Monetary policy still has teeth [1]

Written by **Ben Southwood** [2] | Tuesday 30 April 2013

A storm has erupted over the past few days in a lot of the economics blogosphere, over an article by Mike Konzcal [3], backed by Paul Krugman [4], which claimed that current economic developments were evidence that monetary policy wasn't all-powerful and boosting demand sometimes required fiscal intervention. The claim faced convincing push-back from Scott Sumner [5], Matt Yglesias [6], and Ryan Avent [7]. Before I look at the specifics of the claim, I?ll outline a (heavily oversimplified but still broadly true) model of the economy to help us to understand the debate.

In economists' simplest model of the macroeconomy, aggregate demand (AD) and aggregate supply (AS) interact to produce the price level. At the onset of the financial crisis and recession, AD crashed. Usually a crash in demand would produce a movement along the supply curve until price and supply have both fallen to produce a new equilibrium.

But the biggest market in the economy is the labour market, and many nominal prices (especially one of the most important prices, wages) are sticky-downwards. This means that prices do not fall enough to equilibrate the market, and output stays far below where it could be (this is what economists call the output gap).

This is where fiscal and monetary policy come in. Since prices are stuck, we need extra AD to get back where we were before, at the original pre-recession level of output. In theory, both monetary policy (here I will just look at interest rates) and fiscal policy (cutting taxes or boosting spending) can have the same effect on AD.

As far as I know, pretty much every mainstream economist agrees with everything I've said so far. But a key Keynesian claim ? which the Konzcal article was arguing for ? was that monetary policy is ineffective in special situations. Nominal interest rates can only go to zero ? beyond that point savers will simply stash their cash in their mattress. Real interest rates (taking into account inflation) can only go to zero minus inflation. This is called the zero lower bound.

Konzcal said the Federal Reserve?s ?Bernanke-Evans Rule? ? which promises to keep interest rates low until unemployment falls below 6.5 per cent ? has failed to outweigh the $85bn (£55bn) federal cutbacks as part of ?sequestration?. His evidence is Friday?s GDP release, showing that the US economy grew 0.6 per cent in the first quarter (2.5 per cent sped up as if the quarter were a year) below expectations it would expand 0.7 per cent. Konzcal said this GDP report showed the US economy was stagnating, and that the B-E rule failed to outweigh the sequestration.

But his critics pointed out that this was a big jump in growth over the previous quarter, when government spending hadn?t been cut and the Bernanke-Evans rule had barely taken effect ? and growth was under 0.1 per cent (or 0.4 per cent on an annual basis). They point out that by creating inflation ? and future expectations of inflation ? a central bank can boost AD with monetary policy even when at the bottom bound, reducing real interest rates even when nominal rates can?t fall further. And they argue that monetary policy is dominant; it can always overrule fiscal policy.

If Konzcal's critics are right, it has at least two major implications for the UK. One is that Ed Balls? plan to slow the pace of austerity further while keeping the Bank of England?s two per cent inflation target would only shift output to the government sector, not boost growth. In fact, if he pressed the Bank into actually achieving their target (consumer price inflation has been above target for 39 successive months) it would mean lower demand and perhaps even a triple-dip recession, as they would have to roll back QE and hike interest rates.

A second upshot is that spending cuts have not harmed growth (though the distortions from tax hikes may have). This is because any fiscal austerity has been offset by the central bank. If the government had not cut spending, the central bank would have had to rein in inflation with less quantitative easing (electronic money printing that can be rolled back) ? unless it wanted inflation even further above target.

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