Economic consequences of the financial crisis - A Keynesian point of view

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In spite of strong empirical evidence of structural instability, mainstream macroeconomics continue postulating that individuals make optimal intertemporal decisions, as if it was sensible to base long-term decisions on the current knowledge of a system which is likely to change at any time.

The mainstream's system has well known self adjusting properties that do not allow for any kind of 'economic crisis' (in the sense of a durable slump in markets performances given the degree of competition), although imperfect competition may keep the system away from the 'first best optimum'. Orthodox economists should therefore predict (but all do not dare) that market will spontaneously rejoin 'fundamentals', once the current shock has been absorbed, or even that the future economic trajectory will be higher as far as competitive distortions in financial markets are going to be removed, at least partially. Interest rate, growth rate, unemployment rate… should therefore return more or less quickly to their 'natural' level, depending on the strength of the 'rigidities' which make the adjustment process longer.

Keynes's theory on the other hand emphasizes how fundamental uncertainty (not simply the mainstream's 'white noise') inhibits self regulating mechanisms. Long-term interest rates notably do not adjust spontaneously as to ensure saving and investment equalization, for in the absence of any 'natural' anchor for expectations, interest rates and asset prices depend on conventional 'views concerning the future': when assets prices are above the conventional view (the related interest rates are below the conventional view), expectations feed bearish moods that, indeed, decrease assets prices (increase interest rates) toward the conventional level. As a matter of consequence, aggregate demand for goods does not adjust spontaneously to the aggregate supply[1], with the result that firms production and employment decisions must be taken in accordance with the expected demand. In the labour market, flexible wages would not ensure full employment either, for wage decreases may have negative effects on the expected aggregate demand.

Even though there is no self regulating mechanism, such a system is not necessarily instable, because of the institutions and authorities response to potentially destabilizing competitive forces (see my paper on destabilizing competition and institutional stabilizers, http://halshs.archives-ouvertes.fr/halshs-00332381/fr/). Markets therefore will not recover spontaneously, the worst would be to wait blissfully for the return of a ‘natural order'.

First of all, the financial system in general will go out weakened by the depreciation of the stock of bad debts, which is going to damage the financial institutions balance sheets as long as they will not be recovered, or recognized as losses. The memory of the collapse (maintained by the forthcoming reinforced binding rules and the expensive recourse to public financial support) will curb durably risk-taking decisions, which are nonetheless con-substantial with long-term financing of economic operations. Bank and non bank financial institutions will therefore restrict the financing of private projects in comparison of the pre-crisis era. Households’ saving attitude, on the other hand, will tend to favour low-risk investments, with the result that the relative prices of money as compared with risky assets, namely the long-term interest rates in Keynes’s theory, will rather tend to hang at a higher level. This will certainly make households’ investments in housing and durable goods, as well as firms’ productive investments, costlier, thereby weakening the aggregate demand and production levels.

A degradation of the expected returns of productive investments is also foreseeable. Not only because of the predictable decline of the households demand for goods, which of course will deteriorate the situation, but also and perhaps chiefly because of the weakened entrepreneurial spirit. In addition, the decrease in the demand for investment and consumption goods will be amplified by the negative effects of the economic depression on agents’ income.

Will the increase of unemployment have the self regulating influence on real wages as orthodox economists emphasize? Nothing is less certain. As Keynes stated in *The General Theory*, chapter 19, a decrease in nominal wages is likely to depress further the expected level of aggregate demand, thereby activating a deflationary cumulative depression. The stabilization of the economy in such a scenario requires the expected wage to be stabilized. It depends on the capacity of the labour market institutions (unions, managers, authorities) to stop the wage decline.

After that temporary depressive period, a new regime will take place which, according to the considerations above, should be characterized by higher long-term interest rates and a lower rate of productive-capital accumulation… unless the combined action of authorities and economic institutions succeed in supporting optimistic views, especially as regards investment profitability and aggregate demand; that is, in restoring the ‘state of confidence’ in Keynes’s terminology.

It supposes first of all to strike at the root of the problem. When the depression is stabilized, the liquidity bumped into the market in exchange of the irrecoverable part of private debts should feed inflationary tensions (unless an improbable strong economic recovery take place rapidly), for the money demand will be lowered when the speculative and precaution motives return towards the pre-crisis level (albeit possibly to a higher level) and the transaction motive adjusts to the depressed level of economic activity. As we can hardly imagine that the excess money will be allowed to feed a new speculative bubble in a hurry (but who really knows?), it is the price of real assets and durable goods, rather than financial assets and speculative goods, which is likely to be pushed up first, preceding a possible generalized indexation effect. The depressive forces we have identified could then be magnified by the monetary policy if price stability continued to be favoured.

Because of the public opinion pressure, governments in charge of fiscal policies maybe will show themselves less worried by inflation than by the situation of employment. In this case, the conflict of interest could deteriorate both the relation between governments and central banks and the effectiveness of fiscal and monetary policies. If, however, orthodoxy was maintained in spite of the substantial decrease in tax revenues, the situation would also deteriorate. Therefore, the monetary and fiscal orthodoxy induced by the stability pact in Europe is going to strengthen the feeling that the institutional framework for the conduct of macroeconomic policies is questionable.

The design of an appropriate response to the deterioration of the conditions of economic growth requires a reflection about how the burden of the collectivized share of private losses is to be distributed among economic agents. There are two sources of collectivization in this respect: the one possibly initiated by the central banks acceptance of bad debts as collateral in refinancing operations, and the one initiated by the governments (direct or indirect) purchases of bad debts.

As regards central banks, the collectivization process may consist in letting inflation going on, until the real value of debts has depreciated enough as to compensate for the value of the stock irrecoverable debts (to the detriment of creditors). This solution would preserve economic activity and employment, while the alternative solution of a monetary policy aimed at stabilizing the price index would put the burden of losses collectivization on unemployed (and debtor, as interest rate would increase), until the stock of unrecoverable debts is recognized as losses. Thus, in the absence of an alternative solution, central banks could hardly continue denying the inflation/unemployment trade-off.

As regards governments, the collectivization process may consist in increasing taxes so that fiscal revenues balance the government purchases of irrecoverable private debts. As government purchases of irrecoverable debts do not support economic activity at all, while taxes certainly reduce the private demand for goods and services, this solution would eventually put the burden on unemployed (and taxpayers). If on the other hand current taxes did not compensate totally for bad debts purchases, unemployment would raise to a lesser extend, and some inflationary pressures would remain. Again, in the absence of an alternative solution, the inflation/unemployment trade-off would prevail (but redistributive effects would differ).

The collectivization of private losses along these lines would therefore induce fiscal and monetary responses which could hardly support economic activity. Even if inflation and budget deficit were the chosen solutions, it would only spare restrictive measures like tax and/or interest rates increases.

Although authorities will show aversion towards deliberate stimuli as long as the collectivization process is not achieved (that is, as long as inflationary pressures and weakened fiscal revenues persist), it could be advantageous to anticipate such policies for several reasons. First, expansionary policies are likely to produce strong expansionary effects in a depressed system, by stimulating the expected demand directly and by strengthening the 'state of confidence'. Second, the share of irrecoverable debts is likely to be much lower in a context of economic recovery, which could reduce considerably the source of the trouble, including inflation pressures. Third, strong economic recovery induces fiscal revenues which may help the government to socialize private losses without having to increase tax rate. In a context of low economic growth, a temporary deficit may eventually induce higher economic activity, lower public deficit and lower inflation.

Monetary policy will be at disadvantage in the ground of economic stimulus as long as the state of confidence remains weakened, for it is much more difficult to get a decrease in the long-term interest rates by means of refinancing rate cuts in a context of bearish markets. Long-term rates decreases, indeed, require reducing risk aversion and liquidity preference so that the conventional 'views about the future' changes; it is a matter of confidence, not only a matter of low refinancing rates. Monetary accommodation, however, should not be taken as an inflationary measure at this stage, as far as credit-money finances safe economic investments rather than doubtful operations. The danger would rather be that a restricted credit policy put the burden of past mistakes on safe economic projects.

Whatever the kind of policy mix authorities will consider, it would be wise to bear in mind that, in open systems, expansionary policies produce part of their effects abroad, and that, consequently, isolated policies would be penalized, compared to collective initiatives. International co-operation could be useful in this respect; first, because both the temptation of non co-operative free riding strategy and the risk of others playing that strategy could deter initiatives; second, because co-ordinated responses would prevent negatives externalities, which usually trigger conflicting and damaging reactions; third, because, in the absence of co-operation, exchange rates could be considered tempting instruments for 'beggar thy neighbour' or 'competitive depreciation' policies, which would only produce more instability in the international monetary system.

The future of economic growth will depend finally on the way monetary and fiscal policies respond to the general degradation of the state of affairs. 'Old (pseudo) Keynesian' recipes failed because it was supposed that policy instruments allowed for a strict control over the aggregate demand without major inconvenient. 'New Keynesianism' does not really depart from this approach, although it suggests that demand policies cannot address certain causes of unemployment. Genuine Keynesianism on the other hand suggests using monetary and fiscal instruments more cautiously so as to restore first and foremost the 'state of confidence', the sine qua non for successful public intervention. In the face of the forthcoming economic slump, such an objective supposes to get rid of the poison of potentially irrecoverable debts without throwing the baby out with the bath water; that is, by means of an economic recovery supported by co-ordinated temporary deficits and accommodating monetary policies (which is not to say permanent deficits and inflationary policies), rather than by means of a long economic stagnation and orthodox monetary-fiscal policies that have been designed for an imaginary self-regulated system.

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1. Remember that, at the macro level, aggregate investment must absorb the whole part of the production which is not sold for consumption, that is, aggregate saving, if the production of goods and services is to be entirely sold.