Economic Policies after the New Consensus Macroeconomics

Philip Arestis

Cambridge Centre for Economic and Public Policy, Department of Land Economy, University of Cambridge

Presentation

1. Introduction
2. Theoretical Background
3. Economic Policies
4. Summary and Conclusions

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3. Economic Policies

4. Summary and Conclusions

Introduction

- The New Consensus Macroeconomics (NCM was heavily criticized at last year’s conference along with its policy implications;
- The purpose of this contribution is to discuss potential economic policies that should replace the NCM ones;
- Clearly, macroeconomic policy formulation is heavily conditioned by the underlying theoretical framework that should underpin them;
- We, thus, begin with the essential elements of such a theoretical framework.

Presentation

1. Introduction

2. Theoretical Background

3. Economic Policies

4. Summary and Conclusions

Theoretical Background

- The overall focus of macroeconomic analysis should be: sustainable and equitable economic development and growth;
- The objective of economic policy should be: full employment of the labour force;
- Achieving such objective requires the maintenance of a high level of aggregate demand and sufficient productive capacity.

Theoretical Background

- The general background to the theoretical framework is that the analysis is of a monetary production economy in which finance and credit play a significant role.
- It relates to an economy which has degrees of instability in the sense of being subject to the ups and downs of the business cycle and prone to crisis.

Theoretical Background

- It draws on the following main elements:
- Demand-side of the Economy: this relates to expenditure, income and employment;
- The level of economic activity is set by aggregate demand;
- No market-based mechanism exists to propel the level of aggregate demand to any specific level of output;

Theoretical Background

- Supply-side of the Economy: this is viewed in terms of the interaction between production decisions of firms in the light of the (expected) level of aggregate demand and the consequent decisions on employment and the relationship between prices and wages, and their setting;
- Aggregate demand has a dual role in this model: it is a relative volatile component; and it is also a creator of productive potential;
- This establishes interdependence of demand and supply, which is closely related to path dependency.

Theoretical Background

- Inflationary Process: inflation is viewed as multi-causal and the sources of inflationary pressure vary over time and economy.
- The range of factors, which impact on the rate of inflation, includes a struggle over income shares, the level of and rate of change of the level of aggregate demand and cost-push factors emanating notably from the foreign sector (change in import prices and the exchange rate);

Theoretical Background

- Money, Credit and Finance: Money is endogenously created within the private sector with loans created by banks generating bank deposits. The central bank sets the key policy interest rate, which governs the terms upon which the central bank provides the ‘base’ money to the banking system;
- Foreign Sector: a relevant and significant aspect of this element is that imports and exports are included in the aggregate demand equation, reflecting the effects on demand (and hence employment) of variations in the exchange rate.

Theoretical Background

- Cycles and Fluctuations in Economic Activity: fluctuations in economic activity (cycles, ‘boom and bust’) occur frequently and full employment is at best a rather infrequent occurrence.
- Changes in economic activity impact the rate of change of prices and wages, and consequent changes in the distribution of income between wages and profits.
- Changes in the distribution of income have effects on the level of aggregate demand, with the nature of the effects depending on whether there is a wage-led or a profit-led regime. These interactions can also help to generate cycles.

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4. Summary and Conclusions

Economic Policies

- Objectives of economic policy:
- Full employment of the available labour supply;
- Constant rate of inflation rather than target inflation (evidence shows that inflation and output move together up to around 10%-15% inflation rate);
- Financial stability;
- Instruments of economic policy follow from this way of thinking about the economy:

Economic Policies

- Fiscal policy is paramount both in the short run and in the long-run;
- In the short run, variations in the fiscal stance can be used in conjunction with automatic stabilisers to offset fluctuations in economic activity;
- In the long run, the general fiscal stance should be set to underpin the desired level of output and employment;
- A budget deficit (including interest payments), which bears a constant relationship with GDP, is always sustainable. In fact, it leads to a debt ratio equal to the deficit ratio divided by the nominal growth;

Economic Policies

- Interest rate policy should be set so that the real rate of interest is as low as possible in line with the trend rate of growth;
- This of course may be constrained by world levels of interest rates;
- Most important, though, the operation of the central bank should ultimately be directed towards financial stability and this objective of financial stability should be placed as the most significant one for the Central Bank;
- This requires the development of alternative policy instruments alongside the downgrading of interest rate policy and of any notion of inflation targeting;

Economic Policies

- Financial stability should entail two types of toolkits, both under the banner of the policy makers avoiding rules and employing judgement and thus discretion;
- The macroprudential toolkit, which should account for the failures of the system: low levels of liquid assets; inadequate levels of capital with which to absorb losses; too big a financial sector; too leveraged with high risks to the taxpayer and the economy;
- Thus, macroprudential financial instruments should be able to control the size, leverage, fragility and risk of the financial system;
- Microprudential instruments relate to the structure and regulation of individual banks;

Economic Policies

- Evidence suggests that under fiscal and monetary policy coordination fiscal multipliers are higher than when no policy coordination prevails (even bigger than the Keynesian ones);
- This is possible so long as the fiscal and monetary authority have a common objective, for example maximization of social welfare;
- Industrial and regional policies are required to ensure that supply constraints are not present. Public expenditure, particularly investment, can also be structured to ease supply constraints. There is often a mismatch between available productive capacity and the labour force and its geographical distribution; higher levels of employment require more productive capacity.

Economic Policies

- Exchange rate policy is also important. Changes in the exchange rate affect the domestic economy primarily in terms of the level of demand and inflation.
- Intervention by the central bank in the foreign exchange market with the specific aim to stabilise the exchange rate is important in this respect;
- There is the need to develop an inflation policy. Such approach involves the development of an incomes policy to maintain low inflation.

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2. Theoretical Background

3. Economic Policies

4. Summary and Conclusions

Summary and Conclusions

- The alternative perspective advanced here can be summarised as:
- use fiscal policy in the short term and in the long term to address demand issues;
- use regional and industrial policies to create the required capacity;
- Central bank intervention in the foreign exchange market is necessary to control the exchange rate;
- and to develop incomes policy to maintain low inflation.