



INTERNATIONAL PAPERS IN POLITICAL ECONOMY

Economic Policies for Sustainability and Resilience

Edited by

PHILIP ARESTIS
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International Papers in Political Economy

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This series consists of an annual volume with a single theme. The objective of the IPPE is the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993, until the new series began in 2005, and was published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from the editors: Philip Arestis (pa267@cam.ac.uk) and Malcolm Sawyer (e-mail: mcs@lubs.leeds.ac.uk).

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Philip Arestis · Malcolm Sawyer
Editors

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Preface

This is the eighteenth volume of the series of *International Papers in Political Economy (IPPE)*. This series consists of an annual volume with eight papers on a single theme. The objective of the *IPPE* is the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993 until the new series began in 2005 and was published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from the editors: Philip Arestis and Malcolm Sawyer.

The theme of this seventeenth volume of eight papers is Economic Policies for Sustainability and Resilience. The papers in this volume were scheduled to be presented in late March 2021 at a one-day conference in Cambridge, UK (Downing College), organised by the Department of Land Economy, University of Cambridge, under the aegis of the Cambridge Trust for New Thinking in Economics. The papers were intended to be presented subsequently at the annual conference, entitled *Developments in Economic Theory and Policy*, held at the University of

the Basque Country, Bilbao, Spain in June 2021. These conferences had to be cancelled as a consequence of restrictions on meetings and travel in response to the COVID-19 pandemic. We are grateful to the organisers of the Cambridge Trust for New Thinking in Economics, and to the organisers of the *Developments in Economic Theory and Policy* conference series, for funding and help in the organisation of annual conferences over a number of years, which have enabled presentation of the relevant papers; and subsequently published in the *International Papers in Political Economy* series.

Cambridge, UK
Leeds, UK

Philip Arestis
Malcolm Sawyer

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1

Macro-Economic and Financial Policies for Sustainability and Resilience

Philip Arestis

1 Introduction

This chapter focuses on fiscal, monetary and financial stability policies; their aim is to achieve sustainability and resilience. Sustainability and resilience are defined as “the capacity of a process to be endured or to be maintained and improved” (Vercelli, 2017, p. 15). This contribution relies on our macroeconomic model (Arestis, 2019), which goes beyond the New Consensus Macroeconomic (NCM) model, which has been employed by central banks especially before the Global Financial Crisis (GFC). NCM contains serious problems as the GFC demonstrated (Arestis & González Martínez, 2015), and the recent era of stagflation. There are assumptions of the GFC, which imply that the NCM is lacking

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sustainability and resilience (see, also King, 2016a, who suggests that “The conceptual framework used by central banks was, and remains, flawed”; this framework relies heavily on the NCM paradigm). Our model’s macroeconomic policies for a sustainable and resilient economy, do not account of the NCM assumptions. This enables our contribution to deal properly with fiscal, monetary and financial stability policies, which should be properly coordinated to achieve sustainable and resilient economies. Haldane (2020), correctly argues that, “the extraordinary degree of uncertainty about the economic outlook” implies “monitoring the economy closely, and setting policy to support it”, are “more important than ever” (p. 1).

We proceed in Sect. 2 to highlight our theoretical model. Section 3 discusses the economic policies of our model. Section 4 deals with the coordination of these policies. Finally, Sect. 5 summarizes and concludes.

2 Our Theoretical Model

Our theoretical model (Arestis, 2019), is summarized in the Appendix, and discussed below, with its policy implications discussed in Sect. 3. The main objectives of our analysis are sustainability and resilience, as well as equitable economic growth at full employment. Achieving such objectives requires the maintenance of a high level of aggregate demand and sufficient productive capacity. Our model relates to a monetary production economy in which finance and credit play a significant role, along with relevant distributional aspects.

Our model comprises of five blocks. Block I (Eqs. 1–7) includes both the aggregate demand and supply of the economy. The demand variables are expenditure, income, employment and output. Aggregate demand determines the level of economic activity. Distributional effects are accounted since changes in economic activity affect the rate of change of prices and wages, thereby changes in the distribution of income emerge. These changes have effects on the level of aggregate demand through consumption. Aggregate demand is a volatile component, and it creates productive potential, thereby establishing interdependence between demand and supply. The supply of the economy contains the

following characteristics: the interaction between production decisions of firms in the light of the (expected) level of aggregate demand; and the consequent decisions on employment. Investment, an important part of aggregate demand, influences the supply side of the economy since it is the main determinant of potential output and labour productivity.

Block II (Eqs. 8–13) focuses on the distributional aspects and the inflationary process. The most important variables of this block relate to the struggle over income shares, the level and rate of change of aggregate demand, cost-push factors emanating notably from the foreign sector (changes in import prices and the exchange rate). There are other factors as in the relevant equations of this block. In view of the distributional aspects of this block, it is important to emphasize the role of trade unions, which bargain with employers over conditions of employment and wages. Under such conditions, there is a conflict of interest, since the distribution between wages and profits is determined by the real wage demands of labour and the profit objective of firms. Unemployment restricts the extent trade unions are able to press for their claims, since it relates to the state of the labour market. The desired real wage is predetermined according to the expectations and aspirations of unions.

Block III (Eqs. 14–18) relates to money, credit and other financial aspects. Money is endogenously created within the private sector; it responds to changes in the behaviour of the private sector rather than only to policy actions of the monetary authorities. The behaviour especially of banks, but also of other credit institutions, is relevant; namely, the extent to which these financial institutions are willing to provide loans, and the terms upon which are provided, have an important impact on the level and structure of aggregate demand. The supply of credit depends essentially on demand. It is thereby the determinants of demand that influence the flow of credit and thus money. Central Banks are not able to have complete control of the quantity of money. They can of course control the supply price of credit via interest rate changes or through direct intervention in the financial markets. This is the way that enables Central Banks to provide the ‘base’ money to the banking and the rest of the financial system. Block III implies that the demand and supply of money are interdependent in view of the determinants of money demand that influence the flow of credit and thus money.

Central Banks cannot have a grip over the quantity of money; they can only control the supply price of money via the base rate, which is under their control. Financial stability policies are paramount in terms of the Central Banks being able to influence the financial sector. The main aim of financial stability should be to discourage financial institutions to provide credit for speculative rather than for productive activities, so that they support the productive aspects of the economy. When speculation causes liquidity to increase excessively, direct controls should be implemented to curb it. These aspects are highlighted in Eqs. (16) and (17), and discussed in Sect. 3 as part of ‘financial stability’ policies.

Block IV (Eqs. 19–23) portrays the government sector, with its expenditure and taxes along with the public sector borrowing requirement, and are endogenized. This block includes the relevant fiscal policies.

Finally, Block V (Eqs. 24–27) deals with the open economy. An important dimension of the foreign sector is that exports and imports are included in the aggregate demand equation. They are endogenized as shown in this block. Another important dimension of this block is the inclusion of the effects on aggregate demand (and hence employment) of variations in the exchange rate.

It is paramount for the implementation of relevant economic policies that our model is cyclical and could potentially account for periods of instability. Economic policies should then be employed to stabilize the economy and lead it to high levels of aggregate demand along with employment and output. Thereby the role of public institutions, especially in terms of Blocks III, IV and V, is essential. Governments and Central Banks should collaborate and pursue relevant policies in an attempt to reduce the amplitude of the cyclical behaviour of their economies. Central Banks in particular should support their banking and non-banking sectors to create credit, in view of their role as lenders of last resort. It is also important that national policy institutions should interact with the relevant international institutions, in terms of the ‘open’ economy aspect.

Our macroeconomic model clearly suggests that economic policies are paramount for sustainability and resilience of economic systems. The section that follows concentrates on the economic policies that emerge from our macroeconomic model.

3 Economic Policies

The objectives of economic policies should be to achieve and maintain a high level of aggregate demand and sufficient productive capacity, along with full employment of the labour force, so that full utilization of capacity is achieved, along with fair distribution of income. Policies employed in a co-ordinated manner (see, also, Arestis, 2012, 2015) help on this score. In addition to fiscal and monetary policies, financial stability policies, which had not been sufficiently considered prior to the GFC, are important (see, also, Arestis, 2016, 2018). Bank of England (2015) suggests, “The pre-crisis regulatory system was also ill-equipped to recognise and deal with threads to financial stability emanating from non-traditional banking activities or risk outside the regulatory perimeter” (p. 11). Financial stability policies enable financial development to produce healthy growth. We elaborate on these types of economic policies below.

Between August 2007 and 2011, the OECD countries experienced a banking crisis with their median loss of output around 5% of GDP, and to more than 10% in some small European countries, with unemployment increasing substantially and inflation dropping below central banks’ targets (Bernanke, 2004; Ollivaud & Turner, 2015). The recovery from the GFC was slow, “with tepid economic growth, sluggish employment growth and subdued inflation” (CGFS, 2019, p. 6). More recently the economic situation has been weak due to the COVID-19 syndrome. We refer below to economic policies pursued recently, but most important to the required policies to achieve sustainability and resilience, accounting for recent developments due to the GFC and COVID-19. We refer mainly to the USA, the UK and the Euro Area.

3.1 Fiscal Policy

Fiscal policy should be employed in the short and long run to address demand issues. The ex-IMF Managing Director, suggests, “Under the old paradigm, fiscal policy was definitely the *neglected child* of the policy family. Its role was limited to automatic stabilizers letting budget

deficits move up and down with the cycle and discretionary policy was regarded with deep suspicion. But fiscal policy had a *Sleeping Beauty* moment during the crisis with monetary policy running out of steam, and with the financial system on its knees, the forgotten tool arrived to prop up aggregate demand and save the world from an economic freefall. We need to rethink fiscal policy” (Strauss-Khan, 2011, p. 3). Frequent utilization of fiscal policies in view of macroeconomic developments is necessary. Such a conclusion relies heavily on the objectives of macroeconomic policy to be sustainable, along with equitable economic growth. Within these objectives, the main focus of macroeconomic policy should be the achievement of full employment of the available labour force. Achieving such an objective would require, inter alia, the maintenance of a high level of aggregate demand consistent with full employment of labour. Also, sufficient productive capacity to enable the achievement of full employment is required, where sufficient should be interpreted as quantity, quality and geographical distribution; thereby industrial and regional policies are clearly required to enhance supply. Public expenditure, particularly investment, should be structured to ease supply constraints; especially so public infrastructure plays a key role in this respect, and helps productivity to increase. Schwartz et al. (2020) suggest, “The economic recovery from COVID-19 presents a unique opportunity for countries to build a bridge to the future through well-designed and well-implemented public infrastructure. Public investment to stimulate weak aggregate demand can help boost more inclusive growth, reduce inequalities, and create economic opportunities for all”; this is important now in view of the COVID-19 pandemic. However, under the current COVID-19 pandemic, raising taxes too quickly would risk harming potential economic recovery. There is also the argument that due to possible ‘secular stagnation’ (Hansen, 1939; see, also, Summers, 2014),¹ long-term negligible or no growth and thereby lack of long-run demand, fiscal policy should be used extensively, especially so since unconventional policies cannot really help on this score. Monetary policy, in the form of QE and very low interest

¹ Secular Stagnation was suggested (December 1938) by Alvin Hansen in his Presidential Address to the American Economic Association, entitled “Economic Progress and Declining Population Growth”.

rates, has not helped in view of its underperformance, in that “bank lending to the private sector and the broad money supply have stagnated and the recovery has been weak” (Goodhart, 2015, p. 20). The IMF Chief Economist, Gita Gopinath (*Financial Times*, 3 November, 2020), suggests that under the current global liquidity trap, with monetary policy having very limited effect, big fiscal stimulus is needed. Pérez-Moreno and Bárcena-Martín (2019) propose that inequality is another important cause of secular stagnation since higher inequality is a factor in reducing aggregate demand; low productivity is also relevant. Fiscal policy is thereby paramount.

Fiscal policy is not employed as required based on worries about increases in government deficit and debt. Such increases should not be a worry, especially currently with the record-low official interest rates. Over the 2000 years of recorded interest rates, they have never been as low as recently, which enables governments to borrow. The IMF (2020a), suggests for each dollar of government spending on infrastructure enhances output by nearly three dollars more, and higher tax receipts thereby emerge. Also, when the rate of economic growth is greater than the interest rate, governments that borrow to finance the initial spending as well as the subsequent interest bill would experience falling debt as a share of GDP (Arestis & Sawyer, 2003; Blanchard, 2019). Moreover, in a growing economy debt is reduced as tax revenues grow and outpace debt. Also, “the effect of public debt on GDP growth is small and is zero in recent data. ... many policy decisions to confront public debt via austerity have hinged on the presumption of a threshold. There is no evidence of a public debt threshold above which growth is substantially reduced in any of the data, using any method” (Ash et al., 2020, p. 25). Clearly, fiscal stimulus increases GDP by more than it would increase nominal debt, thereby stabilizing aggregate demand, increasing current and future taxes, and reducing government debt. In addition, not only does fiscal stimulus protect jobs but increases them and enables investment to enhance future growth. Auerbach and Gorodnichenko (2017) examine similar questions in the case of a sample of developed countries to conclude that government spending not only does it increase output, but it also reduces the debt-to-GDP ratio. This result is particularly relevant in periods of economic weakness.

Kelton (2020) deals with ‘The Deficit Myth’, whereby deficits are harmful, undermine growth, and thereby deficits produce fiscal crises; so return to fiscal surplus is the proper fiscal state of affairs; governments should rely on monetary policy, not on fiscal policy. Kelton (op. cit.) suggests that by “tearing down these myths” (p. 233), the Modern Monetary Theory (MMT) produces a relevant understanding of “a *description* of how a modern fiat currency works” (p. 233). And “Both the US Treasury and its fiscal agent, the Federal Reserve, have the authority to issue the US dollar” (p. 17). The USA, therefore, has monetary sovereignty, which means that the country makes the monetary system work for its people and does not have to worry about how to pay for it all. Government spending in countries that issue their own currency with a floating exchange rate and no debt denominated in foreign currency, can never run out of money. Since a ‘sovereign’ government cannot run out of money, an increase in government spending does not have to be ‘paid for’ by either an increase in taxes or a reduction in spending. However, inflation should be accounted for and thereby government spending should stop when the economy reaches the point of ‘over-heating and inflationary pressures emerge’. Kelton (2020) suggests, government spending should be undertaken with respect to its impact on inflation and not on budget deficit. Government debt does not need to be fixed, and “The national debt poses no financial burden whatsoever” (p. 75). Clearly, Kelton (op. cit.) does not support unlimited government spending or monetary financing; the “MMT considers *fiscal policy* a more potent stabilizer and one that can be used to target even broader measures of well-being” (p. 243). An important part of government spending is job guarantee, whereby the government introduces a job guarantee scheme, thereby the government offers to hire the unemployed, along with providing them with new skills (Tcherneva, 2020); also, decent training and education programme. Kelton (2020) suggests that the job guarantee scheme is “not an emerging measure to be turned on during crisis and then shut down as private sector job growth recovers. Instead, the job guarantee is a way to equip our economy with a more powerful driverless stabilizer” (p. 253). Decent training and appropriate education programme are also relevant schemes.

Another relevant issue is the extent to which fiscal austerity affects economic activity. Fiscal austerity was implemented in many countries after the GFC. Jorda and Taylor (2016) provide empirical evidence using “local projections (LPs), rather than structural auto-regressions (SVARs)” (p. 221). The reason for such usage is that “LPs are a convenient pedestal on which all extensions of existing estimation methods can rest. The unified framework provides the reader a way to compare the results across a set of nested estimation strategies. LPs provide a flexible semi-parametric regression control strategy to estimate multipliers and include, as a special case, impulse responses calculated with the SVAR technique. LPs accommodate possibly non-linear, or state-dependent responses easily, and indeed we find that the effects of fiscal policy can be different in the boom and the slump, as emphasized by Keynes in the 1930s” (p. 221). Using LPs along with instrumental variables (IV), and inverse probability weighting (IPW) estimations, the results show that the effect of fiscal consolidation is negative. A 1% of GDP consolidation results in a 3.5% reduction in real GDP over five years. The IMF has also suggested (as reported in the *Financial Times*, 15 October 2020) that countries, which can borrow freely, do not need to pursue austerity, contrary to the IMF’s suggestion a decade ago. These countries have a low cost of servicing their government debt, well below their growth rates. Both the IMF and the World Bank have changed their positions on austerity recently. Senior officials of both at their annual 2020 meeting encouraged countries to avoid ‘fiscal orthodoxy’ and replace it with ‘fiscal activism’ (*Financial Times*, 17 October 2020).

McCausland and Theodossiou (2016), deal with the impact of fiscal stimulus on public debt and economic activity, for 11 OECD countries (Belgium, Canada, Denmark, France, Germany, Italy, Netherlands, Norway, Sweden, UK and USA) for the period 1881–2011, using annual data. A standard fixed-effects regression model is utilized for their econometric approach and for the 11 OECD countries panel. Their empirical results show that fiscal contraction deteriorated public debt as a percentage of GDP. The implication of these results is that fiscal austerity deteriorates economic activity and increases unemployment. These empirical results are supported by Chick and Pettifor (2011), who compare and contrast the pre-World War II in the UK, when

fiscal consolidation emerged and the public debt ratio to GDP increased and macroeconomic conditions worsened, with the post-World War II period, when fiscal expansion took place, the debt ratio to GDP fell and economic expansion materialized. These results demonstrate that in recessions government spending produces multiplier effects, increasing GDP and productivity, and thereby tax revenues, with the ratio of debt to GDP reduced.

Sawyer (2011), and for the UK experience after the GFC, examines the case of budget deficits to argue that there is a serious danger in trying to eliminate budget deficits; this is so because economic activity is influenced negatively and substantially. Sawyer (op. cit.) suggests that fiscal policy reduces budget deficits without influencing negatively economic activity. To achieve it requires high and sustainable level of aggregate demand and economic activity. Also, reducing inequality substantially would greatly help to increase aggregate demand. Sawyer (2012) discusses the UK post-2010 experience, when fiscal austerity was introduced, to conclude that his proposal as in Sawyer (2011), were very relevant and valid to account for the failure of the post-2010 experience with fiscal austerity. Governments around the world, but especially the ones considered in this contribution, have initiated substantive fiscal action in response to COVID-19. This should be maintained as long as it is needed to avoid long-lasting economic damage. A relevant example is the EU's fiscal rules of the Stability and Growth Pact, which the European Fiscal Board (EFB) suggested should be permanently suspended; this, according to EFB should promote 'growth-enhancing spending' (*Financial Times*, 21 October 2020).

3.2 Monetary Policy

Monetary policies, including unconventional monetary policies, pursued by countries since the GFC, are discussed. Quantitative Easing (QE) has been used internationally in view of the Central Banks' main interest rate reduced to the Effective Lower Bound (ELB). Thereby, QE has become one of the main tools of monetary policy for many Central Banks around the world (CGFS, 2019). Dario et al. (2020) review the impact of the

Fed's Forward Guidance (FG) and QE after the Fed's federal funds rate reached the ELB, to conclude that these tools should have been used more forcefully. They also examine the European Central Bank (ECB) and Bank of Japan, which employed similar tools, and suggest that more forceful use of these tools might still fail to achieve their inflation targets.

The Fed's 2% inflation target, and according to its Chair Jerome Powell, at the 27 August 2020 meeting of the annual Jackson Hole symposium, is abandoned in its current version; maximum employment on top of the Fed's objectives, is placed, because of consistently missing the 2% inflation target. A new monetary policy strategy emerges, which is more tolerant of inflation changes, along with more discretion. Instead of the 2% inflation target, an average of it over time will be the focus of monetary policy. Jerome Powell suggests that periods below the 2% inflation target, inflation should be offset by inflation above the target. However, the averaging period is missing. This change puts more emphasis on boosting growth and employment in the USA. This change is vital because of the dramatic reduction in economic activity and the risks of the COVID-19 syndrome. As a result of the Fed Chair's statement, USA Treasury yields rose, particularly the long-term ones. The difference between the 5-year bond yields and the 30-year bond yields widened by 119 basis points (*Financial Times*, 28/29 August 2020). A further point made by Jerome Powell is that FG in the USA relating to low interest rates will continue in the future. The current change is different from the Federal Reserve Reform Act of 1977, according to which the USA Congress gave the Fed three main objectives in the following order: maximum employment, stable prices, and moderate long-term interest rates. In the 1980s Paul Volcker, the then governor of the Fed, gave the greatest emphasis to stable prices. In January 2012 Ben Bernanke suggested 2% as the inflation target, and maximum employment consistent with stable inflation. Currently, maximum employment, the utilization of full capacity labour force, should be attained all the time, unless the average inflation target is severely threatened. These suggested changes to Fed's monetary policy could produce a case of global shift in Central Banks's monetary policies, along similar lines to Fed changes. Jerome Powell, though, has not explained how the Fed would undertake specific policy actions to affect growth and inflation.

A similar suggestion by the ECB's President, Christine Lagarde on 30 September 2020 (as reported in the *Financial Times*, 2 October 2020), is of the possibility of the ECB adopting average inflation targeting.

Andrew Bailey (2020), the Governor of the Bank of England, at the Jackson Hole meeting, stated that the enormous recent expansion of the Bank's size of its balance sheet, larger now than at any point in its history, was undertaken to support the objectives of both monetary and financial stability policies. In terms of the monetary policy objective, the aim is to achieve the inflation target, to provide sufficient liquidity to stabilize the money markets and support corporate financing. The QE approach of the Bank of England (2009) is to provide stimulus in the form of purchasing assets, mainly government debt, concerning the range of assets purchased. In terms of the financial stability, the increase of high-quality assets of the banks (including central bank reserves) has been the main objective of the Bank of England. This is so in view of prior to the GFC, banks had held insufficient high-quality liquid assets. Forward Guidance (FG) has also been introduced, "stating that the Committee does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably" (Bailey, 2020, p. 6). The Bank of England has also helped the government in its massive expansion of government expenditure over the COVID-19 crisis by providing finance directly on a temporary basis. An interesting comment made repeatedly at the Jackson Hole meeting was that monetary policy alone would not be sufficient to restore growth, and government intervention was needed to boost the economy.

An interesting question is how QE works. According to Bailey (2020), it works through a number of channels: "including signalling of future central bank intentions and thus interest rates; so called 'portfolio balance' effects (i.e. by changing the composition of assets held by the private sector); and improving impaired market liquidity" (p. 4). More recently (March 2020) the then QE (£200 billion) also included "a sustainable volume of inflation to target" (p. 4). Whether QE has been effective, Bailey (op. cit.) suggests that it "may be more important during a period of market dysfunction associated with a widespread shock to liquidity demand" (p. 4). Bailey (2020) also confirms that despite the