9. Orthodox vs heterodox thinking in macroeconomics

I. Key features in orthodox macroeconomic analysis

The 'new neoclassical synthesis' represents the principles on which (according to orthodox economists) "almost all modern macroeconomists agree". These principles are listed next.

1. "Inflation is always and everywhere a monetary phenomenon" and monetary policy determines the inflation rate in the long run.

2. Low and stable inflation (price stability) provides important benefits, because high inflation leads to uncertainty about the future price level, which makes more difficult for people to identify the best decisions.

3. In the long-run there is no Phillips curve, that is, no long-run tradeoff exists between unemployment and inflation. In the long-run, the Phillips curve would be vertical over some "natural rate of unemployment". Attempts to lower unemployment below the natural rate only generates more inflation.

4. Expectations play a crucial role.

5. The Taylor principle, which establishes the view that monetary policy must raise the nominal interest rate by more than the rise in inflation, making the real interest rates go up in response to an inflation rise.

6. The time-inconsistency problem: discretional monetary policy may lead to high inflation with no gains in output, because policians are mostly interested in winning elections and that makes them shortsighted.

7. An independent central bank insulates itself from political pressures to pursue excessively expansionary policies stimulated by the myopia of politicians. In an independent central bank bankers are presumed to be more averse to inflation, more credible (mostly, in the eyes of the financial markets) in the pursuit of low inflation. With a more credible policy lower expectations of inflation result and this contributes to achieve low inflation.

8. Commitment to a nominal anchor —that is, stabilization of a nominal variable such as the inflation rate, the money supply, or an exchange rate— is crucial to successful macroeconomic policy outcomes. Commitment to a nominal anchor: (i) makes it difficult for the government to run large budget deficits; (ii) leads to policy actions that promote price stability; and (iii) helps to stabilize inflation expectations.

9. Credibility is central to successful policy making.

Areas of disagreement in orthodoxy include the following.

- The flexibility of wages and prices: are they very flexible or sticky in the short run?

- Time to reach te long run: does it take a short time or a long time to get to the long run?
- Sources of the business cycle: aggregate supply shocks or aggregate demand shocks?
- Effectiveness of stabilization policy: is there no role for policymakers to try to stabilize economic activity or is there a stabilization policy that provides benefits (self-correcting mechanisms act slowly and therefore activist policies can reduce the severity of the business cycle)?
- How dangerous are budget deficits? Most believe they are highly dangerous: budget deficits reduce savings and investment, burden future generations, and are inflationary. The minority who believes in the Ricardian equivalence holds that budget deficits that arise from tax cuts do not burden future generations, higher personal saving do not crowd out investment, and see no inflationary dangers.

II. John Maynard Keynes's basic contributions

Keynes's *The General Theory of Employment, Interest and Money* (1936) tried to explain two anomalies inconsistent with the orthodox theory: unemployment persistence despite price and wage flexibility and absence of an automatic mechanism that leads market economies towards full employment. He proposed three alternative ideas.

- Fallacy of composition effects. Orthodox microeconomic analysis cannot be be automatically extrapolated to the macroeconomic level.
- Uncertainty cannot be avoided. The role of expectations about the future is fundamental in financial markets and the different views concerning the future have a bearing on investment and production decisions.
- Unemployment is determined by aggregate demand, itself deeply influenced by investment decisions.

According to this view, if, existing involuntary unemployment, people decide to save more, aggregate demand contracts, unemployment increases further, and the government deficit worsens. In this context, austerity policies aggravate the unemployment problem and the fiscal deficit problem.

III. Key features in heterodox macroeconomic analysis

1. Aggregate demand influences economic activity in any run (short and long).

   Orthodox view: (i) aggregate supply determines the long run at full employment; (ii) market forces propel aggregate demand towards the long-run supply-side equilibrium; and (iii) the real balance effect is an instrument for demand to adjust to supply.

2. Investment is both a component of aggregate demand and adds to the productive potential of the economy (through the stock of capital).

Investment responds to current events and, particularly, to those determined by aggregate demand, like the firms' capacity utilization and profitability. Investment generates new productive equipment, which is the way technological progress enters the economy.

3. Aggregate demand depends crucially on the distribution of income.

   This feature is captured by the aphorism "workers spend what they earn, capitalists earn what they spend". The propensity to spend out of wages is presumed larger than the propensity to spend out of profits.

   A distinction is made between wage-led and profit-led aggregate demand regimes (or wage-led and profit-led economies). The distinction is important because in a wage-led regime, the orthodox medicine for unemployment (the restraint of real wages) is counterproductive.

4. Aggregate demand and aggregate supply are interdependent and the dynamics of the economy is path dependent.

   For instance, aggregate demand determines the general economic activity, which in turn influences the rate of productivity change.

   Path dependency means that short-term shocks to the economy (accidental features) may have long-term (permanent) consequences: the path followed by the economy is the result of an evolutionary process (if the economy reaches a resting point, that point is influenced by previous states of the economy).

   The orthodox view

   (i) rejects path dependency: the path of the economy is pre-determined (by supply forces);

   (ii) postulates the independence of aggregate demand and aggregate supply (the AS-AD model reproduces at the macro scale the separation between supply and demand at the micro level, where the interaction between supply and demand occurs only through prices); and

   (iii) separates the real from the financial side of the economy (the classical dichotomy: real variables are not influenced by nominal variables, at least in the long run).

5. Money is endogenous (created through the credit system).

   The real balance effect cannot operate under endogenous money because endogenous money does not constitute net worth (real wealth).

   With endogenous money, banks and credit institutions hold the key to economic activity, since the expansion of aggregate demand depends on their decision to supply liquidity (grant loans). The decision of who is granted a loan affects the path followed by the economy: banks may prefer to finance individuals from certain social classes, firms from certain sectors (traditional or leading technologies) or having certain characteristics (large or small, national or

international), or favour some economic activities (real estate investment, construction of infrastructure, public firms…).

When money is endogenous, monetary policy becomes interest rate policy. Endogenous money makes the financial sector more unstable and volatile by its own nature: speculative bubbles and financial crises become more likely.

The orthodox view holds, as an implication of the classical dichotomy, the neutrality of money: changes in the stock of money do not affect economic activity, at least in the long run. With endogenous money, money is not neutral: the productive potential of the economy is linked to investment, which is linked to the credit creation process, which is what creates money.

6. <u>There is no "labour market" determining any supply-side equilibrium</u> to which the economy converges.

   Firms determine prices and production and base employment offers on aggregate demand conditions and expectations in connection with existing productive capacity. Wages are determined directly by firms to encourage workers to be productive (disencourage shirking) or through collective bargaining with the workers' representatives.

   The heterodox view rejects the existence of any automatic mechanism bringing aggregate demand to a presumed supply-side equilibrium derived from the labor market. In particular, real wages do not adjust to clear the labor market and the real balance effect is not operative.

7. <u>Inflation is not a monetary phenomenon</u>.

   The orthodox view presumes a causal connection between the money stock and the inflation rate. The heterodox view regards many other factors as having more influence on the inflation rate. Inflationary pressures may come from:
   (i) changes in aggregate demand (demand-pull inflation) in relation to productive capacity;
   (ii) cost-push factors, like changes in import prices and the nominal exchange rate; and
   (iii) the conflict over the distribution of income (wages versus profits).

   > "If all groups and classes in society were in effect content with the existing distribution of income, then it could be expected that there would not be a problem of inflation: at a minimum it would mean that the rate of inflation was constant." Malcom Sawyer (2009): "The central core of heterodox macroeconomics", in J. P. Goldstein; M. G. Hillard; eds.: *Heterodox Macroeconomics: Keynes, Marx and globalization*, p. 30)

8. The (nominal) <u>exchange rate does not insulate an economy</u> from the rest of the world.

   For example, no purchasing power parity exists ensuring that inflation differentials with respect to the rest of the world are neutralized through modifications of the exchange rate. Therefore, it is to be expected that inflation from the rest of the world will impact on domestic inflation.

Exchange rates (nominal and real) are extremely volatile and their changes are mostly determined by financial (not by real) transactions. Rather than knowing what explains exchange rate movements, it is known what does not explain them: uncovered interest rate parity. In addition, the exchange rate does not vary to equilibrate the balance of payments.

IV. Warren Mosler's deadly economic frauds of economic policy

Some of Warren Mosler's (2010, *Seven deadly economic frauds of economic policy*, Valance) deadly economic frauds of economic policy are reproduced next.

• "Deadly Innocent Fraud #1: The federal government must raise funds through taxation or borrowing in order to spend. Fact: The federal government can always make any and all payments in its own currency, no matter how large the deficit is, or how few taxes it collects. If the government doesn't tax because it needs the money to spend, why tax at all? Answer: The federal government taxes to regulate what economists call "aggregate demand" which is a fancy word for 'spending power'".

• Deadly Innocent Fraud #3: Federal Government budget deficits take away savings. Fact: Federal Government budget deficits ADD to savings. Any $U.S. government deficit exactly EQUALS the total net increase in the holdings ($U.S. financial assets) of the rest of us. In other words, government deficits equal increased "monetary savings" for the rest of us, to the penny. Simply put, government deficits ADD to our savings (to the penny). This is an accounting fact, not theory or philosophy."

• Deadly Innocent Fraud #5: The trade deficit is an unsustainable imbalance that takes away jobs and output. Facts: Imports are real benefits and exports are real costs. Trade deficits directly improve our standard of living. Jobs are lost because taxes are too high for a given level of government spending, not because of imports. In economics, it's better to receive than to give. Imports are real benefits. Exports are real costs. In other words, going to work to produce real goods and services to export for someone else to consume does you no economic good at all, unless you get to import and consume the real goods and services others produce in return."

• Deadly Innocent Fraud #6: We need savings to provide the funds for investment. Fact: Investment adds to savings. Second to last but not the least, this innocent fraud undermines our entire economy, as it diverts real resources away from the real sectors to the financial sector, with results in real investment being directed in a manner totally divorced from public purpose. Savings is the accounting record of investment. Mainstream economists get this all wrong, and somehow conclude that we need more savings so that there will be funding for investment. What seems to make perfect sense at the micro level is again totally wrong at the macro level. Just as loans create deposits in the banking system, it is investment that creates savings."