The Monetarist fantasy is over

By Robert Skidelsky

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UK Prime Minister Boris Johnson, determined to overcome Treasury resistance to his vast spending ambitions, has ousted Chancellor of the Exchequer Sajid Javid. But Johnson's latest coup also is indicative of a global shift from monetary to fiscal policy.

The forced resignation of the United Kingdom's Chancellor of the Exchequer, Sajid Javid, is the latest sign that macroeconomic policy is being upended, and not only in the UK. In addition to completing the ritual burial of the austerity policies pursued by UK governments since 2010, Javid's departure on February 13 has broader significance.

Prime Minister Boris Johnson is determined to overcome Treasury resistance to his vast spending ambitions. The last time a UK prime minister tried to open the government spending taps to such an extent was in 1964, when Labour's Harold Wilson established the Department of Economic Affairs to counter Treasury hostility to public investment. Following the 1966 sterling crisis, however, the hawk-eyed Treasury re-established control, and the DEA was soon abolished. The Treasury, the oldest and most cynical department of government, knows how to bide its time.

But Johnson's latest coup also is indicative of a global shift from monetary to fiscal policy. After World War II, stabilization policy, the brainchild of John Maynard Keynes, started off as strongly fiscal. The government's budget, the argument went, should be used to balance an unstable economy at full employment.

In the 1970s, however, came the monetarist counter-revolution, led by Milton Friedman. The only stabilizing that a capitalist market economy needed, Friedman said, was of the price level. Provided that inflation was controlled by independent central banks and government budgets were kept "balanced," economies would normally be stable at their "natural rate of unemployment." From the 1980s until the 2008 global financial crisis, macroeconomic policy was conducted in Friedman's shadow.

But now the pendulum has swung back. The reason is clear enough: monetary policy failed to anticipate, and therefore prevent, the Great Recession of 2008-09, and failed to bring about a full recovery from it. In many countries, including the UK, average real incomes are still lower than they were 12 years ago.

Disenchantment with monetary policy is running in parallel with a much more positive reading of US President Barack Obama's 2008-09 fiscal boost, and a much more negative view of Europe's post-slump fiscal austerity programs. A notable turning point was the 2013 rehabilitation of fiscal multipliers by the International Monetary Fund's then-chief economist Olivier Blanchard and his colleague Daniel Leigh. As Blanchard recently put it, fiscal policy "has been underused as a cyclical tool." Now, even prominent central bankers are calling for help from fiscal policy.

The theoretical case against relying on monetary policy for stabilization goes back to Keynes. "If, however, we are tempted to assert that money is the drink which stimulates the system to activity," he wrote, "we must remind ourselves that there may be several slips between the cup and the lip." More prosaically, the monetary pump is too leaky. Too much money ends up in the financial system, and not enough in the real economy.

Mark Carney, the outgoing governor of the Bank of England, recently admitted as much,

saying that commercial banks had been "useless" for the real economy after the slump started, despite having had huge amounts of money thrown at them by central banks. In fact, orthodox theory still struggles to explain why trillions of dollars' worth of quantitative easing, or QE, remains stuck in assets offering a negative real rate of interest.

Kenneth Rogoff of Harvard recently argued that fiscal stabilization policy "is far too politicized to substitute consistently for modern independent technocratic central banks." But instead of considering how this defect might be overcome, Rogoff sees no alternative to continuing with the prevailing monetary-policy regime – despite the overwhelming evidence that central banks are unable to play their assigned role. At least fiscal policy might in principle be up to the task of economic stabilization; there is no chance that central banks will be.

This is due to a technical reason, the validity of which was established both before and after the collapse of 2008. Simply put, central banks cannot control the aggregate level of spending in the economy, which means that they cannot control the price level and the aggregate level of output and employment.

A less skeptical observer than Rogoff would have looked more closely at proposals to strengthen automatic fiscal stabilizers, rather than dismissing them on the grounds that they will have (bad) "incentive effects" and that policymakers will override them on occasion. For example, a fair observer would at least be open to the idea of a public-sector job guarantee of the sort envisaged by the 1978 Humphrey-Hawkins Act in the US, which authorized the federal government to create "reservoirs of public employment" to balance fluctuations in private spending.

Those reservoirs would automatically be depleted and refilled as the economy waned and waxed, thus creating an automatic stabilizer. The Humphrey-Hawkins Act, had it been implemented, would have greatly reduced politicians' discretion over counter-cyclical policy, while creating a much more powerful stabilizer than the social-security systems on which governments now rely.

To be sure, both the design and implementation of such a job guarantee would give rise to problems. But for both political and economic reasons, one should try to tackle them rather than concluding, as Rogoff does, that, "with monetary policy hampered and fiscal policy the main game in town, we should expect more volatile business cycles." We have the intelligence to do better than that.

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