Debates in Monetary Macroeconomics

Tackling Some Unsettled Questions

Edited by
Steven Pressman
John Smithin

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For Ingrid Rima, who first brought us together.

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Pressman Steven is Emeritus Professor of Economics and Finance at Monmouth University, Part-Time Professor of Economics at the New School for Social Research, and Associate Editor of the *Review of Political Economy*. He has published nearly 200 articles in refereed journals and as book chapters, and has authored or edited 18 books, including *Understanding Piketty's Capital in the 21st Century* (Routledge, 2015), *A New Guide to Post Keynesian Economics* (Routledge, 2001), *Alternative Theories of the State* (Palgrave Macmillan, 2006), and *50 Major Economists,* 3rd edition (Routledge, 2013). He is also a frequent contributor to newspapers and popular periodicals such as *Challenge Magazine, The Washington Spectator* and *Dollars and Sense*.

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Watts Martin is an Emeritus Professor of Economics at the University of Newcastle, NSW, and Research Associate of the Centre of Full Employment and Equity (CofFEE). He has published over 60 peer-reviewed articles in leading international and domestic academic journals and co-authored 20 book chapters. In 2019, he co-authored a textbook entitled *Macroeconomics*. He has secured funding for Australia Research Council Discovery Projects with colleagues and also participated in an ARC Linkage grant. He holds a B.A. from Essex University, an M.A. from Manchester University and a Ph.D. from the University of British Columbia.

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CHAPTER 1

Some Unsettled Questions in Monetary Macroeconomics

Steven Pressman and John Smithin

1 Introduction

This book attempts to stand on the shoulders of two previous notable works in economics—one by John Stuart Mill in the mid-nineteenth century and one by Robert Skidelsky in the early twenty-first century. Both works did something similar to what we are attempting to do here; that is, to address in a comprehensive way some of the key issues currently in dispute in monetary macroeconomics.

In the mid-nineteenth century, Mill (1844) published a book with the rather imposing title *Essays on Some Unsettled Questions of Political Economy*. The book was comprised of five essays on controversial topics in the field of economics, or 'political economy', as it was called then.

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In order of their appearance in the book, these five controversies are (1) who gains from international trade, (2) the impact of consumption on production, (3) the difference between productive and unproductive labour, (4) the difference between interest and profits, and (5) the definition of 'political economy' and the correct method for investigating it. Mill had hoped to resolve these disputes, or at least contribute to a resolution of these 'unsettled questions', in the near future.

That did not happen, and our goal is not to critique or evaluate the answers that Mill set forth long ago. However, it is worth noting that in the 178 years since Mill's work was published, each of his five topics has experienced a rather different fate. Since the time of Keynes, 90 years after Mill, the issue of consumption and production has been resolved to a large extent. Economists today generally agree that additional consumer spending increases production, and that less consumer spending reduces production, all else being equal. Nonetheless, there are limits to what can be produced in any given year. Getting the right natural resources and parts is one good example of such a limitation. Perhaps one of the best examples of this today is a shortage of computer chips due to the small number of plants producing computer chips and the need for these chips in computers, cell phones, automobiles, and home appliances. A fire in a plant in Japan stopped production there for a while, and production is just starting to return as this book was going to print. At the same time, a drought in Taiwan limited water usage and chip manufacturing because the process requires a great deal of water. This problem still remains. As new plants cannot be built in a month or even a year, chip shortages remain. Furthermore, few firms will want to build new plants, as the problem is a temporary shortage of computer chips and not a long-term shortage that requires greater production capacity.

On the other hand, increased production does not mean that there will be increased consumption of these goods. Some of what is produced will go to profits and interest, and the wealthy individuals who receive most of this income may not spend it. Nor will savings necessarily be lent to individuals, who will then spend it, or to firms that will productively employ it. The result is overproduction or underconsumption, two sides of the same coin. As John Maynard Keynes (1936) pointed out, the consequence of this is that economies will experience bouts of high unemployment which (typically) will require some government remedy.

In contrast to the issue of consumption and production, the issue of international trade and how the supposed gains from trade are distributed

between trading partners remains very much an unsettled question in economics. In fact, the question of trade, trade deficits, and their economic consequences is one of the five unsettled issues (not necessarily the same as Mill's list) covered in this volume. Chapter 8, for example, argues that nations should not seek to run trade surpluses and that when nations do seek to do this it has negative macroeconomic effects. Chapter 9, meanwhile, advances the case that some nations should seek to run trade deficits under some circumstances.

Mill's discussion of the nature of political economy, or its scientific status, and how we should study it, is something that has not been studied extensively. In the late twentieth century, there were several excellent contributions that addressed the question of the appropriate economic methodology, such as Blaug (1980), Caldwell (1982), McCloskey (1985), and Pheby (1988). However, when it comes to those who are actually doing economic analysis, this work on methodology is still generally ignored rather than turned to for insights about how to do economics better.

In his essay on the topic, Mill suggested that the science of political economy was something akin to geometry. It is a deductive science that begins with definitions of simple concepts. From these definitions, it builds theorems about relationships among the various defined terms. The theorems follow, by simple deductive logic, from the definitions of basic terms. This approach to economics is strange for two main reasons. First, Mill was that rare philosopher who has argued that mathematics is empirical in nature (Bloor, 1976). He contended that we learn things like 1 plus 2 equals 3 because of what we observe in the real world rather than a result of the logical properties of number systems, which is the standard view in the philosophy of mathematics (Barker, 1964). The approach is also strange because economists, old and new, have tended to view themselves as empirical scientists who work with data, and use that data to try to understand the world and devise policies that would let economies function better. This is true of the economic work of Adam Smith [1776] (1937), *The Wealth of Nations,* which is full of observations about how the economic world works and how people behave. And ironically it is also true of Mill's own *The Subjection of Women* (1869) which analyzed the impact of social forces on the individual and the economic consequences of this at both the microeconomic level and the macroeconomic level. It seems that economics is an empirical science. At the very least, it

should be more empirical than mathematics. Mysteriously, Mill holds the opposite view.

The issue of productive and unproductive labour has a long history in economics. The Physiocrats in eighteenth-century France saw labour engaged in producing manufactured goods as unproductive, while labour employed growing food was productive. They argued for increasing the consumption, and thus the production, of agricultural goods to stimulate economic growth and development (Pressman, 1994). Adam Smith [1776] (1937) and many other economists have criticized the Physiocrats for this view, but they still tend to hold on to the Physiocratic distinction that some labour is productive and creates a surplus, while other labour is unproductive and does not. Following Smith, most classical economists held that labour engaged in manufacturing production was productive, but that labour engaged in services was unproductive, or less productive. This debate about the distinction between productive and unproductive labour, or the productiveness of labour in different economic sectors, however, disappeared with the rise of neoclassical economics. The standard view among economists was that all labour was productive and that the relative productivity of any worker could be measured by the wage received by that worker. The debate about productive and unproductive labour has thus developed into a debate about the relative productiveness of different types of labour, and whether wages (or wages plus benefits) are a good measure of how productive labour is and how productive different individuals are. More recently, Baumol et al. (2012) called attention to this fact, and argued that the limited ability to improve productivity in services is the reason that the cost of education and health care has been rising much more than the cost of manufactured goods in developed nations.

Finally, there is the question of the difference between profits and interest, which was the subject of the fourth, or penultimate, of Mill's five original essays. (The essay about methodology was the last.) The fourth essay dealt with the important issue of the ontological distinctions between interest and profit and their separate relationships to wages. Taken to its logic conclusion this would be bound to lead to some consideration of the necessarily monetary nature of interest, as opposed to the category of profit, and thereby to such questions as the old debate about the 'forced saving' effect (i.e., the effect of inflation on the rate of interest and on capital accumulation). This was, in fact, one of Mill's main concerns in 1844, but then dropped out of sight in Marxian economics

and neoclassical economics, both of which had a basic two-class structure with 'labour', on the one hand, and 'capital', on the other, to explain income distribution. There was no room for Keynes's 'rentiers'. Nonetheless, this remains an important issue in macroeconomics and has been addressed in more recent times by such authors as Lavoie and Seccareccia (1988, 2016), Pasinetti (1980), and Smithin (2018).

Our other inspiration for this volume comes from the work of Lord Robert Skidelsky. In the mid-2010s Skidelsky was working on a book that he tentatively titled *Unsettled Questions in Macroeconomic Policy*. In the introduction to his *Rethinking the Theory of Money, Credit and Macroeconomics* (2018), John Smithin recounts a conversation with Professor Skidelsky at an academic conference in the mid-2010s which in many ways was ultimately the inspiration of the present volume. Skidelsky's book eventually appeared under a different title, *Money and Government* (Skidelsky, 2018), also in the year 2018. The book that was published mainly discusses the role of the government in the overall economy. As a biographer of Keynes (Skidelsky, 1983, 1992, 2000), it is not surprising that Skidelsky sought to revive the economics of Keynes. His book addresses two questions—one of which is why academic economics seemed, so dramatically, to have lost its usefulness in the late twentieth century, and how this malaise contributed to the real world 2008 economic/financial crisis and its aftermath. However, Skidelsky also takes his reader on a historical journey through past policy debates (for example, how *do* we control inflation) and returns to the philosophical question raised by Mill regarding how do we go about doing economics. For Skidelsky, many of our contemporary economic problems are the result of abandoning the master macroeconomist—Keynes—and instead adopting the questionable assumptions that individuals are always rational and that markets are always 'efficient'.

Our approach in this volume differs from those of Mill and Skidelsky in a number of ways. First, our focus is only on the unsettled questions in what we call monetary macroeconomics. There is no systematic attempt to answer some of the 'big picture' questions raised by Mill and Skidelsky, such as methodology, or how economists should go about doing economics or practicing their craft. Nor does this volume attempts to address things such as the difference between productive and unproductive labour, or more microeconomic questions such as the efficiency of markets. This is not to say that these issues do not arise from time to

time in the various individual contributions. Nor does it say that these issues are not salient.

A more important way in which this volume differs from the similar works of Mill and Skidelsky is that rather than presenting just one perspective on each question, the book presents two different essays on each issue. Each essay defends a different point of view on the topic at hand. We leave it to our readers to decide the validity of the arguments and on which side the preponderance of evidence lies. This may perhaps give the volume less closure in the sense of definitively answering some important questions. But we hope that by adopting this approach we will give readers a sense of the current thinking in economics on each issue, as well as two sets of arguments for how we should resolve each unsettled question.

Third, this work focuses mainly on macroeconomic policy issues that remain a matter of some dispute among economists. We pay less attention to macroeconomic modelling *per se* or to the theoretical constructs devised by academic economists that may, or may not, have any basis in reality (things such as 'potential GDP', 'full employment', the 'NAIRU', or the 'natural rate of interest'). Furthermore, those theoretical concerns that do get debated, in the chapters that follow, all have clear policy implications. For example, when inflation rises and governments begin to think about policies to reduce the rate of price increases, should they employ tax hikes to achieve this end, or will raising taxes only throw fuel on the inflationary fires? Should monetary policy be conducted by setting strict rules that central banks must follow, or should central bankers be allowed discretion in terms of when and how much they change interest rates that are under their control?

The first four chapters in the book focus on the approach that should be taken when implementing domestic monetary policy and fiscal policy. The first two discuss whether central banks should follow strict monetary policy rules or be allowed discretion. This is followed by two papers that discuss whether governments should balance their budgets or not. The next two chapters examine the economic impact of taxes, as just discussed. This debate also has clear policy implications. If, for example, tax hikes create inflation, and were this policy then used to deal with inflation, it would worsen the problem. Finally, the last four chapters deal with two issues related to international economic relationships. One of these issues is something that Mill himself was concerned about—how the gains and losses are distributed when two nations trade with one another—and this

too, has important policy implications. For example, the economic consequences of Brexit for the UK, and whether the USA is helped or hurt by trading with China and incurring a large trade deficit as a result. The other issue concerns what nations should do about managing the international value of their domestic currency. In particular, should exchange rates be fixed or should they be allowed to fluctuate? Again, the papers take different sides on each of these two policy questions.

2 What Are the Questions?

This was the title of a well-known paper published by Joan Robinson in the *Journal of Economic Literature* (Robinson, 1977), and it seems particularly apposite here. As already explained, the original premise in doing this volume was to ask, and to try to answer, what we think are the following five currently 'unsettled questions', in monetary macroeconomics. That we chose five, the same number as in Mill's book, is not entirely coincidental, but for the most part they are different questions. We list them in the order in which they now appear in the book, and also provide our own first thoughts (really our first instinctive reactions) about the correct answer to each of them.

1. *Rules versus discretion in monetary policy?*
   Pressman: DISCRETION Smithin: RULES
2. *Should the central government always try to balance the budget?*
   Pressman: (qualified) YES Smithin: NO
3. *Are tax increases inflationary or deflationary?*
   Pressman: DEFLATIONARY Smithin: INFLATIONARY
4. *Should trade and financial policies always aim for a current account surplus?*
   Pressman: NO Smithin: YES
5. *To fix or float exchange rates?*
   Pressman: FIXED (BUT 'ADJUSTABLE') Smithin: FLOAT

Admittedly these questions were very blunt and straightforward, not leaving much room for nuance. But what surprised both of us was that in several of the cases at least our initial reactions were opposite. We thought that this was strange, because over the years (and it is getting to be very many years now since we were first introduced by our joint mentor, the late Professor Ingrid Rima), we have tended to have similar views on questions of macroeconomic theory and policy, typically of either a 'Keynesian' or 'Post Keynesian' orientation. So, here was something that

certainly needed to be debated and discussed. What we eventually did, therefore, was to commission our contributors to write papers to give us their own views on these questions, for or against. As the reader can see, the contributors include several well-established scholars and Professors *Emeriti*, as well as several of the most promising younger scholars of the present generation. The results are the contributions to this volume. We hope that their collective efforts will assist readers to make up their own mind on these issues and thereby clarify their own views on public policy issues. What emerges (perhaps needless to say) from this long process of debate tends to be much more nuanced and balanced than the immediate reactions outlined above. That indeed is ultimately the purpose of the exercise. Consider, for example, the last question considered, the one about fixed *versus* floating exchange rates. As a practical matter, and on a fuller examination, the positions of Pressman and Smithin turn out to not so very different. Both authors agree that such things as a 'hard peg' for the exchange rate, metallic standards, or currency boards are undesirable. Similarly that currency unions across different political jurisdictions often do not turn out well. Pressman favours a 'fixed-but-adjustable' exchange rate similar to that advocated by Keynes at Bretton Woods, but accepts the position that a flexible exchange allows full monetary sovereignty. Smithin favours a floating exchange rate for the same reason but has also explicitly argued that a fixed-but-adjustable exchange allows for a degree of monetary sovereignty. Similarly, Smithin takes the view (which some have called 'radical Keynesian') that an increase in government spending as a percentage of GDP will always increase the economic growth rate and, in a similar manner to that of the school of modern monetary theory (MMT), to be discussed below, that taxes do not 'pay for' government spending. There is therefore no real downside to so-called deficit financing. Pressman, on the other hand, accepts the Keynesian view in a recession or downturn, but also takes the view that the budget should be balanced over the cycle for distributional reasons. Therefore, every time that one digs a little deeper into each of the original five questions, more and more areas of overlap and agreement emerge.

The next three sections of this introductory chapter provide brief summaries of the papers presented in the chapters that follow. We end with an overview of these macroeconomic policy debates, and how they may be resolved.

3 Domestic Economic Policy: Monetary Policy Rules and Budget Deficits

One important contemporary macroeconomic issue concerns whether policymakers should always follow some sort of rule, or whether they should be given discretion to make policy changes. The issue arises for both monetary and fiscal policy. For fiscal policy, as just discussed, the debate has been over whether government should be required to balance their budget. For monetary policy, the debate has been over whether there should be rules for central bankers to follow regarding either increases in the money supply or, more importantly in the current economic environment, rules regarding the setting of interest rates that the central bank controls.

In Chapter 2, Martin Watts and George Pantelopoulos argue for employing monetary policy rules, specifically an interest rate rule.

They begin by making a historical point. Since the monetarist revolution of the late 1960s, monetary policy has been the main instrument of macroeconomic policy. Fiscal policy has taken a backseat. Empirically, the macroeconomic performance of most advanced countries has been inferior during this time when compared to the several decades following World War II. For example, except for a brief period of fiscal stimulus in the USA and UK at the beginning of the global financial crisis (GFC) and 'Great Recession', these countries employed a tight fiscal policy and a loose monetary policy. Yet their economic recoveries were the weakest since the Great Depression. Moreover, interest rates remained so low in many high-income nations that there was very limited scope for monetary policy in response to the economic damage wrought by the Covid-19 pandemic, without resorting to negative interest rates. As a result, countries have resorted to significant fiscal stimulus measures, which have stronger and more predictable short-term effects.

Watts and Pantelopoulos argue that rather than allowing central bankers to change interest rates based on economic circumstances, interest rates should be subject to rules, such as the imposition of a fixed target rate, rather than remaining at the discretion of central bankers. This means that monetary policy no longer takes the lead in economic policy making. Instead, fiscal policy becomes the main policy instrument and monetary policy occupies the backseat. The authors argue that introducing a job guarantee, in conjunction with infrastructure spending, would remedy the challenges associated with attempting to maintain

both full employment and price stability in the absence of discretionary monetary policy.

After a brief overview of the history of the rules *versus* discretion debate, in Chapter 3 Sarah Small and Bhavya Sinha take the opposite position and come down in favour of discretion in monetary policy. They criticize five well-known monetary policy rules—the Friedman Rule, the Taylor Rule, the Kansas City Rule, the Pasinetti Rule, and the Smithin Rule. One conclusion arising from their summary is that the position economists have taken in this debate over rules (especially the sort of rules suggested) depends on whether they place a greater value on price stability or on economic growth. Some advocates of rules (especially Friedman and Taylor) designed their rules to ensure greater price stability. Opponents of such policy rules generally argue that these rules hinder economic growth. The other three rules, at the other end of the spectrum, push for greater economic growth. In this group are more activist rules, which allow for some discretion based on economic circumstances such as recessions and depressions, and 'Park-it' rules (such as the Kansas City rule or the Smithin rule) that tie the hands of central bankers, and therefore require fiscal policy to achieve economic growth and macroeconomic stability.

Small and Sinha criticize monetary policy rules in general because policymakers cannot observe or measure output gaps or potential GDP, as required by say the Taylor rule. In addition, attempts to follow a similar rule in the 1970s led to inflation. They also note that the Friedman rule would have worked poorly during the Great Recession, when it would have required a decrease in monetary growth that would have increased interest rates and made the economic crisis even worse.

Rules also have distributional effects as is clear in the Kansas City, Pasinetti and Smithin rules. High interest rates benefit rentiers or finance but squeeze workers and firms, as well as debtors. By keeping rates low, the Kansas City, Pasinetti and Smithin rules all seek to help debtors, workers, and firms at the expense of rentiers. The latest incarnation of the Smithin rule (Smithin, 2018, 2021, 2022) makes the distributional aspect explicit. This is the 'zero *real* policy rate' (ZRPR) which argues that the real rate of return on holdings of base money should be exactly zero, neither positive nor negative, implying that the policy rate of the central bank should always be adjusted one-for-one with the inflation rate.

In any event, Small and Sinha come out *against* rules and for discretionary monetary policy. They argue that while rules can be a useful guide

for central bankers and others to think about monetary policy, they don't provide 'infallible answers', as Keynes (1936, p. 297) noted. A large part of the reason for this is that macroeconomic performance is driven by expectations, uncertainty, and particular socio-economic circumstances. Central banks must pay attention to these rather than blindly following some monetary policy rule.

The economic consequences of government budget deficits have similarly been a perennial economic issue. In practice, governments often tend to resort to borrowing rather than taxation to support needed or desired spending. In theory, however, many economists worry about the economic consequences of large government deficits and think that budget deficits matter a great deal.

Chapter 4, by Steven Pressman, begins by presenting several differing views regarding government debt. It then makes a case for running balanced government budgets most of the time—in large part because of the potential impact of government debt on wealth and income inequality. This case rests on the work of Keynes and Thomas Piketty.

The debate about budget deficits was first given prominence long ago by the work of David Ricardo. Ricardo opposed deficit financing, believing that it would crowd out other types of spending, mainly the investment spending that was necessary to put off the day of reckoning when economies would reach a stationary state. More recently, Robert Barro (1979) has updated Ricardo. He argues that government deficits have no impact on economic growth because they crowd out other categories of expenditure. Like Ricardo, Barro believes that governments should always balance their budgets. On the other hand, Abba Lerner developed the doctrine of functional finance (FF) to get around the 'crowding out' argument. Lerner contended that as long as people are willing to lend money to the government there should be no crowding out. This opens the door for expansionary fiscal policy to improve economic outcomes and generate economic growth. The work of Lerner inspired modern monetary theory (MMT) which takes Lerner one step further and contends that the central government of an economy with its own sovereign currency, and either a floating exchange rate or a fixed-but-adjustable exchange rate, faces no binding financial constraint.

One middle position comes from Keynes. While he is generally thought to have favoured government deficits, and argued that theoretical case in the *General Theory*, in later policy work Keynes actually held that

governments should balance their budget over the business cycle—running surpluses in good economic times and deficits to stimulate the economy during recessions and depressions. *Capital in the 21st Century* presents yet another perspective on government deficits and national debt. In this book, Piketty (2014, Ch. 16) opposes government budget deficits because of their distributional consequences. Going even further, Piketty (2014, p. 567) contends that existing government debt should be reduced as quickly as possible. His argument is that bond financing of government spending gives the wealthy an asset that earns them interest. This maintains the rate of return on wealth and contributes to rising income and wealth inequality (due to the rate of return on wealth being greater than the economic growth rate, $r > g$). Rather than borrowing to finance spending, Piketty prefers taxing the rich. Piketty does allow for a Keynesian exception, however, when economies are in recession and need some economic stimulus. Pressman argues that countries should maintain a balanced budget over the business cycle, running surpluses during good economic times and deficits during recessionary times. This is needed both to mitigate income inequality and also to ensure the full employment of labour.

In Chapter 5, David Barrows argues that the debate about public debt has two sides. One is scientific, the other is emotional. The emotional component is based upon perceptions with respect to the role of the state. On the one hand, the state is seen as similar to the family or community. It is regarded as friendly and helpful. The alternative viewpoint portrays the state as distant and as having dominating and dictatorial tendencies. The ancient condemnation of usury, from the criticisms of Aristotle to the censures of medieval church councils, Judaism, and Islam arose from exploitation of the poor—forcing them to borrow to survive a crisis beyond their control. Aquinas provided a qualified defence of lending, which coincided with the origin and growth of modern private banking and lending. With the Protestant reformation came a defence of usury by Martin Luther. The industrial revolution led to further defences of usury by Bentham, Smith, Ricardo, Say, and (once again) Mill.

MMT argues that a county's currency is a public monopoly and can be viewed as a version of Lerner's functional finance. FF is based on the principle of effective demand. Government can finance itself to meet explicit goals such as achieving full employment, ensuring growth, and low inflation. Balancing tax revenue and government spending is of secondary importance. Prosperity is the primary goal. In this view, taxation should