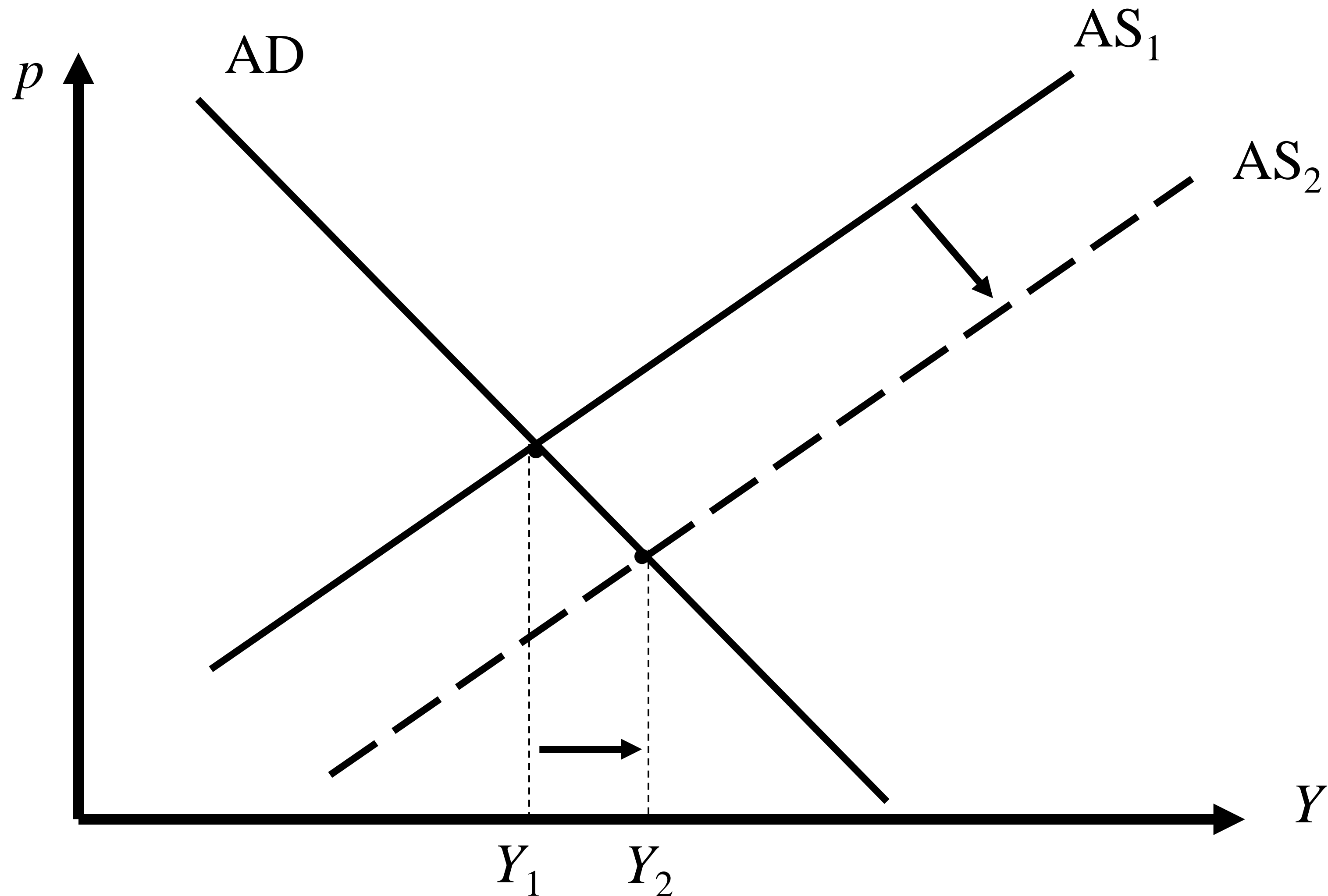
Income equality and efficiency

- It used to be believed that there was a tradeoff between equality and efficiency (Okun)
- There is now the realization that greater income inequality may have helped to generate the global financial crisis.
- There is some empirical evidence that greater income equality actually helps economic performance.
- There is also some evidence that domestic demand is wage-led in all G-20 and Eurozone countries.

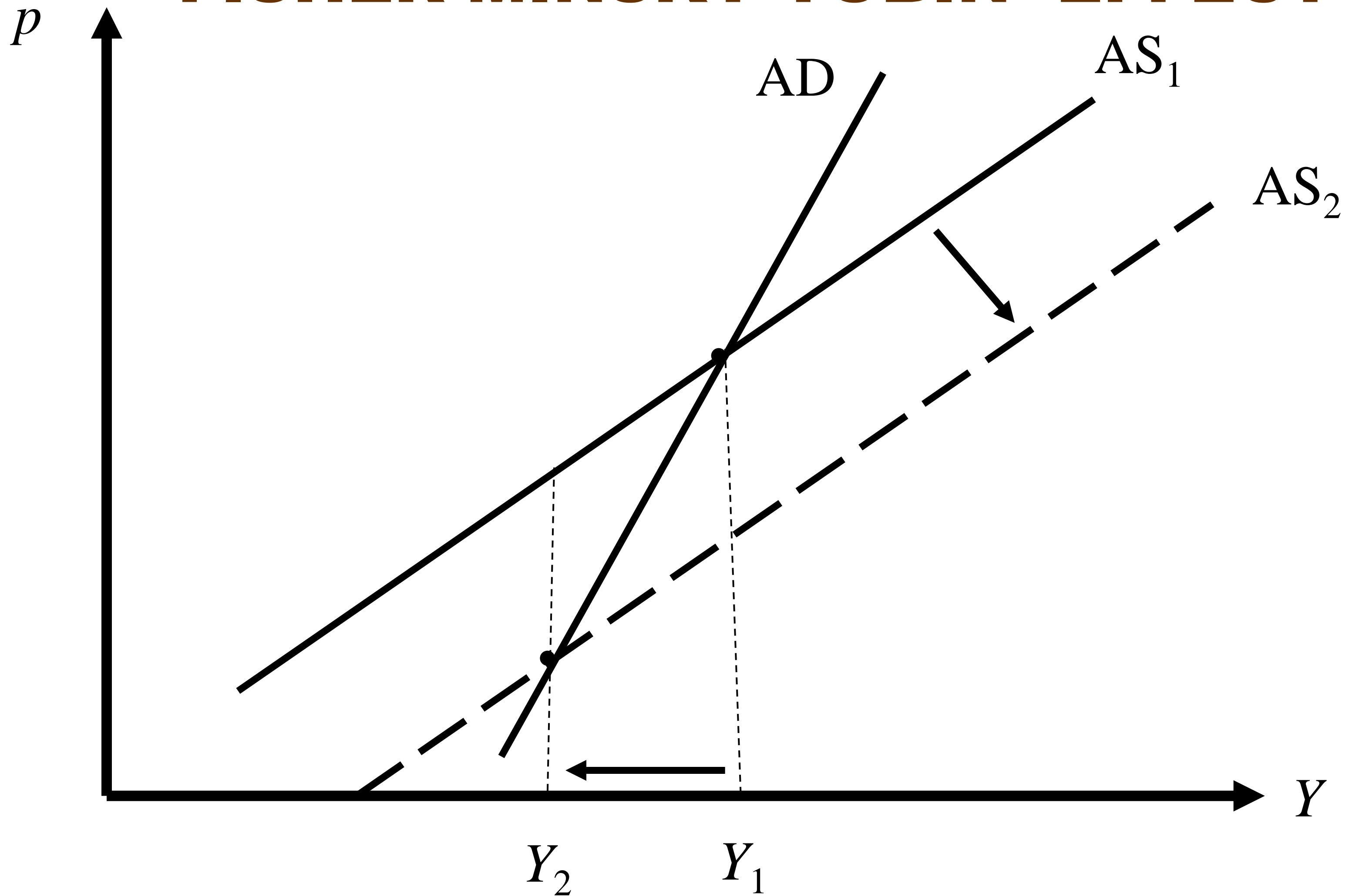
The slope of aggregate demand

- The desperate efforts of central bankers to stop prices from falling has clearly shown that central bankers do not believe that the aggregate demand curve has the standard negative slope.
- Falling wages and prices do not lead to higher output levels.

Mainstream view of falling wage rates



FISHER-MINSKY-TOBIN EFFECT



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The natural interest rate again

- The other justification for the upward-sloping aggregate demand curve, with the inflation rate on the vertical axis, is that the natural rate of interest, due to some negative shock such as a financial crisis, can become highly negative, and that with the zero-lower bound and near-zero inflation, real rates of interest cannot be made negative enough.
- This new New Consensus story (Roemer, Krugman), is no different from the one told by Don Patinkin in the AER, back in 1948: the investment and the full-employment saving functions were said to equate each other at a negative interest rate.
- As the French say, 'plus ça change, plus c'est pareil'!

The income multiplier

- Over the last decades it has been claimed by mainstream economists that the government expenditure multiplier is weak or near zero.
- This arises from the assumption that higher public deficits entail higher interest rates.
- It has been recognized by the IMF (Blanchard) and others (Summers and DeLong) that the multiplier is much higher than previously thought.
- This means that fiscal austerity policies, in particular reductions in government expenditure, have a much greater negative impact on the economy than previously assessed.

Public deficits and interest rates

- In the past, econometric evidence relating public deficits or public debt to high interest rates has always been very weak.
- During the crisis, several countries have encountered large deficits and large public debt to GDP ratios while both their short-term and long-term interest rates have remained low (Japan, USA, UK).
- The existence of a general positive relationship between public deficit or public debt to GDP ratios and nominal or real interest rates (found in the IS-LM model or in the New Consensus model) must thus be relegated to the dustbin.

Sovereign debt and defaults

- Still, some countries (of the eurozone) have suffered from high interest rates during the crisis, when faced with rising debt and large current account deficits.
- These high interest rates arose mainly from the financial market fears of sovereign default.
- There is now a growing recognition that countries that have their own currency and that borrow in their own currency run no risk of insolvency and of default (Krugman, Oct. 2013; De Grauwe; Kregel).

Conclusion

- The crisis has led to the reconsideration of many dogma in macroeconomic and monetary theory.
- Some believe that mainstream economics holds under normal conditions (the yang phase), but that it needs to be modified under zero-lower bound conditions or during balance sheet recessions (Koo's yin phase).
- My belief is that the global financial crisis was caused by policies based on erroneous mainstream macroeconomic theories.
- Macroeconomic theory needs to be revised both for the yang and the yin phases.