



# The knowledge transmission mechanism, and its impact on macroeconomic crises

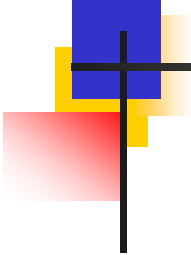
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Simon Wren-Lewis

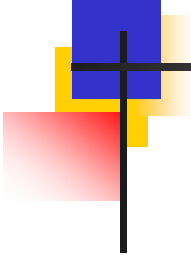
Blavatnik School of Government  
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<http://mainlymacro.blogspot.co.uk/>

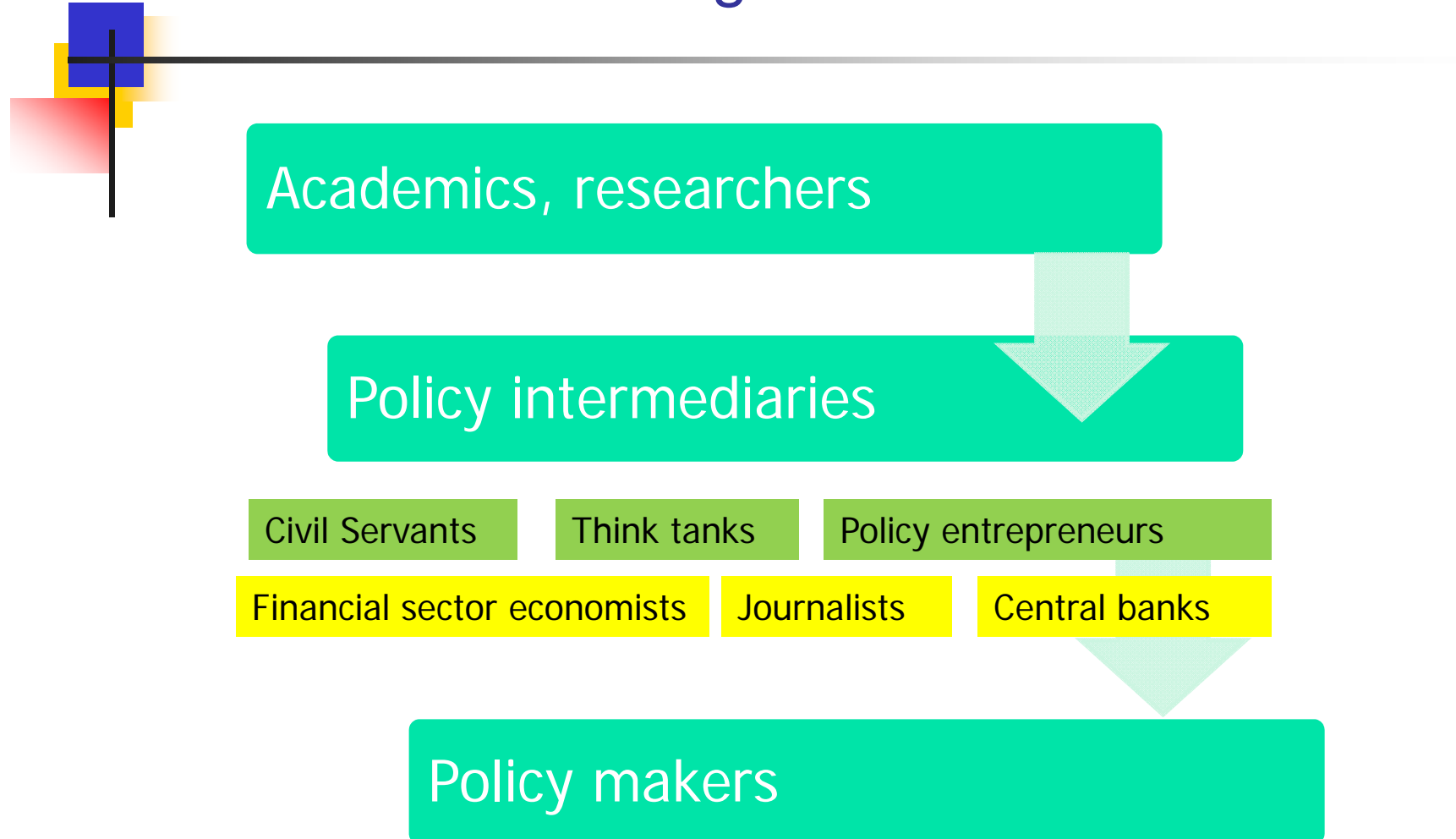
# Asking the wrong question

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- In explaining what has gone wrong in the Eurozone, we should not ask
    - what is wrong with macroeconomic theory, but instead ask
    - why have tried and tested macroeconomic ideas been ignored
  - To answer this we need to talk about the transmission mechanism between academics and policy makers
    - Knowledge transmission mechanism = KTM
    - Does the KTM sometimes mean that minority ideas have too much influence on policy?
    - To what extent does the KTM make it easier for ideology and politics to influence macro policy?

# Some preliminaries

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- Anglo-Saxon economics? Idea of national differences should not be used as an excuse to ignore ideas that are universal in their applicability. When I talk about a consensus/majority view, I mean *internationally* among academics and economists working in the field.
  - The relevant question for macroeconomic analysis is not whether it predicts well – macro models will never do that – but whether widely accepted theory leads to good or bad policy
  - Simple model of economic crises is: bad theory leads to crisis, theory then improves.
  - Eurozone: crisis arose in large part because good theory not used

# KTM: the knowledge transmission mechanism



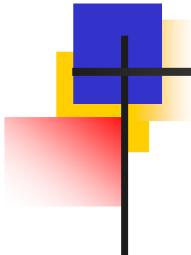
# Great Macroeconomic crises



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- Great Depression
- 1970s inflation
- Financial crisis
- Eurozone crisis
  - Are these crises a simple consequence of inadequate macroeconomic theory, or do we need a richer analysis of the way macroeconomic ideas get used or not used to understand what happened?

# 1970s inflation




- Popular macro story

- Theory, based on a Phillips curve that was not vertical in the long run, said there was a long run trade-off between inflation and unemployment. Policy acted on this advice.
- Friedman 1968 (and maybe Phelps) showed that the long run Phillips curve should be vertical
- With a lag, policymakers understood, and inflation was controlled.

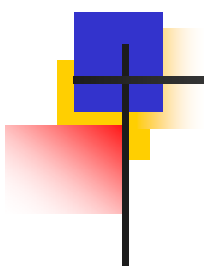
- This story is mainly incorrect

- Too US-centric (Bundesbank response much better than UK/US)
- Forder (2014): there was no consensus before or after Friedman of a long run inflation unemployment trade-off
- Problem was more that policy makers, their advisors and some academics did not want to accept the implications of the Phillips curve for political reasons

# The financial crisis

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- Popular macro story
    - Macro models took the financial sector for granted, ignored the possibility of a crisis, and therefore failed to predict the crisis
  - This story mainly incorrect
    - We already had the economic tools to understand the crisis (a bank run with excess leverage)
    - The problem was not so much a lack of economic ideas, but the political influence (on government, on policy intermediaries and maybe some academics) of the financial sector
    - Academic analysis clearly suggests that capital requirements for banks should be much larger than currently proposed
      - Admati and Hellwig: The Bankers New Clothes
    - If that theory is being ignored after the financial crisis, it certainly would have been ignored before the crisis

# Keynesian macroeconomics has always been ideologically controversial

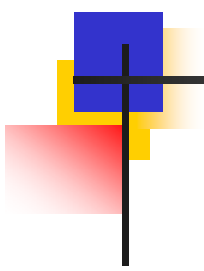
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- Although many on the right accepted the Keynesian framework (Friedman), others remained very antagonistic
    - First Keynesian textbook banned
  - The antagonism came from a neoliberal or ordoliberal perspective, which saw Keynesian theory as encouraging unnecessary state intervention.
  - As Friedman recognised, this is false
    - State intervention is required to ensure demand is neither excessive (inflation) or deficient (unemployment).
    - He thought this intervention was best done through monetary rather than fiscal policy, and that it could normally be minimal, but he never denied that fiscal interventions could influence demand and hence output.
  - New Classical economics, by contrast, wanted to deny the importance of aggregate demand

# The current New Keynesian consensus

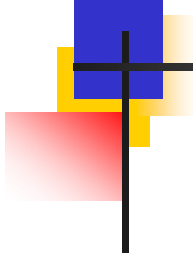


- New Classical economics changed, but did not overthrow, Keynesian theory
- Textbooks still put Keynesian model at centre (including those used in Germany!)
- Surveys suggest most UK and US economists accept the implications of Keynesian ideas
  - US (IFM Forum): only 5% think costs of Obama stimulus exceeded benefits
  - UK (CFM survey): 15% thought Osborne austerity had a positive effect
- The New Keynesian model is the key model used by economists in central banks

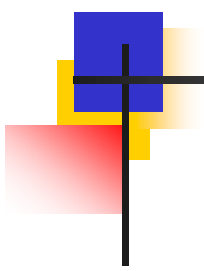
# Implications of New Keynesian model

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- *Temporary* changes to government spending will have a large impact on output for given interest rates (multiplier  $> 1$  quite possible)
  - But if monetary policy unconstrained and optimal, demand implications of fiscal actions can be ignored.
  - But not the case in two situations
    - An individual member of a monetary union (particular if government spending is on domestically produced goods)
    - If interest rates stuck at Zero Lower Bound.
  - Evidence of 'painless' fiscal consolidation when monetary policy unconstrained therefore highly misleading when applied to EZ members, or for the EZ collectively after 2009.

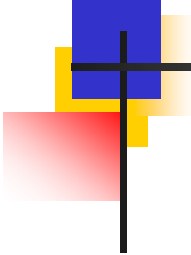
# The Eurozone crisis: bad architecture

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- Before the Euro was formed, it was well understood that
    - Main cost was loss of monetary policy to deal with asymmetric costs. Corrections through competitiveness too slow.
    - This cost could be significantly reduced by national countercyclical fiscal policy
    - This could *easily* be combined with deficit control using simple fiscal policy rules (e.g. responding to inflation differentials)
  - The Stability and Growth pact ignored this analysis
  - If such rules had been in operation, the competitiveness misalignments that grew steadily from 2000 to 2007 could have been significantly smaller, and the debt positions of periphery economies in 2010 would also have been significantly better
  - So why was this basic bit of macroeconomics ignored, and why did it continue to be ignored after the 2010 debt funding crisis emerged. What was the failure in the KTM?

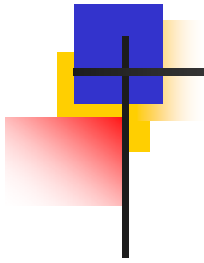
## 2010 Eurozone crisis: inappropriate reaction

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- The idea of a liquidity trap is textbook macro: you try to avoid reducing government deficits and debt when interest rates are at or near their lower bound. This is the view supported by the consensus NK model.
  - This macro consensus was ignored in the US, UK and EZ from 2010
  - Why?
    - Some politicians may have had ulterior motives
    - Policy makers or their advisors picked unrepresentative research (Reinhart and Rogoff, Alesina et al)
    - Were policy makers aware they were focusing on unrepresentative research, or was there a failure in the KTM (knowledge transmission mechanism)?

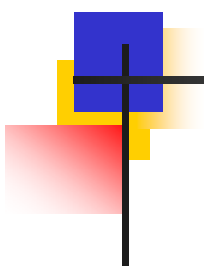
# Cost of austerity from 2010 huge

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- Back of envelope calculations suggest cumulated GDP loss by 2013 around 10% GDP
  - Confirmed by model simulations
    - NIGEM (widely used multi-country model)
    - QUEST (Commission model, Jan in't Veld)
    - Rannenbergh, Schoder and Strasky using adapted versions of 3 models get larger effects
    - Gechert, Hughes Hallett and Rannenbergh uses meta analysis of multipliers, and also get larger effect
  - Standard macro theory says these costs could have been substantially reduced if overall EZ fiscal consolidation had been delayed until short term interest rates rose above lower bound

# Reasons for the 2010 failure in the KTM

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- Media
    - Analogy with household accounts strong (but incorrect!)
    - Tends to look for debate rather than consensus among 'experts'
  - Advice from financial sector clearly biased
    - “bond economists never saw a fiscal tightening they didn't like”
    - With media, focus on day to day movements, weak on longer term policy
  - Civil service
    - focused on expenditure control, not macroeconomic stabilisation? Might have been different if EZ fiscal rules had included countercyclical role.
  - Major puzzle: why did advice from central bank governors not reflect their own modelling?

# Central banks and fiscal policy

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- Why do central banks not reflect the advice of their own New Keynesian models?
  - Mervyn King: “Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy.”
    - Deep seated (but in US, UK and Eurozone irrational) fear of ‘fiscal dominance’.
    - Leads central banks to overestimate their ability to overcome the interest rate lower bound, and underestimate deflation dangers arising from fiscal austerity

# Summary



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- While the Great Depression can be seen as bad policy following inadequate macro theory, less clear with 70s inflation and financial crisis.
- Consensus macro theory seems to have been ignored in the Eurozone's fiscal architecture, and in the global response to 2010 crisis, with huge costs (>10% GDP). Why?
- Part of the answer may lie with a failure in the Knowledge Transmission Mechanism, and in particular in 2010 with the role played by central banks