Economics Working Paper Series

2018/019

Economic Policy in a Recession. Lessons from the Past

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September 2018

Abstract:

When an economy drops suddenly into recession, the paramount objective of any policy initiative is to avoid deflation. To that end, quantitative easing has little to offer. Arguments from the 1930s are assessed within the context of the recent Global Financial Crisis, where the preceding twenty years of the Great Moderation had left economists high on hubris. In avoiding their deserved comeuppance, economists continue to parade an ever-more sophisticated intertwining of statistical data within mathematical relationships that is essentially divorced from social and political relevance. Though sorely needed, the broad strokes of a politico-historical perspective are rarely found within the purview of current mainstream economics.

Keywords: Central Banking, Deflation, Keynes, Simons Sovereign debt.

JEL classifications: B31, E58, H63

* The author acknowledges the insightful comments of Oliver Westall and John Whittaker, but he bears full responsibility.

Easing money

A central bank may act either to ease or to tighten money. The conventional policy choice has been set within a 'Rule' (Taylor, 1993), which indicates adjustments to the short-term interest rate that are perceived to be necessary to counter variations in inflation and unemployment. At the onset of the Global Financial

Crisis, *New York Times* columnist and Princeton economist Paul Krugman presented a Taylor Rule interest-rate calculation of minus 6 per cent, as necessary to mitigate the anticipated downturn. Given the thought that potential ‘lenders will just hoard cash’, that call for a negative policy rate was not taken seriously. Instead, there was a despairing ‘Mayday’ call for ‘a huge fiscal stimulus, unconventional monetary policy and anything else you can think of to fight this slump’ (Krugman, 2009). As short-term rates have remained close to the zero lower bound in the years that have followed, central banks have attempted to maintain the stimulus by means of asset purchase programmes; *i.e.*, quantitative easing.

A policy of quantitative easing involves a central bank exchanging one kind of debt (central bank money) for another kind of debt (bonds), which alters both the ownership and the term-structure of debt. In the UK, the Bank of England created £435 billion of new money in order to purchase (mostly sovereign) bonds. As bond prices rose in response to that additional demand, market competition reduced long-term interest rates and, therefore, the cost of corporate borrowing. The idea was to encourage investment.

Following upon the substantial use of quantitative easing is a suggestion to avoid its future use by raising the inflation target above 2%. According to Janet Yellen (as Chair of the US Federal Reserve), the concern is that policy may

> be constrained by the zero lower bound more frequently than at the time that we adopted our 2 percent objective. So, it’s that recognition that causes people to think we might be better off with a higher inflation objective, and that’s an important set. This is one of our most critical decisions and one we are attentive to evidence and outside thinking’ (Yellen, 2017).

It might be noted that the effective lower bound can be less than zero, as evidenced by the current negative policy rates of the European Central Bank and the Swiss National Bank. The explanation for a lower bound is that, if bank deposits earn negative interest, depositors would be better-off holding zero-earning banknotes, but only if the rate on deposits is sufficiently negative to cover the cost of storage and insurance of the banknotes.

Another aspect of quantitative easing that attracts comment are its distributional effects. As former bondholders rebalanced their asset portfolios and as lower interest rates encouraged greater indebtedness, wealthier households gained most from the impact of quantitative easing on asset values, including those of equity and real estate. With savers generally ‘losing out’, households with mortgages benefited from lowered interest rates, as rising house values told against first-time buyers. A fall in long-term rates boosted corporate investment; but pension funds and insurance companies saw the capitalised value of their liabilities rise in relation to the value of their assets. This reduced the value of annuities to those entering retirement. As businesses diverted funds to support company pension schemes and as savers’ incomes fell, other expenditures were curtailed.

It is therefore evident that, in applying quantitative easing, the central bank is making decisions that have extensive distributional consequences and which are the proper domain of the elected government. Before quantitative easing was applied, the central bank’s task was merely to choose the interest rate appropriate to meet its mandated inflation target. It was given *independence* from government in this task in order to insulate it from government bias. Yet, the distributional impact of quantitative easing raises the question as to whether it should remain independent:

> the independence doctrine becomes impossible to uphold when monetary policy comes to involve choices of inflating or deflating, of favouring debtors or creditors, of selectively bailing out some and not others, of guaranteeing some private sector liabilities and not others, of allowing or preventing banks

> to collude. No democratic country can leave these decisions to unelected technicians (Leijonhufvud, 2009, 748-49).

Ersatz quantitative easing

Quantitative easing merely exchanges new money (central bank reserves) for sovereign bonds; *i.e*., when a central bank buys bonds, a seller is paid by means of a deposit in a commercial bank and that bank, in turn, acquires a claim on the central bank (central bank reserves). In other words, the central bank puts 'new money' into the hands of banks, which the banks can lend. Regardless of whether that bank lending takes place, the reserves created by quantitative easing remain unchanged, which has led to criticism of banks for not increasing their lending.

That criticism exposes a basic misunderstanding. When a bank lends its reserves which a borrower spends, those reserves necessarily become the asset of some other bank. Unless or until quantitative easing is reversed (or commercial bank deposits are withdrawn as banknotes), the value of central bank reserves that are collectively held by commercial banks remains unchanged, *irrespective* of the banks' lending behaviour.

With a number of established economists of considerable repute appearing to have misunderstood the relevance of quantitative easing (among whom Alan Blinder, Martin Feldstein, Allan Meltzer and John Taylor have been cited: see Sheard, 2013), those who are less versed in the dismal science might be forgiven for their own failings. This applies to propositions emanating (for example) from Jeremy Corbyn, John McDonnell and Robert Skidelsky:

> One option would be ... to invest in new large scale housing, energy, transport and digital projects: Quantitative easing for people instead of banks (Corbyn, 2015);

> .. the last round of quantitative easing increased the price of assets and poured money into their [*i.e.*, hedge fund managers] pockets. If you design it properly and make sure it goes into infrastructure and skills you can grow the economy .. (McDonnell, 2015);

> An alternative would be to distribute the central bank's newly issued money directly to housing associations, local councils, or national or regional investment banks - any organisation that could carry out infrastructure projects (Skidelsky, 2016).

None of those propositions, nor others similar in nature, relates to quantitative easing. Yet, in categorising (without aspersion) those propositions as 'ersatz quantitative easing', it can be shown how these have an affinity with *right-of-centre* (*i.e.*, market orientated) arguments emanating from the University of Chicago in the 1930s.

As with the recent Global Financial Crisis, the focus in the 1930s was upon macroeconomic policy in the face of a severe economic downturn. Although policy options are ever controversial, there is timeless agreement on one simple issue: it is better to avoid deflation. Falling prices raise both the real value of nominal debt and the incentive to defer expenditure. As both are likely to exacerbate a recession, the motivation for quantitative easing has been to counteract deflation; but the effectiveness of quantitative easing to achieving that end must be doubted.[1]

Avoiding deflation

Prominent among reactions to the Wall Street Crash of 1929, were the arguments from the University of Chicago.[2] A prime-mover was Henry Calvert Simons, who was as resolute in defending the role of prices within a market economy as he was vociferous in opposing Maynard Keynes's call for public works. In his review of Keynes's *General Theory*, Simons writes that, where Keynes expresses a

> decided preference for an economic system of free enterprise, he does not seriously consider what monetary arrangements or what implementations of monetary policy are most and least compatible with that system (Simons, 1936, p. 92).

Given Keynes's explicit support for the price system, markets and the freedom to choose, Simons castigated his espousal of fiscal deficit spending as 'a highly diffuse kind of political interference' (*ibid*.). The alternative prospectus argued by Simons is that the 'monetary financing'[3] of fiscal deficits unambiguously provides the force to counter deflation, where

> the Treasury would be the primary administrative agency; …. The powers of the government to inject purchasing power through expenditure and to withdraw it through taxation - i.e., the powers of expanding and contracting issues of actual currency and other obligations more or less serviceable as money - are surely adequate to price-level control (Simons, 1936, p. 22).

Simons saw no case for public works. Instead, new purchasing power from fiscal deficits is better delivered by tax reductions:

> What is needed during depressions is deficits, not expenditures; and deficits may properly be obtained by tax reductions as well as through emergency outlays. … Adequate reflationary deficits could be obtained without tossing money recklessly in all directions, without reliance on the hurried schemes of bureaucrats, without the numerous disadvantages of "emergency public works," and without the awful prospect of fiscal reflation carried far beyond the time when it should be reversed (Simons, 1938, p. 223).

The UK Treasury View

The argument made from Chicago runs close to that articulated a few years earlier on behalf of the UK Treasury, when Winston Churchill countered agitation for increased spending from the Liberal Party. In his budget speech of 1929, Churchill cited

> the orthodox Treasury doctrine which has steadfastly held that, whatever might be the political and social advantages, very little additional employment, and no permanent additional employment can, in fact, and as a general rule, be created by state borrowing and state expenditure (House of Commons, 1929, p. 54).

The upshot of the 'Treasury View' is that new credit *per se*, rather than its use to finance public works, is the force which counters deflation. The argument had not been that public works create no employment, but that

> a creation of credit unaccompanied by any expenditure on public works would be equally effective in giving employment. The public works are merely a piece of ritual, convenient to people who want to be able to say that they are doing something, but otherwise irrelevant (Hawtrey, 1925, p. 44).

Long before a zero lower bound had been mooted, Ralph Hawtrey had acknowledged that a policy initiative to counteract a 'credit deadlock' could mobilise resources; but bank credit *is* the essential factor: 'If the new works are financed by the creation of bank credits, they will give additional employment' (Hawtrey, 1925, p. 43); and if public works give employment when financed by credit, then credit creation unaccompanied by public works would be equally effective.

In more detail, Hawtrey had argued that, if public works are privately resourced and if the stock and circulation of money remain unchanged, resources must be drawn, either from income that would otherwise have been saved (so reducing private investment) or from privately hoarded money balances. With the latter, individuals are assumed to reduce their expenditure to rebuild their money holdings. Either way, public works deliver no net boost for recovery.

Keynes was not impressed by Hawtrey's arguments. Although aware that Hawtrey's views had been 'used' by the UK Treasury, he dismissed the core idea. In an open letter to President Roosevelt, he described credit creation *per se* as

> trying to get fat by buying a larger belt. … It is a most misleading thing to stress the quantity of money, which is only a limiting factor, rather than the volume of expenditure, which is the operative factor (Keynes, 1933, p. 234).

The contemporary context of Hawtrey's 1925 paper is important. Like Keynes, Hawtrey had favoured the return of sterling to the gold standard, but not at any cost. With the UK in the final stages of restoring the prewar dollar-sterling parity prior to reestablishing gold convertibility, there had been sharp rises in bank rate, even as unemployment rose above 10%. Hence, the absurdity: proposals for public works were being made as the central bank was doing all it could to prevent credit from rising. Keynes's pamphlet of 1925 - *The Economic Consequences of Mr. Churchill* - was similarly focused upon that same absurdity:

> The President of the Board of Trade has asserted in the House of Commons that the effect of the restoration of the gold standard upon our export trade has been "all to the good." The Chancellor of the Exchequer has expressed the opinion that the return to the gold standard is no more responsible for the condition of affairs in the coal industry than is the Gulf Stream. These statements are of the feather-brained order (Keynes, 1925, p. 208).

Deflation: the key issue

The sources from which fiscal expenditure can be financed are taxes upon the wealth and income of individuals and corporations. With gross domestic product (GDP) serving as an approximate metric for the sources from which taxation is raised, the sovereign-debt-to-GDP-ratio ('debt ratio') is indicative of taxpayers' capacity to repay sovereign debt. (That consideration provides the rationale for the much-ignored sixty percent upper limit to sovereign debt across the eurozone.) An unrestrained increase in the debt ratio is bound, eventually, to cause default or inflation.

Simons delivers scarcely-veiled criticisms of Keynes and gives no support to the 'hurried schemes of bureaucrats' or to 'emergency public works'. Yet, his own recommendations for tax reductions to counter deflation in the 1930s would similarly have caused the debt ratio to rise, resulting in a reduced capacity to deliver sufficient fiscal surpluses to repay sovereign debt. This is the crucial point. The force that leads to inflation (or to arrest deflation) are rising concerns among financial market investors, about the likelihood of sovereign debt being repaid.

Whether it is achieved indirectly by the revised judgement of investors or directly by the issue of central bank money and/or sovereign bonds, this is the essence of the proposals from Jeremy Corbyn, John McDonnell, Robert Skidelsky *and* Henry Simons. It is a rise in the debt ratio that is the force to counter price deflation.

The absurdity in the 1920s of a high bank rate coexisting with high unemployment is paralleled during the Global Financial Crisis by the implementation of austerity measures[4] and the raising of regulatory bank capital ratios; *i.e*., action more likely to induce, than to prevent, deflation.

'What is it that economists do?'

The Global Financial Crisis caught many on their back foot. Twenty-or-so years of the 'Great Moderation' (a period of steady non-inflationary economic growth) had set bankers, economists, politicians, and pundits at ease within what turned out to be their fools' paradise. (In the UK, Gordon Brown would later be remorselessly ridiculed for his mantra of 'No return to boom and bust'.)

Among the many explanations for the Great Moderation are advances in information technology, the independence of central banks, financial deregulation, trade liberalisation and greater financial versatility. Alan Greenspan (Federal Reserve Chairman, 1987-2006) had helped to sustain the boom by means of his 'Greenspan put': periodically reducing policy interest rates to counter every sharp fall in equity prices. It was only after the inevitable denouement that the general public (and, indeed, H. M. the Queen[5]) had cause to reflect and to ask how the Global Financial Crisis had not been anticipated; or more succinctly, 'What is it that economists do?'

Of course it is desirable to find the means to ameliorate the boom and bust of business cycles, but that is an elusive goal. Yet the prevailing fashion, of uncritically concentrating analysis on ever-more sophisticated mathematical modelling and data analysis, has been of little value in addressing the issues at hand. The strictures upon economics as a quantitative science are rarely heeded: '[o]ur precision will be a mock precision if we try to use such partly vague and non-quantitative concepts as the basis of a quantitative analysis' (Keynes, 1936, p. 40). Instead, economic policy interventions are now analysed with shows of mathematical and statistical sophistication that are as likely to impede as to aid understanding.

Practitioners of the pseudo-science tend not to accentuate the provisos which they make in delivering their diagnosis, prognosis and cure. For example, '[t]he financial crisis in 2008 led to the UK economy suffering its deepest recession since the Second World War … leading to a decade of stagnating real earnings growth' (Bunn, *et.al.*, 2018, p. 7); and though the monetary policy response to the Global Financial Crisis 'was not enough to prevent a deep recession', without such intervention

> the economic outcomes may have been much worse. Carney (2016) and Haldane (2016) describe a simulation from the Bank's forecasting model which implies that GDP would have been up to 8% lower than it actually was if there had been no change in monetary policy' (*ibid*.).

Note that, although all the caveats are in place, their prominence is slight. Without intervention a situation 'may have been much worse'. And a 'simulation' produced by a 'forecasting model' gives confirmation to that conclusion.

Descriptions of events become explanations only when they are compared (speculatively) to what might have been. As every counterfactual scenario must pass the (non-quantitative test) of plausibility, it would be convenient to conclude by citing Winston Churchill once more: 'Those who fail to learn from history are condemned to repeat it'. With no evidence to support that attribution,[6] the alternative, more telling conclusion is that the broad lessons that can be drawn from a politico-historical perspective tend not to lie within the current purview of 'modern' mainstream economics, which showcases instead its preference for the spurious precision of mathematical models.

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[1] Quantitative easing in Japan (2001-2006) was judged ineffective and abandoned. See Werner, 2013.

[2] The Chicago Plan for banking reform was the most prominent feature.

[3] Monetary financing exists where public works or tax cuts are financed by the creation of central bank money. It would also apply if quantitative easing were a permanent feature; *i.e.*, if the central bank creates money to purchase sovereign bonds and for that measure to remain permanently in place.

[4] Austerity had followed a change of government in 2010, when the outgoing Chief Secretary to the UK Treasury left a note for his successor: ‘I’m afraid to tell you there's no money left’.

[5] On a visit to the London School of Economics in 2008, H. M. the Queen asked ‘why had nobody noticed that the credit crunch was on its way?’ (Besley and Hennessy, 2009). The summary response was that, in the period to 2007, low interest rates had caused indebtedness to soar. Yet, financial analysts believed that ways had been found to reduce the associated risks to manageable levels:

‘Everyone seemed to be doing their job properly on its own merit. And according to standard measures of success, they were often doing it well. … the failure to foresee the timing, extent and severity of the crisis and to head it off … was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole’ (*ibid.*).

[6] Convenient, but wrong. As a search for key phrases brought no results, Churchill Museum archivists concluded that Churchill ‘never repeated Santayana in so many words’. As his best remark on the subject, they cited a speech delivered by Churchill on May 2 1935:

> ‘When the situation was manageable it was neglected, and now that it is thoroughly out of hand we apply too late the remedies which then might have effected a cure. There is nothing new in the story. It is as old as the sibylline books. It falls into that long, dismal catalogue of the fruitlessness of experience and the confirmed unteachability of mankind. Want of foresight, unwillingness to act when action would be simple and effective, lack of clear thinking, confusion of counsel until the emergency comes, until self-preservation strikes its jarring gong - these are the features which constitute the endless repetition of history’ (*National Churchill Museum Blog Archive*, 2016).