

THE STOCK-FLOW CONSISTENT MODEL WITH ACTIVE FINANCIAL MARKETS

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In summary

- The stock-flow consistent approach is a valid alternative to econometric modelling without microfoundations;
- Problems of causality in sfc;
- Issues of financial inflation & over-capitalisation

The Classic Model

- Essentially the Flow of Funds Matrix
- Reduced to households, firms and banks
- Firms borrow bank deposits of households
- Causality of Savings → Loans → Investment (classical view)

vs.

Investment → Loans → Saving (Withers/
Kalecki/Post-Keynesian view)

Profits of Firms

Saving of Firms (Flow of retained profits)
= Investment Flow – Household Saving Flow
(Levy/Kalecki/Steindl)

Household saving $>$ Investment \rightarrow 'Forced indebtedness' of firms (negative net saving):

Firms' borrowing \rightarrow household savings
 \rightarrow **Lower** investment

EXCESS CAPITAL

- If firms are allowed to hold financial assets
- Firms can borrow in order to buy bank deposits, backed by loans to firms, WITHOUT altering household net saving.
- Firms can also issue capital to each other, backed by holdings of each others' capital issues (balance sheet restructuring, M&A)

LIQUIDITY PREFERENCE

- Overcapitalisation allows firms to regulate their liquidity (excess capital held as liquid assets)
- Liquidity is main consideration in credit ratings
- Position of firms operating in all capital markets is reinforced - Counterpart of excess capital is net debt of households or smaller firms.

CAPITAL MARKET INFLATION

- Firms' excess capital has counterpart in household sector's holdings of long-term financial assets (pension funds, insurance policies).
- Reduced bank borrowing by firms has counterpart in smaller bank balance sheets; or higher borrowing by households (against residential assets?)