SHOULD CENTRAL BANKERS BE KEYNESIAN?

Speech by Robert Skidelsky at the National Bank of Poland, Warsaw, 15th March 2013

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i.Introduction

I would like to address this question to my audience both as central bank officials and as macroeconomic policy makers. For a central banker to be Keynesian is to recognise that a central bank cannot be Keynesian in isolation, but only in partnership with the Treasury. A further division in my remarks is between short-run policy for recovery and long-run policy for reform and sustainability. For it is not enough to be a Keynesian for a few months in a situation of collapse, and then wheel out Milton Friedman, or Hayek, or Lucas or Keynesianism is for the long-run as well as the short-run. Long-run Keynesianism is the best way to prevent short-run collapse.

It may seem odd to give a talk on Keynesianism in Poland. Poland has got through the financial crisis without a single year of negative growth. For Polish policy makers, the crisis might seem like someone else's problem. This would be a mistake. Europe is Poland's most important export destination by a large margin, with Germany taking 26% of Poland's exports. In 2008-9 it benefitted from a 33% devaluation of the zloty against the euro, Poland exports not just goods but labour: surplus labour works all over Europe, and Polish has just been recognised as the second most spoken language in the UK. So what happens in the rest of Europe is bound to have a profound effect on Poland's economic prospects. And that depends on policy. If Europe prospers, Poland prospers: if Europe, and particularly Germany, decays, Poland will do much less well.

ii.Keynes and Keynesianism.

Let us start with Keynes himself. His most important contribution was to deny that a market economy had any natural tendency towards full employment. In other words, he rejected Say's Law: the belief that supply creates its own demand. The normal state of a market economy was one of under-employment equilibrium; a slump was distinguished from the normal state only by the fact that the equilibrium was much worse. So Keynesian policy required government intervention to improve on the equilibrium attainable by unaided market

forces. To maintain full employment Keynes proposed permanently cheap money, what he called the 'socialization of investment', and counter-cyclical budgeting. His policy prescription for slumps was to use monetary and fiscal policy to close the enlarged output gap.

Keynesian policy, as practised in the 1950s and 1960s, was somewhat different. The target was Keynes's: to maintain full employment. But the instruments were partly different. This was because the developed world experienced boom conditions, largely as the result of massive American overseas spending. So Keynesian policy was largely directed at curbing excess demand rather than insufficient demand. Budget surpluses and restrictions on hire-purchase were used to mop up private spending power. More importantly, interest rate policy was reinstated as a tool of demand management. The Phillips Curve was supposed to give policy makers a ‘menu of choice’ between different rates of inflation and unemployment. Anti-slump policy was not tested, because slumps were avoided.

As a result of the disorders of the 1970s – arising ultimately from the failure to control inflation – and the fierce debate between Keynesians and monetarists and the different schools of monetarism, a 'new Keynesian' macroeconomic consensus emerged in the 1990s. Inflation targets replaced full employment targets; monetary policy replaced fiscal policy. The new dispensation rested on two intellectual propositions: (a) a revival of the QTM and (b) revival of the doctrine of the self-regulating market. Price stability, to be achieved by monetary policy, was a necessary and sufficient condition for economic stability, at the 'natural' rate of unemployment. Why this intellectual construction was called 'new Keynesianism' is a bit odd, since fiscal policy had no positive role, and the only bit of Keynesianism in it was 'sticky wages', which were not part of Keynes's own model. In this 'new Keynesianism', the central bank, not the Treasury, was in the driving seat.

This macroeconomic orthodoxy was shattered by the slump of 2008 - a collapse which, according to the mainstream economic models in vogue, ought not to have happened. Indeed, in a famous question, the Queen asked a group of economists at the LSE 'Why did no one predict it?', which was greeted by an embarrassed silence.

I will not try to answer the Queen's question directly today, but two others: what macroeconomic policy is needed to get most of Europe and the UK out of their semi-slump, and what should a permanent macroeconomic constitution look like?

iii. Monetary Policy for Recovery

Reducing Bank Rate was accepted central bank policy for fighting economic downturns even before Keynes. But in the *Treatise on Money* (1931) Keynes added an unorthodox twist by urging on the central bank 'open market operations *a outrance'* which meant the Central Bank 'satisfying to saturation' the desire of the public to hold cash. (TM,vol.2,332). This is now called QE: the central bank pumps money into banks and non-banks by buying government securities. But his rationale for this was different from that of today's Keynesians or indeed non-Keynesians. According to Paul Krugman a liquidity trap –and consequently the need for QE - occurs when 'a zero short-term interest rate isn't low enough to restore full employment'. Keynes's trap, on the other hand, arises when reductions in the Bank rate cannot bring down the long term rate of interest. The zero bound is simply the limiting case, but ineffectiveness of orthodox monetary policy might occur before that limit is reached, because of uncertainty attaching to future bond yields.

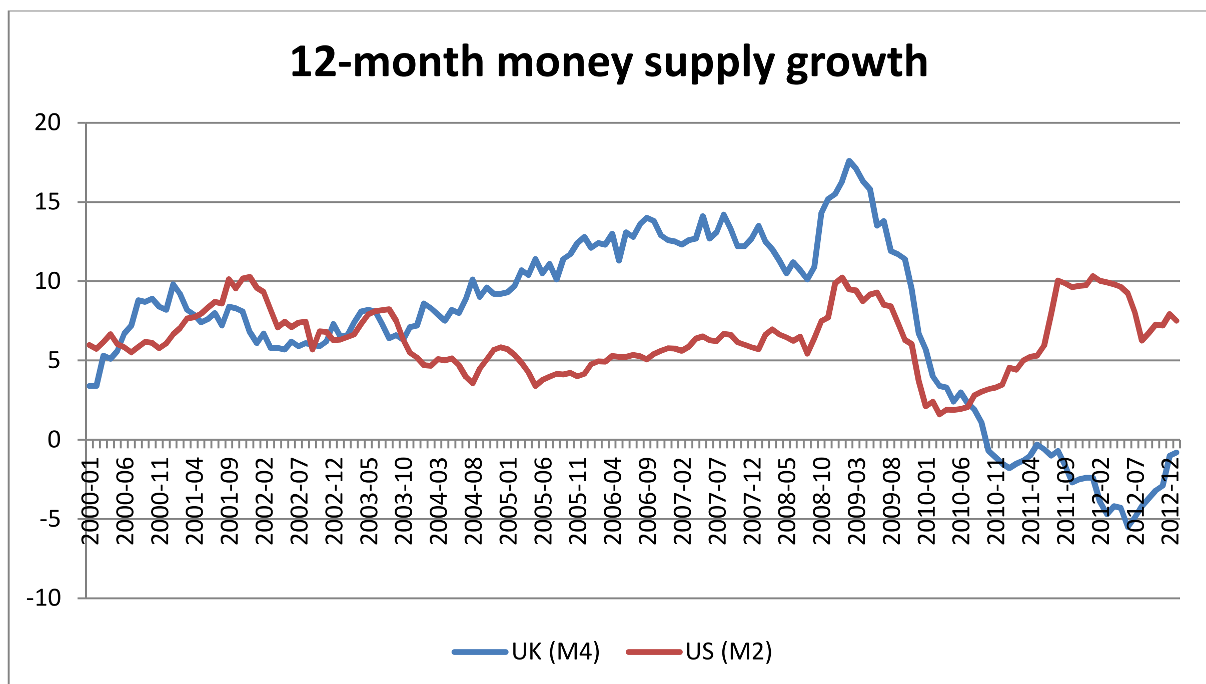
With fiscal policy seemingly disabled by the explosion of sovereign debt, QE has become the main instrument of escape from conditions of semi-slump which prevail today in continental Europe, the UK, the USA, and Japan. In fact, all the main central banks are busy buying government debt, though the ECB is not officially allowed to. The fundamental theoretical rationale for this policy is to be found in the cash balances version of the QTM. 'If the central bank increases the amount of money in the economy it spurs spending: people need only so much money to carry out their spending activities conveniently. So if more is supplied they will want to lend some of it and these offers will push interest rates down, inducing others to borrow and spend more than otherwise'. (B. McCallum).

The theory found support in history. In their 1961 study of the Great Depression of 1929-32, Milton Friedman and Anna Schwartz attributed its depth precisely to the failure of the Fed to sustain the money supply by pursuing open market operations *a outrance* as Keynes had advocated in 1930. This was also the lesson Ben Bernanke drew shortly before he became chairman of the Fed in 2006: 'By allowing persistent declines in the money supply and in the

price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy. …..' (H. Parker Willis Lecture, March 2, 2004). So QE had a long pedigree in the theory, if not the practice, of monetary policy.

A policy is no better than the theory on which it is based. And the result of several years of QE have been disappointing, to say the least. QE may have put a floor under the collapse in 2008-9, but it has not brought recovery. One of many indicators that this is so is given by the money supply figures.

Figure 1: money supply growth



The reason for the relative failure of QE is that QTM, which is its intellectual basis, does not tell the whole story. As Keynes put it, if money is the drink which stimulates the system to activity 'there may be several slips between the cup and the lip'. (CW, vii,173).

The first slip has been cash hoarding by the banks. This creates a credit supply problem, which has been the subject of loud complaints by SMEs. All the financial institutions damaged by the banking collapse have been using the increased cash provided by the central bank to 'de-leverage', i.e., to build up their liquid reserves. There may have been a 'wealth' effect, but the so-called 'portfolio rebalancing' of the rich did not generate enough increased spending on goods and services to offset the more general decline of real incomes.

But there is also a demand slip. Not enough people are coming forward to borrow because confidence is low. Confidence is low because demand is depressed.

A combination of lack of supply and lack of demand has led to a double death of investment. In the UK, annual business investment in 2011 was £20bn lower than in 2008. Against the 2008 benchmark, Britain missed out on close to £60bn in investment over the three years – more than enough to build a high speed rail link between London and Manchester not once but three times.

The latest rounds of QE are explicitly designed to be inflationary. The new recovery mantra for stagnant economies is 'inflate and depreciate'. Inflation will restore profit expectations and lighten debt burdens; depreciation of the currency will increase export demand. But these effects, which are themselves uncertain and problematic (not all countries can depreciate simultaneously) are subject to the same 'slips' which Keynes identified: you can print money but you cannot ensure that it is spent.

Keynes came to doubt the efficacy of the monetary policy he had recommended in 1930 in a heavily damaged economy. In 1932 he wrote: ‘It may still be the case that the lender, with his confidence shattered by his experience, will continue to ask for new enterprise rates of interest which the borrower cannot expect to earn…. If this proves to be the case there will be no means of escape from prolonged and perhaps interminable depression except by direct state intervention to promote and subsidise new investment’. (Q Skidelsky, ii, 441).

iv. Fiscal Policy For Recovery

Insofar as there is a coherent recovery strategy in Europe today it rests on two pillars: monetary expansion to lift the growth rate in the short-run, fiscal austerity to create the conditions for sustained growth in the medium term. The need for fiscal austerity has been the conventional wisdom of all heavily indebted sovereigns since 2009. It is the official policy of the Eurozone.

There are two main arguments in its favour. The first is the practical financing problem: deficit reduction is needed to give confidence to the bond markets that sovereign debts will be repaid. It thus keeps down the cost of government borrowing, and enables heavily indebted governments to go on borrowing in the private markets. This is a practical argument, which is more valid for some sovereigns (eg Greece) than others (eg UK). But it is linked to a theoretical proposition, which is that reducing public deficits will automatically 'crowd in' more productive private spending – known as expansionary fiscal contraction - thus improving the medium-term growth of the economy without depressing its short-term growth performance. The latter assertion has most recently been made by British Prime Minister, David Cameron.

Cameron said: "As the independent Office for Budget Responsibility (OBR) has made clear, growth has been depressed by the financial crisis, by the problems in the eurozone and by a 60 per cent rise in oil prices between August 2010 and April 2011. They are absolutely clear, and they are absolutely independent. They are absolutely clear that the deficit reduction plan is not responsible; in fact, quite the opposite." This brought a rejoinder from Robert Chote, OBR director, who noted that: "Every forecast published by the OBR since the June 2010 Budget has incorporated the widely held assumption that tax increases and spending cuts reduce economic growth in the short term." (See Martin Wolf, 'British Austerity is Indefensible' (FT, 13 March 2013).

Chote admitted that "Economic growth has been much weaker since the end of 2010 than we and most other forecasters expected in June 2010 and it is clearly possible that this is in part because the fiscal consolidation measures have had a greater "multiplier" effect than we anticipated'. This weakness in OBR forecasts reflects a weakness in their underlying model. Keynes would not have been at all surprised by the size of the multipliers. He would have said one person's spending is another person's income. If we all cut our spending simultaneously all incomes will go down. If the private sector is de-leveraging it is fatal for the government to de-leverage. Further he would have said that the only way to cut the public deficit (and in the long term the national debt) is to grow the economy. Putting people back to work increases the national income and thus the revenues of the government. This may require larger not smaller deficits in the short-run. As for the bond markets, they will be progressively unimpressed by government failures to achieve its budgetary targets, so

appeasing them by tightening the fiscal screws is useless. Keynes did say: 'Look after unemployment and the budget will look after itself'

The current state of debate on fiscal policy in the UK runs something like this. Supporters of Austerity argue that Britain suffered a huge supply shock following the recession of 2008. This left it not only with reduced output, but also – by undermining the banking system and by causing a big increase in state spending and the national debt – with less capacity to produce output.

Since the problem is one of reduced capacity, expansionary monetary and fiscal policy will not solve it. Policy should, instead, aim at raising the "medium term growth rate' by "relentless focus on reducing the burden of government spending", combined with measures that include cutting welfare benefits and taxes, rehabilitating the banks, scrapping planning laws and opening up public services to competition. This is the orthodox right wing policy for recovery throughout Europe.

The logic is the familiar one that high public spending, whether financed by borrowing or taxation, crowds out more efficient private spending. So even if the recommended transfer of resources to the private sector involves a large drop in current output, these transitional costs will be worth it. Policies to avoid or mitigate this cost are wrong-headed. If anything we require more austerity, not less.

This argument ignores the subtle connection between demand and supply. Prolonged unemployment, or underemployment, destroys not just current but also potential output. A physics graduate may be able to find employment as a cab driver or waiter. But how much physics "potential" will they retain after years of doing such jobs? Economists call this "rusting away" of human capacity through disuse "hysteresis". If an output gap is allowed to persist, the effect of hysteresis on skills and infrastructure is to reduce the growth potential of the economy itself.

In other words, the recession itself shrinks productive capacity: the economy's ability to produce output is permanently impaired. The intuition behind it is simple enough: if you let an economy subside and stay there long enough for capital and labour to rust away you will

lose growth potential. This is illustrated by the following diagram which focuses on labour supply.

Figure 2: Labour supply

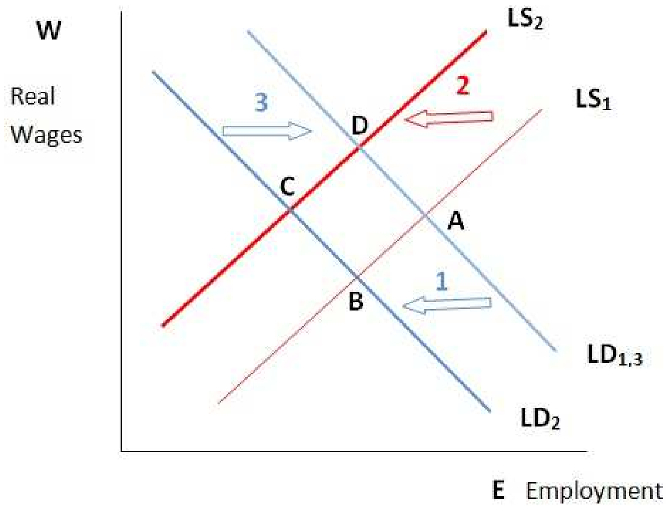
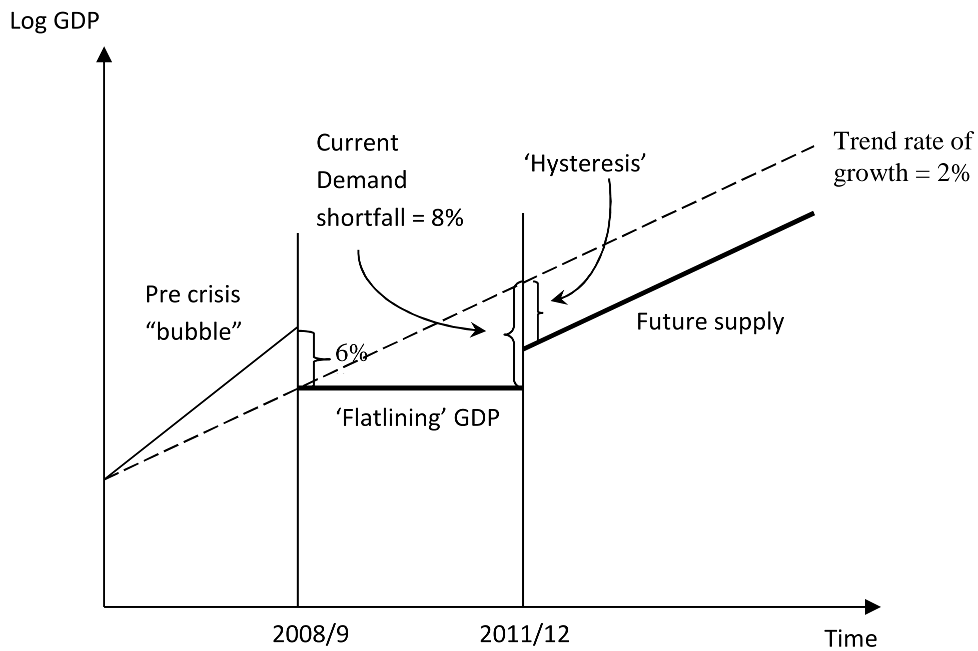


Figure 3: Hysteresis: How current demand shortfall damages future supply



Source: Miller and Roberts (2012)

Instead of supply recovering to restore previous potential output, the economy resumes growth with a lower potential output.

You might think that an economy which has suffered hysteresis would have a lower trend rate of growth than before. But this is not necessarily so. Take two economies, A and B, both growing at 3%, in which A produces 10% more output per head than B. Following a demand shock to both, B quickly recovers, A remains in slump longer, and suffers hysteresis, which deprives it of 10% of its capital and labour stock. They both start growing again at 3%, but now output per head in A has fallen to the level of B's. Its potential output is 10% lower than it was, although its rate of growth is the same. The implication of hysteresis is that any policy which minimises the period of recession minimises the loss of potential output. It is a modern answer to the Treasury view of the 1930s.

Supply-siders and their Keynesian critics both agree that the government should help to protect and promote the output potential of the economy. The difference is that the supply-siders ignore demand and focus entirely on direct measures to improve economic efficiency. By contrast, modern followers of John Maynard Keynes, both in the UK and in the US, believe that an essential element of a growth strategy is to avoid a prolonged recession by acting directly to maintain demand.

We touch here on the oldest debate in macroeconomics. Early in the 19th century, the French economist Jean-Baptiste Say proclaimed: "Supply creates its own demand." There could never be a shortage of demand, he said, because people necessarily spend what they earn, either on consumption or investment. But, in the conditions of the 1930s Great Depression, Keynes pointed out the fault in this logic. Money earned is not necessarily spent: part of it is saved, and savings may be held in cash. Indeed, the lower people's confidence in the future, the more of their savings they will want to hold in cash. So demand can fall below supply.

With skills (or "human capital") recognised as a factor of production, we can transcend this age-old division between supply-siders and demand-siders. Because of hysteresis, pure supply-side policies are not sufficient. Buoyant demand, though necessary for sustained medium-term growth, is not sufficient either: supply-friendly policies are also called for. As

the recent London School of Economics Growth Commission report points out, the promotion of skills, the development of infrastructure and support for innovation are "the essential drivers of the productivity growth on which the UK's future prosperity depends".

In present conditions of depressed demand, the provision of more skills and better infrastructure is not a call for mindless public spending. It is a call for productive investment by both government and private sector to create jobs today and to promote growth in the future

v. Towards a permanent macroeconomic constitution.

A new macroeconomic constitution is needed. The almost exclusive reliance on targeting inflation in the past has been severely compromised. Inflation targeting may have helped achieve price stability in the benign environment of the 2000s, but as the crisis of 2008 revealed it secured neither financial stability nor stability in the economic system as a whole.

This Great Revelation – courtesy of the Great Recession – has spawned a new debate on what comes next. We need to distinguish between what needs to be done now, and what a permanent macroeconomic constitution would look like, though it is not always easy. In mid February, Mark Carney, incoming Governor of the Bank of England, suggested targeting nominal income as a way of combining the inflation target with a growth target. He apparently advocates this both as a recovery and a reform policy. It has been attacked on the ground that the more complicated objective would reduce the effectiveness of managing inflation expectations. It was also pointed out that there is an implicit risk in nominal income targeting because it would keep very loose monetary policy in place even after an economy recovered. Following Bernanke, Mervyn King, outgoing Governor of the Bank of England, wants to amend the inflation targeting role by signalling the market about how long, or under what conditions, a given monetary stance would continue. Thus Bernanke: 'In particular the Committee decided to keep the target range for the Federal Funds rate at zero to a quarter of a per cent and currently anticipates that this exceptionally low range...will be appropriate at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percent above the Committee's longer goal,

and longer term inflation expectations continue to be well anchored'. (FOMC Press Release, 30 January 2013).

It is now recognised that the single inflation target failed to secure financial stability: instead the central bank (in effect the taxpayer) ended up by bailing out banks considered too big too fail. Up to the 1970s, the financial system was highly regulated. In homage to the new financial theory of 'efficient markets', a wave of de-regulation began in the 1970s and 1980s and peaked in the 2000s. The conventional wisdom was that regulation would be replaced by financial innovation, which would provide everything from lower mortgage rates to reduced systemic risk. Banks mutated into global conglomerates outside the weakened regulatory regimes, while becoming too big to fail.

Since the 2008 crash we have put in place Basel III: rules which require banks to keep higher compulsory liquidity ratios to stop bank runs, and adequate capital ratios to obviate the need for credit support. But there is no international authority to ensure that they are observed internationally, opening the door to regulatory arbitrage.

The new regulations act as a tax on risky activities. But moral hazard is only a small part of the problem. The larger risk to which Keynes drew attention lies in the inherent uncertainty of investment. There is the endogenous risk inherent in the banking system itself, which can be dealt with by regulation or –as suggested by Volcker and Vickers –bank restructuring. But there is the exogenous risk, which arises from uncertainty, and can only be dealt with by the state.

This is where fiscal policy has a crucial role to play – not in isolation from monetary policy, not instead of monetary policy, but in conjunction with monetary policy. Unlike the Keynesians of the 1950s and 60s, I do not take this to mean that policy makers can or should attempt to micro manage demand through the tax system. Policy makers lack the information necessary to do this successfully. Rather, we ought to revert to Keynes's original plan of primarily managing aggregate demand through the capital account, i.e. through investment.

A robust fiscal constitution will need to distinguish between current and capital spending, and have rules for each. A spending rule would fix government current spending in either absolute or relative-to-GDP terms and thereby guard against the fear of spiralling public

spending while at the same time allowing automatic stabilisers to run on the revenue side. According to Mills and Quinet, in this way, the Treasury is relieved of attempting to gauge the current position in the cycle but is also not constrained by forward-looking forecasts. The current revenue side will adjust automatically to the cycle as the tax base contracts and expands thereby leaving the Treasury with a deficit in downturns and – if the spending ceiling is geared correctly – with a surplus in boom years. In the medium run, therefore, a current spending rule will bring about roughly the same result as a cyclically-adjusted current balance rule currently popular among Treasuries in Europe but without the associated monitoring difficulties.

At the heart of a new fiscal constitution is a rehabilitation of the investment function of the state. I have excellent authority for this –no less than Adam Smith. Among the duties Smith gave the state was 'the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society. (Smith, *Wealth of Nations*, IV, ch,9, p. 51)

Adam Smith was advancing a public goods argument for certain kinds of investment, which recognized the presence of ubiquitous market failures in provision of infrastructure and education. Even though they might yield a positive return to society, some investment projects are simply too large or too risky for the private sector. Subject to an admittedly tricky additionality test, therefore, a reasonable investment rule would be to allow government to borrow for any capital project that meets two criteria:

First, the capital project is expected to result in a net asset. That is, the value of the asset is expected to exceed the net-present value of the loan. This is a judgment facing any investor – private or public – and neoliberal stances such as 'governments can't pick winners' aside, we have no a priori reason to believe that the government would be worse at making such judgments than the private sector. The rapid growth of the East Asian economies serves to illustrate this. In theory, the net-asset criterion would ensure that the government could sell the asset at some future date to repay the cost of the loan. Moreover, a net-asset criterion would allow the government to undertake investments in economic downturns to assist the automatic stabilisers without being fiscally unsound. In fact, given the typically lower interest

rates and cheaper labour, it will be particularly easy for the government to meet the net-asset criterion during economic recessions – a feature that might serve as a type of automatic stabiliser.

Second, the loan for the capital project can be amortised out of expected current revenue within the physical lifespan of the asset. An example may help to clarify. Imagine that the government wants to build an optic-fibre network that will last for 10 years at a cost of £100 million which passes both the additionality test and the net-asset criterion. In order to debt-finance the bridge, the government would have to show that there will be enough funds in the current account to pay down the loan by £10 million ever year for the next ten years (in addition to paying interest). Naturally, this is a highly simplified example but it demonstrates how the amortisation criterion solves one of the most intractable budgetary problems of the last century: by tying debt-financed capital outlays to the current account it blocks abuse of the capital account as backdoor increases in current spending.

I do think we have a chance now to retreat from the wilder shores of Thatcherism and Reagonomics without falling back into either old-fashioned fiscal fine turning or worse, into state socialism. To work out the lineaments of a new Third Way will be the major challenge to European politics and economics in the next decades. Unless the elites meet it, there will certainly be a peasants' revolt. Indeed it has already started, so time is short.