

Introduction

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The current – and ongoing – crisis has presented interesting challenges to policy makers as they scramble to propose a wide range of policies to deal with the continuing recession. Yet, policies proposed at the beginning of the crisis are radically different from those proposed currently, three years later. In a way, we are now back at square one: adopting pre-crisis policies post-crisis.

At the beginning of the crisis, shortly following the G20 meetings in Washington (November 15, 2008), many countries around the world, including Canada, the United States, Europe, and the UK, adopted an unprecedented degree of activist fiscal policies, ranging, among other policies, from bank and private sector bailouts to direct subsidies to households. This led some economists and pundits to claim aloud that the Master had returned, an obvious reference of course to Keynes (see Skidelsky, 2009). Further, at the Toronto G20 summit held in June 26–27, 2010, it was even recognized that “unprecedented and globally coordinated fiscal and monetary stimulus is playing a major role in helping to restore private demand and lending”. Fiscal policy seemed to be an acceptable policy choice once again. For a while, it seemed that fiscal policy had regained much of its lost luster, dusted off the shelves, and accepted once again as a credible tool of macroeconomic stabilization.

Yet, to anyone with a memory span of more than a few years, these policies seemed somewhat oddly misplaced, given that until then, the consensus among economists and governments was for balanced budgets or even budget surpluses, what is now being referred to as “fiscal consolidation”. Indeed, before the crisis, fiscal expansion was considered inflationary, and an ineffective way of stimulating output and growth. In fact, in new consensus models, fiscal policy is absent, and growth falls entirely on the ability of central banks to fine tune interest rates.

That was then. As the crisis progressed, policy makers did a U-turn and became convinced that the righteous path to growth was no longer through fiscal largess, but rather through fiscal restraints. Keynes was dead and governments reversed their position from about a year before. Indeed,

governments now accepted the fact that austerity was the only means to prosperity. In Europe, perhaps more than anywhere else, austerity became well entrenched, to the detriment of all other possible objectives. The threat of a downgrade like the one that fell on the US was hanging over the heads of state like the sword of Damocles. The unemployed now became accepted casualties in the war against imaginary inflation and fiscal deficits. Countries such as Greece and Italy are being forced to accept draconian fiscal cutbacks in an attempt to clean their house – that is, to put their fiscal house in order. Fiscal consolidation is now a widely accepted policy prescription, dictated by credit agencies.

But at the onset of the crisis, things were quite different, and not only in terms of fiscal policy. Indeed, the Grand Keynesian experience seemed to have been extended to monetary policy as well, as central banks around the world turned to Keynesian-type policies, more specifically keeping interest rates at record low levels, and at near zero levels in the case of the United States, mimicking Keynes's proposal to, at least temporarily, euthanize the rentier class. Indeed, in Canada and the United States more notably, central bankers have even vowed to keep interest rates at near zero for a prolonged period.

Yet, setting interest rates close to its zero lower bound raises an interesting conundrum. With interest rates so low, what else can central banks do to stimulate the economy? Does this lower bound limit the central bank's ability to stimulate the economy? In a real way, the current crisis has thrust central bankers into a policy and intellectual void, not unlike the liquidity trap of the Keynesian era.

Indeed, in the past, in the old Keynesian incarnation of monetary theory, the liquidity trap represented the end of monetary stimulation: it was impossible for central banks to further increase the money supply and lower interest rates. Policy makers hence had no choice but to fall back on fiscal policy: monetary policy became ineffective.

Yet, there was always a mistrust of the effectiveness of fiscal policy among a great portion of the economic profession, which saw fiscal policy as inflationary and worse. In fact, even the theoretical framework of the new macroeconomic paradigm, the so-called "new consensus", now downplays the effectiveness or usefulness of fiscal policy. Monetary policy was always perceived as the only effective (or preferred) tool of expansionary policies. Fiscal policy was never considered an adequate substitute, although in times of a major recession or crisis, its usefulness was recognized. Indeed, fiscal policy appears nowhere in its three-equation model.

But with current rates so low, this called for ways of proving the effectiveness of monetary policy. In other words, modern-day Keynesians sought a solution to the so-called "liquidity trap situation". This is where

quantitative easing or “Operation Twist” policies come in. Indeed, these policies were meant to be a solution to the liquidity trap: a way for central banks and monetary policy to remain relevant despite near-zero interest rates. To wit, the profession at large always sought ways to prove the usefulness of monetary policy even at low rates, going as far back as Alfred Pigou.

Of course, theoretical situations under the old Keynesian approach and the new consensus are different, certainly. Under the old Keynesian framework, interest rates were seen as endogenous and central banks were said to control the money supply, and increasing it no longer had an effect on interest rates. Under the new consensus, however, interest rates are seen as exogenous, similar to what Post Keynesians have been arguing for several decades now.

Yet, regardless of the exogenous or endogenous nature of interest rates, both situations share a similar conclusion: at near-zero rates, what can the central bank do to further stimulate the economy? Under the old Keynesian doctrine, the answer was “nothing” and we had to rely on fiscal policy. Now, central bankers are attempting new policies (some of which have been tried before, in fact) in an attempt to give relevance to monetary policy, despite low interest rates.

Whether these new policies will eventually have an impact on the macro-economy, however, remains to be seen. Federal Reserve Chairman Ben Bernanke, during testimony at the Joint Economic Committee on October 4, 2011, has already labeled Operation Twist as “Significant, but not a game changer”. As for attempts to increase the liquidity of banks through quantitative easing, this was perhaps an ill-fated policy from the beginning. Increased liquidity does not lead to increased bank lending: banks lend because they have confidence in the ability of bank borrowers to repay their loans. This is consistent with the theory of endogenous money and the notion of a creditworthy bank borrower: banks are never constrained by the lack of deposits or liquidity.

Regardless of whether interest rates are near zero, Post Keynesians have always tended to downplay the importance of monetary policy in favor of fiscal policy, while rejecting the liquidity trap scenario altogether. This is not to say that monetary policy does not play an important role, but that it is rather an ineffective way of stimulating aggregate demand. Increasingly, Post Keynesians argue that central banks ought to keep interest rates at a low level and rely on fiscal policy to do the rest.

As of early 2012, many economies are still not on a guaranteed path toward growth. Indeed, unemployment seems stuck at relatively high levels and aggregate demand is, at best, anemic. As a result, there is increasing pressure on governments to continue spending. Yet, this

appears increasingly less likely. The greater question, therefore, is the following: “where will the growth come from in the next decade?”. After all, the household sector is overindebted and its attempt to lower its debt will be a drag on aggregate demand. The private sector, despite healthy profits, does not seem to be willing to invest, and banks are increasingly unwilling to lend. As for the possibility of an export-led growth strategy, the fear is that the pie is not big enough, given the fierce competition for those markets. This leaves only the government sector in the position to stimulate the economy sufficiently to lift it out of recession. But even this strategy seems unlikely as governments are now aggressively pursuing fiscal austerity measures in order to balance their books. In this sense, it is increasingly becoming business as usual, that is, policy makers and governments are turning to pre-crisis policies post-crisis, condemning us perhaps to another eventual crisis.

This raises interesting questions regarding the fate of Keynes after the crisis. Undoubtedly, the crisis shone a much-deserved spotlight on Keynes, no less than on or around the 75th anniversary of the publication of the *General Theory*. But this seems to be temporary. In fact, if the profession at large seems to have embraced Keynes during the crisis, they are just as quick to reject him once the crisis is over – whenever that may be. Indeed, even before the crisis is over, calls for austerity measures in the US as well as in England and the whole of Europe are becoming policy. This raises serious questions about the eventuality of another crisis, and the odds are high that we will go down a path of economic *déjà vu*.

Ultimately, one conclusion that seems to be emerging now is that monetary policy is broken. Its narrow focus on inflation has clearly led many critics to argue that monetary policy is misguided. Some Post Keynesians have recently emphasized this point and have insisted that the rate of interest is an income distributive variable that is best used to this end. Interest rates are not effective when used in a countercyclical manner and as such should be left at a low level (“parked” to use Rochon and Setterfield’s expression) indefinitely. This would be in accordance with Keynes’s expressed desire to euthanize the rentier class, whose “revenge” can be costly. In the end, we are back to where Keynes started: the use of fiscal policy to stimulate effective demand and to leave “monetary details in the background” – that is, keeping interest rates low.

This book is the result of a conference held in Toronto, Canada, on May 27–28, 2009, and financed generously by the Social Sciences and Humanities Research Council of Canada (SSHRC) and Laurentian University. Sponsored by the International Economic Policy Institute at Laurentian University, it brought together a number of leading Post Keynesians who discussed, on the one hand, the possible causes of the

financial crisis, and on the other, and perhaps more importantly, the challenges the crisis posed for current monetary policy and central banking. It is but one of many such conferences financed by SSHRC, and one of many more to come.

We would very much like to thank all the participants for their involvement in the conference. The discussion was both stimulating and rewarding, and further emphasized the need to further discuss the role of monetary policy and its place within the greater macroeconomic policy framework.

REFERENCE

Skidelsky, R. (2009), *Keynes: The Return of the Master*, London: Allen Lane.

