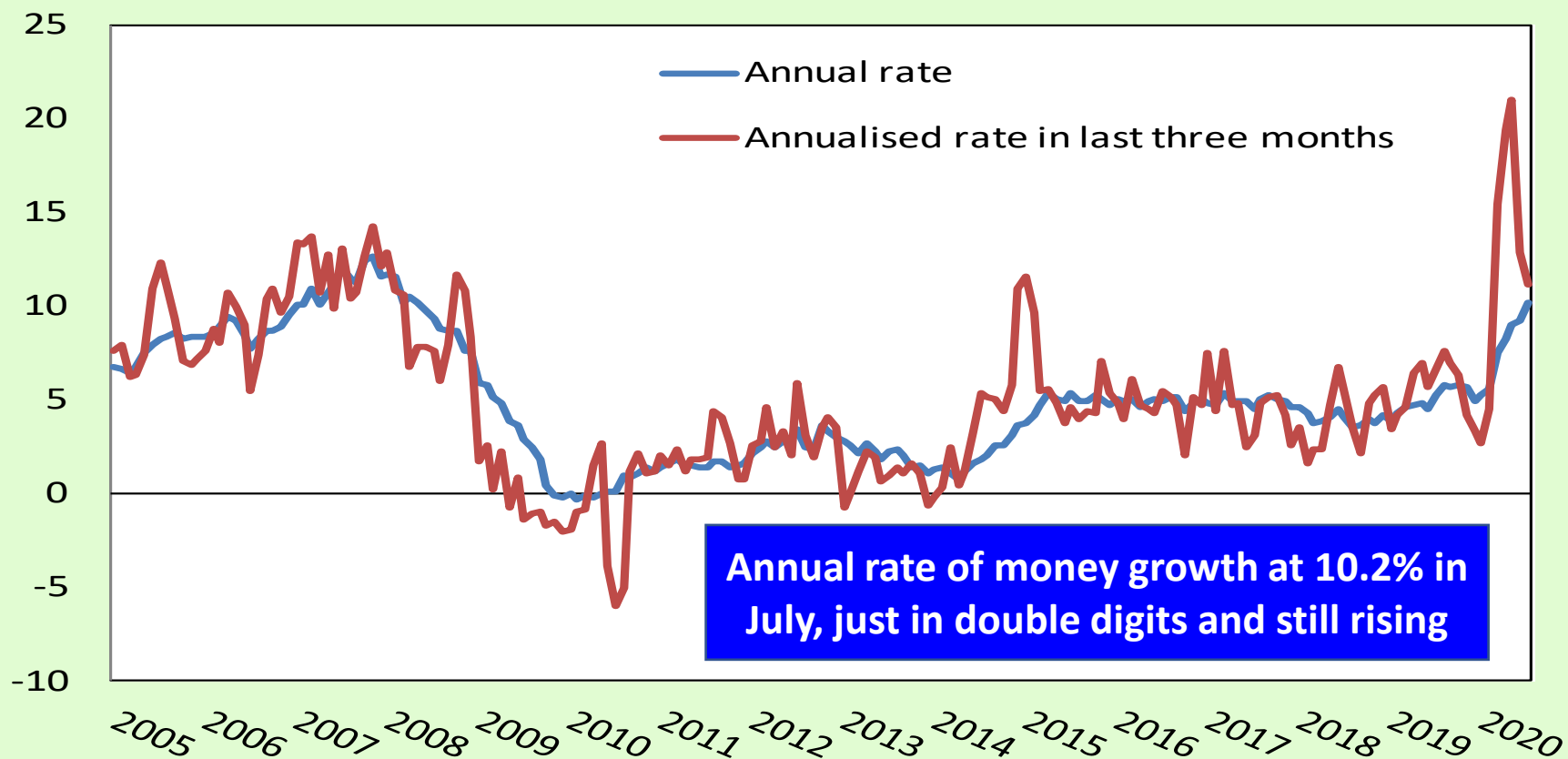


The worrying triumph of New Keynesianism

*A presentation by Professor Tim Congdon CBE,
Chairman of the Institute of International Monetary Research,
in September 2020*

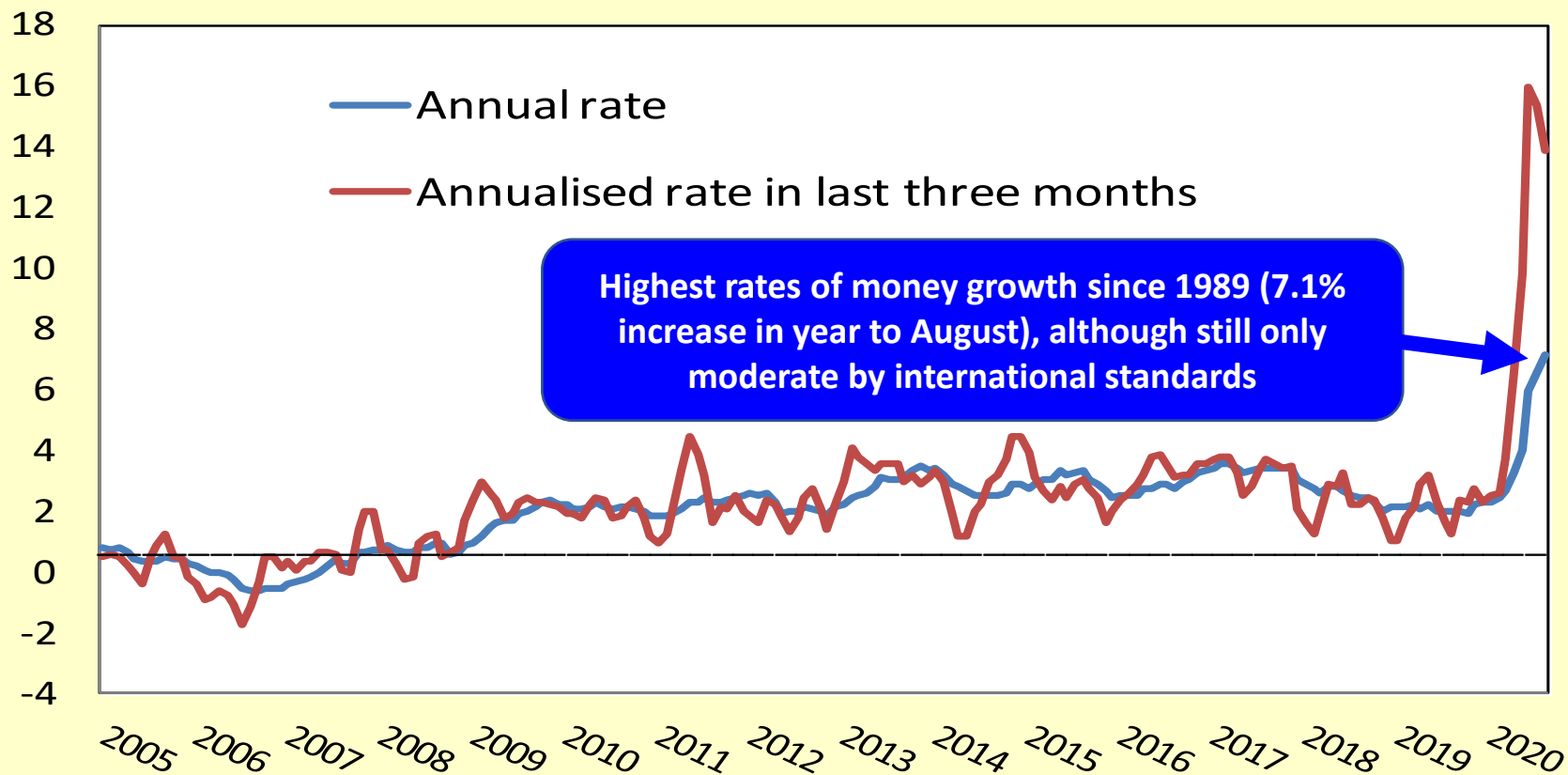
Recent trends in Eurozone money growth

% M3 growth rates, data from the European Central Bank



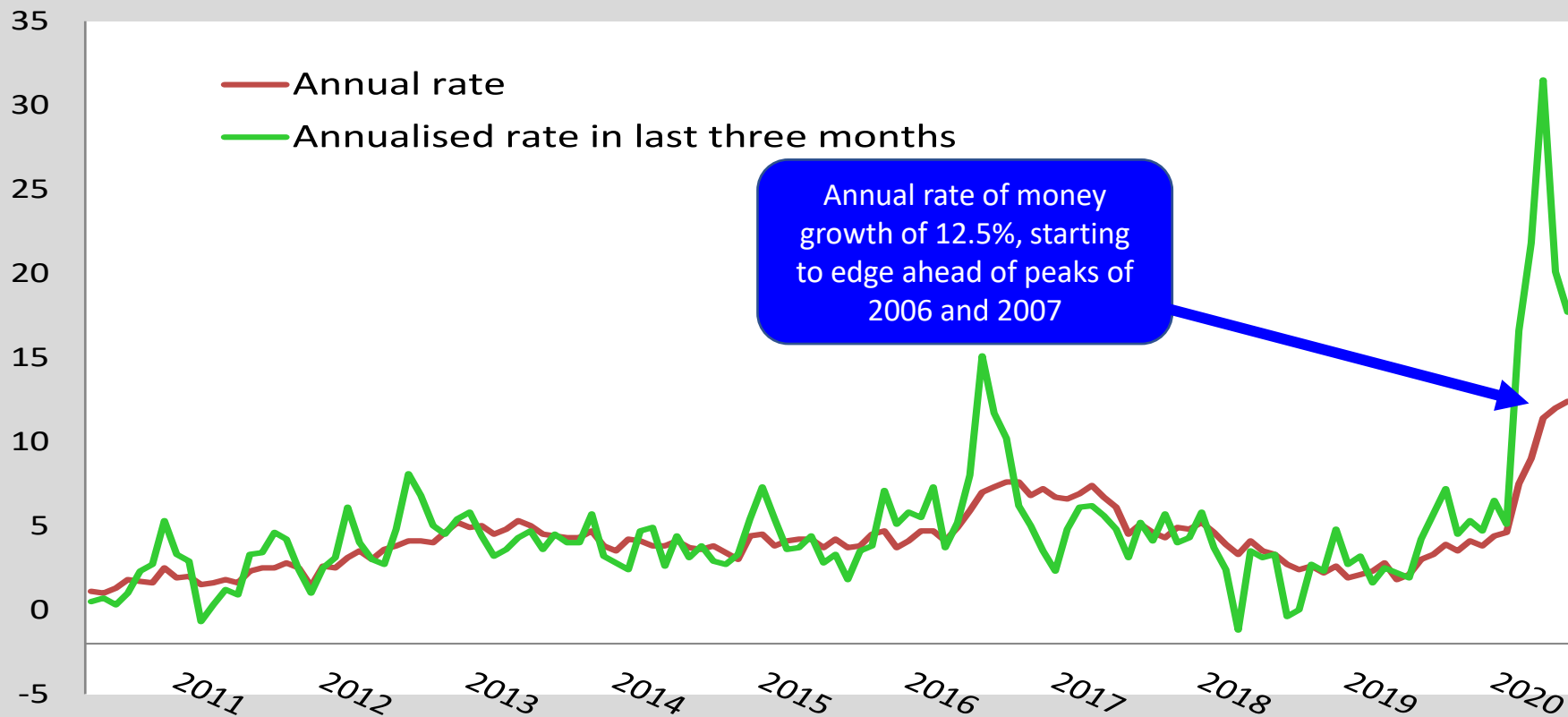
Recent trends in Japanese money growth

% M3 growth rates, data from Bank of Japan



Recent trends in UK money growth

% M4x growth rates, data from the Bank of England



Recent trends in US money growth

% M3 growth rates, with M3 estimated by Shadow Government Statistics



An exchange at a press conference on 16 September with Jerome Powell, Fed chairman

why wouldn't, if the committee was confident that it could reach its new goal of aiming for inflation about 2%, why wouldn't one of those years at least show inflation being above 2% on the mediated forecast?

Jerome Powell: (19:11)

Because we think looking at everything we know about inflation dynamics in the United States and around the world over recent decades, we expect it will take some time. We expect that the economy will recover quickly now, but that that pace will slow as people go back to work and we'll still have an area of the economy, a big area of the economy that struggles. There'll be slack in the economy. The economy will be below maximum employment, below full demand. And that will tend to wear, to put downward pressure on inflation. So we think that once we get up closer to maximum employment, we think that inflation will come back generally. And I mean, that's sort of what happened during the last long expansion. It's a slow process, but there is a process there. Inflation does move up over time. We do expect that will continue today. And we expect that our

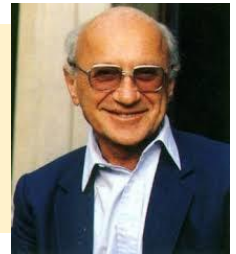
An exchange at a press conference on 16 September with Jerome Powell, Fed chairman

- **Many people believe that the Federal Reserve may find it difficult to raise US inflation above 2%.**
- They believe this even though, in the year to July, inflation was 2,358.5% in Venezuela and 39.2% in Argentina.
- What is the magical property of the Venezuelan and Argentine economies - apparently not found in the United States of America in the 21st century – that enables them to deliver so much inflation?

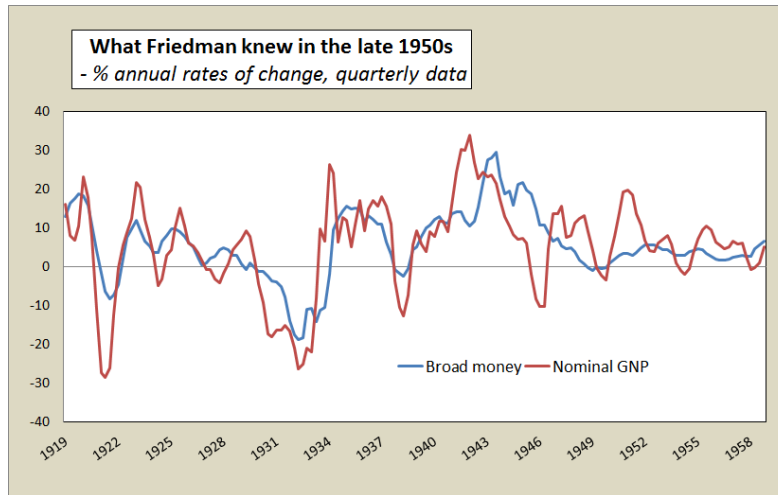
The rotation of ideas in macro-policy making

- 1. **The Keynesian revolution** – from 1936 to some point in the late 1960s and 1970s
- 2. **The monetarist counter-revolution** – from 1967 (?) to the mid-1980s (in fact, another iteration of the Quantity Theory of Money which had been around since the 16th century...)
- 3. **The New Keynesian counter-counter-revolution** – from the mid-1980s to today, with 1999 Clarida, Gali and Gertler article in *The Journal of Economic Literature* and Woodford's 2003 *Interest and Prices* as the focal works, if with origins in papers (Hicks, John Taylor) on the micro-economics of the labour market in the late 1960s and 1970s.

The monetarist counter-revolution: the intellectual background to the Great Moderation

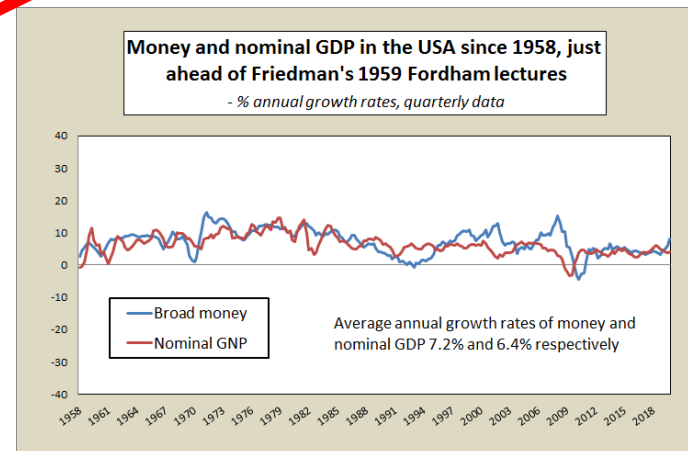


- 1. Inflation is 'always and everywhere a monetary phenomenon', in the sense that the quantity of money has to rise faster than the quantity of goods and services if inflation is to take hold. SO CENTRAL BANKS MUST LOOK AT MONEY GROWTH DATA.
- 2. No long-run trade-off obtains between inflation and unemployment, i.e., the Phillips 'curve' is vertical in the long run. MACRO POLICY SHOULD HENCE FOCUS ON PRICE STABILITY/LOW INFLATION, NOT 'FULL EMPLOYMENT'.
- 3. Monetary policy is more powerful than fiscal policy. CHANGES TO THE BUDGET DEFICIT (i.e., fiscal policy) TO ACHIEVE 'FULL EMPLOYMENT' SHOULD BE DROPPED.



From my July monthly presentation, where I talk about the relationship between changes in money and nominal GDP in the USA

Isn't it reasonable to see a causal connection between money growth instability and nominal output volatility pre-1958, and then between greater stability in the two series afterwards?



The link between changes in the quantity of money and nominal national income: some evidence

	% annual growth rate:	
	M3	Nominal GDP
1960 – 2018	7.4	6.5
1960 – 1970	7.7	6.8
1971 – 1980	11.4	10.3
1981 – 1990	7.7	7.7
1991 - 2000	5.6	5.6
2001 - 2010	7.1	3.9
Eight years to 2018	4.0	4.0

The evidence might be controversial, but the core thesis was *not* – and is *not* – silly.

Key ideas in the New Keynesian counter-counter-revolution

- The economy suffers from **market failures** – particularly in the labour market – which mean that, left to itself, the economy does not necessarily return to ‘full employment’ (or, at any rate, an acceptably high rate of employment).
- **Monetary policy – understood as the setting of the short-term interest rate by the central bank – does affect the growth of demand and output**, and is relevant to employment outcomes, certainly in the next year or two.
- Macroeconomic policy should be used to guide the economy, with the degree of support for **activist fiscal policy** varying between different New Keynesian economists.

Key ideas in New Keynesianism:

‘The Science of Monetary Policy: a New Keynesian Perspective’, by Clarida, Gali and Gertler, in *The Journal of Economic Literature* 1999

- The economy can be described with only three equations,
 - **The IS equation**, which shows how aggregate demand responds to the rate of interest (where the rate of interest is the central bank rate),
 - **The Taylor rule**, a ‘central bank reaction function’ which shows how the central bank adjusts its policy rate according to the inflation rate and the difference between actual and trend output (or ‘the output gap’), and
 - A generalization of the **‘expectations-augmented Phillips curve’**, which shows how the inflation rate is determined, with a. the change in inflation depending on the level of the output gap, and b. the level of inflation inherited from the last period reflecting inflation expectations.

What does New Keynesianism mean for macro-policy?

- **Don't look at money supply data.** Focus on the relationship between the central bank rate and aggregate demand ('the IS curve') and don't worry about money trends.
- Inflation prospects depend on inflation expectations and 'the output gap'/the unemployment rate – or even, with a **'flat Phillips curve'**, they depend on inflation expectations alone. **Analysis of the labour market becomes the dominant theme of central bank research.**
- Fiscal policy returns as a key branch of macro-policy making. Indeed, many New Keynesians believe that – **at the 'effective lower bound' of the zero central bank rate – fiscal policy is to dominate macro-policy making.** Central banks become a sideshow.

What does New Keynesianism mean for macro-policy?

Federal Reserve Chair Jerome Powell has been asked about the Phillips curve, including during his [July 2019 testimony before Congress](#).² He noted that the connection between economic slack and inflation was strong 50 years ago. However, he said that it has become “weaker and weaker and weaker to the point where it’s a faint heartbeat that you can hear now.”

In discussing why this weakening had occurred, he said, “One reason is just that inflation expectations are so settled, and that’s what we think drives inflation.”

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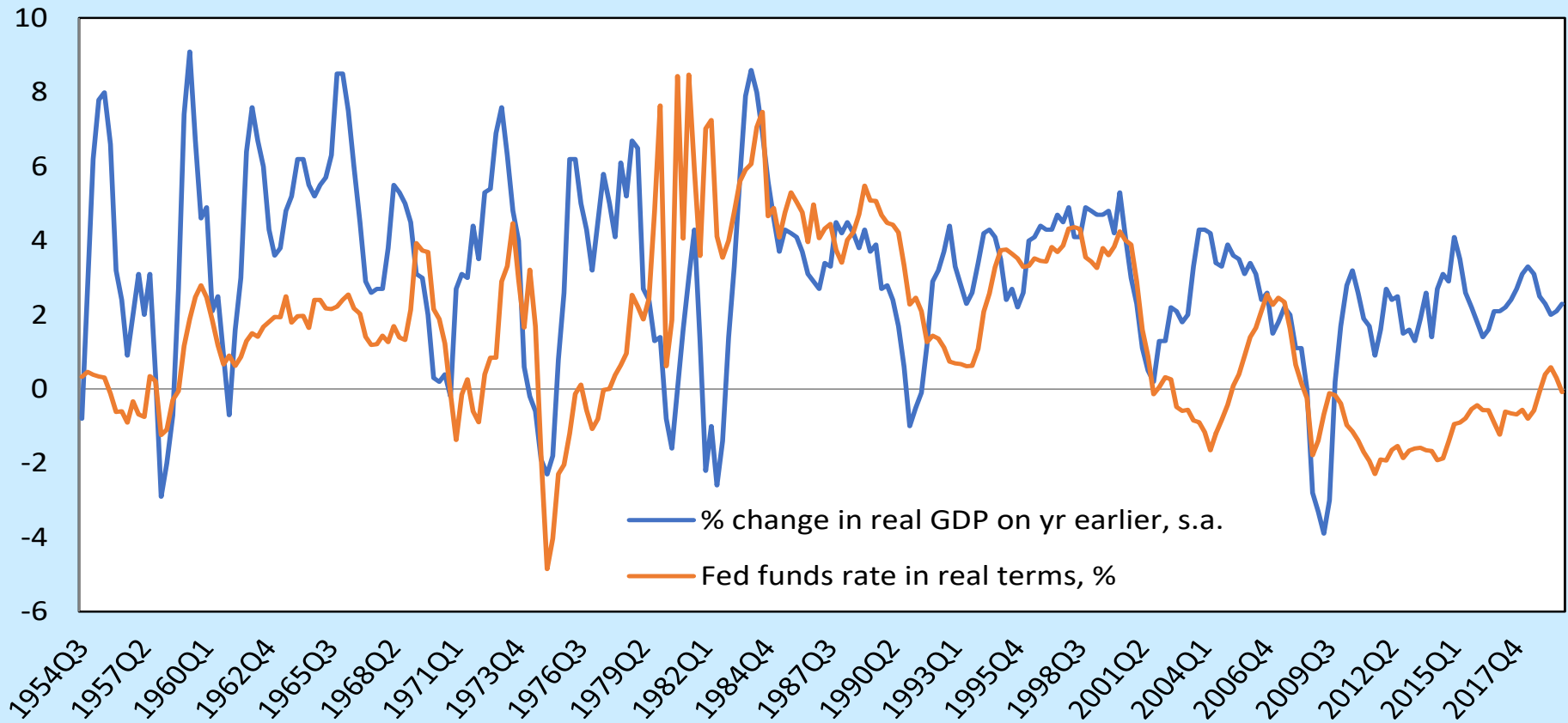
So how – one might ask – are Venezuela and Argentina to reduce their inflation rates? They can apparently carry on printing money like billy-o’ – but, as long as the central banks can persuade the population to expect lower inflation, all will be well.....

What does New Keynesianism mean for macro-policy?

- Inflation prospects depend on inflation expectations and ‘the output gap’/the unemployment rate – or even, with a **‘flat Phillips curve’**, they depend on inflation expectations alone. **Analysis of the labour market becomes the dominant theme of central bank research.**
- Is the reference to ‘the flat Phillips curve’ meant as a joke?
- No. In a recent speech (31 August) on the Fed’s ‘new monetary policy framework’, **Richard Clarida – the Fed’s vice-chairman** – said,

‘With regard to inflation expectations, there is broad agreement among academics and policymakers that achieving price stability on a sustained basis requires that inflation expectations be well-anchored at the rate of inflation consistent with the price-stability goal. This is especially true **in the world that prevails today, with flat Phillips curves in which the primary determinant of actual inflation is expected inflation.**’

Is there a relationship between the Fed funds rate and the change in real output in the USA since 1954?

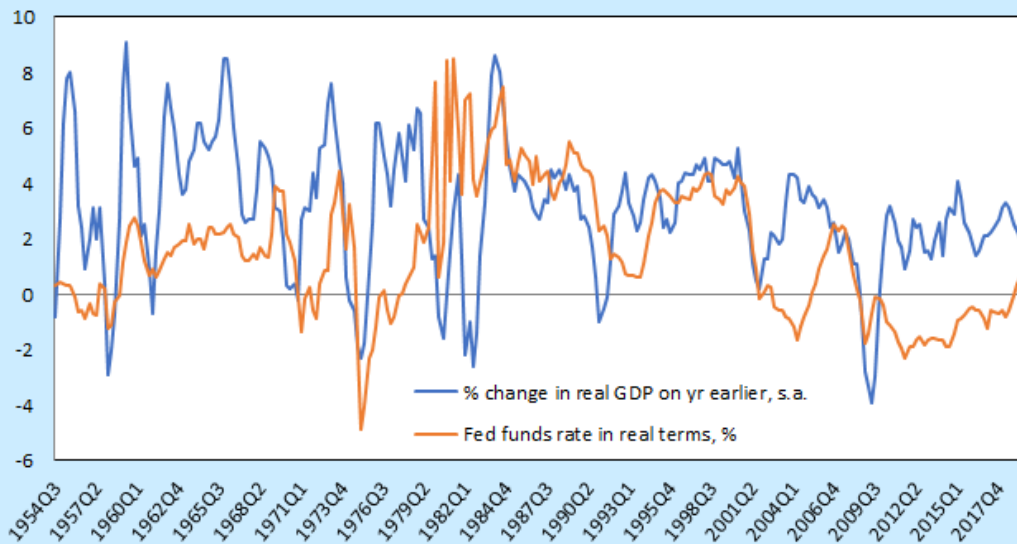


Is there a relationship between the Fed funds rate and the change in real output in the USA since 1954?

	Average annual rate of real GDP growth, %	Average level of Fed funds rate in nominal terms, %	Average level of Fed funds rate in real terms, %
1954- 59	3.3	2.4	0.2
1960-69	4.5	4.2	1.9
1970-79	3.3	7.1	0.5
1980-89	3.1	10.0	5.0
1990-99	3.2	5.1	2.9
2000-09	1.9	2.9	0.7
2010-19	2.3	0.6	-1.0

Notice how high growth coincides with high interest rates!!

Is there a relationship between the Fed funds rate and the change in real output in the USA since 1954?



The sign
is
wrong!!

The least-squares equation for this relationship, with annual data, looks like this,

Change in real GDP % = 2.67% + **0.27** real Fed funds rate%,
with r^2 of 0.07, t statistic on the intercept term of 16.00
and on the regression coefficient of 4.43.

The link between changes in the quantity of money and nominal national income: some evidence

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At least
monetarism
tried to
respect the
facts....

Is the New Keynesian IS Curve Structural?

[ECB Working Paper No. 1236](#)

47 Pages Posted: 25 Aug 2010

[Livio Stracca](#)

European Central Bank (ECB)

Date Written: July 23, 2010

Abstract

There is already a small literature emphasising the empirical failure of the New Keynesian IS curve, but it is not yet known if this failure reflects empirical problems associated with small samples or is rather a structural weakness of the underlying model....panel data from 22 OECD countries over 40 years of data...I find little evidence in favour of the traditional specification where the real interest rate enters with a negative sign due to intertemporal substitution; on the contrary, **it is typically either insignificant or wrongly signed. Overall, I conclude that the New Keynesian IS curve, at least in its most common formulations, is not structural and is overwhelmingly rejected by the data.**

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Livio Stracca Economist



Livio Stracca is the Deputy Director General International and European Relations at the European Central Bank and an adjunct Professor at the University of Frankfurt J. -W. Goethe. He has a PhD in Economics and a postgraduate degree in European Union Law.

- The IS Curve and the Transmission of Monetary Policy :
Is there a Puzzle ?

- Charles Goodhart and Boris Hofmann
- Financial Markets Group, London School of Economics
- Zentrum für Europäische Integrationsforschung, University of Bonn



Published in
Applied Economics
in 2005

ABSTRACT

- In this paper we assess the performance of the New Keynesian IS Curve for the G7 countries. We find that there is an IS puzzle for both the purely backward-looking as well as for the forward-looking IS curve. **The real interest rate does not have a significantly negative effect on the output gap.** Based on an extended specification of the IS curve, also **including asset prices and monetary aggregates**, we are able to restore a significantly negative interest rate effect on aggregate demand in all countries. This finding suggests that a richer specification of the IS curve in empirical work may be necessary in order to obtain an unbiased estimate of the effect of monetary policy on aggregate demand.

- **The IS Curve and the Transmission of Monetary Policy : Is there a Puzzle ?**

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Published in
Applied Economics
in 2005



Charles Goodhart, CBE, FBA is Emeritus Professor of Banking and Finance with the Financial Markets Group at the London School of Economics, having previously, 1987-2005, been its Deputy Director. Until his retirement in 2002, he had been the Norman Sosnow Professor of Banking and Finance at LSE since 1985. Before then, he had worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the outside independent members of the Bank of England's new Monetary Policy Committee until May 2000.

Boris Hofmann is Research Adviser in the Bank for International Settlements' Monetary and Economic Department. He first joined the BIS in February 2011. Before taking up his current assignment in 2018, he was Senior/Principal Economist in the BIS's Monetary Policy Unit.



Verdict on New Keynesianism and its counter-counter-revolution

- If a school of thought is to claim to be 'a science' and 'scientific', it is essential that its most basic elements are consistent with evidence.
- **But – of the three equations proclaimed in the 1999 JEL article about 'The Science of Monetary Policy' – at least one, the IS curve, cannot be established from the data.** (It is interesting that an attempt to rescue the IS curve – by Goodhart and Hofmann for their 2005 article in *Applied Economics* – invoked asset prices and the money aggregates. Quite so!)
- I have discussed only one of the three equations....but the other two have problems as well.
- **A proposition is not science if it is inconsistent with evidence.**

Why does it matter?

- The New Keynesians are in charge of monetary policy-making in the key central banks. **They are particularly well-entrenched in the Federal Reserve.** (The research teams at the European Central Bank and the Bank for International Settlements are more diverse.)
- Monetarism is out of fashion and Milton Friedman's messages are generally ignored in policy-making circles in the main economies.
- **Many people in influential and powerful positions really do believe that at present it is difficult for policy-makers to engineer an inflation rate in the USA above 2%,** even though such nations as Argentina and Venezuela continue to demonstrate that inflation is 'always and everywhere a monetary phenomenon'. **These people – including distinguished and much-respected economists – are completely indifferent to the fastest rate of US money growth since the Second World War.**