3
The Theoretical Framework
That Underpins the Origins of
the ‘Great Recession’

3.1 Introduction

This chapter examines the relevance of the New Consensus Macroeconomics (NCM), or Neo-Wicksellian, model from a policy perspective in the light of the ‘great recession’. It is argued that a monetary policy rule based on inflation, and perhaps also on growth, such as that pursued by the major central banks, would be insufficient to prevent or even detect a crisis such as the ‘great recession’. This drawback is due not only to the limited nature of the policy makers’ objective function, but also to the structure of the NCM paradigm. In particular, the NCM models suffer from a number of deficiencies. First, there is an internal inconsistency in that the policy implications advocated by NCM-style models are assumed rather than being derived explicitly from such models. The propositions that inflation is under the direct control of the central bank, while output and unemployment in the long run are not, are imposed on the model rather than being demonstrated theoretically in a convincing manner. Second, the NCM models are based on the transversality assumption, which leads to the conclusion that commercial banks do not exist in the model, nor monetary aggregates or liquidity preference. Interestingly enough, the absence of monetary aggregates may be at the root of the current woes. Third, financial innovation in the last ten years or so has rendered traditional monetary aggregates obsolete as measures of overall liquidity. Hence, the NCM model is unable to detect and monitor the liquidity in the economy which has been responsible for the finance of three major bubbles in the last ten years (internet, housing and commodities), along with other minor ones, such as in the areas of private equity and shipping. Fourth, the NCM model ignores the role of wealth in affecting the decisions of households to spend and save, which is likely to drive the effects of the ongoing credit crisis on the economy in the next few years.

This chapter attempts to rectify some of these drawbacks of the NCM models and the way in which monetary policy should be designed. First,
it suggests that the policy makers’ objective function should be augmented to include a target on asset price inflation in a way that does not impede the free functioning of financial markets. The variable that suggests itself as a target is the household net wealth as a percentage of disposable income. Second, it introduces a wealth effect in consumption, which is necessary if the effect of bubbles is to be detected and ultimately prevented. Third, it endogenises the wealth effect in consumption by explaining separately financial and housing wealth in a rudimentary way. Fourth, it endogenises potential output and the natural interest rate so that erroneous policy implications are bypassed.

The chapter is organised as follows. Section 3.2 reviews the NCM model, illustrating its deficiencies and extending the structure of the NCM model to the open economy case. Section 3.3 puts the current crisis in a long-term perspective by emphasising the importance of liquidity in the financing of all bubbles in the last ten years. Section 3.4 advances a reformulated Neo-Wicksellian model that rectifies the deficiencies of the original one. Section 3.5 analyses the steady-state properties of the reformulated model and shows that it can capture the characteristics of the ‘great recession’. Finally, section 3.5 summarise and concludes.

3.2 The NCM structure

3.2.1 Introducing the NCM
The New Consensus Macroeconomics (NCM) has emerged over the past couple of decades. During this period it has become highly influential in terms of the theoretical aspects of macroeconomic thinking and policy, especially monetary policy. The birth of the NCM was made possible following the collapse of the Grand Neoclassical Synthesis in the 1970s (Galí and Gertler, 2007). It draws heavily on the so-called New Keynesian economics (Goodfriend and King, 1997; Clarida et al., 1999; Woodford, 2003; Meyer, 2001; Carlin and Soskice, 2005, 2006). This approach to macroeconomics has managed to encapsulate the early developments of macroeconomics in the 1970s, including rational expectations, but with assumptions that were also acceptable to the proponents of the old Neoclassical Synthesis. Galí and Gertler (2007) suggest that the New Keynesian paradigm, which emerged in the 1980s, provided sound microfoundations along with the concurrent development of the real business cycle framework that promoted explicit optimisation behaviour. Those developments, along with macroeconomic features that were absent from previous paradigms, such as the long-run vertical Phillips curve and a monetary-policy rule, resulted in the NCM (Woodford, 2009). Blanchard (2009) summarises this development when he suggests that ‘there has been enormous progress and substantial convergence…The state of Macro is good’ (p. 210).2