Is it Great Depression-II?
Crisis in Theory and Policy

Rohit

South Asian University

January 24, 2012
Outline of the Presentation

Crisis in Theory

- Vertical Phillips Curve (Mainstream) Vs Horizontal Phillips Curve (Heterodox).

Crisis of Policy: Political priorities
- Monetary policy Vs Fiscal Policy.
- Tax cuts Vs Spending Increase.
- Favouring 1% over the 99%.
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Crisis in Theory
Mainstream Theory and Policy

PC: $\pi_t = \pi_e^t - \alpha (U_t - U_{NAIRU})$;

$\pi$ = Inflation; $U$ = Unemployment

Vertical Phillips Curve (NAIRU)

$U^*$

LRPC

New Keynesian

SRPC ($\pi_e^t = \omega_t$)

Friedman's

SRPC ($\pi_e^t = \pi_{t-1}$)

$\omega_t$

$\pi_t + \Omega = \pi_{t-1}$

Capitalism is self-equilibrating.

1. Real Balance Effect (Outside money)
2. Inflation targeting and RatEx (Inside Money).

Basic Arguments:

▶ Monetarism:

$\pi_e^t = \pi_t - 1$

Short Run: $U_t \not\sim U_{NAIRU}$.

Long Run: $U_t = U_{NAIRU}$.

▶ New Classicals:

$\pi_e^t = \pi_t + \epsilon$

Short Run: $U_t = U_{NAIRU}$.

Long Run: $U_t = U_{NAIRU}$.

No policy required.

▶ New Keynesians:

$\pi_e^t = \dot{W}_t - 1$

Short Run: $U_t \not\sim U_{NAIRU}$.

Long Run: $U_t = U_{NAIRU}$.

No policy required in the long run.

In no way can the economy cross its $U_{NAIRU}$. And it reaches there on its own.
Mainstream Theory and Policy

PC: $\pi_t = \pi_t^e - \alpha(U_t - U_{NAIRU})$; $\pi = \text{Inflation}; U = \text{Unemployment}$
Mainstream Theory and Policy

PC: $\pi_t = \pi^e_t - \alpha(U_t - U_{NAIRU})$; $\pi =$ Inflation; $U =$ Unemployment

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Mainstream Theory and Policy

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Vertical Phillips Curve

Basic Arguments:

- **Monetarism:** \( \pi^e_t = \pi_{t-1} \)
  
  *Short Run:* \( U_t \geq U_{NAIRU} \).
  
  *Long Run:* \( U_t = U_{NAIRU} \).

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In no way can the economy cross its $U_{\text{NAIRU}}$. And it reaches there on its own.
Heterodox Theory and Policy

Is it Great Depression-II? Crisis in Theory and Policy

Rohit

Broad Outline

Crisis in Theory

Mainstream

Heterodox

Extension

Crisis of Policy

Political Response

Heterodox Theory and Policy

\[ \pi_t = Z + \max(0, \pi_{t-1} - \alpha(U_t - U_{\min})) \]

L-shaped Phillips Curve

NAIRUs

\[ U_t, \pi_t \]

Heterodox

LRPC

Heterodox

SRPC

+ 

−

\[ U_{\min} \]

▶ Fluctuates between chronic unemployment and inflation.

1. Inflation can't be negative.
2. No RatEx.

▶ \( U \geq U_{\min} \) (Robinson's Inflationary Barrier). Diametrically opposite to the New Classicals.

▶ Policy (particularly fiscal) required both in long and short run.

A critique

▶ At lower rates of unemployment (\( U < U_{\min} \)), accelerating inflation sets in as workers' bargaining strength increases.

▶ However, by accepting a lower bound to unemployment, heterodox theory itself can come under attack for accepting a limit to policy intervention. With increased monopolisation and unionisation, space for policy intervention gets constrained (\( U_{\min} \uparrow \)).
Heterodox Theory and Policy

PC: $\pi_t = Z + \max(0, \pi_{t-1} - \alpha(U_t - U_{min}))$; $Z =$ cost-push

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- Fluctuates between chronic unemployment and inflation.
- $U \geq U_{min}$ (Robinson's Inflationary Barrier). Diametrically opposite to the New Classicals.
- Policy (particularly fiscal) required both in long and short run.
- At lower rates of unemployment ($U < U_{min}$), accelerating inflation sets in as workers' bargaining strength increases.
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L-shaped Phillips Curve

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Heterodox Theory and Policy

\[ \pi_t = Z + \max(0, \pi_{t-1} - \alpha(U_t - U_{min})) \]  
\[ Z = \text{cost-push} \]

L-shaped Phillips Curve

- Fluctuates between chronic unemployment and inflation.
  1. Inflation can't be negative.

- Inflation is non-negative.
- No rate of inflation can be negative.
- Robinson's Inflationary Barrier.
- Opposite to New Classicals.
- Policy required in both long and short run.
- Critique at lower rates of unemployment, accelerating inflation sets in as workers' bargaining strength increases.
- Lower bound to unemployment, heterodox theory itself can come under attack for accepting a limit to policy intervention.
- With increased monopolisation and unionisation, space for policy intervention gets constrained.

PC: $\pi_t = Z + \max(0, \pi_{t-1} - \alpha(U_t - U_{min}))$; $Z =$ cost-push
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Extending the heterodox theory

Horizontal PC

Workers’ bargaining strength takes a beating because of *threat* of job flight to the periphery.

Increased Policy Space under
globalisation [Govt *can* push U as low as required]
Extending the heterodox theory

Horizontal PC

- Workers’ bargaining strength takes a beating because of threat of job flight to the periphery.
- Their nominal wages are tethered to that of the peripheral workers.

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- Relationship between unemployment and wage inflation breaks down.

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- *Relationship between unemployment and wage inflation breaks down.*
- Phillips curve becomes **horizontal with no** $U_{min}$.

Increased Policy Space under globalisation [Govt can push U as low as required]

\[\pi_t = \min[\theta \omega_a t, \max\{p_e \alpha(U_t), \omega_t - 1\}\theta > 1]\]

\[\pi_t = Z + \min[\delta \dot{\omega_a t}, \max(0, \pi_t - 1 - \alpha(U_t - U_{min}))]\]

$Z = \text{cost-push}$
Extending the heterodox theory

Horizontal PC

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- Their nominal wages are tethered to that of the peripheral workers.
- *Relationship between unemployment and wage inflation breaks down.*
- Phillips curve becomes **horizontal with no** $U_{min}$.
- Source of inflation is primarily from the cost-push side (like oil shocks, futures trading, speculation etc.). Demand-pull inflation disappears.

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If core's nominal wage ($\omega$), peripheral nominal wage ($\omega^a$), core's unemployment rate ($U$), expected price ($p^e$), then

$$\omega_t = \min[\theta \omega_t^a, \max\{p^e\alpha(U_t), \omega_{t-1}\}], \theta > 1$$
Extending the heterodox theory

Horizontal PC

Workers’ bargaining strength takes a beating because of threat of job flight to the periphery.

Their nominal wages are tethered to that of the peripheral workers.

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Increased Policy Space under globalisation [Govt can push $U$ as low as required]

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$\omega_t = \min[\theta \omega^a_t, \max\{p^e \alpha(U_t), \omega_{t-1}\}], \theta > 1$

$\pi_t = Z + \min[\delta \omega^a_t, \max(0, \pi_{t-1} - \alpha(U_t - U_{min}))]$ $Z = \text{cost-push}$
Increased Policy Space In Globalisation

Source: Kuttner and Robinson (2010)
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Increased Policy Space In Globalisation

Table: Estimation Results

<table>
<thead>
<tr>
<th>Dependent Variable: Growth in Per Unit Nominal Labour Cost ($\omega_t$)</th>
<th>Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-0.000(0.001)</td>
</tr>
<tr>
<td>$\pi_{t-1}$</td>
<td>1.971*** (0.069)</td>
</tr>
<tr>
<td>$U_{t}$</td>
<td>-0.044*** (0.006)</td>
</tr>
<tr>
<td>$\omega^a_{t}$ [Mexico]</td>
<td>0.009*** (0.003)</td>
</tr>
<tr>
<td>Hansen Test</td>
<td>0.34 (P Value: 0.84)</td>
</tr>
<tr>
<td>No. of Obs</td>
<td>97</td>
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</table>

Notes: 1) *** indicates significance at the 1% level.
2) Standard errors are in the parenthesis.
Source: Rohit and Das (2012) working paper.
Crisis of Policy
Current condition of the US economy

Output Gap as a % of actual GDP

Potential GDP Vs Actual GDP in the US
(Real values in 2005 dollars)

Source: Hersh and Vij (2011) Updated
When will the Output Gap Close?

Two scenarios under the Obama Stimulus

Source: Author’s Calculation from Bureau of Economic Analysis (BEA) [Actual GDP] and Congressional Budget Office (CBO) [Potential GDP]
Limitations to the Monetary Policy

Liquidity Trap in the US

Source: Author’s Calculation from BEA and Federal Reserve Statistics

Federal Funds rate has been close to 0 since 2009:Q1 i.e. for 3 years. There is hardly more that can be done on this front.
Is Spending more productive than Tax Cuts?

<table>
<thead>
<tr>
<th>Type of Activity</th>
<th>Estimated Output Multipliers</th>
</tr>
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<tbody>
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<tr>
<td>Transfer Payments to Individuals</td>
<td>0.8</td>
</tr>
<tr>
<td>One-Time Payments to Retirees</td>
<td>0.3</td>
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<tr>
<td><strong>Tax Cuts</strong></td>
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<tr>
<td>For lower and middle-income</td>
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<tr>
<td>For higher-income</td>
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Source: CBO (2011)

- Social sector spending is almost *double* as productive as tax cuts!
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- Social sector spending is almost *double* as productive as tax cuts!
- Despite making economic sense, why is it not Obama’s priority?
99% are not a priority,

**Employment Generation Under 4 scenarios**

- **Current 3-month rate**: 137,000 jobs p.m.
- **Clinton Era rate**: 200,000 jobs p.m.
- **Labour Force growth**: 100,000 p.m.

*Source: Hersh and Vij (2011). Updated with minor addition*
but 1% is!

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<tr>
<th>Programs</th>
<th>Amt. Committed</th>
<th>Prominent Bail-outs*</th>
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<tbody>
<tr>
<td>Troubled Asset Relief Program (TARP)</td>
<td>$700 billion</td>
<td>Fannie Mae and Freddie Mac</td>
<td>$1.6 trillion</td>
</tr>
<tr>
<td>Fed Rescue Efforts</td>
<td>$6400 billion</td>
<td>Citigroup</td>
<td>$245.4 billion</td>
</tr>
<tr>
<td>FDIC total</td>
<td>$45.4 billion</td>
<td>AIG</td>
<td>$182 billion</td>
</tr>
<tr>
<td>Other financial total</td>
<td>$1700 billion</td>
<td>Bank of America</td>
<td>$124.5 billion</td>
</tr>
<tr>
<td>Other housing total</td>
<td>$745 billion</td>
<td>Automobile Industry</td>
<td>$85.1 billion</td>
</tr>
<tr>
<td>Fiscal Stimulus</td>
<td>$1200 billion</td>
<td>Bear Stearns</td>
<td>$29 billion</td>
</tr>
<tr>
<td>Total</td>
<td>$11 trillion</td>
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<td>$1.2 trillion</td>
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<td>Outright Bail-outs</td>
<td>$1.5 trillion</td>
<td>Tax Cuts</td>
<td>$456 billion</td>
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<tr>
<td>Indirect Insurance</td>
<td>$4.6 trillion</td>
<td>Unemployment benefits</td>
<td>$8 billion</td>
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<tr>
<td>Increasing Liquidity</td>
<td>$3.4 trillion</td>
<td>Students Loan guarantees</td>
<td>$195 billion</td>
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<td></td>
<td></td>
<td>ARRA Stimulus</td>
<td>$499 billion</td>
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<td>Cash for clunkers</td>
<td>$3 billion</td>
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<tr>
<td></td>
<td></td>
<td>Advanced Tech Vehicles Program</td>
<td>$25 billion</td>
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| Political Priority Quotient (Fiscal Expenditure/Financial Initiatives) | 7% |

* Includes other financial assistance

Source: Author’s calculations based on data available at CNNMoney; Note: Figures as of Nov. 16, 2009
However,
References


