The Unemployment Bias of the New Consensus View of Macroeconomics

by

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1. Introduction*

The last couple of decades have seen an unprecedented convergence in the theory and practice of monetary policy. This process of convergence has quickly spread to the entire macroeconomics field. After decades of fierce debates between Keynesians and Monetarists, there is indeed a degree of consensus in macroeconomics, which is unprecedented since the Keynesian ‘Golden Age’ era of the 1960s. It is now safe to refer to the New Consensus view in macroeconomics, without any risk of misunderstanding.

The purpose of this paper is to review the major reasons for this success, before highlighting some problems with the New Consensus view, including the replacement of fiscal policy with monetary policy as the main stabilisation tool, as well as the exclusive short-run view of the role of aggregate demand. More importantly, drawing on records of FOMC meetings at the Federal Reserve System, this paper discusses the ‘unemployment bias’ of the conventional policy strategy of the New Consensus view, namely the persistent tendency to keep the unemployment rate above the NAIRU, as long as the economy is not at price stability.

The second part of the paper discusses a recently proposed amendment of the conventional or deliberate policy strategy of the New Consensus view, the so-called “opportunistic” strategy. This alternative policy strategy was originally discussed during FOMC meetings in the 1990s. It contains two original features, namely path dependency and a zone of discretion. These two features have the potential to eliminate or at least contain the ‘unemployment bias’ of the conventional or deliberate policy strategy of the New Consensus view. For this reason, this paper will closely scrutinise the nature and
The paper is organised in three main Sections. Next Section discusses the modern New Consensus view of macroeconomics, its assumptions and policy implications. Section 3 considers the persistent tendency of modern monetary policy to keep the unemployment rate above the NAIRU, what this paper has labelled the ‘unemployment bias’ of the conventional policy strategy of the New Consensus view. Section 4 examines the so-called “opportunistic” policy strategy, which has the potential to eliminate or at least contain the “unemployment bias” of the conventional view of monetary policy. Section 5 summarises the main arguments of the paper and concludes.

2. The New Consensus View in Macroeconomics

In the last couple of decades there has been an increasing convergence in the theory and practice of monetary theory and policy (Goodhart, 2007; Meyer 2001). This convergence view has now widened to the entire macroeconomics field. A recent UK Treasury-sponsored conference gathered well known economists and practitioners around the theme of “Is There a New Consensus in Macroeconomics?”. The book, which collects most of the contributions of the conference, and which bears the same title, does not leave space for any misunderstanding. “There is indeed a degree of consensus in macroeconomics unprecedented since the Keynesian ‘Golden Age’ era from the late 1950s to the early 1970s. From a polemical ‘schools of thought’ debate, the focus has now moved on to synthesis” (Arestis and Ross, 2007, p. 20). This New Consensus in macroeconomics is indeed so popular that it is slowly, but increasingly used to replace the iconic IS-LM model in undergraduate macroeconomic textbooks (e.g. Carlin and Soskice, 2006, Ch. 3). The success is related to a combination of theoretical and practical arguments.

Starting with the theoretical arguments, the New Consensus model marks a significant progress over previous monetary models. It represents a dramatic shift from the quantity-theoretic framework defended by monetarists and neo-classical synthesis Keynesians alike, toward a non-quantity theoretic framework in the spirit of the monetary contributions of Wicksell and Keynes (Fontana, 2007). This non-quantity theoretic
framework has also shown remarkable flexibility, being able to encompass recent theoretical notions, including the natural rate hypothesis, and the expectations-augmented or inertia Phillips curve. It has also absorbed the rational expectation hypothesis, and built on the insights and methodology of the real business cycle theory.

The practical arguments in favour of the New Consensus view are not less powerful and innovative. Most central banks around the world including the Bank of England and the Federal Reserve have all rejected the monetarist credo and its policy prescriptions. Central banks do not control a (any) monetary aggregate, but the short-run nominal interest rate. The stock of money is thus a residual, an endogenous rather than an exogenous element of the economic process. The old causal relationship between money and price is untenable. Similarly, any recommended cure for inflation based on a monetary targeting rule is considered impracticable. The void left by the monetarist credo and its policy implications has been replaced by new analyses and policies, which are consistent with the New Consensus view. Central banks now use the short-run nominal interest rate to achieve a particular combination of current and potential levels of output, the so-called output gap, which delivers the desired rate of inflation.†

Several authors have explored in details the building blocks of the New Consensus model and its assumptions (e.g. Arestis and Sawyer, 2006; Fontana and Palacio Vera, 2007). For the purpose of this paper, it will suffice to recall the main features of the model, before considering in the next Section the ‘unemployment bias’ implicit in its transmission mechanism. The core of the New Consensus view is based on a simple 3-equations model made of an expectations-augmented Phillips curve, an IS-type curve, and a monetary policy rule (Clarida et al., 1999). The expectations-augmented Phillips curve represents the short-run aggregate supply side of the model, where the IS-type curve and the monetary policy rule provide a reduced form account of the short-run aggregate demand side of the model.

The three equations of the New Consensus model are all derived from explicit optimizing behaviour of individual agents in presence of market failures, including imperfect competition, incomplete markets, and asymmetric information. These market failures generate price and wage stickiness in the short run, which in turn gives support to the view that the central bank is able, via changes in the short-run nominal interest rate
(i), to affect the short-run real interest rate (r), and hence to alter components of the IS curve, like consumption (C) and investments (I). In this way, the central bank can modify the aggregate demand, and hence the current level of output (Y) and unemployment (UN) in the country.†

As far the aggregate supply side of the model is concerned, the Phillips curve shows that movements of the output gap (Y-Y*) have an impact on the rate of change of the inflation rate (π). Therefore, the central bank via changes in the short-run nominal interest rate is able to alter the output gap, and hence to achieve the desired level of inflation in the country. The transmission mechanism described above can be represented by the process as in Figure 1:

$$\Delta i \Rightarrow \Delta r \Rightarrow \Delta C & \Delta I \Rightarrow \Delta AD \Rightarrow \Delta Y & \Delta UN \Rightarrow \Delta (Y - Y^*) \Rightarrow \Delta \pi$$

**Figure 1: The Transmission Mechanism of Monetary Policy in the New Consensus View**

From a Post Keynesian perspective there are several problems with the New Consensus view and its policy implications.§ To start with, the New Consensus model limits the role of aggregate demand to the short run. Aggregate demand affects the current level of output (Y), but never the potential level (Y*), in the so-called output gap (Y-Y*). Aggregate demand and therefore stabilization policies are neutral in the long run (Fontana, 2007). In fact, this long-run neutrality of aggregate demand raises an interesting conundrum for modern central bankers. “Given the central bank claim that, in the medium and longer run, their influence is solely on nominal variables, e.g. inflation, and not at all on real variables, such as output and unemployment, it is somewhat difficult and sensitive to explain that, at much higher frequencies, up to two or so years out, their influence on inflation is via the transmission mechanism of bringing about changes to exactly such real variables, i.e. output and unemployment. Moreover, given the long lags involved before inflation responds to monetary policy, ... an attempt to drive a deviation of inflation from target rapidly back to that target could only be done by enforcing an (undesirably) large change in output, especially if that deviation emanated from an initial supply shock” (Goodhart, 2007, pp. 64-65).
Another thorny issue is related to the different weight assigned to stabilisation policies in the New Consensus model. The monetary authority has the role of achieving the desired inflation target, and subject to that to deliver as much output stabilization as possible in the short run. By contrast, fiscal authorities are either ignored or asked to concentrate on the control and sustainability of public finances. In other words, the New Consensus view downplays the role of fiscal policy at the advantage of monetary policy. However, there is nothing intrinsically monetary in the nature of stabilization policy in the New Consensus model (Fontana, 2008). They may be reasonable practical arguments for doubting of the effectiveness of fiscal policy. For instance, it is undeniable that fiscal policy has potentially long inside lags compared to monetary policy. This practical or political lags may shift the balance in favour of monetary policy, though the latter does have its own practical problems too (Arestis and Sawyer, 2006). Nevertheless, theoretically there is little or nothing to justify the current marginal role of fiscal policy in modern macroeconomics.

Interestingly, in the last couple years, some mainstream Keynesian economists like Allsopp and Vines (2005), and Blinder (2006) have shown dissatisfaction with the role of fiscal policy in the New Consensus. Whereas they have not challenged the pre-eminent position that monetary policy now holds in modern macroeconomics, they have maintained that there are circumstances under which monetary policy alone is a weak instrument of stabilization, and a combined monetary-fiscal strategy is needed. Indeed, in the case of the lower bound problem on the short-run interest rate (Krugman, 2005), or country-specific shocks in monetary unions (Kirsanova et al., 2007), some economists went so far to claim that fiscal policy must reclaim a dominant position as a stabilization policy tool (Symposium, 2005).

In a similar way, some policy makers have also argued that there are circumstances when a combined fiscal and monetary stimulus provides broader support for the economy than monetary policy actions alone. For instance, this is the view of the Chairman of the Federal Reserve to boost the US economy and minimise the risk of a prolonged recession in response to the poor developments in financial markets, and a fragile outlook for the real economy. “Monetary policy (that is, the management of the short-term interest rate) is the Fed’s best tool for pursuing our macroeconomic objectives,
namely to promote maximum sustainable employment and price stability. … Monetary policy has responded proactively to evolving conditions. … However, in light of recent changes in the outlook for and the risks to growth, additional policy easing may well be necessary. … Based on that evaluation, and consistent with our dual mandate, we stand ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks. … Fiscal policy actions might usefully complement monetary policy in supporting economic growth over the next year or so. I agree that fiscal action could be helpful in principle, as fiscal and monetary stimulus together may provide broader support for the economy than monetary policy actions alone” (Bernanke, 2008).

Unfortunately, with some noteworthy exceptions (Arestis and Sawyer, 2003, 2006; Setterfield, 2007) this revival of fiscal policy in mainstream Keynesian economics has being completely ignored by Post Keynesian economists, and heterodox economists, more generally. A young scholar looking for a Post Keynesian view on this revival of interest for fiscal policy in mainstream economics will look in vain for relevant works.**

3. The ‘Unemployment Bias’ in the New Consensus View of Monetary Policy

The previous Section has argued that there is now a New Consensus in macroeconomics, which draws on modern theoretical notions, like the natural rate hypothesis and the expectations-augmented or inertia Phillips curve, and which has been now adopted implicitly or explicitly by central bankers around the world. Notwithstanding the theoretical and practical success, the previous Section has also discussed two problems of the modern New Consensus in macroeconomics.

Firstly, in the New Consensus there is no role for aggregate demand in the long run. This is in contrast to the important role that the latter must play in the short run, in order for the central bank to have any impact on the real economy. Secondly, the New Consensus downplays the role of fiscal policy at advantage of monetary policy. All what seems to matter in the New Consensus view is the role of the central bank in achieving price stability. These are serious issues, and in fact there is now an increasingly large literature discussing them. However, there is another major problem with the New Consensus view, which has surprisingly escaped critics of modern macroeconomics. It is
its ‘unemployment bias’. Some indirect evidence for the existence of this bias can be derived from a rather unsuspected source.

In late 1995, members of the Federal Open Market Committee (FOMC) at the Federal Reserve Board discussed alternative interest rate strategies in order to achieve the long-run aim of price stability. Since the different views about these strategies seemed to converge toward two main policy strategies, namely the conventional or “deliberate” strategy, and the alternative or “opportunistic” strategy (e.g. Federal Reserve Board, 1989), Donald L. Kohn, the current Vice Chairman of the Board of Governors of the Federal Reserve System was asked to prepare a FOMC briefing discussing similarities and differences between these strategies. In December 1995 Kohn circulated his report:

Both strategies [i.e. the “deliberate” and the “opportunistic” strategies] start from the premise that price stability is the appropriate primary long-term goal of policy. The deliberate policy seeks to make steady progress toward this goal. The only way to ensure such progress is to keep some slack in the economy so as to put downward pressure on inflation in labor and product markets. Hence, the deliberate strategy would be earmarked by a persistent tendency for the unemployment rate to exceed NAIRU so long as the economy was not at price stability, albeit by varying degrees depending on the amount of inflation and the Committee's desired trajectory to price stability. A Taylor Rule is an example of a deliberate disinflation strategy (Kohn, in Federal Reserve Board, 1995, Appendix, p. 2).

It is important to note that Kohn opens his FOMC briefing report by making clear that the “deliberate” and the “opportunistic” monetary policy strategies share the same commitment to price stability in the long term. In other words, the “deliberate” and the “opportunistic” strategies are both fully consistent with the main tenet of the New Consensus view, namely that there is no long-run trade-off between inflation and unemployment. For this reason, in the long run the only appropriate policy aim for the monetary authority is price stability.

Leaving any discussion of the “opportunistic” strategy to next Section, it is worthy to elaborate on the suggestion that the “deliberate” strategy seems to have an ‘unemployment bias’ built-in to its transmission mechanism: as long as inflation remains above its long-run target, the monetary authority must engineer a disinflationary process
in order to open a gap between the actual and potential level of output, and hence between the current and NAIRU levels of unemployment, with the purpose of bringing inflation down. In other words, no matter whether inflation is high or low, as long as it is above its desired level, the monetary authority must trigger a disinflationary process in the economy by raising the nominal interest rate in order to curb, via the transmission mechanism described in the previous session, aggregate demand and current output. The deliberate strategy, that is the conventional New Consensus policy strategy for central banks, is thus built on the assumption that the central bank must maintain the unemployment rate above the NAIRU level, when the economy is not at price stability.

Interestingly, members of the FOMC also discussed of the nature of the inflation shocks to the economy. This is another important issue. The previous Section has argued that the central bank can only affect the real economy via short-run changes in aggregate demand. Implicitly, the New Consensus view thus assumes that the source of changes in the inflation rate is not important. Putting it differently, the New Consensus view assumes that the source of inflation is on the demand side, or at least that any rise in inflation can be addressed through the demand side. What it counts then is the current level of inflation rate compared to its targeted or desired level.

What exactly does the term NAIRU mean? It means the level of unemployment we have to attain to stop inflation from accelerating. An oil shock produces a lot of inflationary impetus in the economic system. To prevent an acceleration of inflation, the unemployment rate has to rise sharply and put downward pressure on wages to overcome the oil shock and hold inflation in place. The lesson is that the NAIRU is variable, but changes in it due to supply shocks are temporary. The NAIRU in history came back down again after the oil shock ended (Lindsey, in Federal Reserve Board, 1996, p. 88).

Lindsey offered this argument in an attempt to explain that the NAIRU is invariant to aggregate demand, and monetary policy alike. The argument is also offered in the standard New Consensus framework, where there are one-off output costs and permanent benefits from price stability. Accepting all these assumptions, then a supply-driven inflation shock (e.g. an increase in the price of oil) must be compensated by a demand-driven inflation move of equal size but opposite sign, triggered by the central
bank. This means that whatever the nature of the inflation shocks to the economy, i.e. whether the rise in the current or expected inflation rate is due to an increase in the price of imported inputs or to an excess demand for good and services, the central bank must adopt the same policy: it has to increase the nominal interest rate in order to depress the economy, and bring the unemployment rate above the NAIRU rate. The excess of the former over the latter will put downward pressure on wages in the labour market, which should then be amplified by price reduction in the goods market. In short, and independently of the nature of the inflation shocks, the central bank must fine-tune unemployment in order to bring inflation to its target level.

From a Post Keynesian perspective, there are a few problems with this ‘unemployment bias’ of the new consensus view. Starting with the final point about the nature of the inflation shocks, it is not clear why aggregate demand should be curbed, when changes in the inflation rate (and inflation expectations) are due to aggregate supply shocks, rather than aggregate demand shocks. Secondly, the ‘unemployment bias’ in the deliberate monetary policy strategy defended by the New Consensus relies on the view that there are no hysteresis effects in the labour market, or indeed anywhere else. If the latter is the case, then it is difficult to maintain that it is always worthy to face some short-run output-stabilization costs against long-run price stability benefits. Hysteresis effects in the labour market could make the fine-tuning unemployment policy of the central bank a difficult business. If the NAIRU responds to the current unemployment level, the central bank may get trapped in a vicious circle, where it must trigger increasing levels of unemployment in the economy in order to bring inflation down to the desired level. The reason for this vicious circle is that restrictive policies raise now both the current and the NAIRU levels of unemployment. Therefore, for any given targeted reduction in the level of inflation, the more unemployment is triggered now, the more it will be needed in future.

In short, the modern New Consensus view seems to suffer from several problems, including (a) the absence of any distinction between demand and supply inflation shocks, and (b) the absence of any consideration for hysteresis effects. These two problems define what this paper has called the ‘unemployment bias’ of the New Consensus view. Interestingly, these problems where discussed at several meetings of the Federal Open
Market Committee (FOMC) in the 1990s, and proposals were put forward in order to contain some of the deleterious effects of the ‘unemployment bias’ of the New Consensus view. The next Section discusses some of these proposals.

4. Monetary Policy without the ‘Unemployment Bias’? An “Opportunistic” Approach

The previous Section has argued that the ‘unemployment bias’ in the New Consensus View of Monetary Policy was object of great debates at the Fed in the middle 1990s. One reason for the debates was that in that period the US economy was experiencing low levels of unemployment married with low levels of inflation. Importantly, there were little sign of the economy heating up. This was in contrast to the traditional view, since the unemployment rate had approached, or on some measure had gone below the NAIRU level. Like Meyer argued “the unemployment rate is admittedly below the staff estimate of NAIRU. …However, there is no broad-based evidence of a demand-induced acceleration of inflation despite the persistence of a low unemployment rate for nearly two years. Indeed, core measures of inflation for both the CPI and the PPI actually have moved lower this year. So for my part, if there is any surprise about inflation, it is how well contained it is rather than how high it is” (Meyer, in Federal Reserve Board, 1996, p. 39).

The actual behaviour of the inflation rate in middle 1990s led some members of the FOMC to question the deliberate policy strategy of the New Consensus view, especially what this paper has labelled its ‘unemployment bias’. The discussion at the Fed converged around the idea of maintaining the goal of price stability over the long-run, but with lower unemployment costs. This idea originates from the fact that when inflation is high and well above the implicit or explicit long-run inflation target, the support of policy makers and economists alike for anti-inflationary actions is very strong, despite the cost of lost output and rising unemployment. But, when inflation is only marginally above the long-run target, the support for restrictive monetary policy strategies is less robust. In other words, the benefits from reducing the inflation rate when it is already high say 10% or 15% are large, and may justify the unemployment costs associated with disinflation. But, the benefits of reducing the inflation rate from say a modest rate of 3% are very
difficult to pin down, and hardly justify the costs of disinflation. For this reason, in the middle of 1990s members of the FOMC intensified attempts to explore the possibility of moderating the effects of the ‘unemployment bias’ in the New Consensus view of Monetary Policy by using what came to be labelled an “opportunistic” strategy.†† In fact, in his 1995 FOMC report, after discussing the conventional “deliberate” policy strategy, Kohn highlights strength and weaknesses of the “opportunistic” strategy:

Under the opportunistic strategy, the policy approach depends on the level of inflation. If inflation is high, an opportunistic strategy will induce some output loss, just as under a deliberate strategy, to bring inflation down. … The contrast between the two strategies arises in situations like the present, when inflation is low and steady but not at the Committee's long-run goal. Under these circumstances, the opportunistic strategy attempts to hold the line against any increases in inflation and may need to accept some output shortfall to do so in the case of adverse supply shocks. But otherwise the opportunistic strategy attempts to keep the economy producing at its potential. In effect, it waits for unanticipated developments to produce further disinflation, accepting the reductions in inflation such developments bring, but always attempting to keep the economy at, or return it to, its potential (Kohn, in Federal Reserve Board, 1995, Appendix, p. 3).

Before explaining what these unanticipated developments are, it is important to discuss the main general features of the “opportunistic” strategy. It was mentioned in the previous Section that the “opportunistic” strategy shares with the deliberate strategy the same commitment to long-run price stability. However, the former has two original features compared to the latter strategy, namely path dependency and a zone of discretion, which have the potential of moderating the unemployment costs of pursuing the long-run goal of price stability. These two features are particularly relevant when the current inflation rate is low and steady, but not at its long-run target level. In these circumstances, the dynamic interplay of path dependency and of the zone of discretion suggests a way to contain the ‘unemployment bias’ of the deliberate policy strategy of the New Consensus view.

Let us start with the path dependency feature. Path dependency is here used as a generic term to indicate that policy decisions are the product of the historical sequence of
previous economic outcomes and policy responses. In practice, this means that the central bank does not assess the current inflation rate *per se*, but rather it evaluates it against the historical sequence of previous inflation rates. In other words, the central bank may consider the current inflation rate of say 3% more favourably, if inflation in the previous month was 4%, than if it was 2%. This path dependency or evolutionary perspective explains the behaviour of the central bank to resist an increase in the inflation rate, even though this increase would have been acceptable by previous standards. The “opportunistic” central bank thus strive to “hold the line” on the current level of inflation, and for this reason it is prepared to increase the nominal interest rate, and hence to accept some unemployment, in the case of an aggregate supply-induced price increase. This path dependency feature of the “opportunistic” strategy plays a vital role in maintaining the credibility of the central bank in pursuing price stability in the long-run. It shows the commitment to achieve the inflation target, though through a gradual approach.

The second feature of the “opportunistic” strategy is the notion of a zone of discretion. This is the most innovative aspect of this strategy, and possibly the one closer to the Post Keynesian research agenda (Fontana and Gerrard, 2006). The idea is that when inflation is low and steady, even though above (below) its target level, the central bank should not take anti-inflation (anti-deflation) actions. In these circumstances, the central bank should not thus increase (decrease) the interest rate, curbing (stimulating) aggregate demand and inducing the required additional unemployment (employment) and output shortfall (surplus) in order to bring inflation to its target level. Instead, the central bank should wait for unanticipated developments, like unforeseen recessions (boom) and deflationary (inflationary) supply shock producing further disinflation (inflation). In this way, under the right circumstances, namely low and stable inflation, the economy can operate around full employment without inflationary pressures.

The answer is that there is an asymmetry built into an “opportunistic” strategy, and here is how it works. During good times, we only get up to full employment; we never go beyond it. During other times, the unemployment rate is always above the NAIRU. If the unemployment rate averages above the NAIRU we are disinflating on average. That is what the “opportunistic” strategy does. What goes with that is that if you want to stop at 2 percent inflation, that has interesting implications. It
means that once you get there, for every recession you treat yourself to a boom.
You treat yourself to a little overheating because that is what it will take to keep the
average inflation rate constant (Meyer, in Federal Reserve Board, 1996, p. 58)

Figure 2 explains the particular circumstances that justify this “opportunistic”
approach by the central bank. It describes the relationship between the level of inflation
and the behaviour of the central bank. When prices are rising rapidly, say the current
inflation rate ($\pi$) is above the given threshold ($+\delta$), the central bank adopts a deliberate
anti-inflationary strategy. In this case, therefore there is no difference between the
deliberate and the “opportunistic” strategies. However, when prices are rising and the
current inflation rate ($\pi$) is nevertheless below the given threshold ($+\delta$), i.e. ($\pi$) is between
the upper threshold ($+\delta$) and the lower threshold ($-\delta$), the central bank adopts an
“opportunistic” strategy. This means that it counteracts inflation shocks that will take the
inflation rate above the upper threshold ($+\delta$); otherwise it will wait for unanticipated
favourable developments, i.e. accommodating shocks that bring the inflation rate down.
Conversely, when prices are falling rapidly, i.e. the inflation rate ($\pi$) is below the
threshold ($-\delta$), the central bank adopts a deliberate anti-deflationary strategy, cutting the
interest rate and inducing additional employment and output surplus. Otherwise, the
central bank adopts an “opportunistic” strategy, waiting for unanticipated favourable
developments bringing the inflation rate up.

Figure 2: The Zone of Discretion of the “Opportunistic” Strategy

The existence of a zone of discretion for the setting of monetary policy strategies
has important implications. First, it means that the central bank assigns different weights
to its policy objectives under different circumstances. When the current inflation rate ($\pi$) is between the upper threshold ($+\delta$) and the lower threshold ($-\delta$), the central bank concentrates on output stabilization rather than price stability. Outside the zone of discretion, the central bank reverses the order of its policy objectives. Now price stability takes first seat, and output stabilization is the subsidiary goal.

The second implication of the notion of a zone of discretion is that the central bank ‘accommodates’ recessions or booms, mild recessions and mild booms to be sure, for its own purpose of achieving its inflation target, rather than responding to them. Mild recessions or mild booms are the unanticipated developments to produce the required further disinflation or inflation. For instance, when the current inflation rate ($\pi$) is between the target rate of inflation ($\pi^*$) and the upper threshold ($+\delta$) in Figure 2, the “opportunistic” central bank will wait for next unforeseen shortfall in aggregate demand, rather than inducing a reduction in aggregate demand by a rise in the interest rate. The unforeseen recession with the consequent shortfall in aggregate demand will automatically open up a gap between the NAIRU and the increasing unemployment rate, and hence put downward pressure on wages and prices. This means that as a result of the unforeseen shortfall in aggregate demand the current inflation rate ($\pi$) has now moved closed to the target rate of inflation ($\pi^*$). The central bank can then wait for next recession, till the inflation target is achieved. As Meyer said “when the next recession arrives, whatever the timing, inflation will ratchet down another notch. This strategy, gradually and at low cost, lowers inflation over time until price stability is achieved” (Meyer, 1996, p. 76). Alternatively, the central bank could wait for favourable aggregate supply shocks, like an unforeseen increase in productivity or an unexpected inflow of migrant workers (Mervying King’s “Polish plumber” effect). In this case, it is the supply shock that opens a gap between a falling NAIRU and the current level of unemployment, with the result that the decline in prices and wages brings the current rate of inflation to, or close to, the target rate.

From a Post Keynesian perspective, the “opportunistic” approach is a welcome attempt to amend the conventional or deliberate monetary policy strategy of the New Consensus view. The introduction into the conventional strategy of path dependency effects and of a zone of discretion is indeed a serious attempt to moderate the
‘unemployment bias’ of the deliberate strategy. For this reason, the “opportunistic” approach should be object of further analysis and investigations by Post Keynesian scholars, and more generally all macroeconomists unsatisfied with the persistent tendency by conventional central banks to keep the unemployment rate above the NAIRU, at least as long as the economy is not at price stability.

Notwithstanding this positive view of the “opportunistic” strategy, there are still serious limitations with this strategy. Most, if not all, of these limitations are due to the fact that the “opportunistic” approach is still a policy strategy, a ‘less-unemployment bias’ strategy to be sure, of the modern New Consensus view of macroeconomics, and as such it suffers from the same problems of the latter. In concluding this Section, it is thus worth to recall some of the major problems of the modern New Consensus view of macroeconomics discussed in the first Section.

Firstly, like the conventional policy strategy of the New Consensus view, the “opportunistic” approach does not distinguish demand-induced inflation shocks from supply-induced inflation shocks. It is not clear for instance why an “opportunistic” central bank should “hold the line” and hence curb aggregate demand, when changes in the inflation rate are due to supply-induced inflation shocks. Secondly, and more importantly, whereas the “opportunistic” approach acknowledges the possibility of hysteresis effects in the economy, a long-awaited advance compared to conventional policy strategies, it does not fully appreciate the policy implication of this theoretical advance. An “opportunistic” central bank will not deliberately create slack in the economy, when the current inflation rate is within the zone of discretion. It will wait and ‘use’ next recession to bring the inflation rate at, or closer to, its target level. This means that an “opportunistic” central bank will not induce further unemployment in the economy. Yet, it is not clear why in these circumstances an “opportunistic” central bank should try to trigger further employment through favourable hysteresis effects in the product and labour markets. In other words, in a low and stable inflation environment an “opportunistic” central bank should try to reduce the real interest rate in order to stimulate aggregate demand and boost output and employment. Instead of waiting and using next recession to bring the inflation rate at, or closer to, its target level, the central
bank should treat the economy to a boom, and bring the economy at, or closer to, full employment.

A word of clarification and caution should be added here. Hysteresis effects are a crucial way to introduce long-run effects of aggregate demand in the New Consensus view. Importantly, they are more than just another little assumption to add to the New Consensus model. Hysteresis effects strike at the heart of modern macroeconomics. It is difficult to defend the view, like the New Consensus does, that the central bank affects nominal variables in the long-run, but not real variables, when these nominal effects are actually obtained via a transmission mechanism (see Figure 1), which works through changes of exactly these real variables.

However, be that as it may, hysteresis effects do not justify a ‘boom and burst’ type of policy strategy. They also do not lead to a ‘hydraulic’ view of monetary policy. In a low and stable inflation environment, an “opportunistic” central bank should try to reduce the real interest rate in order to stimulate aggregate demand and boost output and employment, but it should do it with caution, and always aware of the potential inflationary costs of any policy easing. In other words, there are limitations to what a central bank can achieve. For this reason, this paper has argued that the New Consensus view of stabilisation policy is too biased toward monetary policy. Monetary policy should be complemented with fiscal policy (Fontana, 2008).

5. Concluding Remarks

The last couple of decades have seen an unprecedented convergence in the theory and practice of monetary policy. This convergence has now widened to the entire macroeconomics field. It is now safe to refer to the New Consensus view in macroeconomics, without any risk of misunderstanding. This is true not only for the research field, but also in the teaching of our discipline. This paper has reviewed the major reasons for the success of the New Consensus view in macroeconomics, suggesting that this success is related to a combination of theoretical and practical arguments.

Notwithstanding this success, the paper has discussed several problems potentially affecting the modern New Consensus view in macroeconomics. Firstly, the New Consensus view downplays the role of fiscal policy at advantage of monetary
policy. All what seems to matter in modern macroeconomics is the role of the central
bank in achieving price stability. Secondly, in modern macroeconomics there is no role
for aggregate demand in the long run. This is in contrast to the important role that the
latter must play in the short run, in order for the central bank to have any impact on the
real economy. More importantly, the paper has discussed another major problem with the
New Consensus view, which has surprisingly escaped critics of modern macroeconomics.
It is its ‘unemployment bias’.

As argued by Donald L. Kohn, the current Vice Chairman of the Board of
Governors of the Federal Reserve System, the long-run policy goal of the New
Consensus view is price stability. The conventional policy strategy to achieve this goal is
to keep some slack in the economy, in order to put downward pressure on inflation via
the labour market and the product markets. Therefore, the main feature of the
conventional policy strategy in the New Consensus view is its ‘unemployment bias’,
namely a persistent tendency to keep the unemployment rate above the NAIRU, as long
as the economy is not at price stability.

An amended version of the deliberate strategy of the New Consensus view is the
so-called “opportunistic” strategy. This original strategy created a great deal of interest at
FOMC meetings of the Federal Reserve System, in the 1990s. Drawing on FOMC
records, this paper has discussed two main features of the “opportunistic” strategy,
namely path dependency and the zone of discretion. The “opportunistic” strategy is
indeed a serious attempt to moderate the ‘unemployment bias’ of the deliberate strategy.
For this reason, it should be object of further analysis and investigations. However, the
“opportunistic” strategy still suffers from two major vices of the New Consensus view (it
could not have been differently since it was born out of this view). Firstly, the
“opportunistic” approach does not distinguish demand-induced inflation shocks from
supply-induced inflation shocks. Secondly, and more importantly, the “opportunistic”
approach does not fully acknowledged the possibility of hysteresis effects in the
economy. Instead of waiting and ‘using’ next recession to bring the inflation rate at, or
closer to, its target level, when inflation is low and stable, the central bank should treat
the economy to a boom, and bring the economy at, or closer to, full employment.
References


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† Of course, strictly speaking what a zero output gap delivers is a constant rate of inflation, not necessarily the target rate. We finesse this issue as well as the distinction between achieving price stability or the target rate of inflation for the sake of simplicity.

‡ There are two implicit assumptions here worthy to consider. Firstly, there is a short-run trade off between unemployment and inflation, i.e. the Phillips curve is not vertical in the short run. Secondly, changes in the aggregate demand only modifies the current component of the output gap, namely the current level of output (Y), but not the aggregate supply-driven or potential level of output (Y*).

§ There are also more general problems related to two issues. First, in the New Consensus view monetary policy is understood to work through changes in the output gap. However, the potential level of output is not observable, and for this reason the monetary authority may actually make some business cycle peaks endogenous to policy. Second, theoretical and empirical works on path dependency effects suggest that transitory changes in the level of aggregate demand may actually have permanent effects on output and employment. Fontana and Palacio Vera (2007) explores the implications of these two problems with the New Consensus view.

** It is really astonishing that the Cambridge Journal of Economics, the Journal of Economic Issues, the Journal of Post Keynesian Economics, and the Review of Political Economy, just to mention some of the typical outlets for non-mainstream economic papers, have nothing or very little on the role of discretionary fiscal policy in modern macroeconomics.

†† It should be added that in the last few years the mainstream interest for moderating the ‘unemployment bias’ of the modern New Consensus view has also affected other research areas in economics, including the now fashionable economics of happiness. For instance, in a recent NBER paper aptly titled “Is unemployment more costly than inflation?”, David Blanchflower, a Member of the Monetary Policy Committee at the Bank of England has concluded that “across EU countries, a one percentage point increase in the unemployment rate lowers well being by at least one and a half times as much as a one percentage point increase in the inflation rate” (Blanchflower, 2007, p. 1).
More generally, some critics may even question the way supply shocks are presented in the New Consensus view, namely that supply shocks are random and average out at zero: if costs go up today, then they will come down at some point in the future.