UNIVERSITA' CATTOLICA DEL SACRO CUORE
MILANO

Dottorato di ricerca in Politica Economica

ciclo XXIV

S.S.D: SECS-P/02

New Keynesian and Post Keynesian:
Analysis of Monetary Policy and Banking Sector Behavior

Tesi di Dottorato di Olimpia Fontana

Matricola: 3710486

Anno Accademico 2011/12

UNIVERSITA' CATTOLICA DEL SACRO CUORE
MILANO

Dottorato di ricerca in Politica Economica
ciclo XXIV
S.S.D: SECS-P/02

New Keynesian and Post Keynesian: Analysis of Monetary Policy and Banking Sector Behavior

Coordinatore: Ch.mo Prof. Luigi Campiglio

Tesi di Dottorato di Olimpia Fontana
Matricola: 3710486

Anno Accademico 2011/12

Acknowledgements

There are a lot of people I have to thank. Some are directly involved with this work, others are people that have been very important during these four years of PhD.

Among the first group, I am very grateful to Antoine Godin for his collaboration to the third chapter, which has finally begun a published paper; professor Gennaro Zezza for his precious suggestions; professor Marco Missaglia for our early discussions about this work and his support when I was indecisive about the opportunity to undertake a PhD; professor Francesco Timpano for his help and suggestions and professor Marco Raberto for his support during the MAFIN Conference in Genoa and the submission procedure to *Economics* journal.

Among the second, there are all the guys I met in this fascinating, although sometimes stressful, adventure: the mates of the twenty-four cycle of PhD, to which I wish good luck: Gianni, Gabriele, Marco, Giuseppe, Kim and Paola, my dear mate, which I really thank for our endless conversations and for having shared with me doubts, fears and happiness of PhD life and extra-PhD life; the guys of other cycles, in particular Eliana, Sara and Andres, which are far away but close friends, and the other guys met in Louvain la Neuve, during the Master: Serena, Alice, Elias, Clementina, Simone, Erica, Francesca and Annamaria.

Special thanks also to my dear friend Riccardo, which has shared with me a part of this experience, as well as a part of his life; my precious "problem-solving" friend Mario for helping me every time I was desperate in a technological problem and my young friend Elena for our lunches and laughs in the grey doctorate room.

And thanks to my dear Paolo, for his infinitive patience, intellectual curiosity and every day spent with me. Thanks to my parents and family for their love and faith.

Thanks to Piacenza, which hosted me four years ago and still is the place where I have decided to live.

Piacenza, February 27th, 2013

Contents

Introduction

This work is basically divided into two parts. The first provides the economic theoretical background preliminary to the exposition of the second part, which is represented by the elaboration and implementation of a theoretical macroeconomic model, grounded in Post Keynesian theory. The subject under investigation is the securitization process, which has been at the centre of the 2007-2009 crisis in the United States. The aim is to analyze, through the construction of an elaborate model, the links between the financial sector and the housing market and to assess the nature of the crisis: the 2007-2009 financial crisis has been a households-led or a finance-led crisis? The novelty of our work is represented by the detailed description of the private banking sector in the Stock-Flow Consistent approach, assuming that investment banks carry out an active management of their balance sheet.

The work has the following structure. Chapter 1 develops a comparative analysis of New Keynesian and Post Keynesian paradigms, based on their respective literature review. Although the two theories have a common denominator, John Maynard Keynes, the assumptions and models they are based on lead to very different results in terms of policy implications, because of the influences played by other schools of thought that have changed the original message of Keynes. After all, Keynes himself, soon after writing "*The General Theory*", admits that "if the simple basic ideas can become familiar and acceptable, time and experience and the collaboration of a number of minds will discover the best way of expressing them" (Keynes, 1937, p. 212). We take into consideration the developments – or better, the revolutions and counter-revolutions – in recent economic literature, which provides the ground for the model currently used by policy makers, the Dynamic Stochastic General Equilibrium model.

In opposition to the New Keynesian vision, also known as the "mainstream", we present the Post Keynesian theory, whose assumptions, techniques and policy prescriptions totally differ from New Keynesian. Soon, it will become clear that the theory we adopt is more suitable than the mainstream in studying the phenomenon and relationships under investigation in our model at least for the importance it recognizes to the financial side of the economy with respects to the real one in a macroeconomic framework.

Before starting dealing with the model itself and its simulations, in chapter 2 we provide a brief treatment of the topic, that is financialization, which has acquired more and more relevance in recent economic events. We also introduce the particular methodology implemented in our model, the Stock-Flow Consistent approach, which in the last ten years has seemed to attract a wider consensus, at least in the heterodox academic community.

Finally, chapter 3 tries to contribute to the Post Keynesian Stock-Flow Consistent research program with a treatment of the modern banking sector management, which is a crucial aspects at the basis of the 2007-2009 U.S. financial crisis. Probably one of the main advantage of the Stock-Flow Consistent approach is the possibility to integrate the real and the financial side of the economy. It addiction, it can be adapted to reproduce virtually any level of complexity, although one must cope with a trade-off between realism and handiness. As Caverzasi and Godin (2013) find, in Stock-Flow Consistent literature authors have recently concentrated on modeling a more realistic financial market, rather than a more realistic productive structure or households sectors. And this is the case for our model, where in order to address the monetary-financial aspect of the story we have to sacrifice some real aspects and even some fundamental sectors of an economy.

After a wide model is illustrated through subsets of equations fully commented for each sector, we solve the theoretical model numerically and finally run some shock simulations in order to explore the model properties. We also provide appendixes, where the complete model all put together is provided and the values of parameters are declared.