A Critique of the New Consensus View of Monetary Policy

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Abstract

This paper seeks to look at the underlying framework of the New Consensus models of macroeconomic policy for inflation and unemployment, providing a post-Keynesian critique. In the light of this critique, the model is reformulated, with its basic structure intact, but with alternate post-Keynesian specifications of the Phillips curve being considered. It is shown that such modifications, either allow a long run trade-off between the rate of inflation and the level of output, the rate of capacity utilisation and, therefore, unemployment, or, in our preferred specification, changes in output and capacity have no implications for inflation over a large range of capacity utilisation. In either case, macroeconomic policy is restored to its role in maintaining full employment.

Introduction

Macroeconomic policy has been subject to phases of fashion, as different policy instruments have been in and out of favour since the second world war. Initially, the favoured instrument in the post war period was fiscal policy, which was used to fine tune economies, in order to minimise cyclical influences. Following the stagnationary periods of the early 1970s, monetarist doctrines came into favour, and these emphasised the importance of monetary policy, particularly with respect to the fight against inflation. This

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version of monetarism, championed by Friedman advocated a rule for monetary policy, with the main policy variable being growth in money supply which was to be tightly controlled according to a rule. Fiscal policy according to this doctrine is impotent in the long run, and of little influence in the short run. However, the attempt to control monetary aggregates proved to be unsuccessful, as a result of which this version of monetarism was rejected by policy makers.

Recently, a New Consensus with respect to macroeconomic policy has arisen among neoclassical economists (aka the New Neoclassical Synthesis), which has been defined by a number of New Keynesian economists (such as Romer 2000, Taylor 2000, and Woodford 2002), and has been generally accepted by policy maker and economists. This new view seeks to redefine the way in which government should direct its policy in attempting to alleviate both unemployment and inflation. In particular, this new view considers the application of monetary policy by respecifying the most appropriate monetary rule. In other respects it represents a return to the original Friedman analysis of the expectations augmented Phillips curve. This paper seeks to look at the underlying framework of the New Consensus model, providing a post Keynesian critique. In the light of that critique, the model is reformulated, with its basic structure intact. It is shown that such modifications either allow a long run trade-off between the rate of inflation and the level of output, the rate of capacity utilisation and, therefore, unemployment, or, in our preferred specification, changes in output and capacity have no implications for inflation for a large range of capacity utilisation. Both of these open the door for the view that governments have a role in applying macroeconomic policy in order to reduce levels of unemployment.

The "New Consensus"

The irony of calling the emerging view a "new" consensus is extremely strong. The underlying vision of the economy is, in essence, the same as for Monetarism Mark 1 associated with Milton Friedman. Like Friedman, adherents of the new consensus see the self adjusting forces of a market economy as imposing full employment of all resources in the long run, though these forces may be impeded in the short run. So they accept an upwards sloping short run Phillips curve but view the long run Phillips curve as being vertical at NAIRU, or at some similar supply-side determined concept, with monetary policy having no impact on real activity in the long run:

> There is substantial evidence demonstrating that there is no long-run trade-off between the level of inflation and the level of unused resources in the economy – whether measured by the unemployment rate, the capacity utilisation rate, or the deviation of real GDP from potential GDP. Monetary policy is thus argued to be neutral in the long run. An increase in money growth will have no long-run impact on the unemployment rate; it will only result in increased inflation (Taylor 1999 pp. 29-30).

In other words, the inflation rate falls when unemployment is above NAIRU, and increases when unemployment is below it. This, then, is incorporated as the basis of the upward sloping short run Phillips curve and the vertical long-run Phillips curve, where any deviation of capacity, real GDP or unemployment from their normal levels leads to *changes* in the inflation rate. If capacity utilisation is kept above its normal level, this will quickly lead to accelerating inflation. In other words, according to this view, there is no long-term trade-off between any inflation and either output or employment.

This Phillips curve is one of three relations which define the new consensus.

The New Consensus view accepts a conventional IS schedule reflecting the view that monetary policy can have real effects in the short run. This is the second important relation of the New Consensus. As in most macroeconomic models, the New Consensus assumes that investment is inversely responsive to changes in the rate of interest, leading to an inverse relation between the rate of interest and the level of economic activity.

So far there is no real difference between the analysis of Monetarism Mark 1, associated with Friedman, and the New Consensus. However, although both Friedman and the New Keynesian authors strongly argue the need for monetary policy rules, the choice of instrument through which the rule acts differs. For Friedman the rule sets optimal money supply growth, while for New Consensus authors "the interest rate rather than the money supply is the key instrument that should be adjusted" (Taylor 1999, p. 47). The proposed rule would have the central bank responding to both price and aggregate demand shocks (or expected such shocks), and provides the final New Consensus defining relation. Interest rates should be changed if inflation deviates from its target or, as an indicator of inflationary pressure if real GDP deviates from potential GDP. In other words, the main target for policy remains the inflation rate, although now it is accepted that inflation need not be zero. Instead, a target inflation rate is set by the central bank, with any deviation of inflation from its target leading to the central bank

changing interest rate, according to the rule. However, in addition, because of its impact on future inflation, changes in GDP, as proxied by the level of capacity utilisation away from potential or normal levels, are also targeted.

In summary, New Consensus authors rely on a vertical long-run Phillips curve that prevents the possibility of any level of economic activity in the long run bar that corresponding to potential output or normal use of capacity. Although monetary variables play a role in the determination of the level of economic activity in the short run, they have no real effects in the long run. The basic role of monetary variables is to push the economy to its long run equilibrium, though they play no role in the determination of that equilibrium. In other words, we have the long-term neutrality of money, and the long run efficacy of markets, which combine to undermine any role for macroeconomic policy for long run stability.

A Post-Keynesian Critique

Post-Keynesian economists are critical of a number of important features of the New Consensus model described above. We can divide these criticisms into two distinct areas. Firstly, many post-Keynesians are critical of the manner in which it is assumed that the interest rate influences the level of economic activity, a relation which underlies the analysis, and of the related assumption of the efficiency of monetary policy in the short run and monetary neutrality in the long run. Secondly, all post-Keynesians reject the concept of a vertical long run Phillips curve. Points 1–3 below deal with the first of these issues, while the second is the subject of the remaining points.

1. Many Post-Keynesians reject the simple interest rate/investment relation implied in the IS model, where many of the components of aggregate demand, and, therefore of output, respond in a simple and predictable way to changes in the interest rate. There are a number of reasons for this rejection. Firstly, most post-Keynesians believe that the relation between interest rate and investment is more complex than the simple functions (linear or otherwise) assumed in the IS relation. In addition, many economists do not think that there is a one for one relationship between the short term interest rate set by the central bank, and the long term interest rate which affects the components of aggregate demand (see, for example, Pollin 2003, Villieu 2004). In fact, Kalecki argues, partly for this reason, that it is the quantity of credit rather than its price which influences investment (Kriesler 1997). Nevertheless, tight monetary policy associated with increased short term rates will also be associated with increased credit

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tightening and a corresponding fall in the animal spirit of banks, so that, at least with contractionary monetary policy, it may be reasonable to assume that there will be some effect on aggregate demand. (Wolfson 1996)

2. Empirically, evidence suggests that the interest elasticity of investment is non-linear and asymmetric (Taylor 1999). While an increase in interest rates is likely to reduce investment in times of economic booms, the reverse is not true. Reductions in interest rates are unlikely to stimulate investment in times of recession. In the words of the old adage: you can lead a horse to water but you can't make it drink. Many economists think that using monetary policy in a recession is like pushing on string (See Nevile and Kriesler (2002).

3. Partly for this reason, post-Keynesians, as do many monetary economists, believe that monetary policy takes a considerable amount of time to have any effect, unless interest rates are changed by drastic amounts (that may jeopardise the stability of the financial system). Monetary policy is known to be a particularly blunt instrument, with long and variable lags. Several post-Keynesians believe that, before high rates take their toll, real interest rate hikes lead to higher inflation rates, through interest cost push (Galbraith 1957, pp. 130-1; Taylor 2004, pp. 88-90). It can be shown that this effect may jeopardise the neat converging features of the New Consensus (Hannsgen 2004).

4. In contrast to some New Keynesian authors who believe that "short-run non-neutrality and long-run neutrality are ... as well accepted as any proposition in monetary economics" (Mankiw 1999, p. 72), post-Keynesians reject the so-called neutrality of money in the long run as well as in the short run. In other words, they argue that monetary variables will influence real variables in both the short and long run. The main reason for this is that Post-Keynesians reject the notion of a supply-determined natural growth rate. They believe that if the concept of a natural growth rate is to be of any assistance, it is determined by the path taken by the actual growth rate, as pointed out very early in Kaldor (1960, p. 237). "In sum, the natural rate of growth is ultimately endogenous to the demand-determined actual rate of growth .... The natural rate is not an attractor in demand-led growth models" (Setterfield 2002 p. 5). Post-Keynesians reject the vertical long-run Phillips curve.

5. In addition, many Post-Keynesians are even sceptical about short-run trade-offs between GDP/capacity and inflation. There are two reasons for this. First, there is a large range of capacity utilisation rates which are consistent with an absence of demand-led pressures, for reasons tied to the absence of decreasing returns over a large range of production levels

(Lavoie 2004, p. 24). Second, it is believed that with "co-ordinated wage bargaining a constant inflation rate becomes compatible with a range of employment levels, and the NAIRU as the short run limit to employment is no longer unique" (Hein 2002, p. 314).

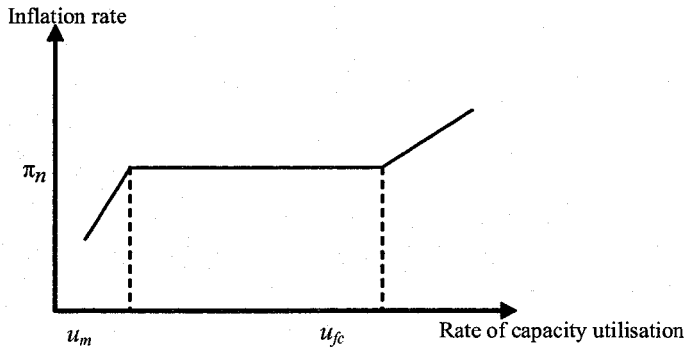
A number of ways of modifying the New Consensus analysis to incorporate explicitly post-Keynesian considerations have been suggested.

Setterfield (2004) emphasises an important post-Keynesian modification in his critique of the New Consensus. He concentrates on the nature of the Phillips curve, pointing out that demand-type considerations are not the only influence on the inflation rate, and the neoclassical Phillips curve suggests. Cost considerations, as well as institutional variables reflecting the wage and price setting process will have significant influence on the inflation rate. As a result, he replaces the vertical Phillips curve with one augmented by these more intricate explanators of inflation. With this kind of Phillips curve, a multiplicity of possible long-run rates of growth and levels of output and employment result. Comparisons of long-run positions show that higher inflation targets allow for higher growth rates and higher levels of employment.

However, further modifications need to be made in order to more fully capture the essence of post-Keynesian analysis, and the policy implications. In particular, many post-Keynesians (but not all) are dubious of the notion that inflation needs to rise with all increases in output. As mentioned in point 5, they argue that, for large ranges of output, there seems to be little impact on inflation. This is compatible with post-Keynesian pricing models of mature economies. In these economies, for most sectors, price is determined as a mark-up over costs. Regardless of which notion of cost is used, prime, variable, normal or full, cost pressures will remain constant over a large range of output levels. So with labour productivity constant, and with mark-ups also tending to remain constant, there need not be any increased pressure on prices with expansions of capacity over that range. In other words, changes in capacity utilisation need only be inflationary at levels of capacity near full utilisation. Similarly, only at very low levels of capacity would we expect some reduction of the inflation rate. In other words, there would only be a tradeoff between inflation and unemployment at very low and very high levels of capacity utilisation, with the inflation rate constant for levels of a large intermediate range of capacity. In this case, the Phillips curve would be horizontal for large ranges of output and employment (Freedman, Harcourt and Kriesler 2004).

This would lead to the replacement of the vertical long run Phillips curve of neoclassical theory with a Phillips curve following type:

Figure 1. Post-Keynesian Phillips Curve



where: u_{fc} represents full capacity utilisation

u_m is some low level of capacity utilisation, below which the inflation rate falls

$\eth_n$ represents the rate of inflation associated with the normal range of output, subject to supply side shock.

For a large range of capacity utilisation u such that $u_m < u < u_{fc}$, we have that $\Delta\eth = 0$, as shown in Figure 1. In this case, if the current inflation rate is the target rate, central bank policy should set the interest rate at a *fair* rate, based on income distribution considerations, in particular the distribution between debtors and creditors, and allow fiscal policy to set the output/capacity level, as more recently recommended by Arestis and Sawyer (2003). The other possibility, in line with the analysis is that monetary policy should be maintained as a instrument in manipulating effective demand to acceptable levels. In this case, the argument for the efficacy of fiscal policy also enters the picture, and so there is a strong case for re-establishing the Keynesian view of the appropriateness of fiscal and monetary policy in achieving and maintaining full employment levels of output.

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Conclusion

The policy implications of the New Consensus flow from their two key relations: the underlying IS curve and the vertical long-run Phillips curve. The second is the most important. This paper has shown that accepting all the basic equations of the New Consensus model amended with the suggested post-Keynesian modifications with respect to the Phillips curve equation, will fundamentally change the model's conclusions. In particular, our amended Phillips curve will yield Kaleckian results, with important roles for fiscal and monetary policy in influencing the level of output, capacity utilisation and employment. In other words, the government will again have an important role in terms of both fiscal and monetary policy, for the maintenance of reasonable levels of employment. Unlike the New Consensus Model, accepting a Phillips curve amended as above means that we can no longer claim that the market will set the long term unemployment rate, which cannot be influenced by macroeconomic policy.

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