POLICY TRADE-OFFS IN CESEE AND ELSEWHERE

Remarks by

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Introduction. Good morning, ladies and gentleman. First, let me thank the organizers for the opportunity to discuss important policy dilemmas, facing not only Central, Eastern and Southeastern Europe (CESEE), but other economies as well.

Also, my contribution to today's panel discussion will not be focused only on monetary policy trade-offs. Instead, I will talk about possible changes in the overall policy mix, taking into account two aspects:

- macroeconomic policy failures in the developed world during the last four decades;
- and, what is often overlooked, distributional effects of various policies.

In my view, the conventional policy mix has clearly reached its limits, and we should be looking for the (old/new) ideas in the *unorthodox* economic theory, which, unjustifiably, received too little attention so far among central bankers.

Monetary versus Macroprudential. First, I would like to offer some thoughts on the division of burden between monetary and macro-prudential (or MacroPru) policies.

For more than two decades developed economies lived happily in the illusionary era of the so-called "Great Moderation", but then, seemingly out of the blue, the lesser depression struck. The "moderation" period was characterized by relatively stable real growth rates and consumer price inflation, but was also accompanied by:

- *first*, a very rapid expansion of credit and debt;
- *second*, widening income inequality;
- and, *three*, recurrent asset price bubbles.

According to the unorthodox economists, the last three phenomena are clearly related and they call the period in question not "the Great Moderation", but "*financialization*" – the epoch of the domination of financial industry interests in the economy and economic policy. They claim, that financialization is a particular form of neoliberalism and it represents the most recent stage of capitalism.[1]

What economic policies could have helped the developed economies to avoid this roller coaster ride with unprecedented accumulation of debt?

Unfortunately, most of the central banks have focused mainly on *moving along* the credit demand curves[2] (by changing policy rates)[3], but failed to control the process of rapid *shifting*

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[1] See Palley, I. Thomas (2013), *Financialization: the Economics of Finance Capital Domination*, Palgrave;
Epstein, Gerald A. (2006), *Financialization and the World Economy*, Edward Elgar;
Hein, Eckhard (2013), *The Macroeconomics of Finance-Dominated Capitalism - and Its Crisis*, Edward Elgar.
[2] In *interest rates-credit volume* space.
[3] How *responsive* is, for example, investment to interest rate changes is an empirical issue. For a pessimistic view see *The Economist* (2014), "Monetary Policy: Tight, Loose, Irrelevant", http://www.economist.com/news/finance-

out of these curves. Since more and more private credit had been flowing to the real estate sector[4], this did not have the first-order impact on the central banks' target – *consumer* price indices, which, conveniently for central banks, exclude *investment* goods such as newly-built houses.

Therefore, in the future, central banks should shift most of the burden from the **monetary policy** (that is, moving along stationary credit demand curves), to the much more important game in town – runaway shifting out of the credit demand curves. And the policy which should be assigned this larger role is the **macroprudential policy**.

Asset-based reserve requirements (ABBRs). Monetary policy can also be improved. Some unorthodox economists[5] have been advocating for decades the use of the so-called **asset-based reserve requirements**, a system, where banks would hold reserves *against their assets*, *not liabilities*, as at present.

The reserve requirement for each asset category would be set at the discretion of the central bank, and that can drive a wedge of any size between the official policy rate and the interest rate on the particular asset class, for example, mortgage loans.

This policy innovation could have helped for example, Sweden, which, simultaneously, has been in the state of lowflation and had to deal with the property boom. Asset-based reserve requirements can spare monetary authorities from the dilemma whether to increase official policy rate in such situations, harming not only the bubbly sector, but the rest of the economy as well, and increasing, rather than decreasing the real debt of households (as prof. Lars E.O. Svensson pointed out).

Distributional effects. Let me now turn to the issue, which, regretfully, has received relatively little attention in the mainstream economic theory – the distributional effects of monetary policy. This topic is clearly related to the policies'-burden-sharing problem discussed above.

The argument that the official interest rate should be downgraded as the main tool for dealing with the financial cycle can also be supported by the distributional dimension, which has finally got the deserved public attention with the publication of Thomas Piketty's *Capital in the Twenty-First Century*.

As was demonstrated by, for example, Willem Thorbecke (1997)[6] in the paper "The Distributional Effects of Disinflationary Monetary Policy", relatively large real interest rate increases, as suggested by the **Taylor principle**, *without* the support of macroprudential policies, have strong asymmetric effects on (a) certain economic sectors like construction and durables manufacturing, (b) low-income worker groups, and (c) borrowers (as opposed to lenders).

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and-economics/21625875-interest-rates-do-not-seem-affect-investment-economists-assume-tight-loose?fsrc=scn%2Ftw_ec%2Ftight_loose_irrelevant

[4] See Borio, Claudio (2012), "The financial cycle and macroeconomics: What have we learnt?", BIS Working Paper No 395.

[5] Palley, Thomas I. (2000), *Stabilizing Finance: The Case for Asset-Based Reserve Requirements*, Report issued by the Financial Markets Center, Philomont, VA, http://www.thomaspalley.com/docs/articles/macro_policy/stabilizing_finance.pdf.

[6] Thorbecke, Willem (1997), "The Distributional Effects of Disinflationary Monetary Policy". The Jerome Levy Economics Institute Working Paper No. 144. Available at SSRN: http://ssrn.com/abstract=70816 or http://dx.doi.org/10.2139/ssrn.70816.

Real wage stagnation and financial industry's incentives have led to an unprecedented increase of private debt in many developed economies – instead of consuming from earned income, households were allowed, as Raghuram Rajan[7] put it, "to eat credit", and banks gladly filled that **structural demand gap,** with the gains from that process going mostly to the so-called "1%", which includes most of the *financiers*.

Paraphrasing Robert E. Lucas, who said about the U.S. fiscal stimulus that [quote] "there's nothing to apply a multiplier to"[8] [end of quote], most of poor people do not have savings "to apply a compound interest rate to" – indeed, relatively high real interest rates in the past have been one of the channels of growing income disparities.

In the context of growing inequality, the unfortunate representative-agent setup, used by many central banks, has allowed them to disregard an important socio-economic cost that higher real interest rates bring upon the societies, if the monetary policy *alone* is used to deal with the excesses of the financial cycle.

Fair real interest rate. What level of real interest rates is fair? Post-keynesians argue, that slightly above 0%, mainly because "profit, not interest, is the reward for enterprise"[9]. To quote John Smithin:

> The real value of existing sums of money, representing past effort in the form of work and enterprise, would be preserved, but there would be no increase in their value arising from the mere possession of money. Further accumulation would only be possible by contributing further work or enterprise, or assuming further risk. This state of affairs would not, however, really constitute the 'euthanasia of the rentier' (Keynes, 1936), as it is not the nominal interest rate that is set at zero but the real rate. Accumulated financial capital at least retains its original real value.

Consensus. As a result of the recent global financial and economic crisis, the right consensus seems to be emerging that business cycles, which have been predominantly caused by credit growth accelerations[10] (see, for example, Figure 1[11]), should be addressed with *both*, monetary and macro-prudential policies. To borrow Andrew G. Haldane's[12] term, macroeconomic policy should be two-handed or ambidextrous, and I would add, that the MacroPru arm should be much stronger than the monetary policy arm due to a) its superior distributional effects and b) effectiveness.

Figure 1. Euro area output gap and credit growth

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[7] Rajan, Raghuram (2011), *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press.

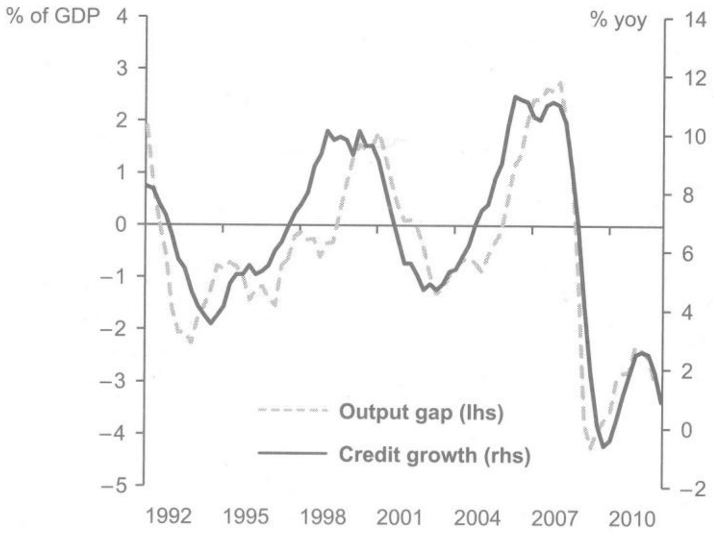
[8] http://delong.typepad.com/sdj/2011/09/department-of-huh-no-department-of-wtf-robert-lucas-edition.html

[9] "The theory of interest rates", an entry by John Smithin, in Philip Arestis, Malcolm Sawyer (eds.) (2006), *A Handbook of Alternative Monetary Economics*, Edward Elgar.

[10] Mayer, Thomas (2012), *Europe's Unfinished Currency*, Anthem Press, p. 92.

[11] Mayer, Thomas (2012), *Europe's Unfinished Currency*, Anthem Press, p. 92.

[12] Haldane, Andrew G. (2014), "Ambidexterity", Speech at the American Economic Association Annual Meeting, 3 January 2014. http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech713.pdf



Source: OECD, ECB, Deutsche Bank Research

Incomes policy. In addition, central banks, in their pursuit of consumer price stability, could reconsider the place of the long-forgotten **incomes policy** in the overall policy mix. Since excessive inflation or deflation is frequently the outcome of the *conflict* between labor and capital, it should be dealt with using the instrument which *directly* moderates the conflicting claims on income.

This approach would also take some pressure off the monetary policy or help in the environment of lowflation/deflation. For example, recently Bundesbank welcomed above-inflation wage increases in some sectors in Germany, despite the fact that BuBa historically has been a strong advocate of wage restraint.[13]

Fiscal policy. Time constraints allow only a brief mentioning of the role of fiscal policy. The main unorthodox fiscal policy doctrine was outlined by Abba Lerner in 1943, and it is called “Functional Finance”. What is meant by “functional”, and what are the main principles of this doctrine? Let me quote the original paper[14] here:

> “The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound.
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> Functional Finance… prescribes… the adjustment of total spending… to eliminate both unemployment and inflation… the adjustment of public holdings of money and of government bonds… to achieve the rate of interest which results in the most desirable level of investment… the printing, hoarding, or destruction of money as needed….
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> [The] result might be a continually increasing national debt…. [This] possibility presented no danger… so long as Functional Finance maintained the proper level of total demand for current output; and… there is an automatic tendency for the budget to be balanced in the long run as a result of the application of Functional Finance, even if there is no place for the principle of balancing the budget….

[End of quote.]

[13] http://uk.reuters.com/article/2014/07/30/uk-germany-wages-weidmann-idUKKBN0FZ03U20140730

[14] Lerner, Abba (1943), "Functional Finance and the Federal Debt", *Social Research*, **10**(1), February, 38-51.

More and more of economists now believe that, it is primarily the euro area, which should be the first to reconsider open-mindedly its fiscal orthodoxy, taboos and Treaty-imposed constraints on what is allowed or not in the fiscal front. Even the smartest **unconventional monetary policy** cannot replace a well-functioning fiscal framework as a way to achieve full employment, not to mention the distributional aspect that unconventional monetary measures help *The Wall Streets* first, before its effects trickle down (or not) to *The Main Streets*. And, judging by the results that are really important for ordinary people, such as unemployment levels, the euro area's fiscal policy has been far from being "functional" in A. Lerner's sense.

Conclusions. Let me to conclude. In my humble opinion, the authorities of the developed countries need a major reconsideration of the relative roles of various economic policies in order to unburden the societies not only from the new waves of financialization (with the resulting mountains of debt), but also from the policy recommendations to avoid the prospect of **secular stagnation** with even *larger doses* of financialization. Unfortunately, many of the policy makers are not free to start with a clean intellectual slate:

- *first*, mainstream macroeconomic textbooks continue contaminating the minds of generations of current and future policy makers by getting so many things wrong – starting from the money creation process and the role of banks, and ending with the disregard of distributional aspects of various policies, to name a few;
- *second*, many countries do not enjoy full monetary sovereignty. Notably, the euro area countries are *users, not issuers* of the euro. In such a set-up financial markets, which are generally prone to producing multiple equilibria, play a leading role in shaping the borrowing conditions and consequently the macro outcomes, not the sovereigns[15]. To quote Randall Wray from his 2003 paper "Is Euroland The Next Argentina?":

> "The ability of a sovereign government with a floating currency to make payments is not revenue-constrained, and it can issue securities at any rate it desires. In contrast, a non-sovereign government must obtain dollars/Euros before it can spend them, and it cannot exogenously set the interest rate. Rather, market forces determine the interest rate at which it borrows."

[End of quote.]

Therefore, while the major reassessment of the policy configuration is needed, I fear that the world will have to wait for another major crisis until this finally happens.

I'll stop here. Thank you.

[15] Wray, R. (2003),"Is Euroland The Next Argentina?", http://www.cfeps.org/pubs/wp-pdf/WP23-Wray.pdf.