Answering the Queen’s question: New Approaches to Economic Challenges

by
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“Why did no one see it coming?” asked Queen Elizabeth II of Great Britain, shortly after the world economy collapsed in 2008. In addressing the question to a group of economists, the Queen was spot on. As OECD Chief of Staff Gabriela Ramos said, “The crisis struck at the core of tightly held economic ideas, modules and policy”. I would go further. Crisis struck because of tightly held economic ideas, models and policies. The policy models used pre-2008 were wrong or seriously flawed; this contributed to the collapse, chiefly by omission. The OECD’s New Approaches to Economic Challenges (NAEC) report recognises this, arguing that the challenge is for economists to develop a better sense of how economies work; and for economic policy to develop policies which reflect this understanding.

To put the matter concretely, we have to determine under what combination of policies and institutions the macro economy will exhibit good performance, defined as cyclical stability, high employment, decent growth rates, stable prices, and human and planetary well-being. I would like to discuss questions which have occurred to me since 2008 along with some observations from the latest NAEC report, which gives much food for thought.

First, money and banking. Monetary policy is not mentioned by the NAEC. Orthodox macro policy before the slump consisted of “one target, one instrument”. The target was the inflation rate; the instrument was interest rates. This was clearly inadequate. But we haven’t yet sorted out what should be the proper aims of monetary policy, what is properly monetary and what is properly fiscal, what is macro and what is micro. For example, bank regulation is micro, but it increasingly counts as part of macro policy. Perhaps we should call macro any micro event or institution which has macro effects.

The NAEC report calls for “Better integration of the financial sector”. What does this mean? Does it mean “better able to serve the needs of the real economy”? If so, what reforms are needed? I’m disappointed that the NAEC didn’t challenge the orthodox view that financial innovation is good. What it does is to make the economy more financial – that is, enable more and more people to earn their living making money out of money. We have to ask further questions on money, starting with whether the central bank can control the
credit system to avoid boom and bust. And if not, what is the alternative? What has been the impact of quantitative easing (QE)? The euro zone is gaily embarking on a massive monetary expansion, when most of the evidence suggests very limited effect for reasons Keynes would readily have recognised.

There is a cluster of issues around fiscal policy. The NAEC report talks of “promoting fiscal soundness and fostering the countercyclicality of macroeconomic policies”. What is meant by “fiscal soundness”? Does it mean balancing the budget? What is meant by balancing the budget? Which budget? All governments are embarked on deficit reduction. We are rarely told which deficit they are planning to reduce. Are there safe upper limits to public deficits and debts? What are the best ways of financing public borrowing – bonds, QE, Treasury bills – and under what circumstances?

Can the public accounts be differently presented to bring out the capital/current account distinction? Should governments have off-budget accounts, for instance a National Investment Bank?

Forecasts of inflation, output gaps, multipliers have been fairly consistently wrong ever since the crisis struck. The whole question of forecasting needs a serious look. Forecasts are highly model dependent. If the model is wrong the forecast will be wrong – or wronger than normal.

Jobs. What is Europe’s natural rate of unemployment? How is it estimated? If, as in Europe today we have zero inflation and unemployment at 10%, is this Europe’s natural rate? Or has the term lost any useful meaning?

Where are the jobs in the future to come from? The NAEC report doesn’t mention the impact of automation on jobs. It talks about need to enhance human skills and capital, which is simply conventional wisdom. Are humans destined to “race with machines” or “race against machines” to quote the question raised by Brynjolfsson and McAfee.

Economic growth. NAEC wants both “economic growth and well-being” and “economic growth and environmental sustainability”, in
other words all the good things in life simultaneously. And so say all of us. But we can’t have them. Continuation of the kind of growth we have had in the past will certainly be inimical to the well-being of humans, and of course of the planet. Growthmanship, and its associated consumerist culture, needs to be challenged much more vigorously.

Distribution and inequality. NAEC writes of “Increasing evidence that large income inequality undermines growth and well-being, by reducing investment in skills by low-income households”. It says that taxation systems need to be reformed to ensure they are “progressive enough”. But what is progressive enough? And what changes in politics will be needed to bring about more progressivity to offset the rise in inequality? Where is the political support to come from?

The woeful state of economics. NAEC says disappointingly little about this. It says economics should draw insight from sociology, psychology, geography, and history. I completely agree, except that philosophy is omitted and history put last. A reading of Aristotle would be a sound corrective to all those who place their faith in financial innovation and consumerism. A knowledge of history would correct the bias of economics to a priori theorising beautifully expressed by the 19th century French economist Jean-Baptiste Say: “What useful purpose can be served by the study of absurd opinions and doctrines that have long ago been exploded, and deserved to be? It is mere useless pedantry to attempt to revive them. The most perfect a science becomes the shorter becomes it history…” We are still waiting for the perfection which will abolish the need for history.

Useful links


OECD New Approaches to Economic Challenges: www.oecd.org/naec