HELICOPTER BEN, MONETARISM, THE NEW KEYNESIAN CREDIT VIEW AND LOANABLE FUNDS

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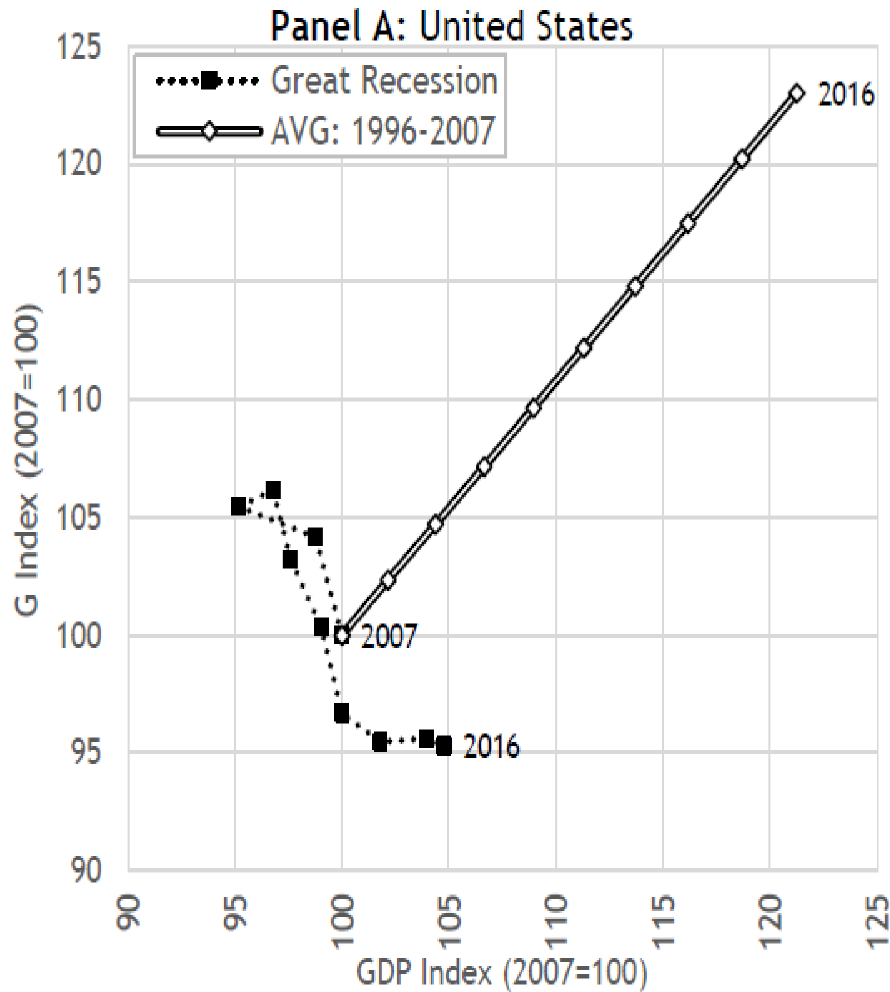
Two views of QE

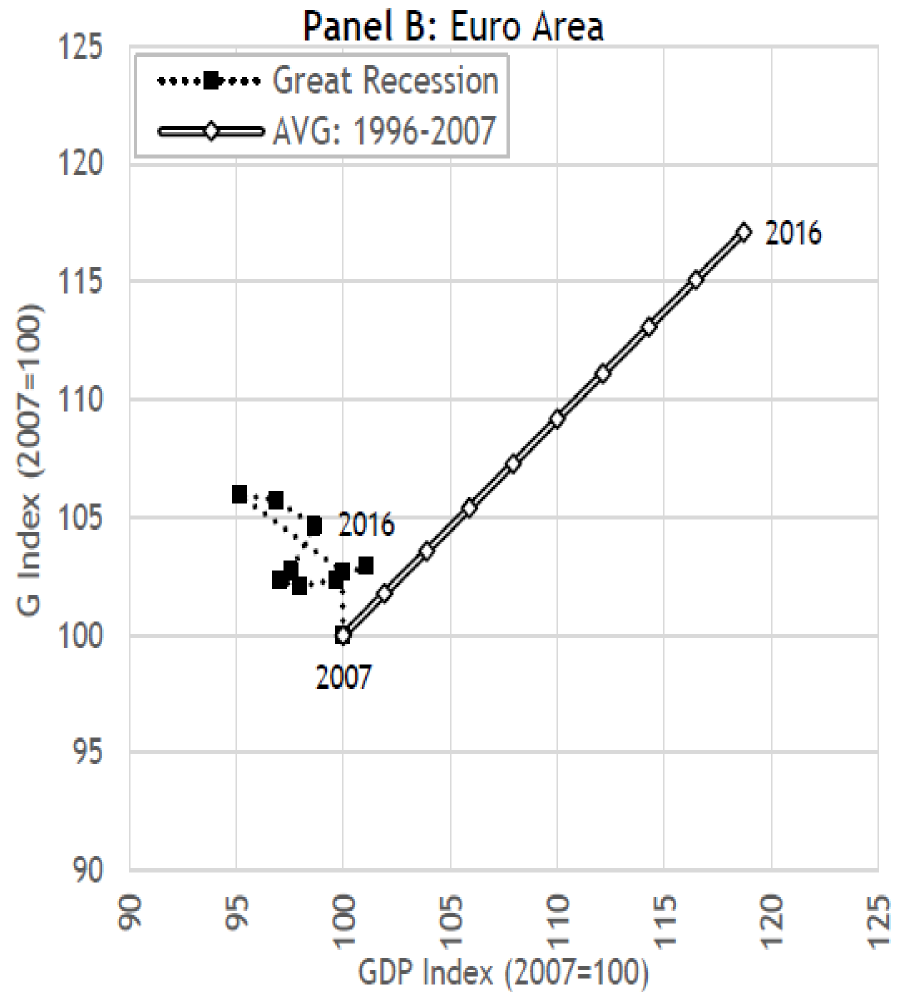
- Two broad transmission mechanisms have been associated with quantitative easing
- The **Keynesian** mechanism: based on decreases in interest rates.
  - This is related to Keynes (1930) and post-Keynesian theory
- The **Friedmanian** mechanism: based on the money multiplier and the fractional-reserve banking system.
  - Both Bernanke and the New Keynesian credit view are associated with the Friedmanian mechanism

Three views of economic policies

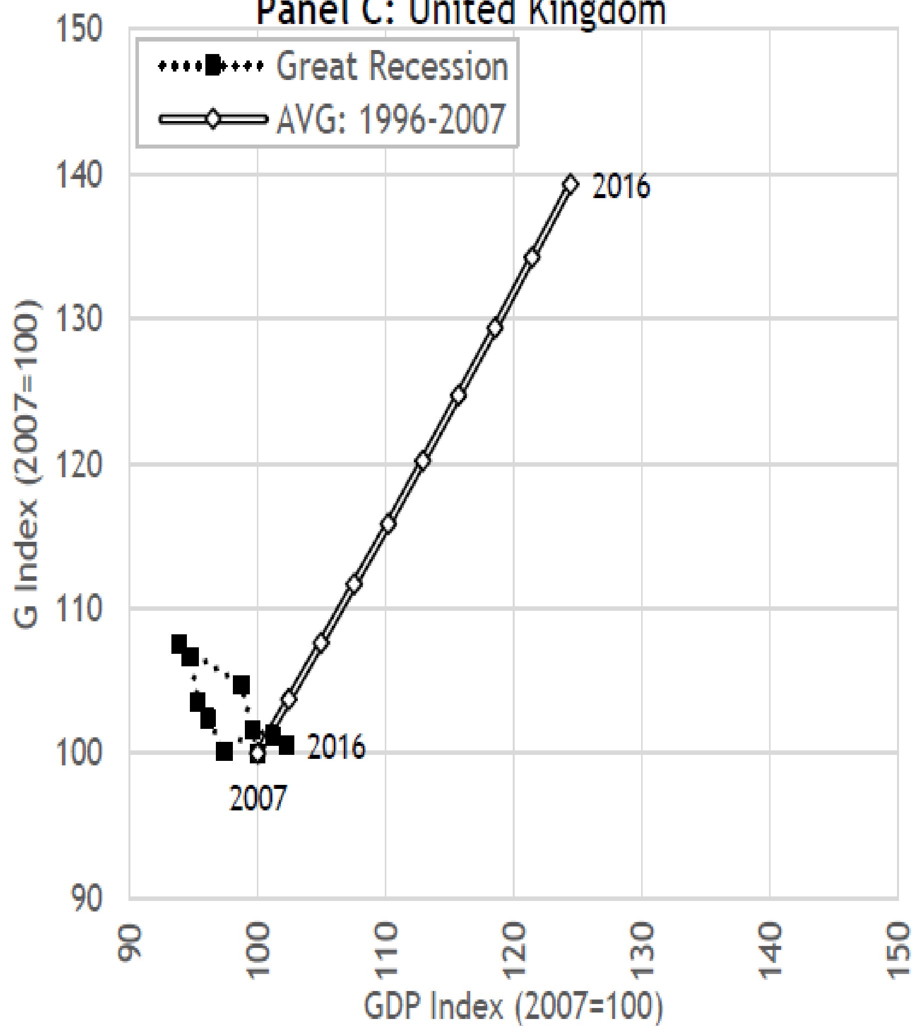
- Friedmanian and New Consensus view
  - Monetary policy is all there is; fiscal policy is useless
  - "I came to the conclusion that… you really didn't need to worry too much about what was happening on the fiscal end … the link from fiscal policy to the economy was of no use" (Milton Friedman in Taylor 2001: 119).
- The post-Keynesian view
  - Monetary policy is nearly useless in a slump, fiscal policy is needed
- The New Fiscalism
  - Expansionary fiscal policy can temporarily boost real output at the zero lower bound, but should be quickly abandoned, as it will have long-run crowding-out effects.

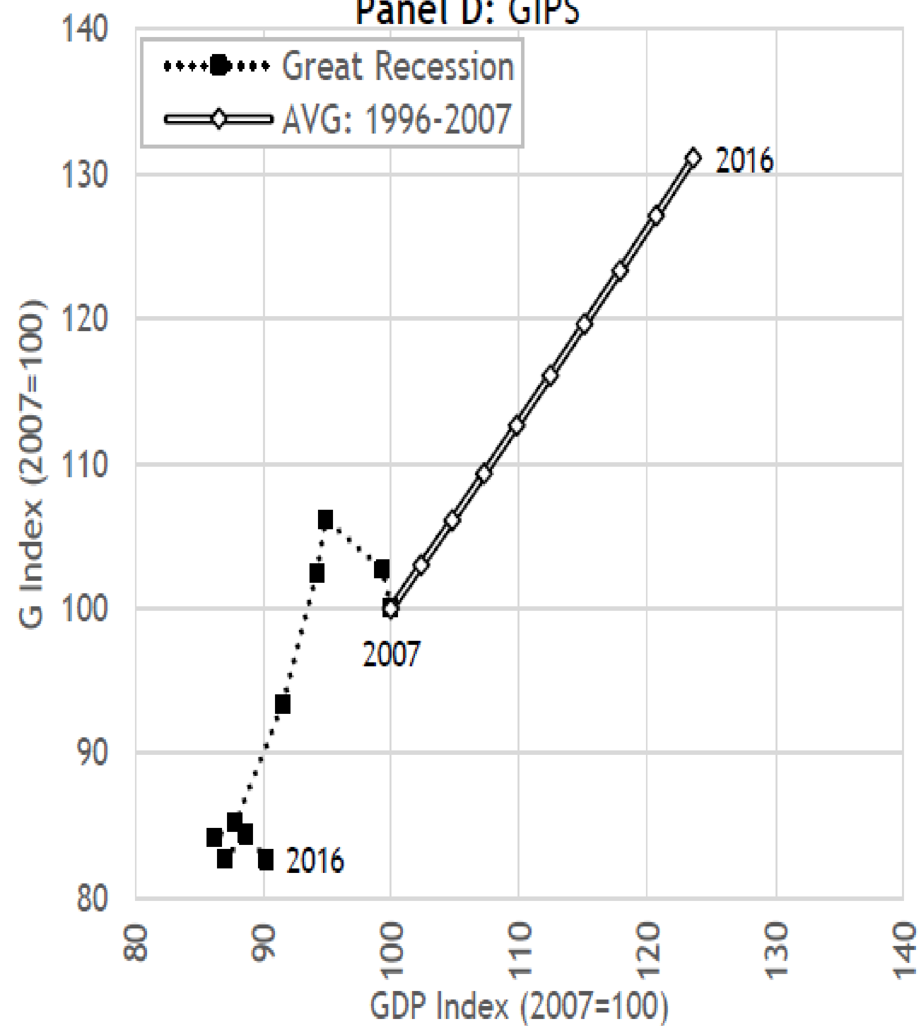
Figure 1: Index Level of Real GDP and G per capita (2007=100)





Index GDP and G per capita





Keynes and extra-ordinary methods

- TM p. 369: in ‘conditions of acute slump or boom… more **extreme** measures will have to be involved’.
- TM p. 370: ‘These **extra-ordinary** methods are, in fact, no more than an intensification of the normal procedures of open-market operations. I do not know of any case in which the method of open-market operations has been carried out ***à outrance***’.
- TM p. 371: ‘My remedy in the event of the obstinate persistence of a slump would consist, therefore, in the purchase of securities by the Central Bank until the long-term market-rate of interest has been brought down to the limiting point…. It should not be beyond the power of a Central Bank … to bring down the long-term market-rate of interest to any figure at which it is itself prepared to buy long-term securities’.

Keynes and QE

- TM p. 371: ‘If the Central Bank supplies the member banks with more funds than they can lend at short-term, in the first place the short-term rate of interest will decline to zero’.
- TM p. 372: ‘If the effect of such measures is to raise the price of « equities » (e.g. ordinary shares) more than the price of bonds, no harm in a time of slump will result from this; for investment can be stimulated by its being unusually easy to raise resources by the sale of ordinary shares…. Thus I see small reasons to doubt that the Central Bank can produce a large effect on the cost of raising new resources for long term investment’.

Keynes and ZIRP

- TM p. 386: Central banks should ‘maintain a very low level of the short-term rate of interest [**zero target rate**], and buy long-dated securities either against an expansion of Central Bank money [**QE**] or against the sale of short-dated securities [**credit easing**].
- TM p. 386: ‘It might be sufficient merely to produce a general belief in the long continuance of a very low rate of short-term interest’. [**Expectations channel**]

Keynes and a monetary alternative to QE

- TG p. 206: ‘Perhaps a complex offer by the central bank to buy and sell **at stated prices** gilt-edged bonds of all maturities, in place of the single bank rate for short-term bills, is the most practical improvement which can be made to the technique of monetary management’.
- **To summarize, Keynes, despite being a supporter of the newly-found money multiplier theory, argued for extraordinary measures on the basis of its effect on interest rates only.**

Bernanke's reverence towards Friedman

- I am ready and willing to praise Friedman's contributions wherever and whenever … both policymakers and the public owe Milton Friedman an enormous debt (Bernanke 2003).
- I have always tried to make clear, my argument for nonmonetary influences of bank failures is simply an embellishment of the Friedman-Schwartz story; (Bernanke 2002a).
- Milton Friedman and Anna Schwartz deserve enormous credit for bringing the role of monetary factors to the fore in their *Monetary History* … By allowing persistent declines in the money supply and in the price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy and, through the workings of the gold standard, the economies of many other nations as well. (Bernanke 2004)
- 'I think of QE as being a basic monetarist principle' (Bernanke 2014).

Bernanke and the money multiplier

- 'The increase in reserves gives the banks the "raw material" they need to issue new deposits … If the Fed increases the stock of reserves, then banks will be able to create more deposits' (Bernanke 1988: 5, 7).
- Bernanke/Gertler (1995: 40) explain that 'Bernanke and Blinder's (1988) model of the bank lending channel suggested that open market sales by the Fed, which drain reserves and hence deposits from the banking system, would limit the supply of bank loans by reducing banks' access to loanable funds'.
- 'By *credit creation* I mean the process by which, in exchange for paper claims, the savings of specific individuals or firms are made available for the use of other individuals (for example, to make capital investments or simply to consume). [In footnote] Note that I am drawing a strong distinction between credit creation, which is the process by which saving is channeled to alternative uses, and the act of saving itself' (Bernanke 1992-93: 50)

Bernanke/Blinder's bank credit channel

- 'All that is necessary for a credit channel is that bank credit and other forms of credit be imperfect substitutes for borrowers' (Bernanke 1993: 56).
- For New Keynesians, the essence of the credit channel is that borrowers who do not have access to the financial markets may get frustrated by credit restrictions, because banks cannot lend more than the deposits and reserves that they hold.
- The credit channel is an enhancement mechanism of the orthodox transmission mechanism.
- As Rochon (1998, ch. 7: 230) says in his critique of New Keynesians): 'While the money supply is credit-driven, it remains supply-determined, dictated largely by the policies of the central bank. Banks can only lend what they have at their disposal, either supplied by the deposits of the savers or the supply of high-powered money by the central bank'.

Bernanke and asymetric information

- While today financial frictions in the banking system are blamed on asymetric information à la Stiglitz/Greenwald (2003), in Bernanke's credit view, banks are there to remove the consequences of asymetric information.
- Bernanke/Blinder (1992: 901) put it this way: 'Loans from financial intermediaries are "special". Specifically, the expertise acquired by banks in the process of evaluating and screening applicants and in monitoring loan performance enables them to extend credit to customers who find it difficult or impossible to obtain credit in the open market'.
- However, for New Keynesians, the central bank is able to decrease or increase the number of frustrated borrowers by controlling the amount of available bank reserves.

Bernanke and banks

- For Bernanke and the New Keynesians, banks are special, but this is only because they are financial intermediaries which can provide credit to borrowers who cannot get it on financial markets.
- Besides this feature, banks appear to be no different from other financial institutions: they are considered to be financial intermediaries, similar in that regard to nonbank financial intermediaries.
- Banks cannot lend more than what they have in the form of deposits and reserves. Thus banks according to Bernanke are *special*, but *not fully so*, in contrast to the banks in post-Keynesian monetary theory, which create credit and money *ex nihilo* or on the basis of collateral.

The central bank as an intermediary?

- One can refer to Blinder (1987) according to whom the amount of deposits of a bank determines the stock of loanable funds; as deposit funds flow into the banks, the supply of credit can expand further. The ultimate source of loanable funds however is the reserves provided by the central bank:
- 'In a system of fractional reserve banking … the central bank has considerable leverage over the latter…. For the banking system as a whole, reserves not deposits, are the binding constraints' (Blinder 1987: 333).
- Gertler/Karadi (2011) defined the central banks as an intermediary of loanable funds: 'We allow the central bank to act as intermediary by borrowing funds from savers and then lending them to investors'. [Cf the critique of Fontana/Passarella 2016].

Bernanke and a credit crunch

- Bernanke/Lown (1991) define a credit crunch as a supply-driven fall in bank credit due to capital constraints.
- Strangely, they rely on Bernanke/Blinder's 1988 model, which has no bank capital and hence no capital constraints.
- As Benjamin Friedman (1991) observed: 'If banks really cannot create money and credit because the *capital* restraint is binding, what effects follow from an increase in the quantity of bank *reserves*?'
- Bernanke's optimism about the capacity of monetary policy to stabilise an economy following a severe financial disturbance (e.g., liquidity trap, credit crunch) was quintessentially Friedmanian at this point of his academic career.

Conclusion

- What orthodox economists and Bernanke have is a theory of loanable funds, embedded in a fictitious barter economy, where thrift is necessary for investment to take place.
- The real world is not a barter economy. Banks do not collect gravel in order to lend it to cement companies.
- There is a huge gap between:
  - on the one hand, Bernanke's New Keynesian understanding of money and credit creation, based on Friedman, loanable funds and the money multiplier story;
  - and on the other hand, the post-Keynesian (horizontalist) monetary theory as could be found in Kaldor (1970, 1982) and Moore (1988).