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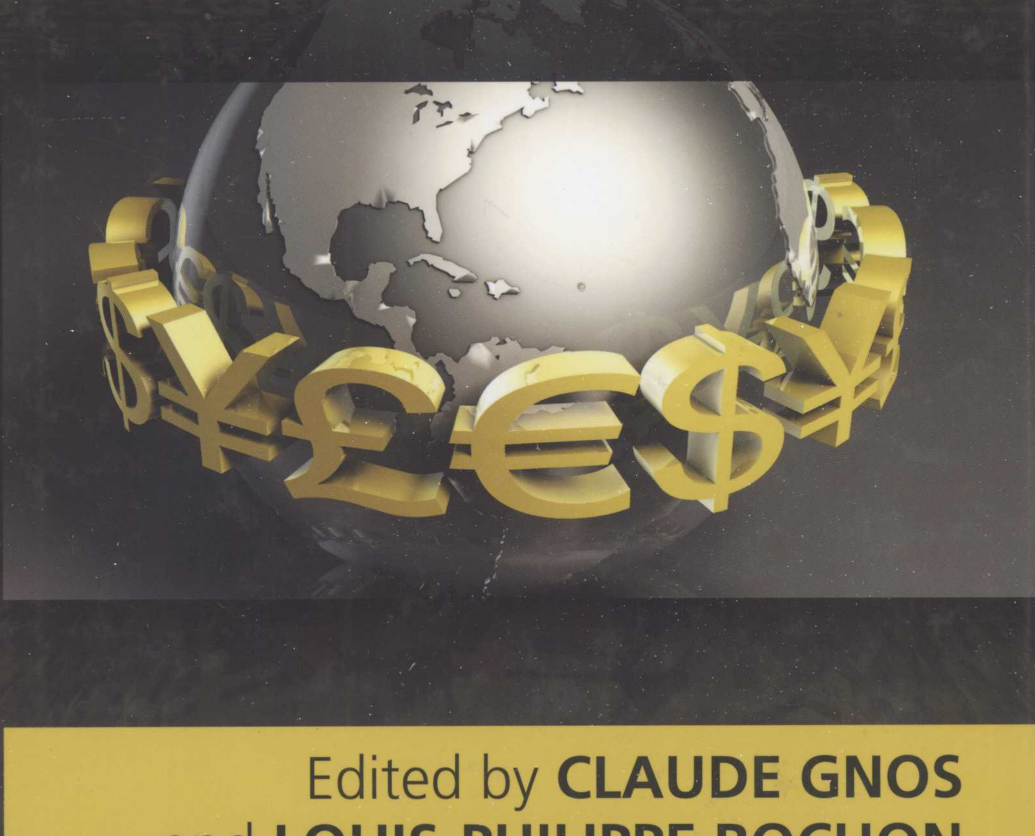
CREDIT, MONEY AND MACROECONOMIC POLICY

A Post-Keynesian Approach



Edited by **CLAUDE GNOS**
and **LOUIS-PHILIPPE ROCHON**

Credit, Money and Macroeconomic Policy

A Post-Keynesian Approach

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NEW DIRECTIONS IN MODERN ECONOMICS

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010930114

MIX
Paper from
responsible sources
FSC® C018575
FSC
www.fsc.org

ISBN 978 1 84844 067 8

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

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Contents

PART III MONETARY POLICY UNDER THE BASEL II ACCORD

PART IV INFLATION TARGETING, NEW CONSENSUS MACROECONOMICS AND MACROECONOMIC POLICY

Introduction: Keynes, Crisis and Macroeconomic Policy

Claude Gnos and Louis-Philippe Rochon

The financial crisis that has gripped the United States and the rest of the world has given all economists, especially those in North America, pause for reflection. What started as a crisis in the sub-prime mortgage sector has now spread, and has become an overall, generalized, worldwide economic crisis. And there is much to reflect on: what were the specific causes of this crisis, how severe was it, are we in danger of a second crisis, and how deep are the needed reforms and regulations? Of course, we also need to ask whether reforms are indeed the panacea that many believe that they are. We doubt that they will be sufficient to stem the possibility of a future crisis. Indeed, policy makers fail to understand that while reforms are certainly a welcome step, they do not address some of the more fundamental problems with how our market economies have evolved over the last 25 years. So while reforms are perhaps necessary, they are not sufficient.

The causes of – and lessons from – this crisis will dominate the economic discourse for years and possibly decades to come. Indeed, our journals will publish countless articles on the crisis, in particular on its possible causes and triggers, not to mention articles on the merits and success of the stimulus package. Did we spend enough? Did we spend in key areas, and is there a need for a second round of stimulus spending?

Articles will dissect the crisis and try to identify 'the' cause or 'the' triggering point, although it will certainly prove to be a difficult task, as the causes are multiple and complex. Moreover, post-Keynesians will be busy arguing whether this was a 'Minsky moment' or not, although there is little evidence that it was.

Nevertheless, there will be discussion and disagreements over the causes of this crisis, and inevitably, economists will align largely along all too familiar theoretical (and ideological) lines. Post-Keynesians will argue that at the root lies an economic crisis, the result of some long-brewing circumstances, such as market-friendly policies, deregulated markets, perverse income distribution, bad fiscal and monetary policies and flawed institutions. In this sense, the current crisis must be placed within a wider macroeconomic context: the transformation of our macroeconomic regime from a production-based economy to a finance-dominated regime with a polarized income distribution and its effect on output and growth.

Indeed, over the last 25 years or so, some deep-rooted changes have taken place that have fundamentally changed the overall macroeconomic framework. Financialization, a growing area of interest for post-Keynesians and heterodox economists in general in the last few years, is characterized notably by the increasing importance of the financial sector, over the more traditional industrial sector. As Baragar and Seccareccia (2008, p. 61) observe, we have moved away from a 'Keynesian form of industrial capitalism, where finance was regulated . . . and subordinated to productive industrial activity, to a predatory finance capitalism, where casino-type activities have become the norm'.

The rise of this 'new capitalism' can be traced to the aftermath of the stagflation of the 1970s, facilitated by a new thinking in economic theory. The rise of free-market thinking and Chicago economics have given theoretical credence to much that has happened since: high interest rates, fiscal prudence, deregulated markets, both nationally and internationally, and other such market-friendly policies, as epitomized by the Washington Consensus.

The transformations that have ensued have had pronounced implications for economic growth. In comparing the pre- and the post-inflationary period of the 1970s, we notice important changes in virtually all major indicators. But most importantly, we observe changes in the way our economies operate. As we move away from an economy of production to a casino type of capitalism, the role of banks, which are at the heart of the circuit approach, has changed dramatically. In fact, the same can be said about households and firms: in many ways, the roles and behaviour of each macro group at the heart of the circuit have been transformed, leading to a more fragile and unsustainable system.

In many ways, the description of the economy provided by the monetary circuit, say as developed by Augusto Graziani and Alain Parguez, for instance, seem no longer to be applicable to the casino-type capitalism of the pre-crisis. But this is precisely the problem and the source of the crisis: we have witnessed institutional developments that essentially clash with the way an economy is supposed to operate, such that it became fragile and unsustainable. The result, all too familiar, was the need to bail out our institutions, and the many cries for reform.

And this is why the monetary circuit theory is perfectly suited to analysing the crisis by offering a systematic macroeconomic analysis that also incorporates institutional features, and an approach centred on the existence of macro groups. In such an analysis, problems arise essentially out of effective demand constraints, in a very Keynesian way. First, there can be a lack of credit to finance production, which translates into a decline in investment. It can also arise from the inability of firms to pay back their initial debt, usually from households and workers who are keen to retain a greater part of their savings. This is the problem of the closure of the circuit. It carries many implications, which are too numerous to discuss here. Nevertheless, it leads directly to a strong argument in favour of fiscal policy and deficits to accommodate the lack of demand from the private sector and from households.

But the crucial element in this analysis is the role of financial markets: finance is subservient to the needs of production. Its role was limited essentially to trying to capture households' hoarded savings on behalf of firms, through the emission of assets. But it is precisely the morphing of financial markets in recent years, the process of financialization, that has jeopardized the well-being of markets and the dynamics of the monetary circuit. Post-Keynesians have been warning and writing about the excesses of such a new capitalism for several years now, and have identified this as a cause for concern.

Mainstream economists, on the other hand, fall back on more traditional explanations, with no consideration for institutional details. In fact, a rewriting of the causes of the crisis has already begun. For instance, some will blame the crisis simply on the inability of market players to properly assess risk, given that it is a difficult and complex task, especially with the creation of new financial instruments in recent years. If we had had better methods of calculating risk, this mess would certainly have been avoided. Thus, the long period of economic growth and prosperity, coupled with low interest rates, encouraged agents to pursue increasingly risky assets, improperly assessed.

Provided that we possess the proper tools to evaluate risk, we would be able to eliminate – or at least greatly diminish – the possibility of a crisis. Reforms therefore must hinge on a better understanding of risk and a greater flow of information (greater transparency). The conclusion is clear: the crisis is reduced to a mere imperfection.

Post-Keynesians would certainly agree that greater transparency may have stymied the extent of the crisis. Certainly, the role played by credit agencies in rating various assets played a significant role. Yet post-Keynesians would also argue that at the root of this financial crisis is an economic crisis, some two decades in the making, along with some deep-rooted changes in finance.

A surprising aspect of this crisis, moreover, is the renewed interest in John Maynard Keynes. Indeed, there seems to have been something of a Keynesian revival: it would certainly appear that fiscal largess and low interest rates are the policy prescriptions *du jour*, and everyone is now referring to Keynes to justify large-scale fiscal stimulus packages. Of course, the severe nature of this crisis, which many have labelled the 'Great Recession', has prompted some interesting comparisons with the Great Depression. Such a parallel makes Keynes a natural source of inspiration.

Interestingly enough, however, it now appears that everyone has become an expert on Keynes, and our daily newspapers are simply littered with newly-anointed Keynesians writing on the need to stimulate the economy with fiscal expenditures.

Moreover, it appears that even central banks are jumping on the Keynesian bandwagon, and appear to have espoused Keynes's idea of the 'euthanasia of the rentier' by setting and keeping interest rates at record lows – in fact to effectively zero in the US and Canada. Moreover, Mark Carney, the Governor of the Bank of Canada, even went so far recently as to remind us of Keynes's warning about the paradox of thrift!

Therefore this 'perfect storm' would seem to be the perfect opportunity for post-Keynesians to claim their rightful place at the head of policy advisory tables across the world, and to make a lasting imprint on the policy process. And while there are some encouraging signs already, history could simply repeat itself and the revolution will once again be aborted. This may happen once the economy grows again and the fear of economic collapse recedes.

While Keynesian policies are all the rage, this does not mean that we are all Keynesians. It appears that the ultimate synthesis now seems to be that some version of Keynesian policies works during a recession, but that we need to revert back to mainstream neoclassical policies during the expansionary phase of the cycle. The paradox of thrift seems to apply only in recessions. This bizarre conclusion is difficult to comprehend: savings are bad in recession but necessary in an expansion!

For post-Keynesians, of course, this born-again Keynesianism is perhaps welcomed on one level, but on another, it merely masks the true causes of this crisis. Indeed, if economists go back to advocating neoclassical and mainstream policies once the recession is over, we are simply bound to repeat these crises. Certainly, for the last 25 years, coinciding with the so-called 'financialization' of the economy, crises seem to have been here to stay, and we are simply moving from one crisis to another.

Are the causes of this crisis strictly financial or are they the result of some bad macroeconomic policies? Post-Keynesians would argue that bad policies, such as the lifting of regulations and high interest rate policies, among other policies inspired by neo-liberal and globalization ideologies, contributed to the actual crisis. In this context, therefore, post-Keynesians must continue their work in developing policies appropriate for a monetary economy of production. It is becoming increasingly clear that post-Keynesians are following the proper route with their emphasis on endogenous money and demand-led growth.

The purpose of this book is not to discuss the financial crisis exclusively, at least not directly, although some chapters do so. However, the crisis looms over many of the chapters. Indeed, one question is whether it is in fact a financial crisis, or whether it is the result of bad economic policies. In this sense, post-Keynesian economic policies are relevant to discussing the aftermath of the crisis.

STRUCTURE OF THE BOOK

The book is divided into four parts. In Part I, Riccardo Bellofiore and Joseph Halevi (Chapter 1), Robert Dimand (Chapter 2) and Robert Guttmann (Chapter 3), all deal with the current financial crisis. In the opening chapter, Bellofiore and Halevi argue that it would be difficult and even impossible to understand today's capitalism and what has been happening in the European Union outside a global macroeconomic framework, which includes the United States and Asia. The recent subprime crisis that erupted during the Summer of 2007, and which spread throughout the world financial markets, seems to confirm some of the authors' earlier interpretations based on the 'trinity' of: traumatized workers, indebted consumers and manic-depressive savers. They further argue that these aspects must in turn be set in the context of the policies pursued in the present regime of financialized capitalism where labour itself is subsumed under finance and debt. They then elucidate the mechanism of investing by asset stripping through leveraged buyout operations. The chapter begins with a reasoned historical account of the subprime crisis, and then raises the issue of the 'Minsky moment' and how it can be placed in the present context.

Dimand, in Chapter 2, argues that the credit crunch of August 2007 in markets for collateralized debt obligations (CDOs), which provoked large-scale central bank interventions, abruptly renewed interest in a historical parallel: the debt-deflation process that followed the Wall Street crash of 1929, which once again undermined confidence that the growth of new debt instruments assures the stability of global financial markets. The author argues that after Minsky and Tobin, and renewed interest in Fisher's 'Debt-Deflation Theory of Great Depressions' and in Chapter 19 of Keynes's *General Theory*, this line of analysis was taken up by Mervyn King in his 1994 European Economic Association presidential address on 'Debt Deflation' and by Ben Bernanke, in his *Essays on the Great Depression* (2000). The author argues that as chairman of the Federal

Reserve Board and Governor of the Bank of England, respectively, both Bernanke and King face a situation with some apparent parallels to the boom and crisis of the late 1920s. The author wonders what lessons Bernanke and King learned, and what lessons could they have learned, from the historical experience of the 1920s and 1930s and from what Keynes and Fisher wrote about the fragility of financial markets and how central banks should act during booms and crises.

In Chapter 3, Guttmann writes that while it is still too early to tell where the global credit crunch of 2007 will lead us, this latest financial crisis is well worth analysing. An acute crisis, with its ruptures, ripples and shifts across time and space, reveals qualitative aspects of the system's modus operandi usually hidden under the veil of normalcy. Any closer look at what has transpired so far may well show this to have been the first systemic crisis of a new finance-led accumulation regime, and as such an important stress test for an entire infrastructure of financial markets underpinning this regime.

Part II deals with monetary policy and policy rules, both monetary and fiscal. For instance, in Chapter 4, Theodore Koutsobinas assesses the potential for fiscal policy rules. He begins by outlining the post-Keynesian critique regarding the 'new consensus', and then highlights and contrasts the differences between those who wish to improve the existing framework of monetary policy, with those who de-emphasize monetary policy in favour of a fiscal policy rule. Regarding the latter, the author identifies certain mainstream suggestions that are of common interest to post-Keynesians. In this context, the evidence regarding Japan's 'lost decade' is analysed, with significant implications for the use of fiscal policy. Finally, the author discusses a framework that links sound finance principles with policies of economic growth.

In Chapter 5, Alain Parguez sets out to test empirically some central elements of the monetary circuit, on which he has written for the last 40 years or so. In his contribution, he sets out to explain the leading role of consumption as an exogenous variable, the perfect passive role of investment, and the exogenous nature of public expenditures, all within the context of endogenous money. In this case, he also shows how the state is not constrained by taxes, and the now obvious fully negative role of thriftiness. Such an increasing empirical support strengthens the core propositions of the monetary circuit: without a long-run full-employment policy, sustaining the growth of consumption and state expenditures, unemployment will rule. There are no constraints on the state: the only way to generate true price stability is to target full employment. Finally, he argues that there are no true foreign constraints and there is no trade-off between inflation and employment.