A New Synthesis for macroeconomics

Por Jorge Nascimento Rodrigues em 21 Dezembro 2009

***AN INTERVIEW WITH WILLIAM WHITE** , Chairman of the Economic and Development Review Committee of the OECD and former chief-economist at the Bank for International Settlements (from 1995 to 2008).*

THE CHALLENGE

Instead of a synthesis towards the Neoclassical thought (that gave birth to excessive formalism, equilibrium abstract models, like the DSGE, and efficient market hypothesis of Eugene Fama) which dominated the mainstream macroeconomics in the last decades, economist William White, wisely, search for a **new partner** for Keynesianism: the old "Austrian" school of Economics. Simultaneously, he points out the importance to return to the **original** thinking of John Maynard Keynes, cleaning the mess engineered by the neo-Keynesians.

Dr. White puts emphasis in particular aspects of "Austrian" thinking that seems useful to the understanding of current dynamics, almost like a surgeon does. And he adds: "This should not be taken as a blanket acceptance of all things Austrian thinking says. Much of it is, to me at least, impenetrable and many scholars would point out both errors and contradictions."

AN INTRODUCTION

Opening "bridges" between Keynes and the "Austrian" economic school of thought (with 20th Century "stars" like Friedrich von Hayek and Ludwig von Mises) is one of the fields of economic research of Dr. William White, the economist the central bankers do not listened to during the bubble of the 2000's.

His most recent conferences and articles argue for a "new synthesis" from both applied Keynesian economics and "Austrian" criticism of the procyclicality dynamics of the financialization wave of last decades. His quest is challenging: "How can we blend into the Keynesian framework some of the insights of "Austrian" theory?"

The way forward for the crisis of macroeconomics must be the search for a paradigm shift, he suggests, a shift in the mindset in academia and among policymakers in government (particularly ministers of Finance and their teams) and central banks directors and technical staff.

A shift for two reasons.

First, politicians tend to extend popular Keynesianism "remedies" beyond the "abnormal" and exceptional period that Keynes considered critical in severe recessions. "The Keynesian model remains of crucial importance, says White. It rightly focuses on the determinants of the flow of expenditures (i.e. aggregate demand) in an economy during a given time period, and recognizes that demand can be both excessive – this aspect of Keynes thinking is often ignored – and deficient."

The trade-off of the addicted Keynesianism (which Keynes never professed) is resistance from politicians and business men from certain global sectors to needed structural adjustment in the depression period.

That resistance will bring with it decline in the level of potential growth and risk of stagflationary economics. “Keynesian demand-side stimulus might well have near-term benefits, but could eventually have less desirable effects if it impedes necessary adjustments in production capacities. Over time such considerations matter”, explained White. And he add: “Support for the financial system has the longer term effect of creating moral hazard, potential zombie banks and financial institutions that are even bigger, more complex and rent-seeking than they were before. Finally, government programs to support particular industries suffering from chronic over capacity threaten to create zombie companies to go along with zombie banks.”

Second, in the upward of the business cycle, central bankers used easy monetary policy to accommodate stock and housing bubbles despite the alerts from contrarian economists. We must remember Hyman Minsky study about the dynamics of excessive credit growth, monetary creation, debt accumulation, spending imbalances, massive increase in supply potential in many industrial and service clusters, bubbles ending in Ponzy mega-schemes, high volatility and violent crashes. Says White: “We need to resist more efficiently the credit driven expansions that fuel asset bubbles and unsustainable spending patterns” from economic agents and states (remember recent near-default from Dubai, the estimated high record fiscal deficits for 2010 in Ireland and UK, the high public debt in Greece, Italy or Belgium; the current bubble in China).

Excessive debt and bubble dynamics were engines of the financialization wave and consolidation trend inside certain oligopolistic sectors which dominated the economy of the last decades, a global complex of bigger and bigger financial services, construction, wholesale and retail distribution and car production (the automotive civilization), White refers.

Sectors that in the run-up to the crisis were making indeed huge sums of money, particularly in *rentier* activities more than in its core historical businesses, while in the downturn of the cycle reveal a surprising dramatic state of insolvency. Some of the big financial entities were even called *zombies* by the media in the peak of the Financial Panic of 2008. One of the political barriers to the needed adjustment is the popular theory of too big to fail (TBTF). White replies: “The upshot is that many of them are now too big and must be wound down.”

That’s why White picks from the “Austrians” some core arguments: “In contrast to the Keynesian framework, Austrian theory focuses on the creation of money and credit by the financial system, and how it leads to cumulative ‘imbalances’ over many periods.”

INTERVIEW HIGHLIGHTS

A CONTINUUM: “I would say that Hayek, (Anthony) Fisher and Keynes were all right. Hayek said try to avoid getting into this mess in the first place. Fisher added his support by noting that the downturn had been much more severe than even Hayek imagined and then explaining why. Keynes was right in saying that in such extreme cases there was a role for monetary and above all fiscal policy.”

THE BIG POLICY MISTAKE: “I do think the reliance on macroeconomic tools has got us on a very bad path. In effect we use such stimulus to avoid the need to restructure and the underlying problems then build up over time to truly unmanageable proportions.”

INTERVIEW by Jorge Nascimento Rodrigues © 2009, janelanaweb.com

Q: Reading your article “Modern Economics is on the Wrong Track” at Finance & Development IMF magazine (December, 2009, pp.15-18), it seemed that it can be useful to extract cirurgically the “Austrian” criticism about the pro-cyclical policies in the boom period, but reject its laissez-faire approach for the depression times. That’s your idea regarding the “Austrian” economics school of thought?

A: You are right. Even Hayek admitted the need to lean against the downturn in the case of a “secondary depression”. By this, he seemed to mean a cumulative downward spiral independent of (even if catalyzed by) the primary depression caused by “imbalances/maladjustments” in the upward phase of the cycle. I would say that Hayek, Fisher and Keynes were all right. Hayek said try to avoid getting into this mess in the first place. Fisher added his support by noting that the downturn had been much more severe than even Hayek imagined and then explaining why. Keynes was right in saying that in such extreme cases there was a role for monetary and above all fiscal policy. Note, however, that pump priming was for Keynes intended for extreme circumstances. In practice, it has been used repeatedly to deal with even minor downturns.

Q: The Austrian approach emphasizing the need for economic restructuring in depression times after the bubbles can be also useful, as an antidote against excessive Keynesian subsidizing and state intervention?

A: I do think the reliance on macroeconomic tools has got us on a very bad path. In effect we use such stimulus to avoid the need to restructure and the underlying problems then build up over time to truly unmanageable proportions. That is where we are now, I fear.

Q: The problem with popular Keynesianism is what Joan Robinson criticized as the “bastard Keynesianism”?

A: For a fuller examination of this, see Axel Leihonhufvud’s **On Keynesian Economics and the Economics of Keynes** (a book of 1968). Axel [Professor emeritus at the Department of Economics of University of California at Los Angeles] introduced the distinction between Keynesian Economics (Hicks and Samuelson “synthesis”) and the true Economics of Keynes.

Q: You refer macroeconomics is on the wrong track. What is the most important wrong aspect of the modern macroeconomics?

A: Probably the assumption of rational expectations on the part of a “representative agent”.

<!--[endif]-->*Q: Do you think the Irish approach facing the government deficit crisis (14.7 per cent, the largest one regarding GDP, estimated in the EU for 2010) is a practical “mix” of Keynesianism and Austrian thought?*

A: I am not sure how to apply labels here. The Irish (and the Hungarians and others) have been strongly procyclical in that they used discretionary fiscal policy to offset the “automatic stabilizers" and reduce the overall increase in the deficit associated with the downturn. One rationale for this is that the structural deficit was originally far larger than earlier estimated. Many countries took the tax receipts associated with the "boom" as structural (rather than cyclical) and these were assumed to continue to flow forever. They didn't, and thus adjustments had to be made to help ensure longer run sustainability. A second rationale would have a more Austrian flavor, but I do not think the Irish and Hungarians ever espoused it. Namely, when downturns put people out of work in sectors that had over-expanded in the boom (e.g. construction in Ireland and Spain), the government should get out of the way and let the private sector determine where cheaper labor might now be better deployed. The third rationale is I think the most important; namely, to respond to market concerns about the unsustainability of the fiscal situation. In the Irish case, this was manifest in rising bond and CDS spreads. Thus, the hope was that fiscal tightening would, by reducing these contractionary spreads, actually prove expansionary. This would have been a typical IMF recommendation for decades. For the Hungarians, with their own currency, the increased risk premium showed up both in spreads and downward pressure on the exchange rate. Given that so many Hungarian mortgages were denominated in Swiss francs (thus, depreciation is contractionary through this channel, as service requirements rise) we again conclude that tighter policy can actually be expansionary.

Q: But how we accomodate the anticrisis policies against severe negative effects (like unemployement growth, credit scarcity to small business and the real economy) simultaneously with the need to control public finances in red or orange alert?

A: The current state of the financial system is such that it cannot be assumed that a global recovery is assured. This raises the question of further negative feedback effects on the financial system, and what policies - a Plan B - might be required in such dire circumstances to facilitate an eventual recovery. It is also worth noting that the absence of a sustained economic recovery would not necessarily imply there was no need to contemplate "exit" policies.

Q: Can you explain how to blend anticrisis strategies and "exit" policies?

A: From a one period Keynesian perspective, it would seem evident that stimulus should not be withdrawn in such circumstances. However, thoso who worry about the negative, longer term effects of current policies must ask themselves whether the short term benefits are actually worth it. Longer run concerns about zero interest rates and Quantitative Easing have already been noted. Fiscal stimulus raises agreggate demand in the short run but also raises sovereign debt levels, in many cases from already high levels, and constrains similar policies in the future. In short, Plan B could conceivably encompass exit strategies as well.

FOCUS ON AXEL LEIJONHUFVUD

Another forgoten Economist

Besides Hyman Minsky, Dr. William White refer the importance of Swedish born economist Axel Leijonhufvud, 76, professor emeritus at UCLA, in the US, for the rediscovery of Keynes original thinking.

Peter Howitt, from Brown University, presented, in 2002, the main contributions of Axel for Keynesianism.

A few highlights from Howitt presentation of the core ideas of Axel:

1- He was one of the first in the 1960s and 1970s to claim that new-Keynesian theory was in need of a fundamental reorientation. He argued that the theory of markets underlying IS-LM (Investment/Saving- Liquidity preference/Money suply) model created by John Hicks was fatally flawed and should be replaced.

2- Axel argued that wage and price adjustment, which economists generally portray as stabilizing market forces, can sometimes be destabilizing, and that there are other market forces, which are usually ignored in macro theory, that are destabilizing.

3- Instead of the Walrasian general equilibrium theory, Axel proposed what he called a cybernetic approach for economics, one with no presumption that the system is in equilibrium state. Axel argued that in broad outline ***Keyne's own theory was a cybernetic one***. Axel introduced the economics of information into macroeconomic theory. Cybernetic approach is antithetical to the the Chicago School rational expectations theory engineered by the neo-conservative movement in the 1970s.

Categories: Ardina na Crise, Competitividade, English articles, Entrevistas Gurus, Novidades, Reportagens, Tendências
Tags: a new synthesis for macroeconomics, Austrian School of economics, Axel Leihonhufvud, bastard keynesianism, bubbles, credit driven expansion, crises engines, crisis of macroeconomics, EFH, Eugene Fama, features, fiscal deficits, Hayek, Hicks, Hyman Minsky, Keynes, neoclassical synthesis, public debt, Samuelson, von Mises, William White

One Response to "A New Synthesis for macroeconomics"