

Session 2: A Post-Keynesian Critique of the Current Consensus

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Outline

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Introduction

The NK baseline model and an important open question

- ▶ The CB guides the economy back to "natural" equilibrium,
- ▶ which is determined by labour market institutions.
- ▶ What about long term effects of recessions?
 - ▶ If workers stay unemployed their skills deteriorate.
 - ▶ Strong/weak growth stimulates/stifles investment and thus productivity improvements
- ▶ We will look at what happens if we amend the baseline model along these lines!

Theoretical Hysteresis Literature

- ▶ Lavoie (2006, p. 180), Hargreaves-Heap (1980) and Kaldor (1957): strong investment growth increases productivity growth
- ▶ Dosi, Pereira, Roventini, and Virgillito (2018) develop agent based model
- ▶ For further discussion see Jump and Stockhammer (2019)
- ▶ Also several mainstream authors incorporate hysteresis effects:
 - ▶ Carlin and Soskice (2014) have brief discussion of endogenous natural output in chapter 15
 - ▶ Blanchard and Summers (1986) and Lindbeck and Snower (1986) are first insider outsider models
 - ▶ Layard and Nickell (1986) first long term unemployed paper

Empirical Hysteresis Literature

- ▶ LeonLedesma and Thirlwall (2002): Presents empirical evidence for 15 OECD countries
- ▶ Ball (1999) and Ball (2009) provide evidence for Europe
- ▶ Further see Stockhammer and Sturn (2011), Stanley (2004) and Gechert, Horn, and Paetz (2018)

Alternative model amendment

- ▶ Another way of making (fiscal) policy effective in long run is different Phillips curve
- ▶ If $y_t > y^n$ workers (unions) and firms would enter wage-price spiral
- ▶ Proper institutional setting could allow to avoid wage-price spiral (and leave economy at higher equilibrium output)
- ▶ Case for wage-price coordination at national level!

Long term effects of booms and recessions

Amending the baseline model

Lavoie (2006) proposes to add one equation to the baseline model:

- ▶ IS: $Y_t = A - cr_{t-1}$
- ▶ Phillips curve: $\Pi_t = \Pi_{t-1} + \alpha(y_t - y_t^n)$
- ▶ Taylor rule: $r_t = r_t^n + \frac{\alpha\beta}{c} (E[\Pi_{t+1}] - \Pi^T)$

And the new equation:

$$y_t^n = y_{t-1}^n + \phi(y_t - y_t^n)$$

Endogenous natural output (NAIRU)

$$y_t^n = y_{t-1}^n + \phi(y_t - y_t^n)$$

- ▶ The change in natural output is directly proportional to the output gap!
- ▶ If $y_t > y_t^n$ then y_t^n adjusts towards y_t
- ▶ Now y^n is not determined by labour market institutions only but also by y_t
- ▶ There is no unique level of natural output anymore to which the economy adjusts.
- ▶ Idea: The long run is a sequence of short runs. So the long run depends on the adjustment path

Endogenous natural output (NAIRU)

We will see several far reaching implications:

- ▶ Recessions are very costly and policy should react aggressively
- ▶ Austerity has permanently negative effects
- ▶ But: structural reforms still valid to influence y^n

Scenario III: A temporary demand shock in amended model

Scenario III: A temporary increase in gov spending

What happens if government increases spending for one period: one-off increase of autonomous demand from A to A' in the amended model

- ▶ We start from equilibrium: Y^* , Π^* and r^*
- ▶ Government increases its expenditures for 1 period and returns to previous level afterwards
- ▶ Let's see how the economy reacts

Scenario III: Dynamic adjustment to temporary demand shock

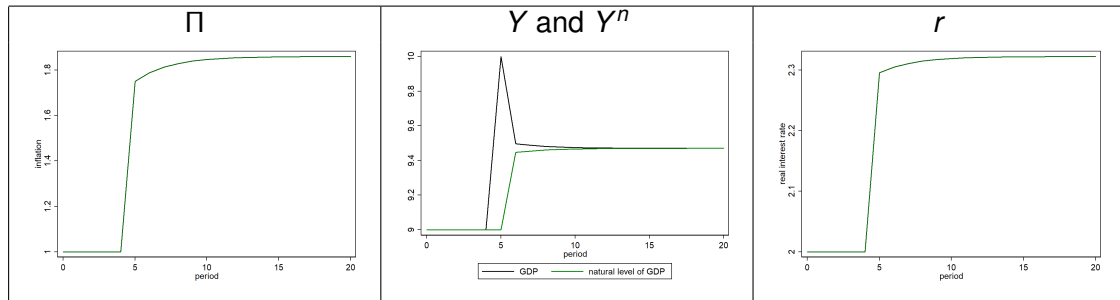
We start from equilibrium: $Y^* = 9$, $Y^{n*} = 9$, $\Pi^* = 1$ and $r^* = 2$:

Government expenditure increases in period 5 by 1 and returns to previous level in period 6:

period	Y_t	Y_t^n	Π_t	r_t
period 1	9	9	1	2
period 4	9	9	1	2
period 5	10	9	1.75	2.29
period 6	9.49	9.45	1.79	2.30
period 7	9.48	9.46	1.81	2.31
period 10	9.47	9.47	1.85	2.32

Scenario III: Dynamic adjustment to temporary demand shock

A temporary positive demand shock hits the economy in period 5:



Interpretation I

- ▶ Expansion of gov expenditures creates boom,
- ▶ which increases natural output as well.
- ▶ Inflation goes up due to GDP expansion and
- ▶ the CB reacts by increasing real interest rates.
- ▶ New equilibrium at higher level of output, inflation and real interest rates.
- ▶ (if we endogenised also r^n then the CB would hit its inflation target)

Interpretation II

- ▶ In the amended model fiscal policy is effective and can influence y^n
- ▶ Superiority of supply side reforms (over fiscal policy) breaks down
- ▶ Wage restraint and "anti-labour" legislation still effective.

From models to reality

A reflection on shocks

- ▶ What about asymmetries: austerity vs fiscal expansion?
- ▶ Temporary demand increase:
 - ▶ long run effect likely to be small (for fiscal expansions)
 - ▶ long run multiplier likely to be (substantially) larger in recessions Gechert et al. (2018)
- ▶ Permanent demand increase:
 - ▶ very strong assumption to have no long run effect!
 - ▶ other actors need to reduce spending (crowding out, Ricardian equivalence) (in current model it is purely the CB)

Summing up

- ▶ Carlin and Soskice (2014) New Keynesian model completely supply determined in long run
- ▶ Austerity not harmful and fiscal expansion not beneficiary (rather inflationary) in long run
- ▶ "Structural reforms" only way to increase equilibrium output
- ▶ Depends fundamentally on assumption of unique natural level of output / employment (NAIRU), independent of goods market equilibrium
- ▶ Limited role for distribution (no effect on aggregate demand)
- ▶ Endogenising natural output changes model fundamentally

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