A New Paradigm for Macroeconomic Policy

Philip Arestis, University of Cambridge and University of the Basque Country
Malcolm Sawyer, University of Leeds

Abstract
In this paper we advocate a way of approaching macroeconomic policy, which stands in contrast to the now discredited ‘new consensus in macroeconomics’ policy framework. The five pillars of our approach are: the need for budget deficits to support the level of aggregate demand; full consideration of income distribution and its implications for the level of demand; the interest rate policy pursued by the Central Bank should aim for a constant real rate of interest with that interest rate broadly in line with the rate of growth; the co-ordination of economic policies with the implication of an end of Central Bank independence; and the key policy objective of the Central Bank should be financial stability.

Keywords: fiscal policy, monetary policy, financial stability, income distribution, budget deficits

JEL Classification: E44, E58, E62, E63

Address for correspondence:
Malcolm Sawyer
Leeds University Business School,
University of Leeds,
Leeds LS2 9JT,
UK

Email:m.c.sawyer@lubs.leeds.ac.uk
A New Paradigm for Macroeconomic Policy

1. Introduction

The dominant paradigm in macroeconomic policy over the past two or more decades can be described as fiscal consolidation with numerical targets for budget deficits and monetary policy devoted to inflation targeting. This policy agenda, which to greater or lesser extent has been followed by many industrialized countries (and others), has close links with the ‘New Consensus Macroeconomics’ (NCM) (Arestis, 2007, 2009b; Arestis and Sawyer, 2008). We have argued elsewhere (Arestis and Sawyer, 2008; see, also, Angeriz and Arestis, 2007a, 2007b, 2008, 2009) that inflation targeting has not been an effective instrument for achieving low inflation, and the recent experience in many countries with inflation above the target helps to reinforce that point. Despite the focus on numerical targets for budget deficits, industrialized countries have often failed to meet their numerical targets for budget deficits. A notable example here is the countries of the euro area who are subject to the Stability and Growth Pact budget deficit limits of 3 per cent of GDP with budget in balance or small surplus over the cycle, but where deficits have many times exceeded 3 per cent and have not averaged zero over the cycle.

In this paper we advocate a rather different way of approaching macroeconomic policy. The five pillars of our approach are: (i) the need for budget deficits to support the level of aggregate demand and to achieve high levels of economic activity; (ii) full consideration of income distribution in the setting of consumer expenditure and savings, and specifically advocating large shifts in the distribution of income to help secure high levels of demand without unsustainable (private) debt; (iii) the interest rate policy pursued by the Central Bank should aim for a constant real rate of interest with that interest rate broadly in line with the rate of growth; (iv) the co-ordination of economic policies with the involvement of the Central Bank with the implication of an end of Central Bank independence; and (v) the key policy objective of the Central Bank should be securing financial stability with the need to develop relevant policy instruments to help achieve that objective.

We present a macroeconomic policy framework, which contrasts sharply with that based on the NCM. This is so in that the five points of our approach just mentioned are radically different from those of the NCM (see Arestis and Sawyer, 2010, 2011 for macroeconomic analysis and model, which underpins these approaches to macroeconomic policy). This policy framework is new in the sense of being different from that new consensus in macroeconomics, but it does draw heavily on reviving old ideas (essentially from Kalecki and
Keynes) along with developments since the writings of the authors just mentioned and responding to the policy experiences of the past two decades or so.

2. Functional Finance and the Need for Budget Deficits

The relationship between savings and investment has been central to many debates within macroeconomics. The mainstream approach has essentially been that the interest rate (set at the ‘natural rate of interest) was capable of equating *ex ante* savings and *ex ante* investment at some supply equilibrium (such as the ‘natural rate of unemployment’ or the zero output gap where actual output equals potential output). It then, of course, simply follows from the relationship: savings plus tax revenue = investment plus government expenditure that the budget deficit of zero is the relevant position for fiscal policy. The argument can be modified for an open economy with an additional view that the exchange rate is flexible and set such that there is a current account balance. It is the potential difference between savings and investment (at high level of economic activity), which creates the requirement for a budget deficit (and if investment exceeds savings for a budget surplus). The difference between savings and investment can only be realized (and hence savings realized) if there is a budget deficit. It could be argued that investment should be interpreted to include public investment, and the equality between savings and investment modified accordingly so that the budget deficit = savings minus investment = savings minus (private investment plus public investment), and hence budget deficit covers public investment, that is a form of the ‘golden rule’.

Despite this view and the general arguments for zero deficits, it has been a general practice for many countries to have budget deficits. In the past 40 years, the budget position in the UK has been in deficit in 34 years. The pre-crisis public debt had varied in the range of 30 to 40 per cent of GDP, and it can be readily calculated that such a ratio is consistent with an average budget deficit of around 1.5 to 2 per cent of GDP (assuming a growth rate of nominal GDP of 5 per cent). Germany had operated according to some form of ‘golden rule’ with current budget intended to balance over the cycle with borrowing for investment. The UK had in place since 1997 a similar rule. Given the orders of magnitude of public investment the resulting structural deficit would be of the order of 2 to 3 per cent of GDP.

The alternative perspective coming from the Kaleckian/Keynesian tradition is that there will in general be differences between the propensity to save and to invest, which cannot be bridged by variations in the rate of interest. The ‘functional finance’ view (Lerner, 1943; Kalecki, 1944) sees the role of budget deficits (or indeed surplus) as bridging the gap between savings and investment, which would be forthcoming at high levels of economic
activity. The budget deficit enables the savings to occur (in excess of investment): in the absence of a budget deficit, savings and investment would have to somehow be brought into equality, and that would be seen as coming from movements in the level of economic activity. The required budget deficit would then be given by:

\[
G - T = S(Y_f) - I(Y_f) + Q(Y_f) - X(WT)
\]

where the symbols have their usual meaning, so that G stands for government expenditure, T for taxes, S for savings, I for investment, Q for imports, X for exports, Yf for full employment income and WT for world trade. When written in this way, it should be apparent that there is a clear constraint on the budget deficit, and hence that it is not correct to argue that there is no constraint on budget deficit in this approach. Equation (1) provides the constraint on the budget deficit – the sum of the net savings plus net capital account inflow, which would be generated at a high level of economic activity. Thus, while the mainstream view is that there is a constraint of the form \( G - T = 0 \) (or more generally an inter-temporal budget constraint (see, for example, Arestis and Sawyer, 2009), the ‘functional finance’ is that it should be given by equation (1). This constraint on the budget deficit could in effect be put into practice (and thereby undermine arguments that ‘functional finance’ promotes profligate governments) through external evaluation on whether the constraint is being adhered to. In effect, budget deficits would be judged as ‘excessive’ if they were seeking to push the level of economic activity past some desired level.

Policy debates in many countries and within the European Union are now heading firmly in the opposite direction. It is not only that there is a predominant focus on reducing the budget deficit (whatever the consequences for economic activity), but also striving to enforce essentially balanced structural budgets. The extreme case of this (though the relevant constitutional change was conceived before the onset of the financial crisis) has been the German requirement for a Federal budget deficit of 0.35 per cent of GDP by 2016 and a balanced budget from 2020 onwards. The UK government has declared its intention to remove the structural budget deficit by 2015/16.\(^1\) “Cyclically adjusted public sector net borrowing will be reduced by 8.4 percentage points, from 8.7 per cent of GDP in 2009-10 to 0.3 per cent of GDP in 2015-16” (HM Treasury 2010, p.16). The EU is proposing much more stringent restraints on national budget deficits and more stringent application of the rules of

\(^1\) “The Government has therefore set a forward-looking fiscal mandate to achieve cyclically adjusted current balance by the end of the rolling, five-year forecast period” (HM Treasury 2010, p.1). However, the figures given in their Table 1.3 for 2015/16, indicates a cyclically adjusted current budget surplus of 0.8 per cent of GDP, and cyclically adjusted net borrowing of 0.3 per cent of GDP (and implies public investment of 1.1 per cent of GDP, which is rather below the figure for recent years).
the Stability and Growth Pact, which has within it notions of overall budget being in balance or small surplus over the cycle. The British and German proposals represent a considerable tightening as compared with the ‘golden rule’ (borrowing for investment purposes) previously in place.

The major difficulty with striving for a balanced structural budget (cyclically budget deficit of zero) can be readily illustrated in the following. Would \( S(Y^*) - I(Y^*) + Q(Y^*) - X(WT) = 0 \), where \( Y^* \) is potential output for a structural balanced budget (that is the budget deficit arising at \( Y^* \))? In answering this the historic experience referred to above, namely that many governments have on average run budget deficits, is relevant, for that implies that past experience has been along the lines of \( S(Y^*) - I(Y^*) + Q(Y^*) - X(WT) > 0 \). Hence, in order for a cyclically adjusted zero budget deficit to be achieved, would require some combination of lower savings, higher investment, lower imports and higher exports at the level of output corresponding to a zero output gap. The notion of lower imports and higher exports clearly cannot be achieved for all (or even most) countries; consequently, the focus would have to be on lower savings and higher investment.

How should this record of generally budget deficits (rather than surpluses) be interpreted? One claim could be that these budget deficits, as with all budget deficits, have crowded out private expenditure, with some form of Ricardian equivalence operating. But the question can be asked as to whether there was any evidence of crowding out and overheating: and this would not be at the top of the boom when after all budget deficits tend to be small – reflecting the idea that variations in economic activity come from variations in private demand to which tax revenue, budget deficits respond. Indeed the cyclical nature of budget deficits serves as evidence that private demand fluctuates (which would not be anticipated from inter-temporal budget constraints or from Ricardian equivalence arguments). It is rather whether at the average position over the cycle when there was on average a budget deficit there was any evidence of crowding out.

There are some well-known (but often forgotten by the fiscal consolidationists) relationships between budget deficits and debt which we repeat here as an aid to discussion below. It can readily be shown that a total budget deficit, that is primary deficit plus interest on debt, the ratio to GDP of \( b \) would, if sustained, lead to a debt ratio of \( d = b/g \), where \( g \) is the nominal growth rate. In numerical illustrations a figure of \( g = 0.05 \) is used as reflecting an approximation to the nominal growth rates of many EU countries. If the budget deficit is split into primary deficit \( b' \) and interest payments of \( r.d \) then it follows that \( b' = (g - r).d \), and hence whether there is a primary deficit or surplus depends on whether \( g \) is greater or less
than \( r \). The case where \( g \) and \( r \) are equal, which we would argue is a rough approximation for the actual relationship, also remembering here that for the government it is the post-tax rate of interest which is relevant, is of particular interest. In those circumstances, \( b' = 0 \), and the overall budget deficit is equal to interest payments: borrowing from the rentiers to pay interest to the rentiers! Pasinetti (1997, p. 163) remarks that this case “represents the ‘golden rule’ of capital accumulation. … In this case, the public budget can be permanently in deficit and the public debt can thereby increase indefinitely, but national income increases at the same rate (\( g \)) so that the \( D/Y \) ratio remains constant. Another way of looking at this case is to say that the government budget has a deficit, which is wholly due to interest payments” (p. 163).

The achievement of a structural budget position close to zero would for many countries be unprecedented (at least in the post war world). In other words, the intentions of the private sector (with regards to savings, investment and the current account position) have been consistent with a budget deficit (in general) and not with a budget deficit around zero. If a zero budget deficit is to be secured, there would have to be changes in private sector behaviour.

Trying to achieve a structural balanced budget is undesirable in itself through its likely involvement with cuts in public expenditure, but also unlikely to be achievable. This is argued not on the grounds that the government will ‘lack the bottle’ and face insurmountable obstructions – though that is not to be ruled out. It is rather that there is a failure to appreciate why budget deficits are generally necessary and a failure to appreciate that budget deficits can only be reduced if there are a set of changes in the behaviour of the private sector.

A frequent objection to the use of fiscal policy is the argument that government may not be able to fund budget deficits, and hence attempts to stimulate the economy through fiscal policy and budget deficits will be frustrated. This argument is clearly wrong, since budget deficits are required because there is an excess of (\( ex \) ante) savings over investment (at the desired level of income). If a budget deficit cannot be funded, that is because there is an absence of that excess of savings over investment, in which case a budget deficit would not be required. When there is an excess of savings over investment, then a budget deficit is required to absorb the excess savings, but that, of course, is precisely the situation in which the budget deficit can be funded.

3. Inequality and budget deficits

When fiscal policy is considered from a ‘functional finance’ perspective – that is budget deficits are incurred where it is necessary to support aggregate demand, and in effect absorb
the excess of private savings over private investment, these arguments have no validity (as was shown long ago by Kalecki, 1944; see also Arestis and Sawyer, 2004, Sawyer, 2009). At one level, interest payments on government debt can be treated as a transfer payment, and akin to the other range of transfer payments, which are made by government. The objection, which can be raised, is that in general interest payments are a transfer from taxpayers to rentiers and quite likely from the general taxpayer to the relatively rich. It should be readily apparent that running a budget deficit enables people to save: when the intention to save exceeds the intention to invest, savings can only be realised in the presence of budget (and overseas lending). The inequality of the holding of debt arises from the inequality of savings, which in turn comes from the inequality of income. Further, whatever set of mechanisms are used to achieve a high level of economic activity, there will be a corresponding profile of savings. The savings will lead to accumulation of wealth and corresponding inequality of returns on the wealth.

But the main point to be made here is that the ‘problem’ arises from the inequality of income and the (likely) greater inequality of savings. For a given level of income, there would be a level of savings generated, which would depend on the inequality of income. If that level of income were achieved through a sufficient level of investment, there would be a pattern of savings and a corresponding pattern and distribution of wealth. There would be an inequality in the returns on savings. Now consider the same level of income but now generated through a combination of investment and budget deficit. The inequality of savings and of wealth would be rather similar to the previous case. If there is concern over the distribution of interest payments between households, the relevant policy is not to forego a budget deficit but to change the distribution of income. The ‘burden on future generations’ argument can be readily dispensed with. Government debt is a liability for the government (and taxpayers) but an asset for the bondholders. The future interest payments will be a transfer from taxpayers to bondholders – though as indicated above when the real post-tax rate of interest on government debt is around the average real rate of growth of the economy, then the transfer is in effect from rentiers to rentiers; that is, borrowing from rentiers to pay interest to rentiers. Further, operating a fiscal policy, which raised the level of economic activity in the present, would be associated with higher levels of investment (broadly conceived to include private and public investment and to include investment in education and health provision), which benefits future generations.

In ‘Three Ways to Full Employment’, Kalecki (1944) envisaged three alternatives to securing a level of aggregate demand which would be consistent with full employment. These were (i)
the use of budget deficits, (ii) stimulation of investment, (iii) income redistribution. From the equations above, the stimulation of net exports should also be added. Another possibility could also be added, namely raising both public expenditure and taxation and by appeal to the ‘balanced budget multiplier’ this could raise income, in effect through taxation reducing disposable income and thereby savings. Within that perspective, a direct tax on savings could be used to reduce savings intentions.\textsuperscript{2}

3.1 Investment

In order to provide full employment there has to be a sufficient capital stock in regard to size and distribution (across geographical areas). This is then a matter of having the relevant capital stock, and ensure that investment provides that capital stock. The role of investment over a longer term as a component of aggregate demand is much more limited. Here we focus on two reasons. First, the share of investment in national income $I/Y = (I/K)(K/Y)$; the first term is the growth of the capital stock, which with a constant capital-output ratio would be growth of output. Hence a capital-output ratio of 4 and growth rate of 2.5 per cent yields a 10 per cent net investment to GDP ratio. The capital-output ratio has tended to be constant. But even if the capital-output ratio was rising, the rate of profit would be tending to decline, unless of course profit margins and profit share are rising. Second, investment is clearly intended to be an addition to the capital stock and to enable growth of output to occur. There are clearly limits to how far and how fast growth can proceed on environmental and resource grounds. Consequently, there are then limits on investment.

3.2 Net Exports

The limitations of the use of net exports as a general means of stimulating aggregate demand are straightforward – not every country can improve their net export position. For a single country there may be possibilities through exchange rate variations and through industrial and similar policies. Apart from the limited number of countries which could pursue this route, and a number of them come to mind, it could also be said that in general the scale of a swing in net exports which would be required on its own to secure high level of demand compatible with a zero budget deficit would in its own terms be relatively large. By this we mean that the reduction of budget deficit from an average of 3 per cent of GDP to zero would require a shift in net exports of the same order of magnitude.

3.3 Reducing Inequality

\textsuperscript{2} For further elaboration on the arguments in this section see Sawyer (2010).
The broad changes in the distribution of income in industrialised countries over the past three decades are well-known; namely, a general tendency towards increases in inequality in the personal distribution of income and a shift away from wages towards profits. The general presumption would be that this leads to a higher level of savings/lower level of consumer expenditure, with detriments on the level of demand.

The present patterns of savings behaviour (these remarks apply to the UK) are conducive to the build-up of debt as a response to ‘over savings’ in that corporate savings exceeds corporate investment. The household sector engages in savings into pension funds with low overall savings (as measured in national income accounts); but savings in cash terms being negative, as savings in national accounts are reckoned to include increase in equity in pension funds and pension contributions made by employees and by employers. Further, corporations have savings in excess of investment, and apart from lending to government (budget deficit), and overseas, the lending of savings by corporations to households involves the latter in debt accumulation. This may occur directly (e.g. companies providing finance to households to facilitate purchase of goods produced by the companies, financial corporations are included in the corporation figures) and indirectly. Hein and Truger (2011) provide similar and more extensive arguments, and give indications of elements of the trends towards inequality.

If wage share were say 5 percentage points higher, and there is a difference in the marginal propensity to consume between wages and profits of say 0.3, then savings would be lower by 1.5 percent of GDP. A redistribution of income from the top two deciles to bottom four deciles of 10 per cent of earnings, that is 6 to 7 per cent of GDP, and the marginal propensity to consume difference of 0.2, a further 1.2 to 1.4 per cent; these two, rounded up to 3 per cent of GDP would solve much of the budget deficit problem.

There have been substantial (of the order of 10 percentage points) in the wage share in Germany over the past two decades or so. Figures in Office for Budget Responsibility (2010) suggest a decline of the order of 5 per cent between 2005 and 2015. In the UK, over the period 1977 to 2006, the shares of income by quintile changes from quintile 1 8.3 per cent, quintile 2 13.4 per cent, quintile 3 19.5 per cent, quintile 4 24.1 per cent and quintile 5 34.7 per cent to 7.4 per cent, 11.7 per cent, 16.6 per cent, 23.3 per cent and 41.0 per cent respectively; hence the income share of bottom 60 per cent fell by 5.5 percentage points and that of the top 20 per cent rose by 6.3 percentage points.

Changes in the distribution of income would lead to changes in the distribution of savings, and at a later stage changes in the distribution of returns on savings including those coming from interest payments on government debt.
The policy measures designed to shift the distribution of income can be easily listed, but the difficulties of the political acceptance of them are strongly correlated with the ease of listing them! Significant increases in minimum wages where such already exist and their introduction elsewhere, adoption of ‘living wage’ ordinances, structuring wage awards in the public sector to increase lower wages faster than higher wages, enhancing the power of trade unions, all can make a difference. Making the tax system progressive through, for example, capital gains treated as income for tax purpose, removing caps on earnings limits for social security contributions (with no commensurate changes to social security benefits), enhanced property taxation, are further possibilities.

4. Setting the Policy Interest Rate

In recent decades, monetary policy has often been organised around inflation targeting, with an ‘independent’ Central Bank setting the policy rate of interest seeking to achieve an inflation target (often around 2 per cent per annum). This policy approach has involved ‘independence’ of Central Banks which is addressed below. It has also involved attempts to fine-tune the rate of inflation through the frequent change of the policy rate of interest. We have argued elsewhere (see, for example, Arestis and Sawyer, 2008) that the inflation targeting policy has not been instrumental in securing low inflation. It may also be questioned how far monetary authorities actually followed the Taylor rule approach to the setting of interest rates (Arestis and Sawyer, op. cit.). Further, the policy interest rate will have effects on a range of variables, notably the exchange rate and asset prices. Indeed those variables are viewed as part of the channels through which changes in the policy rate of interest is supposed to influence the level of demand and thereby the rate of inflation (see, for example, Bank of England, 2004). There are questions of the strength and reliability of those channels, but the point here is that there can be effects, and some of them may be adverse. For example, Goodhart (2005) argues that a focus on domestic variables only in interest rate determination may provide “a combination of internal price stability and exchange rate instability” (p. 301). In recent times, an important aspect of this can be the influence of low interest rates on asset prices, and whether the stimulus to asset price rises, coming from low interest rates can be the spark setting off a price bubble. The argument of Wicksell (1898), and more recently by others (see, for example, Arestis and Karakitsos, 2009), could be seen as one that suggests interest rate policy has an effect on asset price inflation – or at least some sub-set of asset prices; asset prices develop a speculative element (meaning here purchase of asset to benefit from expected rise in price, rather than for income stream from asset); it is obvious to say that
asset price bubbles have developed – dot.com, house prices, etc. Current monetary policy arrangements are powerless to deal with those bubbles.

This leads us to suggest a ‘constant real rate’ of interest rule. The ‘inflation targetting’ approach is itself based around an underlying real rate of interest rule, that is the ‘natural rate of interest’ with variations around that rate to address deviations of inflation from target level and output from potential output. The argument here is to dispense with the variations of real interest rate around the average level and maintain the average level. How should the average level be set? We do not accept the notion of a ‘natural rate of interest’ in the sense used by Wicksell3, nor do we think that the ‘natural rate’ is a well defined concept. But it can be noted that in Taylor’s original formulation of the rule for setting the rate of interest, “the 2-percent ‘equilibrium’ real rate is close to the assumed steady-state growth rate of 2.2 percent” (Taylor, 1993, p. 202).

The rationale for dispensing with frequent adjustments to the real rate of interest (whether in pursuit of an inflation target or otherwise) is the possible instabilities associated with such adjustments. An example here could be that when interest rate in a country increases unexpectedly, it would be anticipated that the exchange rate would rise as the country now attracts more capital inflows. But a higher interest rate in a country would tend to be associated with a depreciating exchange rate (in so far as ideas of interest rate parity hold). There would then to an ‘overshooting’ situation whereby an increase in domestic interest rates leads to a higher exchange rate followed by depreciation.

The operating rule which is put forward here for the real rate of interest is one related with the rate of growth of the economy. This rule can arise from a number of considerations. The ‘golden rule of capital accumulation’ in the framework of a neo-classical model with the marginal productivity of capital equal to the rate of interest generates such an outcome. Another, to which we give much greater weight, is the ‘fair rate of interest’ (Pasinetti, 1981), which “in real terms should be equal to the rate of increase in the productivity of the total amount of labor that is required, directly or indirectly, to produce consumption goods and to increase productive capacity” (Lavoie and Seccareccia, 1999, p. 544).

The remark above on Taylor’s rule suggests that in practice the real rate of interest comes close to the rate of growth of the economy. Another suggestion along similar lines comes

---

3 Wicksell wrote in the following terms. “There is a certain rate of interest on loans which is neutral in respect to commodity prices, and tend neither to raise nor to lower them. This is necessarily the same as the rate of interest which would be determined by supply and demand if no use were made of money and all lending were effected in the form of real capital goods. It comes to much the same thing to describe it as the current value of the natural rate of interest on capital”. (Wicksell, 1965, p. 102, emphasis added).
from a recent report where it was proposed that “Students with higher earnings after graduation will pay a real interest rate on the outstanding balance for the costs of learning and living. The interest rate will be equal to the Government’s cost of borrowing (inflation plus 2.2%)” (emphasis added) (Browne Report, 2010, p. 35). Unfortunately no source is given for this statement and it is presumed that this relates to the rate of interest paid by government. However, interest payments are liable to taxation for domestic holders. The significance of this figure is that a real rate of interest of 2.2 per cent is somewhat below the trend rate of growth of the UK economy usually put somewhere in the range of 2.5 per cent to 2.75 per cent (recently Office for Budget Responsibility has pitched a little lower at 2.3 per cent).

The setting of the interest rate has some clear and obvious implications for the operation of fiscal policy. The sustainability of a budget deficit depends on the level of interest rates (and specifically the post-tax rate of interest on government bonds, labelled $r$). If $r < g$, then any primary budget deficit of $d$ (relative to GDP) would lead to an eventual debt ratio (to GDP) of $b = d/(g - r)$ (either both of $g$ and $r$ in real terms or both in nominal terms). If $r > g$ then a primary budget deficit would lead to growing debt ratio. In a similar vein, a continuing total budget deficit of $d$ (including interest payments) leads to a debt to GDP ratio stabilising at $d'/g$ where here $g$ is in nominal terms. This implies that $b + rd = gd$, i.e. $b = (g - r)d$ and hence if $g$ is less than $r$ the primary budget deficit is negative (i.e. primary budget is in surplus). The case where $g = r$ is of particular interest. Pasinetti (1997, p. 163) remarks that this case “represents the ‘golden rule’ of capital accumulation. … In this case, the public budget can be permanently in deficit and the public debt can thereby increase indefinitely, but national income increases at the same rate ($g$) so that the $D/Y$ ratio remains constant. Another way of looking at this case is to say that the government budget has a deficit, which is wholly due to interest payments” (p. 163).

The simplest way to implement such a policy would be to set the nominal policy interest rate at the beginning of the year, taking into account the expected rate of inflation for the coming year (with perhaps some adjustment based on difference between actual and expected inflation in the preceding year). Outside of crisis (and perhaps even then) the nominal policy interest rate would be maintained for the year, with avoidance of costs of further decision-making and implementation of interest rate changes. There are some issues with such a policy approach to be resolved. The arguments for a constant real rate equal to the rate of growth relate to some market rate of interest, which is not equal to the policy rate, and which may bear a varying relationship with the policy rate. There can be international complications in so far as domestic interest rate relative to interest rates elsewhere can have implications for
the exchange rate. This is neither to suggest some simple uncovered interest rate parity idea nor to suggest that the effects of interest rate differentials on exchange rate are firm and predictable.

In effect we wish to put forward two lines of argument here. First, to suggest that the arguments against fine tuning apply to the setting of interest rates, and that such fine tuning should be foregone and rather the nominal rate of interest should be set to achieve a constant target real rate of interest. Second, there are a number of arguments to support the view that the target real rate of interest be the underlying rate of growth of the economy.

5. Ending Central Bank independence

Ever since Kydland and Prescott (1977) and Barro and Gordon (1983), where the notion of time-inconsistent behaviour and the inflation bias syndrome were introduced, there has been a sustained trend towards Central Bank Independence (CBI) around the globe. This trend constitutes a fundamental institutional shift from previous practices, and has progressed along with the acceptance by policymakers of price stability in particular as the most important goal of monetary policy. There seems to be a broad consensus among central banks in particular that this important goal should be assigned to an independent central bank. Such institutional innovation has been introduced during a period associated with a striking decline in world inflation from the time of the early introduction of CBI, which plummeted to low levels by the end of 2006.

The arguments for CBI with operational independence (specifically from politicians) were based on two interconnected propositions. First, that the single instrument (interest rate) affecting the single objective (inflation) was a viable one. This in turn rested on the Phillips curve type approach in that interest rate could influence the rate of inflation and that there is an equilibrium rate of interest, which is simultaneously compatible with constant inflation and with supply-side equilibrium (expressed in the form of either the ‘natural’ rate of unemployment or a zero output gap). The achievement of a constant rate of inflation would secure the achievement of supply-side equilibrium (which was assumed to be uninfluenced by the path of aggregate demand and to have some desirable properties). The ability of the equilibrium rate of interest, along with market flexibility, especially flexibility in the labour market, to secure the supply-side equilibrium was in effect sufficient to rule out any requirement for active fiscal policy.

Second, the short-run Phillips’ curve suggests that lower unemployment (higher output) comes with a higher rate of inflation, and that elected politicians at times will be tempted to boost demand with its benefits of lower unemployment and higher output at the cost of higher
inflation. Central Bankers are then viewed as uniquely able to influence the level of demand without falling to the temptation to raise demand at inappropriate times, to be more committed to low inflation and to avoid the problems of time inconsistency. The notion that the Central Bank has, or can acquire, credibility in terms of its commitment to the control of inflation, and that it is the Central Bank alone (the ‘conservative’ central bankers argument) that has this creditability with respect to the control of inflation are central themes in the central bank theoretical framework.

There is also the question of the empirical evidence on CBI. Cornwall and Cornwall (1998), for example, argue that “Considering each foundation stone of the greater CBI argument, closer analysis fails to reveal convincing evidence to support the case for increased CBI. The econometric results offered by its advocates cannot withstand even the most elementary scrutiny, the theoretical models are based on implausible and internally inconsistent assumptions and the historical record gives little support for either the theoretical base or for some key tenets of the neoclassical counterrevolution that we identified as the temper of the times” (p. 63). Those sceptical arguments were summarized in Forder (2003), “The advocates of independence face three challenges: to advance a theoretical account of the benefits of independence; to provide evidence supporting it; and to make a persuasive argument that any restrictions on democratic decision-making are a price worth paying” (p. 41). Recently, Bibow argues that ‘as to the empirical evidence supposedly supporting CBI, we are struck by the nonexistence of any compelling evidence for such a case. The theoretical support for CBI as supposedly provided by modelling exercises on the so-called time-inconsistency problem in monetary policy is found equally wanting’ (Bibow, 2010, p. 3).

In terms of the evidence it is questionable in this view whether CBI reduces inflation or produces other benefits. More recently Angeriz et al. (2008) reach similar conclusions. In this study, the question is asked whether CBI significantly improves inflation performance, tackles inflation persistence, and constrains inflationary expectations. In this way, not only do the authors investigate the impact of CBI on inflation at the point of intervention but also throughout the period the framework has been in operation. Their sample includes twenty developed and developing countries around the globe, which implemented CBI. Although evidence of a marginal effect of CBI on special features has been observed in some countries, CBI has not been such a major success once all different angles are considered. Inflation level, persistence in inflation and inflation volatility seem to have very little to do with CBI.

The operational ‘independence’ of a Central Bank in any serious sense would preclude co-operation between the Central Bank and other public authorities. In a one instrument—one
objective framework (bearing in mind the first point above, namely that constant inflation and the supply-side equilibrium are in effect two sides of the same coin) this could be acceptable. But once it is demonstrated that the impact of the rate of interest is not quite as robust as the proponents argue and consequently that the interest rate tool is not adequate to achieve the objective so that more tools are required, and that (at least intermediate) objectives such as the exchange rate and the level of and growth of output are on the agenda, then doubt must be cast on the independence of central banks.

6. The Objective of Financial Stability

It is the case that concerns over financial (in)stability have not been at the forefront of discussions of monetary policy and decision making over monetary policy to say the least. The widespread belief in the efficiency and essential stability of financial markets prevented a realistic and necessary approach to financial stability (IMF, 2010). As a result, both the supporters of the New Consensus Macroeconomics framework and policymakers have ignored “the implications for systemic stability of financial market imperfections, including those stemming from international frictions, moral hazard and other distortions to incentives, such as externalities and herding” (IMF, op. cit., p. 7). As a result potential systemic risk was ignored and financial regulation and supervision “were increasingly light-touch and reliant on self-correcting market forces” (IMF, op. cit., p. 7); and, indeed, in the case of the US ‘shadow banking’ it was completely absent.

The focus of financial stability should be on the effective control of the financial sector so that it becomes socially and economically useful to the economy as a whole. Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves. In order to achieve these objectives a number of prerequisites should be in place. To begin with, the core function of banking should be re-stated. This should be to facilitate the allocation and deployment of economic resources over time and place to socially useful purposes. It should also be to maximise long-term financial and social returns under conditions of uncertainty. In order to achieve these objectives a number of reforms should be undertaken. The most important, perhaps, is the separation of commercial banking from investment banking. Commercial banking sits at the moment uncomfortably with the risky activities of the investment banking; and most commercial banks have moved into investment banking in search of quick profits. Separation then should allow investment banks to go bust, if necessary, thereby instilling greater discipline and avoiding moral hazard. A second reform should be the break up of banks that are ‘too big to fail’. Allowing banks that are big to fail creates moral hazard: banks pursuing high risk activities confident that the
public will have to bail them if and when things go wrong. Also banks need to be broken up both to reduce costs and risks to the taxpayer, and also to improve the quality and range of services. A further reform is to tax the financial sector and, also, introduce a financial transactions tax. These would need to take place on a worldwide basis and used to slow financial speculation, one of the main causes of the credit crunch. Better regulation should be introduced. Banks should hold more capital, in the form of leverage and liquidity requirements, particularly in booms when risks are by far greater. This proposed requirement, which forces banks to hold more capital, could push the countries concerned into depression. This can come about since stringent capital requirements may leave the banks with insufficient funds for lending purposes. Due care and attention are, therefore, vital when constructing the relevant new rules. Above all, though, it is high time that banks, and financial institutions more generally, should operate along the more familiar, and healthy, lines: direct credit as needed and in the process support enterprise; and be part of the system that generates investment and innovation for a healthier and more prosperous economy. Big banks should be brought back to a healthier size and, of equal importance, limit their capacity to speculate. Of equal importance is the need to curb the power and influence of the credit rating agencies. All in all, we need a smaller and safer banking industry.

We would argue, therefore, that financial stability, rather than inflation targeting, should become the central objective of the Central Bank. Buiter (2008) indicates that in practice “financial stability means (1) the absence of asset price bubbles; (2) the absence of illiquidity of financial institutions and financial markets that may threaten systemic stability; (3) the absence of insolvency of financial institutions that may threaten systemic stability” (p. 10). It can be noted that the recent Banking Act 2009\(^4\) in the UK establishes that “an objective of the Bank [of England] shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom (the ‘Financial Stability Objective’)”, with the Bank working with other bodies, such as the Treasury, to establish a Financial Stability Committee. At present this is placed along side the monetary stability objective under the heading of inflation targeting. This could be seen a significant step away from the operational independence of the Bank of England and from the single inflationary objective. Our argument here is that the financial stability objective should be the prime objective of Central Banks and their operational independence should be abolished.

The ‘great recession’ coming from the financial crisis of 2008/09 and more generally the record on financial crises (see, for example, Laeven and Valencia, 2008, for details of crises over the past three decades and their costs) indicate that the substantial costs are associated with a lack of financial stability (which would far outweigh any costs associated with inflation). Thus there is a strong case for the objectives of macroeconomic policies (and others) to include the promotion of financial stability.

In terms of the general multiple instruments, a multiple objectives framework it may not be possible to uniquely assign each instrument to a specific objective. Nevertheless, it may be possible to link an instrument mainly with a specific objective, recognising that co-ordination in the use of instruments is advantageous. In this context, the argument is that the main link should be monetary policy and financial stability. On this score we would agree with Goodhart (2007), who in fact suggests that “[i]n so far, therefore, as the central bank has a prime concern for systemic financial stability, it should want to promote a program of counter-cyclical prudential regulations, where these latter become restrictive during asset price bubbles and relax during asset price downturns. Unfortunately the system of financial regulation is developing in a manner which will have exactly the reverse proclivity” (p. 68).

The argument here relies on the removal of inflation targeting as the main stabilization instrument and instead worry about unemployment and other macroeconomic goals.

There is an element here of the end of monetary policy, and its replacement by (or incorporation into) financial stability policy. Monetary policy is about money and involves banks since they are those financial institutions whose liabilities are regarded as part of the stock of money. Monetary policy in the simple IS-LM type framework is viewed in terms of the (policy) rate of interest and the stock of money and the notion that Central Bank could set one of the variables and then had to accept the consequential value of the other variable. In the endogenous money framework the Central Bank sets the policy interest rate as the terms on which it will supply reserves (monetary base). One of the key roles of the Central Bank has been viewed as the lender of last resort, which would involve supplying liquidity to the banking system as and when required. With an objective of financial stability, the Central Bank would become more like a Central Financial Agency (CFA). It would be responsible for policies, which seek to influence the credit and lending policies of the full range of financial institutions by, for example, targeting private sector net wealth as one of us has argued in Arestis and Karakitsos (2009).
7. Concluding Comments
The key objective of macroeconomic policy should be the achievement of full employment of labour (in the context of sustainable growth). The macroeconomic policies outlined above are advanced with that objective firmly in mind. Thus, it replaces the obsession of the NCM with inflation by an obsession to achieving full employment. It is firmly recognized (as we have argued in Arestis and Sawyer 2011) that macroeconomic policies cannot alone achieve full employment. Specifically there are requirements to ensure adequate productive capacity (in terms of its quantity and geographic distribution) to be in place through industrial and regional policies. There is also a need to develop policies which can secure low inflation without resorting to deflationary targets. We present the policy framework above as our contribution to the development of alternative macroeconomic policies for full employment.

References


