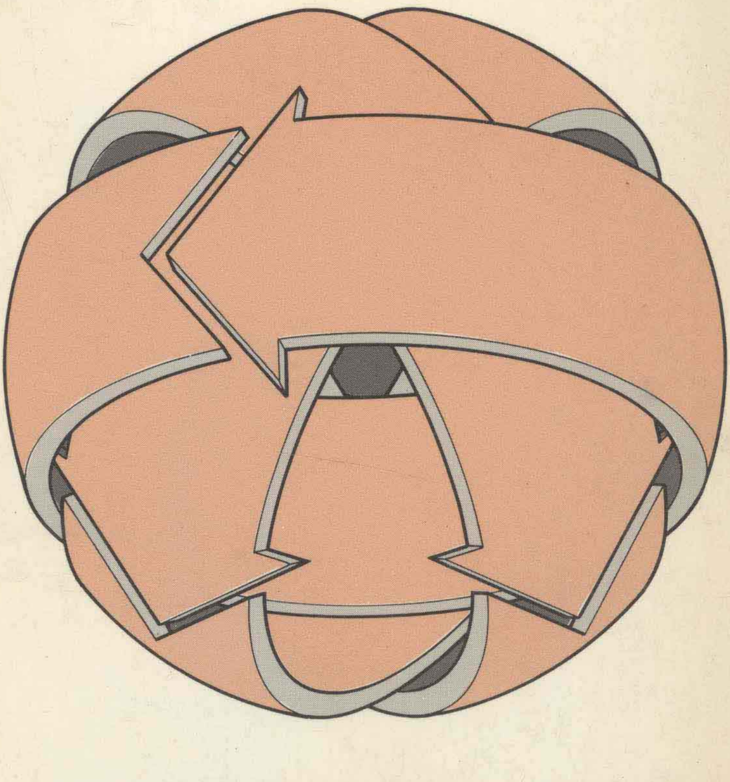
Macroeconomic Policy

The New Cambridge, Keynesian and Monetarist Controversies

Keith Cuthbertson



MACMILLAN NEW STUDIES IN ECONOMICS

MACROECONOMIC POLICY

THE NEW CAMBRIDGE, KEYNESIAN AND MONETARIST CONTROVERSIES

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Preface

Any new textbook worthy of consideration should aim to fill a gap in the market, if only in an attempt to maximise the author's expected remuneration. A large number of undergraduate macroeconomics texts devote considerable space to an analysis of the theoretical aspects of individual behavioural equations in the economy such as the consumption, investment and demand for money functions but spend little time in drawing out the detailed workings and quantitative policy implications of the complete models implied by these behavioural equations. At the other end of the spectrum numerous texts present a purely verbal account of the macroeconomic policy implications of various schools of thought without an adequate analysis of the crucial behavioural relations that underly such views. It is the aim of this text to bridge this gap and by so doing to assess the ability of three main alternative schools of thought in explaining and forecasting the behaviour of industrialised economies, particularly the U.K. economy. Essentially, then, the book is best viewed as an introduction to the use of models in empirical macroeconomic analysis and policy-making.

The book is aimed primarily at second- and third-year students doing either an economics degree or general social science degrees (such as business studies, marketing, or politics) which include economics as a major area of study. With its emphasis on macroeconomic policy debates it would seem to be a fairly comprehensive and useful macroeconomics text for this latter group as well as for professional economists in industry, teaching and the public sector who may wish to 'brush up' their knowledge in this area.

It is assumed that the reader is familiar with the simple Keynesian expenditure model and the behavioural equations that underlie it. An elementary knowledge of money-supply determination and the demand for money function would be an advantage. Mathematics and statistics are kept to a minimum. However, as a feature of the book is its emphasis on the need for quantitative results, a knowledge of elementary algebra and also an ability to interpret simple regression statistics would be helpful. For those readers who are deficient in these areas, Appendix 1 provides a brief overview of some of the techniques required.

Potentially the subject-matter of a book such as this is voluminous, embracing as it does elements of macroeconomic and monetary theory, the theory of macroeconomic policy, econometrics and an assessment of recent policy measures. No doubt there is a reasonable consensus amongst professional economists on what ought to appear in a textbook dealing with any one of these subject areas. However, in a 'hybrid' text such as this it is exceedingly difficult to decide on a reasonable balance both between and within these diverse subject areas and economists who specialise in one or other of these areas are bound to argue that some topic should have been treated in greater depth, or perhaps not included at all. Bearing in mind the aims of this text and its intended readership, it would therefore seem useful if I explain briefly the general principles that governed my choice of the appropriate balance between the economic theory of individual behaviour equations, an assessment of their empirical results, the behaviour of complete models and an analysis of recent policy measures.

Central to the book is an analysis of the main ideas of three schools of thought on economic policy. I have sought to present a coherent account of these views by providing the reader with relevant material that is not covered adequately in existing macroeconomics textbooks and may sometimes only be found by searching through economics journals. At all stages I have tried to emphasise the policy implications of the subject-matter under discussion. This is partly because I believe that an important reason for studying macroeconomics is to assess the usefulness of alternative policy prescriptions and partly because I think this approach stimulates and maintains the interest of the reader. However, in pursuing this objective I have not considered it necessary to present a *detailed* account of recent economic policy measures; instead I have chosen to emphasise policy aspects by spending more time than do existing texts in analysing the quantitative results that one obtains using complete models of the economy. In general this book perhaps places more emphasis on the implications of empirical results, on individual behavioural equations, rather than on their theoretical underpinnings. Nevertheless, where the subject-matter is relatively new, or usually omitted from other texts, or where in my experience students find difficulty in understanding a topic, I have spent more time discussing theoretical aspects. The New Cambridge expenditure equation, rational expectations and international monetarist models probably fall under the first heading, and export prices and real wages under the second heading. Under the final heading I include the determination of the money supply. Here I have tried to introduce an element of portfolio choice into the simple bank multiplier and also tried to highlight the linkage between fiscal and monetary policy through the government budget constraint, though this has not been done in a full general-equilibrium approach as in the Blinder and Solow (1973) type of analysis. I have also tried to present a clear, albeit simple, account of the theory behind the price-expectations-augmented Phillips curve and the natural rate of unemployment. Similar considerations to the above were applied when deciding on the inclusion of detailed empirical evidence on individual behavioural equations. Representative rather than exhaustive references, as well as a list of selected reading at the end of the book, enable the interested reader to follow up these matters further.

Some readers might consider the omission of the set of topics which loosely come under the heading of 'the theory of macroeconomic policy' somewhat strange. While it is undoubtedly true that optimal stabilisation policy provides a useful approach to the conduct of macroeconomic policy under uncertainty, it is not dealt with here because it is mathematically too complex and its practical application to macroeconomic policy and forecasting is, as yet, in its infancy. The 'second-best' solution adopted here is to take account of such uncertainties in a more eclectic (albeit less rigorous) fashion. The deficiencies of the Mundell and Swann diagrams are well documented and their practical relevance is limited, and therefore these theoretical constructs are not discussed. Although it is widely used, the *IS–LM* diagrammatic approach to macroeconomic analysis also has well-known theoretical limitations and I have found that the average student seems to learn more about draughtsmanship than economics when using this approach. On this question I have compromised by alluding to the *IS–LM* diagrammatic approach but presenting the relevant analysis in algebraic form.

In extracting the central elements of the three main schools of thought on macroeconomic policy I hope that the selection process has not been unduly influenced by my own views and (necessarily) limited knowledge and experience. After completing the book I hope the reader agrees that the emphasis has been on those areas of analysis that have practical relevance, that he is more aware of the importance of other related areas of economics and that he is encouraged to study these problems further.

The structure of the book is outlined at the end of Chapter 1.

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The main weight of typing and retyping fell upon Jan Borders and Rita Leach, assisted by Pat Addison, Norma Phayer and Fran Robinson. My thanks to them all. Finally, I must apologise to my family for somewhat underestimating the time required to write this book. I hope my numerous absences and monomania of the last year are rectified in the future.

K. C.

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Contents

1
An Overview

Over the past few years most of the Western industrialised countries have experienced macroeconomic problems. Indeed some would claim that these problems are of crisis proportions. In a number of these countries there has been a high rate of inflation accompanied by a slow growth of output and high unemployment and this hitherto unprecedented state of affairs has been dubbed 'stagflation'. Also over this period there have been large imbalances in the current-account balance-of-payments position of these countries and this has been accompanied by large capital flows across the foreign-exchange markets causing sharp changes in exchange rates.

It is a widely accepted view that macroeconomic policy deals with the ways in which certain policy instruments such as government expenditure, the money supply and the exchange rate can be used to achieve certain desirable macroeconomic targets such as full employment, balance-of-payments equilibrium and a low rate of inflation. As indicated above, a number of industrial nations, most notably the United Kingdom, Italy, the United States and France have been in the unenviable position of achieving none of these targets. This poor macroeconomic performance has created a sense of urgency and also sharpened the debate amongst those who claim to have the answers to this crisis. In fact it is probably the case that at no other time since 1936, when Keynes's *General Theory* was published, have economists held such divergent opinions on the conduct of macroeconomic policy.

This text seeks to analyse the theoretical ideas and empirical evidence that lie behind the policy prescriptions of the main schools of thought in this debate. It is both difficult and dangerous to organise a large number of diverse and complex views concerning the conduct of macroeconomic policy into a small number of coherent groups. It is difficult because however we define the views of a particular group, not all the members of the group will hold exactly the same views; it is dangerous because there is a tendency on the part of the reader to see each school of thought as expressing views totally incompatible with any of the other groups. While noting these difficulties it nevertheless seems useful on both pedagogic and methodological grounds to group these diverse ideas into three *main* competing schools of thought, which we have classified as Keynesian, New Cambridge and Monetarist.

At this point it is worth mentioning a fourth group which we may classify as 'post-Keynesian'. We define post-Keynesianism as intermediary between Monetarism and Keynesianism. This school of thought is not dealt with directly; instead, for reasons of clarity of exposition as well as limitations on space, this is dealt with indirectly, mainly in Chapter 5, when a critical overview of alternative views on macroeconomic policy is presented. Similarly, a rather extreme monetarist view, which we have called 'rational expectations monetarism', is only briefly discussed in Chapters 4 and 5.

Broadly speaking the economic models that lie behind the three schools of thought can be used to analyse the macroeconomic behaviour of all developed industrial economies; however, in this text empirical evidence and policy prescriptions are discussed mainly with reference to the U.K. economy and to a lesser extent the U.S. economy.

In the remainder of this chapter we first present an overview of the structure and policy conclusions of the three schools. As the models which embody the ideas of these schools are fairly complex, this provides the reader with some basic reference points to guide him through the details of each model when these appear in Chapters 2, 3 and 4. Second, we give a brief account of the macroeconomic performance of the U.K. economy, together with an account of each school's interpretation of these events. Finally, we discuss the structure and philosophy that underlie this text.

KEYNESIAN VIEWS

Throughout the 1950s and early 1960s there was a broad consensus amongst economists on the type of model that best explained the workings of the economy; the centrepiece of this doctrine was the so-called 'income–expenditure model'. Naturally this view has undergone some modifications over the years but its main elements are still propounded by a large number of economists, particularly in the United Kingdom. Keynesian views, as expressed in this text, are closely associated with an important independent forecasting body in the United Kingdom, the National Institute of Economic and Social Research (N.I.E.S.R.). When, in Chapter 2, we present a detailed account of the structure of a Keynesian model we take the N.I.E.S.R. model as our example. Keynesian views are probably held by the U.K. Treasury and until quite recently were also held by another independent macroeconomic forecasting body, the London Graduate School of Business. Undoubtedly a large number of academic economists in the United Kingdom are also 'Keynesians'; Kahn and Posner deserve to be mentioned here as they were first to defend the Keynesian view against the attack by New Cambridge economists.[1]

While Keynesian models have been primarily used in forecasting and policy analysis over the short run, i.e. over a period of about six months to two years ahead, nevertheless they can and have been used in medium-term or long-run analysis, i.e. over a period up to ten years ahead.

In general terms the distinguishing characteristics of the Keynesian school are its belief in the primary of fiscal policy over monetary policy almost to the point where 'money does not matter', its adherence to the view that the exchange rate is an important policy instrument in achieving a balance-of-payments target and its view that incomes policy is important in helping to achieve an inflation target. Finally, Keynesians believe that it is possible to obtain a more stable macroeconomic environment if policy instruments are used in a discretionary manner by the authorities rather than being set according to some simple rules. Let us now consider some of these points in more detail.

Fiscal, Inflation and Exchange-rate Policy

In the Keynesian model fiscal policy influences output via the familiar multiplier process. Since employment and unemployment are primarily determined by output, fiscal policy instruments are a major weapon in achieving a particular employment target.

Prior to 1966 most Keynesians probably believed in the simple Phillips curve relationship whereby (in the absence of incomes policies) wage inflation was primarily influenced by excess demand in the labour market, as proxied by the level of unemployment. On the other hand prices were determined by a mark-up on unit costs, the major determinants of which include wage costs and import prices. Thus the authorities' main influence on the rate of wage and price inflation (given that import prices were largely outside its control) was via changes in fiscal policy acting on the level of unemployment. The pre-1966 Phillips curve for the United Kingdom indicated that this 'trade-off' between unemployment and inflation was not too severe. Also, a level of unemployment of about $2\frac{1}{2}$ per cent would ensure a zero rate of price inflation, assuming constant import prices and labour productivity rising at its long-run trend rate of growth of about $2\frac{1}{2}$ per cent p.a.

This simple Phillips curve relationship also played a prominent though indirect part in determining the balance-of-payments position (on current account). Since export and import volumes are in part determined by one's competitive position, then for the United Kingdom, if unemployment could be kept at about $2\frac{1}{2}$ per cent, U.K. prices would be competitive on world markets and the balance of payments close to equilibrium.

Hence in this early Keynesian world, tax rates (and to a less extent government expenditure) could be adjusted frequently in order to keep unemployment at a level to ensure low inflation and near balance-of-payments equilibrium. Further, if for some reason the balance of payments did move into fundamental disequilibrium, then this could be corrected by pegging the exchange rate at a new par value. For example, if the balance of payments were in deficit, then a *once-and-for-all* devaluation would secure a *permanent* improvement in the balance-of-payments position. In fact this was the policy advocated by Keynesians for the United Kingdom in the mid-1960s when the authorities' pursuit of a low level of unemployment had led (via the Phillips curve) to the United Kingdom pricing itself out of world markets, thus causing a payments deficit.

After 1966 there was one major change in Keynesian ideas. Keynesians no longer believed in a Phillips curve relationship whereby wage inflation could be *strongly* influenced by the level of excess demand or unemployment. Instead, they gradually came to support the view that wage inflation is primarily determined by some form of trade-union (T.U.) power or pushfulness. T.U. pushfulness operates independently of other macroeconomic variables and T.U.s use their bargaining strength to attempt to obtain wage increases in excess of past or expected future price increases and productivity. Thus fiscal policy becomes at most an ancillary policy instrument in fighting inflation and is superseded by some kind of long-term incomes policy.

As well as T.U. power, international events carry considerable weight in the Keynesian explanation of inflation, particularly in the period of the late 1960s and throughout the 1970s. This international transmission of inflation operates via changes in individual countries' import prices, which leads (via the price mark-up hypothesis) to changes in domestic prices and a wage–price spiral. The initial change in import prices may be caused by devaluations or revaluations of the domestic currency or by changes in world commodity prices.

Monetary and Credit Policies

We shall now present a summary of mainstream Keynesian ideas on the role of monetary and credit policies. The reader should note that this is a particularly difficult task since the individuals and institutions we have dubbed as holding Keynesian views do have somewhat divergent opinions in this area.

It is probably the case that up to about 1970 most Keynesians believed that at less than full employment, changes in the money supply had no effect on the level of output or the rate of inflation. In the 1960s and 1970s the Monetarist view, which emphasised the importance of the money supply as a policy instrument, gradually gained prominence amongst a number of economists in all industrialised countries. While it would be unfair to characterise the current Keynesian position on the rôle of the money supply as being as dogmatic as its earlier one, nevertheless it is the author's view that the groups we have classified as Keynesian still believe that the money supply has a negligible effect on output and prices; therefore, within very broad limits the rate of growth of the money supply is an unimportant policy instrument (as far as influencing these policy targets is concerned).[2]

It is also the case that Keynesians do not support fixed (or even flexible) targets for the rate of growth of the money supply. Such a policy, they believe, might lead to undesirable changes in the exchange rate or in the fiscal policy decisions of the authorities.

Thus although Keynesians would not disagree that a massive increase in the rate of growth of the money supply has some effect on output and the rate of inflation, nevertheless, over the range of experience that has or is likely to occur in the United Kingdom, the Keynesian position may still be characterised by the view that for all practical purposes 'money does not matter' (as far as influencing output and inflation is concerned).

Keynesians argue that large changes in interest rates may alter the level of investment in house-building, fixed investment and possibily stocks, but such effects are thought to be small and uncertain. Hence the interest rate is not used to alter the level of output; however, it is important in influencing the balance-of-payments position by altering the level of capital flows (in a fixed exchange-rate regime). Finally, changes in credit policy instruments such as the level of hire-purchase credit and bank advances to the personal sector are thought to have a strong predictable effect on the level of consumers' expenditure on durable goods, and Keynesians believe that the authorities should influence these magnitudes by directly imposed credit ceilings.

Rules versus Discretion

Keynesians believe in using policy instruments in a discretionary manner to influence the economy over the short run as well as the long run. Implicit in this view is the notion that without intervention by the authorities there would be undesirable changes in the policy targets; that is, the economy is in some sense unstable. Also, for discretionary policy to be successful it is necessary that, by and large, such 'instabilities' are both predictable (using forecasts of a macroeconomic model) and can be offset by the prior use of various policy instruments.

MONETARIST VIEWS

Throughout the 1960s and 1970s, particularly in the United States under the academic leadership of Professor Milton Friedman at the University of Chicago, many economists criticised the above Keynesian ideas and propounded a view that stressed the efficiency of the free-market mechanism and the overriding importance of the money supply in economic policy. This Monetarist view, as we shall call it, did not really come to prominence in the United Kingdom until the Manchester University Inflation Workshop under Professors Laidler and Parkin got underway in the early 1970s. However, it had a zealous and influential adherent long before this in Professor Harry Johnson, of the London School of Economics and the University of Chicago.

The monetarist view in its modern form was developed predominantly in the context of a closed-economy model, i.e. one which has a negligible amount of international transactions. It is only in the last few years that sophisticated Monetarist models have been developed which purport to explain the behaviour of small open economies (i.e. economies like the United Kingdom that are small in relation to the world economy and which engage in a substantial amount of international trade). These 'open-economy' Monetarist models are also known as 'international Monetarist' models. In this text the term 'Monetarist' will be used to embrace both open- and closed-economy Monetarist models.

The Monetarist view outlined below might be considered by some to be a particularly extreme Monetarist position. Nevertheless such views seem worthy of discussion because they are held by a large number of economists, particularly in the United States. Also, as noted earlier, a more moderate Monetarist position which we have called 'post-Keynesian' is dealt with in Chapter 5.

Most Monetarists seem to base their policy precriptions on a loosely defined model which is a synthesis of the results obtained by a number of different monetary economists. In fact there are very few complete Monetarist models that are regularly used in forecasting. However, the Federal Reserve Bank of St Louis use a closed-economy Monetarist model to forecast the U.S. economy, while for the United Kingdom, open-economy Monetarist models have only recently begun to emerge.

Two general points are worth mentioning at the outset. First,