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# **NEW CONSENSUS MACROECONOMICS AND KEYNESIAN CRITIQUE**

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# Presentation

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1. **Introduction**
2. **The Economics of the New Consensus Macroeconomics**
3. **Economic Policy of the New Consensus Macroeconomics**
4. **New Consensus Macroeconomics and Keynesian Critique**
5. **Summary and Conclusions**

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# The Economics of the New Consensus Macroeconomics

*Aggregate demand equation*

$$Y_t^g = \alpha_0 + \alpha_1 \cdot Y_{t-1}^g + \alpha_2 \cdot E_t [Y_{t+1}^g] + \alpha_3 \cdot (R_t - E_t [p_{t+1}]) + \alpha_4 \cdot (rer)_t + s_1;$$

*Phillips curve*

$$p_t = \beta_1 \cdot Y_t^g + \beta_2 \cdot p_{t-1} + \beta_3 \cdot E_t [p_{t+1}] + \beta_4 \cdot \{ E_t [p_{w,t+1}] - E_t [\Delta er_t] \} + s_2;$$

*Monetary policy rule*

$$R_t = (1 - \gamma_3) \cdot [RR^* + E_t [p_{t+1}]] + \gamma_1 \cdot Y_{t-1}^g + \gamma_2 (p_{t-1} - p^T) + \gamma_3 \cdot R_{t-1} + s_3;$$

# The Economics of the New Consensus Macroeconomics

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*Real Exchange rate equation*

$$rer_t = \delta_0 + \delta_1 \cdot \left\{ (R_t - E_t [p_{t+1}]) - (R_{W,t} - E_t [p_{W,t+1}]) \right\} + \delta_2 \cdot CA_t + \delta_3 \cdot E_t [rer_{t+1}] + s_4;$$

*Current account equation*

$$CA_t = \lambda_0 + \lambda_1 \cdot rer_t + \lambda_2 \cdot Y_t^g + \lambda_3 \cdot Y_{W,t}^g + s_5;$$

*Nominal Exchange rate equation*

$$er_t = rer_t + P_{W,t} - P_t ;$$

# The Economics of the New Consensus

## Macroeconomics

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- Six equations and six unknowns: output, inflation, interest rate, current account, nominal and real exchange rate;
- Basic assumption: intertemporal optimization of a utility function that reflects optimal consumption smoothing;
- Based on the transversality condition meaning that all debts are ultimately paid in full: economic agents are credit worthy; all IOUs are perfectly acceptable in exchange; nobody is liquidity constrained;

# The Economics of the New Consensus Macroeconomics

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- It is a non-monetary model: no banking or any other financial sector or monetary variables.
- Objective: price stability; inflation is a monetary phenomenon;
- Inflation is controlled directly via changes in the rate of interest;

# The Economics of the New Consensus Macroeconomics

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- A change in the nominal rate of interest is followed by the real rate of interest affected in the same way (price and wage rigidity is assumed);
- Changes in the real rate of interest can only affect aggregate demand in the short run;
- Phillips curve is vertical in the long run at NAIRU;



# The Economics of the New Consensus Macroeconomics

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- Changes in the rate of interest affect inflation only in the long run;
- NAIRU is a supply-side variable;
- Say's Law holds: the level of effective demand does not play an independent role in the long-run level of economic activity;

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# Economic Policy of the New Consensus

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- Inflation Targeting (IT) is embedded in equations 1-3;
- IT is a monetary policy framework whereby public announcement of official inflation target is undertaken;
- Equations 2 and 3 entail an important role for 'expected inflation';
- Credibility attained through pre-commitment to the inflation target without government interference;

# Economic Policy of the New Consensus

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- Transparency of inflation forecasts is a paramount element of the policy, and it enhances credibility; but...
- The centrality of inflation forecasts and the margin of errors represent a major challenge to this framework.

# Economic Policy of the New Consensus

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- These ingredients are supported by the publication of the minutes of the Central Bank's Monetary Policy Committee, by the Inflation Report and the speeches of the Monetary Policy committee members;
- Further important ingredients: Accountability; Credibility; and Individual Reputation of the Monetary Policy members, especially in those cases where minutes are published, which reveal outcome of voting.

# Economic Policy of the New Consensus

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- Fiscal policy should not be used for short-term objectives; only for medium- to long-term ones;
- Constrained discretion: neither pure discretion nor rules;

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# New Consensus Macroeconomics and Keynesian Critique

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- **Main Problems (Theory):**
- Liquidity Preference is absent in view of the transversality condition;
- Central Bank changes the rate of interest and influences the term structure in a stable fashion;
- But the term structure of interest rates is influenced by a host of other factors, most importantly the market power of the banking sector, i.e. liquidity preference;
- No banks or monetary aggregates in the model;



# New Consensus Macroeconomics and Keynesian Critique

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- The absence of banks in the NCM implies serious problems;
- Since banks and their decisions play a significant role in the transmission mechanism of monetary policy;
- And since decisions by banks as to whether or not to grant credit play a major role in the expansion of the economy (in the sense that a failure of banks to supply credit would imply that expansion of expenditure cannot occur);
- There is a disjuncture between this analysis and the role of monetary policy;
- Recent research has exposed these problems further:

# New Consensus Macroeconomics and Keynesian Critique

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- The 'standard' NCM model, with no banks and monetary aggregates, is compared with a similar 'enlarged' model, which is endowed by including banks that create deposits and make loans.
- The enlarged NCM model introduces real money balances (essentially cash and bank deposits, the M2 definition of money, which is used for transaction purposes);
- and real government bond holdings (on the assumption that economic agents use government bonds to manage their liquidity) in the representative household's utility function.

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- Canzoneri et al. (2008) calibrate the two models in an attempt to ascertain the extent of their differences.
- Impulse response functions are utilized to study how various shocks infiltrate through the model economies.
- Two conclusions are relevant for our purposes: Monetary indicators are useful in forecasting inflation in the enlarged NCM model; not so in the standard NCM model.

# New Consensus Macroeconomics and Keynesian Critique

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- Still, the authors do not recommend M2-targeting monetary policy. This is so since a broader measure of liquidity is shown to be a more reliable indicator of inflation than simply M2.
- The authors readily admit that this is in fact a controversial proposition that deserves more careful scrutiny.
- The inevitable conclusion from this more recent work is that bank lending to the private sector is more relevant than money for macroeconomic theory and policy.

# New Consensus Macroeconomics and Keynesian Critique

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- The next compelling question is how credit variables should enter equation (1). This can be undertaken through the assumption that marginal utility of consumption depends on credit variables. The standard way is to resort to the utility function models, whereby credit variables are supposed to affect the marginal utility of consumption and, therefore, as such enter equation (1) in the above six-equation model.

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- This is the non-separability principle. A utility function is additively separable between consumption and credit variables if it can be separated into two functions, one containing only consumption and the other only credit. If the utility function is not additively separable then the credit variable will enter equation (1).
- The evidence is mixed when using narrow definitions of credit, which has led authors to argue that without “integrating the credit markets into both the theoretical and the practical analysis of monetary policy is going to be harder” (Friedman, 2003, p. 6).

# New Consensus Macroeconomics and Keynesianism

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- Price stability has been associated with benefits to the economies pursuing it; but there are problems:
- Price stability might not be sufficient to avoid serious macroeconomic downturns; and history is replete with examples of periods of relative absence of inflationary pressures followed by major economic and financial crises; best example is the recent financial crisis!

# New Consensus Macroeconomics and Keynesianism

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- The determination of the equilibrium real rate of interest ( $RR^*$  in equation 3), which is often seen to correspond to what is called the Wicksellian 'natural rate' of interest, is problematic.
- There is a great deal of uncertainty in view of its imprecise empirical value. Weber et al. (CJE, April 2008) provides a wide ranging discussion on problems with the estimation of this rate.



# New Consensus Macroeconomics and Keynesianism

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- Keynes (1930) in his *Treatise on Money* accepted the notion of 'natural rate of interest'.
- However, Keynes (1936) in the *General Theory* explicitly rejects the idea of a unique natural rate of interest, and in effect argues that there is a natural rate of interest corresponding to each level of effective demand, which would bring savings and investment into balance.
- “In my *Treatise on Money* I defined what purported to be a unique rate of interest, which I called the natural rate of interest - namely, the rate of interest which, in the terminology of my *Treatise*, preserved equality between the rate of saving ... and the rate of investment ..... I had, however, overlooked the fact that in any given society there is, on this definition, a *different* natural rate of interest for each hypothetical level of employment.

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- And, similarly, for every rate of interest there is a level of employment for which the rate is the 'natural' rate, in the sense that the system will be in equilibrium with that rate of interest and that level of employment. Thus it was a mistake to speak of the natural rate of interest or to suggest that the above definition would yield a unique value for the rate of interest irrespective of the level of employment. I had not then understood that, in certain conditions, the system could be in equilibrium with less than full employment" (pp. 242-243).
- Further serious problems can be highlighted:

# New Consensus Macroeconomics and Keynesianism

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- When we account for bank credit as the main source of financing for firms, loan rates are of course important. Under such circumstances where the rate of interest on bank loans differs from the policy rate of interest,  $RR^*$  may not be a useful indicator for monetary policy.
- De Fiore and Tristani (2008) show that under such circumstances, and on the assumption of asymmetric information and of credit treated in nominal terms in an otherwise NCM model,  $RR^*$  is heavily model dependent.

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- It reacts differently to aggregate shocks depending on the underlying model assumptions. The crucial distinguishing assumption in this context is whether markets are frictionless or not.
- They conclude that “it might be difficult for a central bank that is uncertain about the true model of the economy to identify its movements and to use it as regular indicator for the conduct of monetary policy” (De Fiore and Tristani, 2008, p. 33).

# New Consensus Macroeconomics and Keynesianism

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- **Main Problems (Policy)**
- IT, the main policy implication of NCM, is designed to fight demand shocks, that is demand-pull type of inflation;
- Supply shocks, which produce cost-push type of inflation, cannot be handled, as current experience shows;
- The position taken by IT on supply shocks, is that they should either be accommodated, or that supply shocks come and go – and on average are zero and do not affect the rate of inflation; nor do they impact on the expected rate of inflation;

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- Insufficient attention paid to exchange rate:
- Exchange rate is not included in equation (3); only weighting it into decisions when setting interest rate;
- A strong real exchange rate contributes to 'imbalances' in the economy through its impact on the domestic composition of output: declines in manufacturing and exports, and increases in services and current account deficit, occur;
- There is, thus, the danger of a combination of internal price stability and exchange rate instability; should include exchange rate in equation (3);

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- The pass-through effect of a change in the exchange rate first on import prices and subsequently on the generality of prices, both goods and services, has weakened since the late 1980s. Consequently, the stronger real exchange rate has had less offsetting effect on domestic prices than in earlier periods;
- Consequently, the stronger real exchange rate has had less offsetting effect on domestic prices than in earlier periods;
- The argument normally used to justify appreciation in the exchange rate that such a move slows inflation is no longer valid under such circumstances;

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- Impact of interest rate changes may have become more ambiguous; evidence seems to show that capital movements are based more on equities than on other assets: a change in interest rates then may have the opposite effect on capital movements than otherwise;
- A secondary instrument in the form of direct intervention is necessary: central banks should engage in intervention on their own as a monetary mechanism.



# New Consensus Macroeconomics and Keynesianism

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- Countries that do not pursue IT type of policies have done as well as those who do;
- Monetary policy used for short-term stabilization purposes but not fiscal policy (due to crowding-out); fiscal policy should only be used for long-term purposes:
- Does IT work in practice as the theoretical framework suggest? Is monetary policy so effective and fiscal policy so ineffective?

# New Consensus Macroeconomics and Keynesianism

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- The transmission mechanism of Monetary Policy has changed:
- The build up of household debt and asset holdings has made household expenditure more sensitive to short-term interest rate changes;

# New Consensus Macroeconomics and Keynesianism

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- Looking at debt statistics, we find that between 1998 and 2002 outstanding household debt, including mortgage debt, in the UK was 72.0 percent of GDP; between 2003 and 2007 it shot to 94.3 percent of GDP;
- In the same periods as above, outstanding household debt jumped from 76.7 percent to GDP to 97.6 percent of GDP in the case of the US;
- And in the Euro Area from 48.5 to 56.6 respectively (see BIS Annual Report, June 2008, p. 29);

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- Consequently, the dangers with the current conduct of monetary policy are clear: frequent changes in interest rates can have serious effects;
- Low interest rates cause bubbles; high interest rates work through applying economic pressures on vulnerable social groups;
- Regulatory and prudential controls become, then, necessary.

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# Summary and Conclusions

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- We have highlighted the theoretical framework and the policy implications of the New Consensus Macroeconomics;
- We have also provided a comprehensive critique of this paradigm from a Keynesian perspective;
- The financial crisis of August 2007 and subsequent developments have exposed the inability of the NCM to account for such problems;
- More serious research is desperately needed on the current state of macroeconomics and economic policy.