Fiscal responsibility and monetary policy

Aggregate Demand

Roger Farmer:

Although I've said a lot of wonderful things about Keynesian ideas coming from the General Theory there's one idea that I think needs revision. And that is the central component of the theory of aggregate demand that's built into the Keynesian cross diagram. Is the idea that consumption depends on income. It's that idea that's behind the Keynesian idea of the multiplier by which if government were to spend more that would not only increase GDP by the amount the government spends but by a multiple of that as more people go out, get more jobs, spend more money, consumption goes up, consumption goes up. More jobs are created, more people get income, more people spend. Central idea in Keynes.

In the 1950's there was a lot of research on the consumption function by economists such as Milton Friedman who wrote a book on that. And by Franco Modigliani and Albert Ando in America. And the ideas that came out of that work on the consumption function that are important and relevant here are that consumption depends more on wealth than on income. And by wealth they meant a very inclusive concept, which includes all of the income that you expect to earn as a worker over the rest of your life cycle.

Now when you take that idea into account it becomes I believe quite plausible that increases in government expenditure as some of the classical economists have been arguing can lead to crowding out of consumption expenditure. People reduce their consumption because they're worried about having to repay higher taxes and there may be fewer pension benefits because of the potential government budget issues that are now being discussed in the austerity debate.

So that leads to a really difficult question. If you're a Keynesian as I am that you're discouraged by the possibility of fiscal policy how do you think about stabilising the economy? That's where I think it's important to go back to Keynes' notion of Animal Spirits.

In my view if consumption is driven by wealth and there's a lot of evidence that it is, then the right stabilisation policy is one in the asset markets as opposed to the goods markets. So rather than having government borrow and spend I think the kinds of creative quantitative easing policies that we've seen the Bank of England engage in have had the right kind of effects. In particular if you look at the timing of QE in the United States the inception of the programme of buying mortgage backed securities which are really very risky assets, quite close to the stock market. And the ending of that programme coincide quite closely with the turn around of the US stock market. And in my own work I've shown that there's a close relationship between stock market growth and unemployment three months later.

So I think preventing these big swings we see in asset markets and in particularly stabilising asset markets on the down side is the right way forward to get us out of this persistent unemployment trap that we now find ourselves in.