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Rethinking Macroeconomic Policy after the Pandemic

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Abstract

The paper discusses the different phases of macroeconomic thought from the great depression to the present and looks at the different policy responses to the 2008 global financial crisis and the 2020 pandemic crisis, from the prism of the development of macroeconomics. The policy responses to the last two crisis episodes, were driven by different philosophies on deficit spending and Central Bank debt financing. Unlike austerity policies adopted in the aftermath of the global financial crisis, the response to the pandemic crisis in 2020 led to unprecedented fiscal and monetary expansion. Macroeconomic orthodoxy does not provide a conclusive assessment of what may happen in the aftermath of this unprecedented fiscal and monetary expansion and beckons the question if the inflation of 2021-22 is a transitory phenomenon or the result of the policies that preceded it. In the latter, we may have to rethink macroeconomic policy again.

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Introduction

The policy response of Governments and Central Banks to the pandemic was massive and unprecedented. In the USA, the Federal Reserve Bank put out $3 trillion in high powered money between March and June 2020 equal to what it did in its first hundred years, 1913-2013. In the UK the Chancellor asked Parliament to approve £40 billion of deficit spending in March 2020 and ended up borrowing £400 billion in the next 12 months, 92% of it financed by the Bank of England. This note considers the question of whether the aftermath of this policy justifies rethinking macroeconomic policy.

The Genesis of Macroeconomics

The 1930s marks the beginning of macroeconomics. During the Great Depression of the 1930's, Keynes in his famous work *The General Theory* introduced the concept that the key to full employment was sufficient demand by the private and public sectors to keep all available resources in the economy fully employed. As private consumption and investment, together with net exports, and are not always guaranteed to generate sufficient demand to ensure that all the output produced is sold, government spending could provide the needed extra demand for full employment. This conclusion was contrary to the prevailing orthodoxy at the time that relied on a theory known as Say's Law that maintained that there can never be general overproduction because 'supply always creates its own demand'.

Keynes also established macroeconomics- the study of the economy as a whole- as a distinct subject in economics. He warned against committing the fallacy of, in his words, "extending to the system as a whole conclusions which have been correctly arrived at in respect of a part of it taken in isolation". This logical fallacy of composition is exemplified by the "paradox of thrift", where increased individual savings reduce national income and thereby aggregate savings, which illustrates that what is true for the part is not necessarily true for the whole.
This insight has important implications for economic policy making including the idea that in a depressed economy deficit spending rather than austerity is the appropriate policy. That the government budget can be used as an instrument of economic policy was a revolutionary idea at the time. The "New Deal" in the U.S.A. is a high-profile example of this approach. The dominant prevailing Treasury View insisted on the need to balance the government budget: Keynes challenged this view arguing that always balancing the government budget, including in a severe depression, is counterproductive.

The Keynesian Revolution and the Rise and Fall of Fiscal Policy

This gave rise to the idea of *countercyclical fiscal policy* which became the dominant macroeconomic policy framework through the post war period and into the 1960's i.e., budget deficits during downswings and budget surpluses in the upswing. Meanwhile, a group of economists at the University of Chicago, led by Milton Friedman (that became known as the 'monetarists'), developed an alternative macroeconomic framework focusing on the money supply as the key determinant of economic activity.

The first key message of the Chicago School was that government intervention in the economy in the form of fiscal policy is destabilizing and to be avoided. To the extent that it was necessary to intervene, only monetary policy should be used by following this simple rule: the monetary authorities should control the money supply so that it grows at the same rate as the economy's rate. No more, nor less. The second major theme of the Chicago School was the claim that there is a "natural" level of unemployment. If unemployment is reduced below this level, accelerating inflation will result. In other words, as Friedman claimed in his famous Presidential address to the AEA in 1968, there is no Phillips curve trade-off: lower unemployment by tolerating higher inflation.

By the 1970's, faith in fiscal policy was shaken: long and variable lags before impact on the economy, and politics interfering with sound public finances, were seen as a source of instability. Moreover, high debt to GDP ratios, resulting from persistent deficit spending, were perceived as crowding out private capital investment via higher interest rates, thereby burdening future generations by lowering future output.

The Monetarist Counter Revolution

The 1970s were characterised by the last serious inflation episode (until the current one); global and US demand were powered by the US fiscal spending on Vietnam and the Great Society and an OPEC oil shock, and powerful unions (stronger that they are today) pushing wages onto a wage-price spiral. It took a sharp increase in interest rates and a severe recession to bring down the resulting inflation. The experience of stagflation (accelerating inflation combined with high unemployment and near stagnant economic growth) in the 1970's led to a weakening of the Keynesian and strengthening the Monetarist approach to macroeconomic policymaking. With the election of Reagan in the US and Thatcher in the UK, the Chicago-Friedman narrative prevailed with monetary policy focusing on price stability to deliver optimal output and employment. The money supply and interest rates were the key tools of monetary policy: like in any free market you can control the price, or

the quantity supplied, but not both. As there was a shifting definition for the money supply, the interest rate became the dominant policy variable.

Since the mid-1980's, trade and capital movement liberalisation and globalisation has powered productivity growth and held down inflation; a huge increase in the global labour force kept the cost of goods and wages in advanced economies down: a 40-year span of essentially price stability followed. Significantly, the famous Phillips Curve of the 60's and 70's seems to have flattened: unemployment stayed low for long periods without inflation.

Over the same period, a steady decline in interest rates reflected mainly strong savings for demographic reasons, as older people save more, and weak investment demand relative to the savings glut. On their way down, interest rates fell below the growth rate of the world economy; growth rates higher than interest rates on government bonds are important for debt sustainability. With interest rates at the effective lower bound (meaning they cannot be pushed any lower), monetary policy could not stimulate the economy and fiscal policy re-emerged with a key role in keeping output at its potential; a reversal of the 1970's when emphasis was on monetary policy.

The Policy Response to the Global Financial Crisis (GFC)

This theoretical consensus was first tested during the GFC. The severe recession of 2008, caused by the 2007 financial crisis, required a coordinated global response. In 2009 Gordon Brown at the G-20 meeting in London secured such an agreement for a coordinated fiscal expansion to raise global demand. With interest rates close to zero, Central Banks had to innovate. The innovation took the form of Quantitative Easing to directly provide liquidity to the banking system by buying bonds in the secondary market. This led to asset price increases rather than more private sector spending through increased bank lending.

Fiscal expansion moderated the decline in economic activity but, as many countries were already deep in debt, it led to further deficit spending and a sharp increase in public debt. According to the prevailing narrative at the time, public debt above 80% of GDP was inimical to economic growth. This threshold was supported by empirical evidence which subsequently was shown to contain errors that invalidated these conclusions. Nevertheless, the 'debt threshold must not be exceeded' narrative was powerful enough to produce a reversal of the coordinated fiscal expansion at the Toronto G-20 meeting in 2010. A period of austerity, a sharp reduction in public spending with negative economic and social consequences followed.

The 'austerity mindset' affected policy making during the Eurozone crisis, particularly in the case of Greece where the economic and social consequences were unnecessarily severe. It is likely that with today's mindset on public indebtedness and Central Bank support for government deficit spending, the Eurozone crisis would have been handled differently. The limited fiscal expansion meant that recovery from the financial crisis was slow; in retrospect, recovery was delayed by austerity as many countries were dealing with the legacy of high debt as well as the concern to maintain enough ammunition to deal with the next crisis. Slowly however, a return to moderate economic growth was achieved through 2019. The next crisis came in an unexpected form.

The Policy Response to the Pandemic

With the onset of the pandemic, a coordinated and sustained response was more forthcoming. There was immediate and substantial fiscal response to protect incomes and employment and keep enterprises alive. There was unprecedented public spending globally and collective borrowing by the Eurozone in support of member countries. Even the traditional proponents of fiscal prudence, such as the IMF, encouraged increased public spending. As a result of increased deficit spending, public debt rose sharply but historically low interest rates, supported by Central Bank financing of these deficits, kept debt service low and financial markets marginalized. The macroeconomic policies implemented globally during the pandemic were contrary to the two most basic norms of the prevailing macroeconomic orthodoxy which were (a) no large-scale deficit spending and (b) no Central Bank financing of government debt. Both conditions were significantly set aside during the pandemic.

Circumstances were exceptional and that is why unorthodox polices were followed. At this point it is worth examining briefly the macroeconomic policies followed by Japanese governments for more than 25 years, which were like the policies pursued by the rest of the world during the pandemic. To deal with the severe economic depression caused by the bursting of 'the worst property bubble in history', Japan implemented expansionary fiscal policies involving huge deficit spending financed by the Bank of Japan. As a result of persistent budget deficits, the debt to GDP ratio in Japan skyrocketed to 250% and almost 50% of all JG bonds are on the balance sheet of the Bank of Japan.

Traditional macroeconomics predicts that these policies will lead to an increase in interest rates, rise in inflation and fall in the exchange rate. None of these predictions materialised. The so called 'Japanification' of macroeconomic policy during the pandemic raises the question of whether these policies (deficit spending financed by the Central Bank) will have similar consequences, namely no rise in inflation and interest rates. If the effects are

similar, then it is likely that a new post-pandemic macroeconomic narrative may emerge. Before we discuss this question, it will be helpful to take stock of the argument so far.

a) Economists before the 1930's did not see the point of studying macroeconomics or the need for government intervention because the economy was self-regulating with an automatic tendency to full employment, in the long run to which Keynes replied: 'in the long run we are all dead'.
b) Keynes disagreed: Studying the economy 'as a whole', was different from the study of its individual parts and government intervention was necessary to ensure full employment.
c) This led to the Keynesian Revolution in macroeconomic policy during the 50's and 60's during which fiscal policy was used in addition to monetary policy.
d) The stagflation of the 70's led to the abandonment of Keynesianism in favour of monetarism. Fiscal policy fell out of favour and a belief in the self-regulating capacity of the market economy was restored. This belief was shaken in turn by the GFC. The GFC briefly saw the use of fiscal policy, but 'business as usual' was soon restored, with austerity measures taking hold.

A New Macroeconomic Narrative?

We now, hopefully, entered the post-pandemic period and the final question I want to discuss is whether a new macroeconomic narrative is emerging. As noted earlier, the response to the pandemic was massively expansionary fiscal and monetary policies globally. The focus has shifted away from the fear of an increasing debt to GDP ratio towards the likely impact of government spending on inflation. There was some concern about the prospect of inflation but overall, the mindset was one of 'we will do whatever it takes'. We are now experiencing high inflation. Under the traditional macroeconomic thinking this would have been the expected consequence of excessive deficit spending during the pandemic. However, the double supply shock because of the pandemic and the Russian invasion of Ukraine, which brought sharp increases in energy and commodity prices, is complicating the debate on the causes of the high inflation the world is currently experiencing.

Before discussing the causes and the policy response to the current inflation, let me spend a minute on a key part of the post-pandemic policy narrative, namely the reappraisal of the role of government in the economy. Within the framework of the accepted paradigm of a mixed economy of private and public sectors it was generally presumed that the private sector was more efficient and therefore the role of government should be limited. But the success of governments in fighting the economic impact of the pandemic (and the failures of the private sector in the 2007 financial crisis) has bestowed a greater role to government. In

that spirit, there was a reversal of the accepted view that deficit spending is not sound policy: if large government spending can be successful in dealing with the pandemic why can it not be used to prevent, for example, a climate change crisis?

Economists were divided between those focusing on supply constraints (temporary inflation) and those blaming excessive spending (permanent inflation). Initially Central Banks took the view that inflation was a transitory phenomenon and took no action. As inflation persists, a simultaneous demand and supply shock (reminiscent of the 1970's stagflation) poses a sharp dilemma for Central Banks: to signal their independence and that they are serious about avoiding runaway inflation they need to anchor inflationary expectations by normalizing monetary policy quickly but that risks a slowdown in economic activity and even a recession. The concern is that not only can tighter monetary policy and a sharp rise in interest rates cause a recession, but it may also lead to a financial crisis in debt and equity markets.

While the aim is to have a "soft landing", meaning to bring down inflation without causing a recession, doing too little now may necessitate a larger monetary contraction and a much steeper increase in interest rates in the near future, if inflation gets out of hand. The likelihood for this to happen depends to a large degree, on the state of the labour market in each economy. A wage-price spiral would only occur if workers had sufficient bargaining power to force wages up in anticipation of future inflation.

On the fiscal side too, there are no easy solutions. To soften the impact of inflation by reducing indirect taxes and increasing transfer payments to low-income groups dampens the decline in real incomes that helps reduce demand. On the other hand, increasing taxes and reducing welfare payments to help with the deficit will hit hard many vulnerable groups. Increased public spending would be preferable for investments that will reduce supply bottlenecks over time. Supply-chain bottlenecks however are global in nature and cannot be solved by the action of one country alone.

Beyond inflation there is also concern about high debt; but this time (unlike 2010) the advice to governments is to respond by implementing structural reforms to enhance growth prospects rather than by spending cuts and tax increases. A revisiting of the debt sustainability issue: earlier it was thought that 80% debt to GDP was detrimental to growth based on econometric evidence that turned out to be erroneous as mentioned earlier. It was also believed to be unsustainable. But as many eminent economists have recently pointed out, the issue of sustainability primarily relates to of whether the economy's growth rate is higher than the interest rate on government borrowing, rather than the size of the debt to GDP ratio.

While Central Bank public debt financing and a flexible approach to debt sustainability are important features of a post-pandemic macroeconomic paradigm, some economists take the revision further. These economists speak about the "Japanification" of macroeconomic policy, namely that it is possible to have massive deficit spending that is not "paid for" by reducing spending elsewhere or increasing taxes. To the observation that this pandemic-related spending has led to inflation that had been dormant for decades, they answer that this inflation is due to supply disruptions and is therefore transitory. Accepting this view would be a far-reaching revision of macroeconomic policy.

Conclusions

Two global crises in 2008 and 2020, respectively, produced two different policy responses formulated by different philosophies on deficit spending and Central Bank debt financing. In response to unprecedented crisis, policies earlier rejected were adopted. For the past 40 years a consensus was established whereby macroeconomic policy put little emphasis on fiscal policy. A key feature of this consensus was Central Bank independence which meant no Central Bank financing of public debt and no political interference with the setting of interest rates.

While Central Bank financing continued to be absent, this consensus was broken during the GFC when fiscal policy came into favour again, but only temporarily. Fear of mounting total indebtedness led to widespread adoption of austerity policies.

In sharp contrast with 2010, in fighting the pandemic in 2020 not only was there sustained fiscal stimulus but it was financed by Central Bank purchases of government bonds. We know the welfare cost of austerity and slow recovery from the 2008 Global Financial Crisis. It remains to be seen what happens in the aftermath of the unprecedented fiscal and monetary expansion to fight the impact of the pandemic. Important questions are still waiting to be answered. How high will interest rates have to rise and will inflation be tamed at a relatively low output cost? Did policy makers do too little in 2008, fearing fiscal deficits and rising debt; or did they do too much in 2020-21 misled by 40 years of no inflation? Will Central Bank public debt financing work in long-run?

I have argued in this presentation that macroeconomics went through several phases since its inception in the 1930s, involving significant re-thinking of macroeconomic theory and radical changes in the direction of macroeconomic policy. The latest example of this process is regarding the ‘unorthodox’ policies pursued during the pandemic. Would these policies be viewed as a temporary deviation from ‘business as-usual’ to deal with an unprecedented emergency or could it lead to a more radical re-thinking of macroeconomics? The answer to these questions crucially depends on the verdict with regard to the causes of the current

inflation. Time will tell, therefore, how far we will have to rethink macroeconomic policy. In the meantime, central bankers are taking no chances as they begin a process of raising interest rates.