ÖNB Workshop: Discussion of Prof Peter Bofinger's "MONETARY analysis versus REAL analysis: What are the main differences?" by Josef Falkinger

Dear Prof Bofinger let me first thank you for the interesting contribution. When looking through the slides of your presentation and reading the CEPR background paper you sent me, I have got the impression you want to send us two messages: First, it is misleading to look at a modern economy from a real rather than a monetary perspective. And second, if seen correctly, recent developments are more normal than some people suggest. Well, a lot of real things happened too in the last ten years and not all of them seem to be normal to me. But let me turn to the specifics.

1. Loanable funds theory (LFT) vs flow of funds analysis (FFA).

As salient proof for how economists were misguided by the real approach you mention the so-called "saving glut" hypothesis. The hypothesis explains low interest rates by an excess of saving over investment. Prof. Bofinger argues that the hypothesis, far from being supported by evidence, is rooted in a wrong economic mind set, the so-called loanable funds theory (LFT) with its work horse the Andreas cross of S and I as functions of the interest rate. Yet, funds for investment are not created by saving of households, so Bofinger, but by the financial system, as the monetary perspective with its flow of funds analysis shows. Moreover, funds are not only used for real investment but for financing all sorts of things. So if anything low interest rates come from a "financing glut" rather than a saving glut.

Now, I could hardly imagine stronger disbelievers in Say's law than the teachers who introduced me into macroeconomics. "Saving does not create investment" was the mantra I grew up with. So I could not agree more with your critical view on the saving glut.[1] And still, I hesitate to surrender as real economist and seek salvation in a mere monetary view.

Let us agree on the financing glut. The financial system – including central banks – has been very creative in creating funds for financing all kind of stuff. New investment may be part of this stuff, but as you point out, other uses of funds

[1] I do however believe that sluggish investment is a problem in advanced economies. That the expansionary monetary policy of the ECB has not been complemented by equally substantial investment efforts, for instance in public infrastructure, is regrettable.

may be more important, for instance, the financing of real estate or more generally the purchase of existing assets. You are right in emphasizing that it is this flow of funds that determines the interest rate. And the more the flows of funds are decoupled from the saving-investment process the less we should look on saving or investment if we want to understand interest rates. So far so good. But to be honest, I cannot find any comfort in this insight. To the contrary, the more it is true the more I ask myself:

- Why is it that the flow of funds has become so decoupled from the saving and investment process?
- What are the consequences of the decoupling? For instance, is it a good thing or a bad thing if funds are absorbed in the real estate business rather than in the financing of new production capacity?

My preliminary personal answer to these questions is that the decoupling of the flows of financial funds from the saving and investment process goes hand in hand with a new business model: Redistribution of wealth instead of creation of wealth. To give a prototype example, if funds are used to buy existing houses (rather than to finance the construction of new houses) we have as a result: rising house prices and a new ownership structure.

In sum, maybe we should take your appeal to a monetary view as starting point for developing a more realistic real view: After all, financial flows have real consequences.

My second couple of comments concerns your discussion of the IS/LM model.

2. IS/LM – AS/AD analysis

I was happy to see that you emphasize the merits of this model in separating the financial market from the goods market by adding the LM analysis to the IS analysis. At the same time, however, I was a bit deceived that your LM curve is drawn as straight line. I have always thought that the beauty of the IS/LM model lies in the non-linearity – the vertical "classical" part and more important the flat associated with the "liquidity trap". After all, it is the liquidity trap that represents the decoupling of saving and investment from the flows of funds in its pure form.

Now, maybe you don't belief in the hoarding of money under the mattresses, nor do I. But still we should not ignore that a lot of speculative business is involving

liquidity holding. Apart from that the flat in the LM curve reminds us of a more fundamental point as well: As outlined before, financial funds are not only used for productive activities, which in the end would be somehow related to the level of aggregate output, the Y in the diagram. A lot of music is going on that has no relationship to Y, for instance asset price bubbles or the redistribution of Y. So in the two-dimensional picture, the liquidity trap should also serve as warning sign that other dimensions have to be kept in mind. In other words, if it is true that we live in times where the flows of funds are to a large extent decoupled from the saving and investment process, then the IS/LM curves become uninformative. Maybe we should therefore look for a new diagram with asset prices on the vertical and wealth concentration on the horizontal axis.

You also mention the AS/AD analysis. But I didn't see how you put the diagram into action. After all, a lot of things happened in the last ten years or so that should have affected this diagram substantially. For instance, how should I think of the non-orthodox monetary expansion? Did it lead to a strong outward shift of the AD curve? Did it affect price expectations and thus induce an upward shift of the AS curve. I understand that money creation kept interest rates low, but why didn't it have the other effects we would expect in the AD/AS framework – real expansion and inflation.

Maybe in this case it is better to not follow your advice and to switch back from a monetary to a real perspective. If I remember the textbook correctly it is the wage setting curve that drives the price expectation-inflation mechanism. Now, one of the real things that happened in the last decades is that wage growth was meagre. So maybe we should look for fundamental changes in the distributional mechanisms in advanced economies before jumping too quickly from REAL to MONETARY.

Let me end with two shorter comments

3. Development of interest rates.

The evidence you present on US real interest rates from 1954 – 2018 fits to the broader historical picture on real rates of return from 1870 – 2015 in the data of

Jordà/Knoll/Kuvshinov/Schularik/Taylor.[2] According to this data, safe rates indeed tend to be surprisingly volatile and relatively low quite often in history. In contrast, returns on residential real estate and equities ("risky rates") tend to be less volatile and high at levels around 7 - 8 %. So low interest rates seem to be indeed more normal as one might think. All the more we should be aware of the distributional consequences. While wealth invested in real estate and risky assets generates substantial income, ordinary people who don't save in risky assets suffer from low interest rates.

From the perspective of ordinary people, another point is important when comparing low real interest rates today with low rates in the fifties or sixties. Maybe the real interest rates were equally low then as they are now; but many other things were quite different. First, growth, in particular wage growth, was high then. Second, the population was young and growing so that the prospects for future income – including transfers from future generations - were bright.

4. Kalecki equation

Prof Bofinger stresses that household saving reduces the liquidity position of the corporate sector and refers to Kalecki in this context. The equation associated with his name suggests that the saving household (say worker) takes something away from the profit earning corporation (say capitalist). This could be misleading. One of the merits of Kalecki is the careful distinction between active and passive agents. Clearly, he thought that the tone is set by the capitalists, that is, the corporations. So if anything the presented equation would have to be read somehow as follows: Corporations profit by keeping wages low so that workers spend what they get.

[2] Oscar Jordà, Katharina Knoll, Dimitriv Kuvshinov, Moritz Schularik and Alan M. Taylor, "The rate of return on Everything, 1870 – 2015", mimeo 2015