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“Global attempts to dissipate the threat of secular stagnation via monetary policy following the 2008 financial economic crisis have been futile.” Discuss. Cambridge Society for Economic Pluralism Essay Competition 2019

2

PART I: INTRODUCTION Although the Great Recession began to take full effect in late 2008, the aftershocks of the crisis are still apparent today. *In theory*, monetary stimuli should work to boost aggregate demand (AD) and therefore propel the economy forwards with enough velocity to force it out of a slump. *In theory*, all consumers would respond to lower interest rates by decreasing their marginal propensity to save. *In theory*, investors’ animal spirits would pick up during periods where quantitative easing sees higher liquidity as banks’ cash reserves increase. However – whether it is for psychological, political or financial reasons – human decisions do not always align with economic theory, and this is exemplified by futile post-recessionary monetary policies.

PART II: DATA ANALYSIS The idea that humans are unpredictable is at the core of this essay. The idea of secular stagnation (Hansen, 1939) revolves around AD, and therefore related policy measures are more Keynesian in nature. In an attempt to increase AD, central banks adopted loose monetary policy; with the Federal Reserve cutting interest rates to record lows of almost 0.25% (Reuters, 2016) and engaging in quantitative easing to increase the overall supply of money to encourage consumption and investment through cheaper credit. The impact of the change in interest rates in comparison to average propensity to save (APS) is illustrated by figure one (see appendix). The data shows that despite a 5% decrease in interest rates (Q2, 2009) consumption fell by almost 7% in the same quarter. In fact, APS (which = 100- MPC) only returned to levels experienced prior to the financial crisis 4 years after the dramatic interest rate cuts, proving that monetary policy did little to stimulate demand: ‘even with the Fed’s aggressive monetary policies, recovery in the US has been weak’ (Summers, 2016). Analysis also suggests that US and EU economies also experienced the same response to decreased interest rates (shown by figures two, three and four). In essence, consumers in the USA, UK and the Eurozone were not receptive to a significant decrease in interest rates, despite being cut to 0.25% (FRED, 2019), 0.5% (ONS, 2019)and 0.25% (ECB, 2019) respectively in 2009. So it can be established that monetary policy was futile after the Great Recession; it took far too long to ‘kick in’ and actually had an inverse relationship with APS, which undermines its efficacy. The reasons that monetary stimuli had little effect on encouraging consumers to spend more can be explained in relation to the four components of AD: consumption **(C)**, government spending **(G)**, investment **(I)** and net exports **(X-M)**.

The secular stagnation experienced after the Great Recession was particularly damaging to the economy because of its effects on unemployment (Figure 5: UK rates peaked at 8.5% in 2012) and animal spirits. Analysis of the Keynesian Cross [Figure 6] (Samuelson, 1948) can illustrate the impact of a decline in AD in relation to the multiplier, which essentially drives the economy forward. This links clearly to figure 1, as since savings represent a leakage in the circular flow. Figure 6 assumes a linear consumption function (CF):

**Ep = [1/(1-MPC)1]Y2 + [G+I+(X-M)]**

and – since G+I3+(X-M) are modeled as constants for simplicity – planned expenditure (Ep) is simply a parallel shift of CF. The 45 ̊ line (Y=O) intersecting the origin represents the locus of all points where the economy is in equilibrium (where Output ≡ Income, which is the result of the circular flow of income), and hence the intersection between planned expenditure, output and income is the equilibrium point. As G, I and (X-M) decrease (due to the recessionary climate) and lower AD, Ep shifts to Ep1 and a new equilibrium is established. The difference between Y and Y1 represents the change in output and the change in planned

3 expenditure (shown by the green arrows) illustrates leakages through savings (the opportunity cost of G, I and exports).

It is clear to see that:

Where

Y-Y1 > k – k1,

1 1/(1-MPC) is the multiplier [G+I+(X-M)] = k

2 Where Y = income And k1 is the new y-intercept after the shift from Ep shifts to Ep1

3 *Planned* investment

Hence we can deduce that the decrease in injections (k – k1) lead to a proportionally larger decrease in output, demonstrating that a reduction in AD can ultimately lead to the slowdown of the multiplier effect in an economy. This is the main reason why the UK, USA, and Eurozone experienced secular stagnation. Theoretically, a lower multiplier means that injections (e.g. investment) are less effective in yielding maximum returns; hence investors are deterred from spending their capital. Since investment is a component of AD, a vicious cycle can be outlined as decreased demand lowers confidence, which subsequently leads to a further decline in AD and secular stagnation. Hereafter, it becomes imperative to examine the causes of the decreases in each component of AD.

PART III: DISCUSSION 1. Consumption

As APS rises, APC falls since [Consumption + Savings = Disposable Income]. As alluded to previously, consumers do not always act rationally or in line with what economic theory suggests (in this case, that demand would increase as interest rates fall) due to a number of different reasons which led to a paradox of thrift. This is a clear demonstration of how psychology can stop consumers from acting in a way that will benefit the economy as a whole. In this case, the reason why consumption failed to increase despite monetary stimuli was low confidence and high unemployment. Lower confidence in the financial sector (along with a rise in unemployment) made for a turbulent economic climate, as banks were less willing to allow consumers to finance their purchases on borrowed credit after the subprime mortgage crisis that triggered the recession. Furthermore, households started to save more – lest they were to face job losses or other financial hardships. Uncertainty effectively pushed economies into a liquidity trap, where interest rates ceased to have power over the spending habits of the public, rendering monetary policy futile.

2. Government Spending

Arguably the most catastrophic political impacts of the crisis were felt in the Eurozone. The European Central Bank set the same interest rates for all EU countries (excluding the UK), which meant that both Germany and Greece – two economies that differ greatly in terms of their debt to GDP ratios – were subject to the same monetary policies. After the adoption of the Euro in 2002, the initial rise in consumer confidence made for irresponsible lending. It was assumed that Euro bonds were low-risk investments, however, the interest rates charged on Greek bonds were very similar to German bonds, despite obvious differences in their respective levels of fiscal deficit. After 2008, ‘bond markets woke up to the fact that countries concerned with poor government finance had no independent monetary policy’ (Cleaver, 2015). Hence, countries with large debts (such as Greece and Spain) faced tough austerity packages, which meant a severe decline in government spending in order to balance the fiscal budget. Figure 6 illustrates that a decline in injections leads to a nullified multiplier effect, which hinders economic growth and any real chance of recovery. The

4 effects of austerity were seen in the Eurozone Crisis of 2009 through the ridiculously high increase in unemployment rates (which reached 27% in 2013) (Trading Economics, 2019) and in the steep decline in the price of real estate in certain countries. In effect, decreased government spending as a result of the financial crisis, along with the uncertainty and political turmoil that this created completely cancelled out the effects of lower interest rates in certain EU countries, as people had neither the funds nor the confidence to finance expenditure.

3. Investment

The combination of low animal spirits and limited access to credit limited domestic levels of investment, as productivity slumps equate to a lower accelerator coefficient, meaning that investors have to invest more capital to see a return. This makes it particularly difficult for there to be any real progression in the economy as far as productive potential is concerned because without any funds for innovation or development the economy stays stuck at low output levels. Skidelsky argues that since ‘the amount of unemployment depends on AD’, the equilibrium point of effective demand might not be the point of full employment, as workers without incomes cannot consume unsold goods (Skidelsky, 2010). This means that – unless there is a change in employment and therefore labour productivity, AD will not increase. This is precisely why investment would be needed to stimulate an economy, however – due to low productivity and low confidence – monetary policy was unable to persuade people to finance their expenditure on investments.

4. Net Exports

To fully examine the ‘global’ element of this essay title, the impacts of globalization must be explored. The very reason that the Great Recession was so lethal was because of global financial integration, or systemic risk. This meant that the effects of the crisis rippled out from the epicenter (the USA) to all over the world, with very few countries being able to avoid being hit by a recession. This is important to consider in relation to net exports when central banks tried to stimulate AD through monetary policy. The value of pounds sterling, euros and dollars (Trading Economics, 2019) all depreciated (to varying degrees) after the financial crisis, which can be explained in part by the decreased demand for the three currencies due to lower interest rates, and therefore a lower volume of hot money inflows. This would have led to stronger exports, but since global AD was so low due to systemic risk goods were not being demanded. Therefore it can be seen that monetary policy did little to help increase AD through net exports.

PART IV: CONCLUSION

This essay concludes that monetary stimuli were ineffective in dissipating the threat of secular stagnation, as shown by the fact that the average propensity to save did not decrease after interest rates were cut. Methods of Keynesian analysis prove that reduced aggregate demand/expenditure the USA, UK and Eurozone left the economy in a state of stagnation due to the nullified effect of the multiplier (which was also caused by a deficiency of demand) hence proving that there was a vicious cycle of negative economic growth present after 2008. These factors were perpetuated by the paradox of thrift, a liquidity trap, strict political frameworks, and rising unemployment, which therefore rendered monetary policy futile in the aftermath of the Great Recession.

5 **Works Cited** Cityam. (2015). Retrieved from https://www.cityam.com/economic-well-being-four-charts- show-how-uks-growth-compares-its-european-neighbours/ Cleaver, T. (2015). *Economics: The Basics.* ECB. (2019). Retrieved from https://www.ecb.europa.eu/stats/policy\_and\_exchange\_rates/key\_ecb\_interest\_rates/html /index.en.html FRED. (2019). Retrieved from https://fred.stlouisfed.org/categories/22 Hansen. (1939). Retrieved from http://digamo.free.fr/hansen39.pdf OEE. (2019). Retrieved from http://www.oee.fr/106-1-Savings+Rates.html ONS. (2019). Retrieved from https://www.ons.gov.uk/search?q=interest+rates Summers, L. (2016). Retrieved from http://larrysummers.com/category/secular-stagnation/ Samuelson. (1948). Retrieved from https://archive.org/details/in.ernet.dli.2015.50126 Skidelsky, R. (2010). *Keynes: The Return of the Master.* Slideshare. (2017). Retrieved from https://www.slideshare.net/sadraus/the- householdconsumption-sector Reuters. (2016). Retrieved from http://blogs.reuters.com/reuters-right- now/files/2016/01/Central-bank-interest-rates.png Rose. (2018). Retrieved from http://faculty.haas.berkeley.edu/arose/Macro8.pdf Trading Economics. (2019). Retrieved from https://tradingeconomics.com/united- kingdom/unemployment-rate Trading Economics. (2019). Retrieved from https://tradingeconomics.com/greece/unemployment-rate Trading Economics. (2019). Retrieved from https://tradingeconomics.com/euro- area/currency

6 **Appendix**

**Figure One: Economics Help** (ONS, 2019)

**Figure Two: USA Savings as a % of Disposable Income** (Slideshare, 2017)

7

**Figure Three: EU household savings ratio** (OEE, 2019)

**Figure Four: EU Household spending** (Cityam, 2015)

**Figure Five: UK Unemployment Rates** (Trading Economics, 2019)

8

Aggregate Expenditure AE AE1

k k1

**Figure 6: Keynesian Cross Analysis of a shift of AD**

Y Y1

Aggregate Income/R.N.O.