

Keynesian alternative to inflation targeting

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Abstract

A collective reflection has been recently engaged with the aim of conceiving a Post Keynesian alternative to the mainstream's economic policy. Some authors suggest 'activist' interest rate rules, while others plead in favour of a policy aimed at maintaining the interest rate at a low level. Though they contain stimulating ideas, these contributions however never consider seriously that the central bank's control over the long run (and sometimes the short run) interest rate may be hindered because of the liquidity preference volatility. There is some remaining hydraulic Keynesianism in assuming that the central bank can freely set the rate of interest at the desired level. Could economic policies ensure full employment and prices stability by means of a set of simple or even sophisticate rules, any Post Keynesian policy mix would, at best, do as well as the mainstream's optimal one. The mainstream always will be the sovereign of the enchanted 'optimizable' world. Post Keynesians have to resign themselves to reign without magic wand over the uncertain and therefore imperfectly malleable real world. The mainstream notion of credibility is irrelevant in such a world, for in the face of uncertainty, it makes not much sense to wonder whether authorities will or will not honour their commitment on an unfeasible ideal target. The question is whether authorities pursue feasible objectives that have been pragmatically defined in accordance with the context, and therefore have been widely understood and accepted. It is a matter of confidence about the authorities capability to influence the interest rate convention so as to get high employment, rather than a matter of credibility. The paper explores the basic economic policy principles involved in such a Keynesian approach.

”... we must remind ourselves that there may be several slips between the cup and the lip.” J.M. Keynes, *The General Theory*.

1. Introduction

Let us start with the foundations of the ‘inflation targeting’ rule.

- Competitive forces (supposedly) adjust relative prices so as individual choices lead to the Pareto optimal collective outcome, or some second or third... best according to the kind of distortion.
- Owing to the markets imperfections, the system adjustment to exogenous shocks may require some delay, which allows for stabilization policies aimed at reducing economic volatility. These demand policies operate through temporary unexpected inflation, which allows for temporary relative prices variations and real effects in the presence of sticky nominal prices (notably wages).
- In the medium-long run, while competitive forces are (supposedly) efficient, monetary authorities may be tempted to get extra output persistently and/or lighten the public debt by repeating inflationary shocks, with the result that the expected inflation rate would feed the effective inflation rate. A credible commitment to low inflation tempers the expected inflation rate, and therefore the effective inflation as well. Such a commitment requires the central bank being independent and having a price stabilization mandate; it requires also the government commitment to safe public finance, in order to discard the necessary monetization of an unsustainable public debt.

As a matter of fact, the underlying theory of this modern version of the mainstream policy requires three rather strong postulates:

- Competitive forces lead the economic system to the optimal outcome (or 2^d best, 3rd best...), that is, with the jargon syntax: a (quasi) complete market structure, where gross substitution holds, is a realistic representation of the economic systems), which is questionable (to say the least) from the mainstream’s point of view itself.
- Rational expectations are not biased in the long run, which is widely admitted to be wrong (including by mainstreams highly renowned authors).
- Low inflation targeting over the medium-long run is better than high inflation targeting or no inflation target at all, which simply has no justification since what matters in the long run, according to the theory under consideration, is the ability of people to anticipate the rate of inflation, whatever it is, and this is also postulated.

Inflation targeting therefore rests on three embarrassing strong postulates, which shows the weakness of its theoretical foundations. This state of affairs should have made it easier for Post Keynesian to gain acceptance for alternative proposal, which has not really happened yet. Why?

The Old Keynesian recipes have been discarded as no longer credible because they were designed within the degenerate hydraulic Keynesianism, where shifting the IS and/or LM curve(s) accurately was regarded as the elementary solution to restore full employment. The mainstream then consistently developed the idea by considering that agent expectations could not ignore the future of such a simple machine. And here we are: 'inflation targeting' (say 'Non Inflationary Stabilizing Policy') became the optimal policy response to stochastically disturbed (though dynamically stable¹ and therefore optimizable) regimes, as stipulated within the new standard DSGE modelling (for a recent stylized version see Benassy, 2007). As the mainstream basically provides the optimal economic policy when possible, Post Keynesians would certainly have lost the argument if the real economic system was 'optimizable'. But, provided they do not overlook their methodological foundations (that is, as the future is uncertain economic systems are not 'optimizable'), Post Keynesian can offer fresh policies with superior performance.

Echoing a reassessment of monetary and fiscal policy by Arestis and Sawyer (2003a,b,c), a collective reflection has been engaged with the aim of conceiving a Post Keynesian alternative to the mainstream's economic policy. The recent symposium on monetary policy (*JPKE/ 2007*, 30(1)) collects emerging ideas on monetary policy (see also Fontana and Palacio Vera (2007), Setterfield (2007b), Setterfield and Tadeu Lima (2006), Atesoglu (2007), Palley (2006a)). Some authors suggest making inflation targeting more countercyclical so as to have stronger real effects over the cycle and growth path, while others plead in favour of a policy aimed at maintaining the interest rate at a low level. Though they contain stimulating ideas, most of these contributions however never consider seriously that the central bank's control over the long run (and sometimes the short run) interest rate may be hindered in case of a shift in the liquidity preference. There is some remaining hydraulic Keynesianism in assuming that the central bank can freely set the rate of interest at a desired level (see how the recent events triggered urgent and necessary interest rates changes).

A similar argument applies to more ambitious proposals which aim at designing a monetary-fiscal policy mix (Arestis and Sawyer (2003b), Camara Neto and Vernengo, 2004, Setterfield, 2007a), sometimes including income policy (Hein & Stokhammer, 2007). Arestis and Sawyer (2003b) for example suggest a 'fiscal Taylor rule' so as to compensate for the monetary policy weakness (see also Setterfield, 2007a). Could economic policies ensure full employment and prices stability by means of a set of simple or even sophisticate rules, any Post Keynesian policy mix would, at best, do as well as the mainstream's optimal one. The mainstream always will be the sovereign of the enchanted 'optimizable' world. Post Keynesians must resign themselves to reign without magic wand over the uncertain and imperfectly malleable real world.

Section 2 focuses on the Post Keynesian methodological roots and their superiority as compared with the mainstream's approach. Section 3 discusses the mentioned Post Keynesian alternative proposals, with special attention paid to their consistency in 'non optimizable' contexts, and draws general principles aiming at improving the effectiveness of Post Keynesian macroeconomic policies.

¹ Dynamic stability of a stochastic process is known as ergodicity; see Vercelli (1991, pp. 40, 154) and Davidson (2002, pp.39-69).

2. General and singular theory of equilibrium

2.1. The essence of Post Keynesian macroeconomics

There are differences, sometimes disagreements, among Post Keynesians, but there is one point about which all agree: firms hire until the level beyond which the expected proceeds would be lower than the supply price of output. The employment level at which expected proceeds and the supply price of output are equal is the point of effective demand. The level of effective demand may or may not be the full employment level.

Of course, the mainstream also can explain market failures. GCE theorists have shown for long that imperfect competition and incomplete markets may cause dysfunctions. But the solutions hold in reinforcing competition and creating more markets, not in stimulating the demand for goods, except when it is possible to take advantage of certain nominal rigidities in order to speed up the relative prices adjustment. The reason is basically that the aggregate demand can not constrain the aggregate supply once the relative prices adjustment is completed: either, markets clear through the relative prices adjustment, or, if market imperfections prevent the optimal outcome at the collective level, the distorted relative prices and the involved individual optimal decisions make the distorted aggregate supply and demand equal, so that it remains inadequate to stimulate the aggregate demand.

Assessed at the macroeconomic level, an insufficient aggregate demand in the goods market, or, equivalently, an excess of saving, is not a stable situation, and would therefore, according to the mainstream, trigger a decrease in the rate of interest which simultaneously clears both the market for goods and the market for saving (Say's law). As the supply of goods can not be constrained by the demand, firms may freely decide to hire as long as the marginal product of labour exceeds the real factor cost.

If one considers the fourth market however, namely the money market, then the interest rate decrease caused by a depressed aggregate demand ('Keynes's effect) and the real balance effect (which has now to be taken into account) may meet two kinds of obstacles. First, it may be that the depressive forces harm the state of the confidence so that people increases the liquid assets share in their portfolio (this would limit or inhibit both the Keynes's and Pigou's effects). Second, the worsening business climate could deter investment projects despite the (possible) decrease in the interest rate.

Why doesn't the mainstream consider these obstacles? The answer is because uncertainty is not really considered, but 'risk'. Therefore, when a depression arises, people do not increase the liquid-assets share as far as the depression is considered a white noise (such an increase would suppose a regime shift in the modern macroeconomics terminology). In the same spirit, a depression does not change the long run expected return on capital either².

² Because he embraced the widest definition of uncertainty, Keynes conceived his general theory without postulating any 'natural' position or trajectory. That does not mean that people can not make rational expectations, but the meaning and usefulness of such forward looking information is far weaker than the one usually given to it in the mainstream approach. Keynesian rational expectations admit that people make use of all available information of course, but whatever the kind of

The point is that Say's law only holds under the restrictive condition that a depression is considered a temporary deviation (a white noise), which postulates some regulatory forces that operates in the long run so as to anchor the economy in an imaginary 'natural' position. In the face of true uncertainty, the demand for money and the inducement to invest are subject to the shifting state of the confidence, so that the Say's law does not work in general, even in competitive markets³.

As it does not restrict the future to a predictable trajectory, such a theory is basically more general than the mainstream's theory. Consequently, in a flex-price competitive system, Keynes's theory delivers a different equilibrium for every state of the 'view concerning the future', while the mainstream's new synthesis only reckons the Pareto-optimal equilibrium as a result of optimal intertemporal choices in a world 'where all things are foreseen from the beginning'⁴. Uncertainty, thus, is the source of money non neutrality and, as a matter of consequence, of the possibility that the aggregate demand does constrain the supply of goods despite the relative prices adjustment has operated. It is therefore also the source of the possibility of unemployment in a competitive market system.

But the demonstration would remain incomplete if the adjustment of wage in the labour market was not considered. The question is to decide whether, in case of unemployment, the pressure on wages is likely to stimulate the effective demand and remove unemployment (thereby relegating the effective demand theory to the explanation of a temporary phenomenon owed to an adjustment delay in the labour market), or, if not, what will be the final outcome. As far as the 'invisible hand' fails to implement the optimal equilibrium, real wages are higher than the marginal disutility of labour. That suggests that competition between workers will reduce the nominal wages. But, although such a mechanism sometimes works to some extent, it may fail to remove unemployment because of possible negative effects on the demand side, especially through the marginal efficiency of capital (*The General Theory*, 1936, ch. 19). When the wages decrease does not stimulate the effective demand, or even does

probabilistic tools they use, true uncertainty makes it not so rational to consider expectations a good basis for decision making. That is the reason why Keynes thought that decisions actually "also depend on the *confidence* with which we make this forecast -on how highly we rate the likelihood of our best forecast turning out quite wrong" (Keynes, 1936, ch. 12, s. 2).

³ According to Keynes himself, the influence of changing views about the future is the ultimate criterion of differentiation vis-à-vis the orthodox theory:

"Or, perhaps, we might make our line of division between the theory of stationary equilibrium and the theory of shifting equilibrium -meaning by the latter the theory of a system in which changing views about the future are capable of influencing the present situation. [...] We can consider what distribution of resources between different uses will be consistent with equilibrium under the influence of normal economic motives in a world in which our views concerning the future are fixed and reliable in all respects; with a further division, perhaps, between an economy which is unchanging and one subject to change, but where all things are foreseen from the beginning. Or we can pass from this simplified propaedeutic to the problems of the real world in which our previous expectations are liable to disappointment and expectations concerning the future affect what we do to-day." (Keynes, *The General Theory*, ch. 21, s.1, 3rd paragraph)

⁴ Yet, general equilibrium theorists have pointed out for a long time that gross substitution of excess demand functions must be postulated to ensure the competitive equilibrium stability.

amplify the depression⁵, wages continue to fall towards zero until workers are able to stop the decrease in wages, unless the depression in output and prices succeed in pulling the demand for money and the rate of interest in such a way that the effective demand eventually reach the optimum level. In the most favourable case where it stimulates the effective demand, wages flexibility can remove unemployment completely, either by itself, or, possibly, with the help of the interest rate. That is the only eventuality the mainstream considers. But, in the Keynesian theory, it is only one of many less-happy outcomes which depend on the level where the state of confidence, together with workers ability to resist, fixes the effective demand and, therefore, the equilibrium level of employment.

These results show that there is no, strictly speaking, flex-price competitive equilibrium with Keynesian unemployment, as Keynes himself stated: "If [...] money-wages were to fall without limit whenever there was a tendency for less than full employment, [...] there would be no resting-place below full employment until either the rate of interest was incapable of falling further or wages were zero. In fact we must have *some* factor, the value of which in terms of money is, if not fixed, at least sticky, to give us any stability of values in a monetary system.' (*The General Theory*, 1936, ch. 21, s. 5, 3rd paragraph). But that is not to say that flex-price competitive markets ensure full employment, nor is it to say that the cause of unemployment holds in the rigidity of prices as stated in the Benassy (1984)-Malinvaud (1980a,b) range of models (in this literature, it was argued that flexible prices would eventually lead the economy toward the Walras outcome)⁶. In Post Keynesian economics, flex-price markets do not remove unemployment necessarily, and may even increase it. Nominal rigidities in this case are not the cause of unemployment, but the necessary stabilizing consequence of a vicious circle of increasing unemployment and decreasing wages. Contrasting with the orthodox macroeconomics, where competition induces flexible wages and optimal employment level, in the Keynesian uncertain world, competitive forces may induce rigid money-wages and unemployment.

2.2. Uncertainty in the mainstream's enchanted world

Nowadays, the mainstream 'New macroeconomics' reigns over academic and policy circles, and over international institutions. One major reason is that the mainstream gave a (degenerated) rationale for every key Keynesian concept within the traditional ergodic approach to competitive markets, with the result that the general theory, mistakenly, seemed to be digested. The damage lies in the fact that the reassessment of

⁵ Expectations of further wages decreases tend to delay investments. See Tobin (1975) and Palley (2006b) about the cumulative depression involved in such a context.

⁶ In Malinvaud (1980) however prices flexibility could produce a cumulative depression in case of unemployment, but that result was obtained within a two-market economy (labour and goods). The cumulative process resulted from the assumption that the decrease in prices produced by the supply excess of goods is weaker than the decrease in wages (hence the real wage increases so that firms reduce the production level), without any consideration for the stabilizing 'Keynes effect' that would have been triggered in the presence of a money market. In Keynes theory, on the other hand, the Keynes's effect may be countered by shifts in the state of confidence and in the liquidity preference.

Keynesian concepts within a restricted definition of uncertainty dispossessed them of their original and revolutionary meaning.

For example, when Post Keynesians put forward the speculative motive in the money demand theory, they thought about consequences of uncertainty and about liquidity preference. Empirical evidence against the single transaction-money theory then called for a theoretical response in the mainstream. But the answer consisted in justifying the speculative demand for money in terms of some optimal portfolio trade-off between interest and risk⁷, which reduces uncertainty to a measurable phenomenon based on probabilities.

Another crucial example is given by the marginal efficiency of capital, which meaning was cautiously distinguished by Keynes from the marginal productivity of capital, precisely because of uncertainty. But Keynes's theory of the inducement to invest, which proved to be better than the traditional function of the interest rate, was translated in terms of 'Tobin's Q ' deviations from the equilibrium value (that is 1) within an ergodic stationary model⁸. Yet, Keynes' Q clearly departed from the ergodic vision of the world (Keynes, 1936, ch. 11, s. 2, and ch. 21, s. 1).

As we have argued, according to the Post Keynesian economics, there is numerous of possible equilibria owing to the different possible 'views concerning the future', while, by reducing the definition of uncertainty to risk, the mainstream reduces the set of possible equilibria to the sole (assumed) 'natural' one. There is a similar methodological degeneration in econometrics. Let us consider how it works.

Time-series econometrics aims at finding the data generating process (DGP) of any economic series. That requires the series to be stationary in one way or another. Hence econometrics starts by making the series stationary (differentiating it if needed). It is however always possible to derive stationary series, but that does not mean that the DGP of the period $t-n$ to t will hold in the subsequent periods. It could be that adding some historical data does not modify the DGP significantly (though that is wrong in general), but one can never tell what the future will be, as suggests the growing literature on shifting and switching regimes (Hendry 2002, Hinich, Foster & Wild 2006)⁹.

Yet, mainstream economists (and econometricians) use to extrapolate the model that econometrics found in a set of historical data, forgetting by the way that what statistics effectively can say is turned towards the past, and differs from what economists would econometrics could say, which is often turned toward the future. Indeed, the mainstream 'New macroeconomics' view rests on the idea that agents have a model of the economy and base their (rational) expectations on the future 'the model' predicts, which in ergodic stationary contexts would ensure that forecasting errors will only be a white noise. But as far as changes in the DGP may arise, such expectations look not so rational.

⁷ See Tobin (1958).

⁸ See Brainard & Tobin (1968, p 105).

⁹ Hence, while it is not impossible to identify (temporary) stationary regimes in historical data and to usefully enlighten their properties by means of some 'structural' VAR and VECM methods, 'structural stability' should not be postulated without great caution, especially in prospective works.

Consequently, mainstream theorists can not but admit larger definitions of uncertainty more and more, with the result that adaptive learning and expectations no more look irrational nowadays (Sargent 1999, Farmer 2002, Evans & Ramey 2006, Preston 2006). It is convenient to mention here the most advanced mainstream theorizing of uncertain systems, namely the Rational Beliefs Equilibrium theory (RBE; see Kurz 1994, Kurz & Motolese 2001, Wu & Guo, 2003), a theory of nonstationary (therefore nonergodic) systems, where people expectations change according to their (rational) beliefs. This approach unquestionably improves the role of uncertainty by allowing for nonstationarity, but it assumes however, implicitly, that agents always are confident about their expectations in spite of the fact that their theory is likely to change in the future. This is an unfortunate assumption which dispossesses uncertainty of its venom. Indeed, the 'state of confidence' is a key concept of the decision theory in uncertain contexts. In their job search model for example, Nishimura and Ozaki (2004) showed that, while an increase in risk ("mean preserving spread of the wage distribution the worker thinks she faces") increases the reservation wage, an increase in Knightian uncertainty ("a decrease in her confidence about the wage distribution") reduces the reservation wage. The intuitive reason strongly recalls Keynes's arguments of the liquidity preference and inducement to invest theories: when uncertainty increases, people aim at reducing it by accepting a job so that they cancel a future search (that is by preferring a certain amount of money today, rather than an uncertain amount tomorrow). Thus, the death of the 'natural' equilibrium' is forthcoming, for the mainstream can hardly avoid considering the role of the changing state of confidence seriously. In Mark Hayes's words, the reunification of political economy is in progress, and the General Theory is the gateway.

2.3. Economic policy of the magic wand

As far as competitive forces drive the system to the 'natural' anchor, macroeconomic policy, at best, provides a stabilisation device when rigidities delay the adjustment process. In such a context, automatic monetary and fiscal rules can be formulated, since they aim merely to offset deviations from the target (the 'natural' value). Insofar as such governance principles work symbiotically within the 'New Consensus' approach¹⁰, they stabilize perfectly the macroeconomic system. But the same rules may produce severe drawbacks if they are implemented in a Keynesian system (Asensio 2006, 2007a,b, Atesoglu & Smithin, 2006, Palley, 2007, Sawyer 2007, Setterfield & Taddeu Lima, 2006).

As Asensio pointed out, in the absence of a spontaneous return towards the full employment, the actual unemployment and interest rates serve as macroeconomic policy targets as long as they are considered the 'natural' rates, with the result that the policy mix 'symbiotically' anchors the system away from the full employment (provided the central bank has enough influence on the long term interest rate). The situation then may persist for it seems to be the consequence of real wages rigidity, which is one of the main causes of natural unemployment in the 'New Consensus' macroeconomics. This line of argument suggests a kind of unemployment trap, to

¹⁰ See Dixit & Lambertini (2003).

which the mainstream uses to refer to as hysteresis¹¹: when authorities lack room for manoeuvre in the face of a negative shock, for example because of budget balance considerations, the output stabilization only works partially, and unemployment increases. Since nothing tends to reduce it then, authorities take the actual unemployment rate as the new 'natural' one.

Similar drawbacks may arise in case of distributive tensions. Inflation factors depend on income distribution concerns (mark-up, fiscal tax rate, wages pressure relative to productivity gains¹²). These factors influence indirectly the unemployment rate through the monetary policy reaction they may trigger. Whatever the causes of inflationary pressures are, the central bank always can restrict the effective inflation by increasing the interest rate and the level of unemployment in such a way that the pressures fade (the control of the long run interest rate is hardly questionable when increases are considered). Actually, inflation always is a monetary phenomenon since it expresses higher monetary prices of goods and services, but while the mainstream's economics incriminates irresponsible or lax policies, the Keynesian approach points out the dilemma involved by the distributive tensions: to preserve the value of money and assume higher unemployment, or to preserve employment and let inflation develop. The former states moreover that reducing monetary inflation has no permanent cost in terms of unemployment, whereas it does for the latter, as far as persistent tensions induce monetary authorities to 'incomes policy of fear' (Davidson, 2006)¹³.

Obviously, the New Consensus macro policy is not the adequate policy in a Keynesian world; the magic wand yields flawed targets and instruments misuse. There is room for a Post Keynesian alternative.

3. Getting rid of the wand

Proposals for a Post Keynesian alternative to inflation targeting have been made recently in two directions.

3.1. 'Parking it' monetary rules

'Parking it' monetary rules actually are a response to both, the idea that 'inflation is first and foremost the result of conflict over the distribution of income' and therefore monetary policy is not the appropriate tool to fight inflation (Rochon & Setterfield, 2007b), and the idea that the wisdom of active monetary policy is questionable owing to many transmission obstacles (Wray 2007, Bateman). A 'Parking it' rule therefore should be understood as a full policy mix proposal which is based on the following principles:

¹¹ On hysteresis, ergodic and non-ergodic regimes, see the Minisymposium in the *Journal of Post Keynesian Economics*, 15(3), Spring 1993.

¹² In an open economy, the prices of oil and imported intermediate goods should also be taken into account.

¹³ See Palley (1997, 2001) for an empirical discussion.

- income policy aims at fighting inflation;
- monetary policy hardly may control inflation and, therefore, parks the interest rate at some chosen level with an ‘explicit distributional objective’;
- fiscal policy works as a countercyclical policy device;

Some ‘parking it’ rule rest on parking the short run nominal interest rate, while the other can be considered real interest rate rules.

Real interest rate ‘parking it’ rules

Let us discuss first the ‘fair rate’ based rule, in the spirit of Pasinetti (1981, see also Lavoie, 1997), and the ‘low’ real rate proposed in Smithin (2007, also Atesoglu & Smithin, 2006). Both of them rest on the normative purpose of providing economic policy with an ‘explicit distributional objective’, Smithin’s rule differing essentially because ‘it does not, however, guarantee a share for *existing* wealth holders (as opposed to entrepreneurs or workers) in *current* productivity increases, as would the notion of the “fair” interest rate [...]. This omission might be justified on the grounds that it is the latter, rather than the former, who are actually responsible for the productivity increases’ (p. 116).

Hence, both rules aim at setting the real rate at a determined level, but actually it is not clear how a central bank might control the real rate of interest. Remember that, in a monetary economy, the real rate of interest is not a single variable (as it would be in a barter economy); it is the difference between the price of liquidity (the nominal rate) and the inflation rate, which may vary independently of each other, the mainstream excepted¹⁴. How could therefore the central bank go about things with only one instrument but two (intermediate) targets? It would require that both variables were closely linked to each other, as in the mainstream (see footnote 14), but in this case, there will be no influence of the monetary policy over the real rate either, beyond some possible temporary effect.

Zero short run nominal interest rate and euthanasia of the rentier

As the nominal short run rate of interest is very closely related to the central bank’s overnight rate, the central bank control over the short run inter-bank nominal rate (and therefore the technical feasibility of ‘parking it rules’ expressed in terms of short run

¹⁴ In the mainstream approach, the central bank can not control the equilibrium real rate of interest or even any real magnitude, at least in the long run. If the central bank sets the short run nominal interest rate in such a way that the money supply matches continuously the real cash balance demand, there is no inflation and the real and nominal long run rates are identical (but the equilibrium real or ‘natural’ rate is determined on the bonds market, independently of the monetary policy). If the short run nominal rate is lowered below that ‘natural’ rate that the money supply grows say 2% faster than the real demand for money, and that a 2% inflation rate will result. In that case, the nominal long run rate will be 2% higher than the real rate, but the central bank only determines the rate of inflation and, therefore, the long run nominal interest rate on which lenders and borrowers will agree so that the real rate remains not affected by inflation.

nominal rate) are hardly questionable. But, technically feasible rules may have such negative implications that it would be preferable not to implement them in fact, as will be argued in the following paragraphs.

As the famous ‘Kansas city rule’ refers to ‘euthanasia of the rentier’, let us first consider Keynes’s argument. The social philosophy towards which the General Theory might lead (chapter 24, s. 2) focuses on our ability to manage the rate of interest so as to raise the inducement to invest at the level where, given the aggregate propensity to consume (including the State), there is full employment. As far as the accumulation of capital decreases the marginal efficiency of capital, a decrease in the interest rate will be required in the long run. That is the essence of Keynes’s prediction of the euthanasia of the rentier. According to the argument, the ideal policy is not to maintain unconditionally the interest rate at a low level; it is to adjust the interest rate at the level which ensures full employment, given the MEC and the aggregate propensity to consume. As these variables may change according to the rate of accumulation, to the productivity gains or to the government propensity to consume, among other causes, it would be imprudent to adopt a rule that would not be influenced by these causes. The interest rate could indeed be parked at such low a level that it would be inflationary, or at such high a level that it would not allow for full employment.

As it recommends a zero overnight rate, the ‘Kansas city’ version of the short run nominal rate parking rule (Wray, 2007)¹⁵ would work as well as possible against unemployment, but in the face of distributive tensions, it would allow for a monetary accommodation of inflationary pressures. It is unquestionably a good thing that the central bank accommodates when the banks need to refinance themselves as a result of the credit-money they have created in response of viable activities, but when the demand for credit-money results from distributive inflationary pressures, the central bank faces a dilemma: either it accommodates inflation so as unemployment does not rise, or it fights the distributive conflict by means of higher interest and unemployment rates. Such a dilemma has no objective solution that could be picked out from economic theory, especially if inflation pressures are strong and threaten the confidence on money. It is a decision which belongs to the community.

The dilemma could however vanish if, as recommended in Setterfield (2007b, see also Setterfield & Taddeu Lima, 2007, Setterfield & Rochon 2007a,b), the income policy could pacify the distribution of income. Could the zero-rate rule be implemented under the (not so easy) condition that the distribution of income was pacified? Not obviously, for there is some events which may force the central bank to adjust the overnight rate. Wray (2007) invokes the case for exchange rate stabilisation in fixed peg regimes, but its discussion then discards the problem by assuming flexible exchange rate. Note however that such an assumption does not really discard the problem in the case of a big or medium country, for country’s A exchange rate variations in that case produce both externalities and policy responses in countries B, C... which aim at limiting the exchange rate variations... Once again, there is no

¹⁵ Camara Neto and Vernengo (2004) also advocate a policy of low rate of interest so as to make it easier for the government to implement a sound countercyclical fiscal policy (that is, without excessive deficit and debt, that is without ‘unnecessary’ deficit according to Arestis and Sawyer, 2003b).

objective solution as far as there is no ‘natural’ exchange rate in the Keynesian representation of the world. The decision here belongs to the community of nations.

Exchange rates are not the only variable which variations may force the central bank to deviate the interest rate from the parking location. The recent financial turmoil for example has changed the Fed’s policy. Another example could ensue because of the huge amounts of dollars that have been injected on the markets. As in the case for distributive tensions, this accommodation is not the counterpart of sound economic activities; it is the urgent response to a rush on liquidity which is threatening the viability of numerous financial institutions and banks. The Fed will therefore probably be under pressures once the storm is gone, as to fight the ongoing inflationary pressures. Another example can be found in the case of a full employment situation where an overnight zero rate could feed unnecessary inflation¹⁶, which would result from too easy credit money and over-accumulation of capital (the ‘sub-prime’ crisis being a variant).

Eventually, the proposed rules prove to be either inapplicable, or too rigid to deal with a shifting uncertain world. Advocates of the ‘parking it’ approach therefore have prudently suggested that the central bank could deviate from the rule in ‘extreme’ circumstances (Rochon & Setterfield, 2007b, Smithin, 2007). Note however that the situations which could justify such deviations, as discussed above, may hardly be considered ‘extreme’ circumstances, and therefore the theoretical examination of the policy which is adequate in these (possibly not so frequent) situations should not be removed from the agenda.

Thus, Post Keynesian theory does not escape from the necessary reflection on monetary policy making according to the context. Obviously, this will be a harder task, compared with the invariability of simple rules, all the more so as, as advocates of the ‘parking it’ approach put forward, monetary policy effects over aggregate demand and inflation are uncertain. But there is no way out; it is the uncomfortable position of central banks and governments that they have to manage so that the economy does not go on unbridled, in spite of the fact that there is no ‘natural’ way of doing it.

3.2. ‘Activist rules’ or discretion?

The second stream of the recent Post Keynesian works on interest rate policy is the one Rochon and Setterfield (2007) have called ‘activist rule’.

According to Palley’s (2007), monetary policy affects inflation, unemployment, real wages and growth, so it ‘picks a quadruple’. Inflation targeting therefore is a ‘suboptimal policy frame because it biases decisions toward low inflation by obscuring the fact that policy also affects unemployment, real wages, and growth’ (p. 61). Considering the long run effects of monetary policy, Palley calls for setting the interest rate so as to deal with the trade-offs of lower unemployment and higher real wages versus lower growth. Fontana (2003) as well pays attention to the long run potential

¹⁶ According to Keynes indeed: ‘we have shown that [...] the scale of investment is promoted by a low rate of interest, provided that we do not attempt to stimulate it in this way beyond the point which corresponds to full employment’ (*The General Theory* ch 24, s.2).

effects of monetary policy (see also Orphanides & Wilcox, 1996, Palacio-Vera, 2002, Fontana & Palacio-Vera, 2005, Sawyer, 2007). The original proposal of a ‘flexible opportunistic approach’ seeks to make an active contribution to the growth rate of output and employment, besides stabilizing output in the short-run and achieving price stability in the long-run. It recommends a prudent monetary policy which should avoid increasing the interest rate in case of low inflation pressures (or even should decrease moderately the interest rate in the ‘flexible’ version), so as to take advantage of a possible increase in the potential output which could subsequently offset the temporary inflation tensions. This approach suggests an interesting way of managing with some aspects of uncertainty, though it is specified in terms of real interest rate rule, and is therefore subject to the same limitations as the Pasinetti and Smithin rules. Notice however that it might be that the flexible opportunistic approach need not being specified in terms of real interest rate rule.

Activist rules, anyway, rest on the questionable assumption that the interest rate can easily be adjusted so as to reach the ideal target. The point is that unforeseeable shifts in the state of confidence have heavy implications on the capacity of monetary policy to control the long-term interest rate, especially if interest rates decreases are considered. When the monetary base is increased through lowering the short term rate, lower long term bank rates in principle boost the demand for credit, provided the liquidity preference does not shift too much. But an increasing liquidity preference may conversely make banks able to sell more credit without having to reduce their interest rates, for non-bank loans (bonds) rates in this case tend to rise in order to compensate the increasing liquidity preference. Therefore, rules that assume that authorities always can adjust the rate of interest to a desired target could hardly be implemented in a Keynesian context. Actually, even when authorities do control the interest rate effectively, the possibility of unforeseeable shifts in the marginal efficiency of capital and inducement to invest makes the outcome uncertain.

Consequently, macroeconomic policy actually can not be but discretionary in uncertain contexts, meaning by the word that authorities can not commit themselves to such and such objectives¹⁷, though they can express intentions. The future instruments responses can not be summarized in a single of even complex rule, for the future effects of these responses are simply unpredictable.

The Post Keynesian alternative to inflation targeting: general principles

According to Keynes argument on the social philosophy to which the general theory might lead, the ideal policy is to adjust the interest rate at the level which ensures full employment, given the marginal efficiency of capital and the aggregate propensity to consume. It is the merit of those Post Keynesian rules that have been discussed above to reintroduce the philosophical dimension in the theoretical debate on economic policy. It is the positive contribution of the ‘parking it’ approach to question, in normative terms, the role of monetary policy in the ground of income distribution. It is

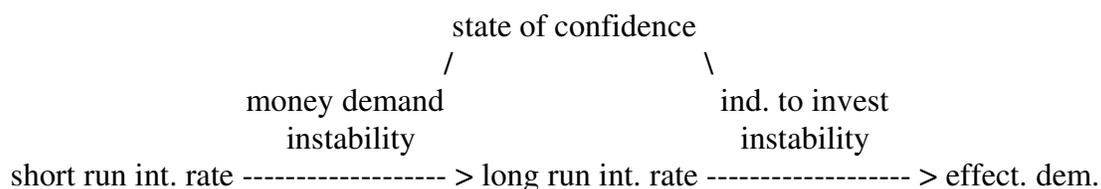
¹⁷ The term ‘discretionary’ is taken as opposed to the commitment on some automatic rule. Hence, our argument actually rejoins Bateman observation that Keynes rejected the hold ‘hydraulic’ acceptance discretionary policies (not discretionary policy in general).

the positive contribution of the ‘activists’ to emphasize the inadequacy of inflation targeting owed to the fact that monetary policy may have long run effects on economic growth, and to promote policies aimed at drawing advantage of these effects.

However, because of the questionable feasibility of their proposals, Post Keynesians have not yet totally won the argument against the mainstream inflation targeting rule. They must now, putting the social philosophy in the background, go ahead and propose feasible policies. Keynes’s *General Theory* often tackles the subject, especially in chapter 13 (section 3), chapter 15 (section 2), and chapter 19, (section 2 & 3), with a great deal of prudence as concerns the difficult task of passing the transmission channels. Two related difficulties are identified.

The first one is that the equilibrium interest rate ‘is a highly conventional [...] phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as *likely* to be durable *will* be durable; subject, of course, in a changing society to fluctuations for all kinds of reasons round the expected normal.’ (*The General Theory*, ch. 15, s. 2). Therefore ‘unemployment develops [...] because people want the moon’, that is, because the equilibrium long run interest rate is not low enough when the liquidity preference is too high, given the marginal efficiency of capital and the aggregate propensity to consume. The difficult task of monetary policy is to drive the convention so as the long run interest rate allows for a higher employment level.

The second difficulty is that the volatility of confidence makes the demand for money and the inducement to invest unstable and uncertain, in the Keynesian acceptance of the term, with the result that both the control over the long run interest rates may be disturbed, and the final effect on effective demand as well.



The policy problem all the more is complex as short run interest rate moves may interfere with the state of confidence, thereby provoking shifts in the macroeconomic relations, and making uncertainty endogenous to the monetary policy itself. In Bateman words, who opportunely have recalled the special attention Keynes paid to the state of confidence and its implications for the making of economic policy, successful policies have to ‘take into account the unpredictable reactions of businessmen to those policies’ (p. 82). ‘Thus a monetary policy which strikes public opinion as being experimental in character or easily liable to change may fail in its objective of greatly reducing the long-term rate of interest, because *M2* may tend to increase almost without limit in response to a reduction of *r* below a certain figure’ (*The General Theory*, ch. 15, section 2).

On the other hand, a prudent monetary policy may draw advantage of the conventional nature of the interest rate ‘if it appeals to public opinion as being

reasonable and practicable and in the public interest, rooted in strong conviction, and promoted by an authority unlikely to be superseded'. 'Public opinion can be fairly rapidly accustomed to a modest fall in the rate of interest and the conventional expectation of the future may be modified accordingly; thus preparing the way for a further movement—up to a point. The fall in the long term rate of interest in Great Britain after her departure from the gold standard provides an interesting example of this;—the major movements were effected by a series of discontinuous jumps, as the liquidity function of the public, having become accustomed to each successive reduction, became ready to respond to some new incentive in the news or in the policy of the authorities (*The General Theory*, ch. 15, section 2).

But the way may be narrow. If the central bank behaves so as to decrease gradually the long run interest rate, the expected decreases may have a negative impact on the marginal efficiency of capital, and if, on the other hand, the central bank aims at adjusting the long run interest rate immoderately, the liquidity preference may raise (and the marginal efficiency of capital may decrease)¹⁸. Hence, there are conditions to the success of a (reasonable) monetary policy, the study of which would shed some light on the way monetary policy should be designed from the Post Keynesian point of view.

4. Conclusion

The recent Post Keynesian reflection on economic policy has yielded various alternative rules to inflation targeting. It is worrying that a common theoretical background gives rise to contradictory remedies. It has been possible, however, to identify important non contradictory aspects: to reintroduce the philosophical dimension in the theoretical debate on economic policy; to question, in normative terms, the role of monetary policy in the ground of income distribution; to emphasize the inadequacy of inflation targeting owed to the fact that monetary policy may have long run effects on economic growth, and to promote policies aimed at drawing advantage of these effects.

In spite of their positive contributions to the debate, the mentioned proposals however never consider seriously that the central bank's control over the long run (and sometimes the short run) interest rate may be hindered because of the liquidity preference volatility. There is some remaining hydraulic Keynesianism in assuming that the central bank can freely set the rate of interest at the desired, optimal level. As, the mainstream basically provides the optimal economic policy when possible, Post Keynesians would hardly produce a fresh alternative to the mainstream's inflation targeting if real economic systems were 'optimizable'. But, as far as the world is uncertain, economic systems and policies are not 'optimizable' and there is room for a genuine Post Keynesian economic policy with superior performance in the real world.

As uncertainty prevents the economy to anchor in any 'natural' predetermined position, and as the ideal position in general is inaccessible to the current economic

¹⁸ 'Just as a moderate increase in the quantity of money may exert an inadequate influence over the long-term rate of interest, whilst an immoderate increase may offset its other advantages by its disturbing effect on confidence...' (*The General Theory*, ch. 19, section 2).

policy (though it may be accessible in favourable circumstances), the Post Keynesian challenge is to provide principles for the conduct of economic policy in a system which equilibrium is deprived of any 'natural' anchor and is subject to unpredictable shifts due to the volatility of the state of confidence¹⁹. The success of such policies rests on their capacity to move the interest rate convention in accordance with a feasible employment target.

The mainstream's concept of credibility is irrelevant in such a world. In the face of uncertainty, it makes not much sense to wonder whether authorities will or will not honour their commitment on an unfeasible ideal target. The question is whether authorities pursue feasible objectives that have been pragmatically defined in accordance with the context, and therefore have been widely understood and accepted. It is a matter of confidence, rather than credibility²⁰. It is quite different to drive cautiously the interest rate convention as close as possible of the full employment level in an uncertain world, and to stabilize the economy round the 'natural' position in a fundamentally stable system. Definitely, hydraulic policy recipes changed sides.

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¹⁹ A formal first attempt is suggested in Asensio (2006, 2007a).

²⁰ See Le Héron (2006, 2007) for an analysis of Greenspan's strategy in terms of confidence versus credibility.

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