
Innovative Thinking on Economic Policy and the 'New Economics'

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Presentation

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

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2. Theoretical Background

3. Economic Policies

4. Summary and Conclusions

Introduction

- Current thinking on economics and its economic policy implications has come under severe attack recently;
- No wonder when claims such ‘great moderation’, NICE decade, the end of boom and bust’, have not lasted for long;
- The current ‘great recession’ has vividly demonstrated that all these claims, and the supporting New Consensus Macroeconomics (NCM) theoretical framework, and its policy implications, need to be replaced by ‘New Economics’;

Introduction

- Thus, the current conference;
- The purpose of this contribution is to discuss a different type of economics and economic policies that could potentially replace the current ones;
- Clearly, economic policy formulation is heavily conditioned by the underlying theoretical framework that should underpin it;
- 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 economic 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 this theoretical framework 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;
- This theoretical framework draws on the following main elements:

Theoretical Background

- The 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;
- Aggregate demand has a dual characteristic in this model: it is a relatively 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

- The supply-side of the economy: this is viewed in terms of the following characteristics;
- The interaction between production decisions of firms in the light of the (expected) level of aggregate demand;
- And the consequent decisions on employment;
- It is also viewed in terms of the relationship between prices and wages, and their setting;
- Clearly, this approach denies the validity of the NCM approach that portrays the long run as characterised by supply-side equilibrium (at full employment), with aggregate demand having no impact whatsoever.

Theoretical Background

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

Theoretical Background

- The money, credit and finance sector: money is endogenously created within the private sector with loans created by banks generating bank deposits;
- The behaviour of banks and related credit institutions become important for the economy. Their willingness or otherwise to provide loans and the terms on which they are provided impact on the level and structure of demand;
- 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.

Theoretical Background

- Open economy: the openness of the economy means that the domestic economy is buffeted by events in the rest of the world.
- A relevant and significant aspect of the foreign sector is that imports and exports are included in the aggregate demand equation;
- This inclusion also reflects the effects on demand (and hence employment) of variations in the exchange rate.

Theoretical Background

- Cycles and Fluctuations in Economic Activity: such fluctuations 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 contribute to the generation of cycles.

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2. Theoretical Background

3. Economic Policies

4. Summary and Conclusions

Economic Policies

- The objectives of economic policy:
- Full employment of the available labour supply;
- Inflation rate consistent with output growth rather than an inflation rate target;
- Financial stability;

Economic Policies

- The instruments of economic policy to achieve these objectives are:
- 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 to GDP, is sustainable. In fact, it leads to a debt ratio equal to the deficit ratio divided by the growth of nominal GDP;

Economic Policies

- Interest rate policy should be set so that the real rate of interest is as low as possible, but 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 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 as a whole;
- Should the socially useful banks be separated from the 'casino' banks?

Economic Policies

- Microprudential instruments relate to the structure and regulation of individual banks;
- Banks that are 'too big to fail' should be cut down in size;
- Guarantees to retail depositors should be limited to banks with a narrower range of investments;
- Risky banks to taxpayers and economy should face higher capital requirements;
- Large and complex financial institutions can be wound down in an orderly manner;
- And, large banks should not be allowed to combine retail banking with risky investment business.

Economic Policies

- Ultimately, though, coordination of policies is paramount, especially fiscal and monetary 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;
- The multiplier under fiscal and monetary policy coordination, and in the case of deficit spending, is found to be of the order of 3.8;

Economic Policies

- When there is no policy coordination, i.e. when the central bank is 'goal independent', the deficit spending multiplier is zero;
- This result is particularly important in view of much current theory and practice that see fiscal policy better divorced from monetary policy;
- This large difference in fiscal multipliers is explained by the expectations channel, which is thought to work via inflation expectations;
- Fiscal expansion increases expectations about future inflation, real rate of interest is reduced (provided the central bank collaborates with the fiscal authority) and spending is stimulated;

Economic Policies

- Expectations of future income also improve, thereby stimulating spending further;
- These results suggest that macroeconomic stability is the joint responsibility of the monetary and fiscal authorities: potentially destabilising behaviour by one authority can be offset by an appropriate stance of the other authority;
- Perhaps more importantly the monetary authority can trade off some inflation for lower unemployment, even in the long run;

Economic Policies

- In the coordination of macroeconomic policies an important consideration should be environmental issues;
- So alongside creating jobs this coordination should have another objective: to green the economy and to provide a 'green new deal' to lift the economy out of the recession;
- Government expenditure and taxation should also be focused on tackling environmental issues;
- Taxing 'overuse of fossil fuels' to quote Adair Turner (head of FSA); making sure that changes in government expenditure are based on environmental considerations whenever possible;

Economic Policies

- Indeed, investing in the low-carbon and energy-saving technologies is the job of the government; the market cannot be relied upon to deliver on this score;
- The latter initiative would boost job creation and tax receipts, as well as reduce significantly imports of carbon energy sources, such as coal and gas;
- Also of considerable interest is the recently announced partnership of some leading firms with academic institutions to 'green' UK's infrastructure;
- The aim of this partnership is to retrofit homes in an attempt to overhaul household energy, water, transport and waste provision with the focus on drastically curbing carbon emission;

Economic Policies

- 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;
- Here again, environmental issues are pertinent: green industries, we are told by our Chancellor, as a whole can add half a million jobs to the economy;

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 policies to tackle inflation when it reaches high levels;
- Such approach involves the development of an incomes policy to maintain low inflation.

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1. Introduction

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;
- Employ regional and industrial policies to create the required capacity;
- Central bank role should be financial stability;
- Also, central bank intervention in the foreign exchange market is necessary to control the exchange rate;
- Develop incomes policy to maintain low inflation if necessary;
- And never forget the green economy dimension.