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Between the cup and the lip
On Post Keynesian interest rate rules and long-term interest rates management

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(1st draft, May 2009)

Abstract

The paper states that, although Post Keynesian interest rules may be feasible and sustainable in favourable circumstances, there is a shared difficulty as for the setting of long-term interest rates in a context of strong uncertainty and shifting liquidity preference. According to Keynes theory of the interest rate, the variation in the long-term interest rate that authorities are seeking for must correspond to the market convention, in order to preserve the state of the confidence and avoid disruptive shifts in the demand for money. It is argued that authorities should therefore announce a long-term interest rate target in accordance with the normative objective the opinion has debated on and agreed with. Also, such a *conventional target* cannot be very distant from the current rate, and the short-term rates authorities control should be adjusted gradually (but not slowly).

Moving the interest rate convention is harder to get in the context of the current crisis, because of the deleterious effects on private and public accounts, and thereby on the state of confidence, that the innumerable amounts of bad debts have carried. We put forward strong arguments in favour of reducing the amount of bad debts by means of temporary large public deficits and accommodating monetary policies (which is not to say permanent large deficits and inflationary policies), even though long-term interest rate do not respond much to the short-term impulses of central banks.

Keywords: interest rate, rule, convention, monetary policy, financial crisis

JEL classification: E12, E52

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"If, however, we are tempted to assert that money is the drink which stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip." *Keynes, General Theory*

1. Introduction

Because financial institutions and banks hold huge amounts of bad debts, they lost confidence in one another, and the other economic agents lost confidence in the stability of the financial system as well. The banking crisis specter consequently is still hovering, thereby discouraging firms and household from launching long-term productive and financial investments. Although central banks promptly reduced their intervention rate drastically and pumped high powered money massively, they have not found much success as regard economic activity. The 'transmission mechanisms' look to be broken.

The literature on monetary rules will be seriously shackled because of the renewed evidence that monetary policy is first concerned with confidence, and confidence is rarely referred to in that literature. The paper emphasizes how powerful this concept is in explaining the monetary transmission chain, and how, as a matter of consequence, monetary policy should deal with confidence if the transmission mechanisms are to be recovered.

While the discussion will tackle various aspects of the subject, it will not focus specifically on the prudential aspects, to which, on the other hand, much attention is paid elsewhere. Our questioning will serve two purposes: first, to go into the Post-Keynesian general approach to monetary policy in depth; and second to deal with monetary policy in the current context, which raises specific problems.

The Post Keynesian approach to monetary policy is exemplified by the various interest rate rules that have been proposed recently¹. Contrary to the mainstream, which is still concerned with the design of a mythic "optimal monetary rule", the Post Keynesian rules should not be thought of as automatic responses to any interest rate gap or output gap regarding a supposed "natural" position; they rather have to be considered a device aimed at approaching normative, ideal objectives which maybe will not be reached, depending on how strong uncertainty and the related 'state of confidence' impact the individual decisions and, thereby, the monetary transmission channels.

Section 2 emphasizes both the positive contribution these works made to the Post Keynesian modern theory of monetary policy and the hindrances that interest rules

¹ See *Journal of Post Keynesian Economics*, vol. 30, n°1 (2007) and *International Journal of Political Economy*, vol. 37, n°2 (2008) for a recent appraisal.

may come up against, owed to strong uncertainty and the related changing state of confidence. As we are not really concerned in this paper with the policy ultimate objectives², the discussion will mainly focus on the control authorities have on the intermediary objectives, namely the short-term and long-term interest rates.

Section 3 focuses on the way confidence can be introduced within the recent Post Keynesian literature on monetary policy theory. It starts from Keynes's definition of the interest rate as a conventional variable, subject to the changing 'views about the future', and investigates how monetary authorities should manage to have a chance of moving the market convention toward the desired level. The section is also aimed at discussing issues at stake in the current and forthcoming troubled situation. The focus will be put on the difficulty of recovering the confidence of the public, given the intricate state of affairs (fragile financing system, deflation and unemployment) and forthcoming threats (huge public deficits and potential inflationary pressures).

Section 4 summarizes the main findings and concludes the paper.

2. Post Keynesian interest rate rules and their operating channels

Rochon & Setterfield (2007a) have proposed an enlightening classification of the Post Keynesian proposals in terms of "activist" and "parking it" rules. While both rules are aimed at taking advantage of the potential effects of monetary policy in the long run, the former focuses on policies which are aimed at operating through the short run relation between long-term interest rates and effective demand (Atesoglu, 2007, Palley 2007, Fontana & Palacio-Vera 2003, 2007), while the latter focuses on policies which are aimed at operating through the relation between (short/long-term) interest rates and income distribution (Pasinetti 1981, Lavoie 1999, Rochon & Setterfield, 2007a,b, 2008, Smithin 2007, Wray 2007)³.

Rules operating through the short run relation between the long-term interest rate and output

The rule proposed in Atesoglu (2007) is based on Keynes's definition of the 'neutral rate' (1936: 243), the interest rate which is consistent with full employment. The rule is aimed at adjusting the central bank rate at a neutral level, that is, in such a way that the long-term interest rate is adjusted to its own neutral level as well. Although Atesoglu's proposal does not deal explicitly with the long-term effects of monetary policy, his approach does not discard these effects of course.

² There is a consensus about the ultimate objectives of interest rules "in terms of their capacities to promote desirable (high growth, low inflation) macroeconomic outcomes and to assist the growth and inflation targeting objectives of the policy authorities" (Rochon & Setterfield, 2007b).

³ In Palley's model, income distribution also plays a role as far as the long run consequences of the monetary policy are concerned, but the derived interest rate policy is not of the parking it type.

The innovative proposal for a ‘flexible opportunistic approach’ developed by Fontana and Palacio-Vera (2003, 2007) seeks explicitly to encourage the growth rate of output and employment, besides stabilizing output in the short run and achieving price stability in the long run (see also Sawyer, 2007). The standard opportunistic approach (Orphanides & Wilcox 1996) states that, in order to be able to take advantage of a possible exogenous adjustment of the inflation rate towards the long-run target, the central bank should not adjust interest rates as long as the actual inflation rate remains within some predetermined upper and lower limits around the target. By contrast, the flexible opportunistic approach puts forward that the possible long-run effects of monetary policy on potential output argue in favour of a policy loosening when the actual rate of inflation is below the target but above the predetermined lower bound. In a similar way, if the actual rate of inflation is above the target but below the predetermined upper bound, the flexible opportunistic approach states that monetary policy should moderately decrease the interest rate so as to take advantage of a possible increase in potential output, which would subsequently offset possible inflationary pressure.

Palley (2007) considers further real effects of monetary policy, besides the effects on potential output and growth, and argues that inflation targeting ‘biases decisions toward low inflation by obscuring the fact that policy also affects unemployment, real wages, and growth’ (Palley 2007: 61). Taking these real effects into account, Palley calls for setting the rate of interest so as to balance the possible advantages that may follow from accepting an increased inflation rate with the advantage of low inflation. In his model, when unemployment is sufficiently high, the only cost to monetary stimulus is increased inflation. The authorities in that case may reduce the rate of interest so that unemployment decreases towards Palley’s MURI (minimum unemployment rate of inflation, beyond which further inflation increases would have a counterproductive effect on employment⁴). However, a trade-off between higher wages and lower unemployment, versus higher inflation and lower growth, may arise as unemployment falls. This is because the economy, under certain conditions⁵, becomes profit-led (as the profit rate is negatively affected by unemployment).

This interesting feature of Palley’s model suggests that the rate of interest should not be adjusted according to a rigid predetermined rule, for the economy may become wage-led or profit-led depending on the level of unemployment, which affects the terms of the trade-off facing monetary policy.

Rules operating through the relation between interest rates and income distribution

Rules that aim at operating through the relation between interest rates and income distribution do not deny that the interest rate policy impacts the economy trajectory in

⁴ This is related to the backward-bending Phillips curve of the model: as real wage resistance increases as inflation increases, the ‘grease effect’ on employment, which is associated with the negative effect of inflation on real wages, erodes as inflation increases. See Palley (2007) for details.

⁵ If real wages do not rise too steeply as unemployment decreases, authorities may reach the MURI without encountering a growth trade-off; otherwise, there may be a trade-off between growth and pushing the unemployment rate to the MURI (Palley 2007: 74).

the short run, although they focus on the sharing of the product of economic growth in a long run perspective. They respond to the doubt that, owing to the many uncertainties in the transmission mechanism (Wray 2007, Bateman 2003), monetary policy could get much success in the 'activist' way of setting interest rates. It is therefore recommended that the interest rate is set so that undesirable distributive effects are avoided. The resulting 'Parking it' rules divide into short-term nominal rate and long-term real rate rules.

Let us first discuss the 'fair rate' rule, understood in the spirit of Pasinetti 1981 (see also Lavoie 1999), and the 'low real rate' proposed in Smithin 2007 (also Atesoglu & Smithin 2006, Hein & Stockhammer, 2007). Both are real rate based rules and share the normative purpose of providing economic policy with an 'explicit distributional objective'. The 'fair rate' rule consists in equalizing the real interest rate with the productivity growth rate, so that the rentiers' share in the national income is constant. Smithin's rule, on the other hand, holds to setting the real interest rate at a low level (a cheap money policy). The distribution effect here differs essentially because 'it does not [...] 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' (Smithin 2007: 116).

As Wray (2007: 120) also rejects "discretionary policy and doubt[s] the veracity of conventional views of central bank ability to achieve traditional goals such as robust growth, low inflation, or high employment", the 'Kansas city' rule recommends a constant zero short-term nominal rate⁶ which aims at returning 'to Keynes's call for low interest rates and euthanasia of the rentier'⁷.

Table 1 below summarizes some central features of the 'activist' and 'parking it' rules.

⁶ Camara Neto and Vernengo (2004) also advocate a low interest rate policy so as to make it easier for the government to implement a sound countercyclical fiscal policy.

⁷ According to Keynes, 'The social philosophy towards which the General Theory might lead' (Keynes 1936: 374-377) focuses on our ability to manage the rate of interest so as to raise the inducement to invest to the level where, given the aggregate propensity to consume (including the State), there is full employment. Insofar as the accumulation of capital decreases the marginal efficiency of capital, a decrease in the interest rate will be necessary in the long run. That is the essence of Keynes's prediction of the euthanasia of the rentier. According to his argument, the ideal policy is not to maintain the interest rate at a low fixed level unconditionally; it is to adjust the interest rate to the level that ensures full employment, given the marginal efficiency of capital and the aggregate propensity to consume. As these variables may change in response to changes in the rate (and the state) of capital accumulation, in productivity growth or in the government's propensity to consume, among other factors, it would be imprudent to adopt a rule that could not take account of such developments.

Table 1 – Post Keynesian interest rate rules and operating channels

Op^{ing}. channel	Income distribution (parking it rules)	Output gap (activist rules)
Interest rate of the rule		
Nominal interest rate	<i>Short-term nominal rate</i> (‘Kansas city rule’ – Wray)	<i>Long-term nominal rate</i> (‘Picks a quadruple’ – Palley ‘Neutral rate’ - Atesoglu)
Real interest rate	<i>Long-term real rate</i> (‘Fair rate’ – Pasinetti/Lavoie, Smithin's rule)	<i>Long-term real rate</i> (‘Flex. opport ^{tic} rule’ – Fontana & Palacio-Vera ⁸ , Sawyer)

The success of interest rate rules rests on the condition that the transmission mechanisms do work, which is often implicitly assumed in this literature. Let us examine the point.

Do central banks control long-term interest rates?

First of all, it is important to notice that the central bank does not control directly the long-term interest rates, which are decided by banks (as far as bank loans are considered) and by the markets conditions as far as private loans are considered. Of course, the central bank's refinancing policy influences both: when the central bank refinancing rate is increased, banks tend to pass the difference more or less on the various credit rates they offer, and as credits become more expansive, borrowers tend to get finance in the non bank sector, which transmits the long-term rate increase to that sector as well.

The central bank influence on the long-term rates however is not the only force which determines the level of interest rates, as stated in Keynes's liquidity preference theory. The point is that the shifting nature of the state of confidence has serious implications for the ability of monetary policy to control the long-term interest rate, especially in the case of interest rate reductions. In order to make this clear within the Post Keynesian approach to endogenous money, let us suppose that the monetary base is increased as a result of lower short-term interest rates, and that consequently, lower long-term bank rates boost the demand for credit. If, at the same time, liquidity preference increases, banks may be able to sell more credit without needing to reduce their interest rates, for non-bank loan (bond) rates tend in this case to rise in order to compensate for the increasing liquidity preference. Even if ‘the monetary authority were prepared to deal both ways on specified terms in debts of all maturities, and even more so if it were prepared to deal in debts of varying degree of risk’, there would be ‘limitations on the ability of the monetary authority to establish any given complex of

⁸ It is not clear whether the flexible opportunistic approach needs to be specified in terms of a *real* interest rate rule.

rates of interest for debts of different terms and risk...’ (Keynes 1936: 205, 207).⁹ Some of these limitations (see Keynes 1936: 207-208 for a detailed discussion) can be considered purely theoretical, insofar as they would only arise in extreme circumstances (virtually absolute liquidity preference when rates are considered too low; breakdown of stability in the rate of interest – owing to a flight from the currency or other financial crisis); but others apply in normal circumstances (the intermediate cost of bringing the borrower and the lender together, the allowance for risk required by the lender, including liquidity risk). Changes in liquidity preference may be triggered by the central bank policy itself. For example, let us suppose that the cut in the short-term rate starts to have some effect on the long-term rate. According to Keynes’s theory of interest, if the market belief is that the ‘conventional’ long-term rate is higher than the actual, it will expect a future increase, and agents will increase their liquidity-preference (this point is discussed further in section 3), thereby limiting or possibly preventing the reduction in the long-term rate.

Hence, the Post Keynesian endogenous money approach is right when it states that banks do deliver the amount of credit money that is demanded at the current interest rate structure. It is also correct to say that the rate of interest is exogenous in the sense that it does not result from a market clearing process. But this is not to say that the central bank has enough control as to set the rates at the level it decides, as suggested in Smithin (1994: 172-173), Lavoie (1996: 277, 1999: 2, 7) or recently in Rochon & Setterfield (2008: 6)¹⁰.

The point has obvious implications in the debate on interest rate rules. Whether long-term interest rates have to be adjusted with respect to the output-gap or according to some distributional objective do not close the debate; it remains to deal with the delicate question of how to get the desired interest rate adjustment. The problem is even more difficult when the policy rule involves real rates, for it is assumed in this case that, provided the central bank is able to adjust the long-term nominal rate, it can easily adjust the nominal rate to take account of the expected inflation rate. But this requires that the expected rate of inflation is independent of the nominal rate of interest, which is not self-evidently true. Even if authorities intend to anchor expectations by committing themselves to an inflation target, the official target would not anchor expectations if agents thought the nominal interest rate was inconsistent with the target. Thus, either the central bank anchors the expected inflation but cannot set the nominal rate independently, or the central bank sets the interest rate but cannot anchor the expected inflation rate independently. In either case, the central bank can hardly be said to control the real interest rate.

⁹ On monetary policy and debt management, see also Tily (2006).

¹⁰ According to Lavoie (1999: 2), ‘monetary authorities have the ultimate say on the convention’, but the author also pointed out that the spreads between the long-term rates and the overnight rate vary according to the liquidity preference of the commercial banks and the participants in the financial markets: ‘As Smithin (1996: 93) puts it, a role for Keynesian liquidity preference can be retained in this scenario, in that liquidity preference considerations may well periodically insert a wedge between those rates of interest which are more or less directly under the central bank control and rates elsewhere’ (Lavoie 1999: 2).

Conflicting objectives and short-term interest rate rule sustainability

If the rule is specified in terms of the policy instrument, or in terms of a rate strongly related to the policy instrument, as in the 'Kansas city rule', things go differently. Although a zero short-term nominal interest rate is highly recommendable in the current context of economic deflation (and indeed it is approximately implemented in many countries), and although the need for cheap money is going to hold for a while (the point is discussed further in section 3), Wray's 'parking it' rule feasibility might be questionable in others contexts. The question of feasibility of the rule here is not to be taken in the strict sense of the word, since the central bank can reasonably be said to have a good control over the short-term rates in general; it rather relies on both the relevance or sustainability of the rule and its effectiveness with respect to the 'euthanasia of the rentier'.

As for the effectiveness, the transmission between the short-term interbank interest rate and the long-term interest rates of the economy is subject to the limitation discussed above. Sustainability on the other hand requires that no prior objectives could normally lead authorities to renounce to implement the rule. But there are recurrent forces in our economics systems which could give raise to such prior objectives if the 'Kansas City' rule was maintained unconditionally. In the face of distributive tensions aimed for example at increasing the share of profits, or wages, or government revenues, a zero refinancing rate would allow for monetary accommodation of the resulting inflationary pressures¹¹. It is no doubt a good thing that the central bank accommodates the banks when they need to refinance themselves as a result of the credit-money they have created in response to viable activities, but when the demand for credit-money results from the kind of distributive inflationary pressures mentioned above, the central bank faces a dilemma: either it accommodates inflation, so that unemployment does not rise, or it fights the distributive conflict by means of higher interest and unemployment rates¹². Such a dilemma has no objective solution that could be picked out from economic theory, especially if inflationary pressures are strong and threaten confidence in the purchasing power of money. It is a political decision, a matter for the community as a whole.

The dilemma would vanish if, as recommended in Setterfield (2007, see also Hein & Stockhammer 2007, Setterfield & Lima 2008, Rochon & Setterfield 2007a,b), an incomes policy could harmonise the distribution of income. But even in that case, it is

¹¹ Hein and Stockhammer (2007:17) suggest that low real interest rates rather reduce inflationary pressures and that it is, on the contrary, high interest rates that fuel inflation, based on a cost push argument. Although such a mechanism must of course be considered, notice that there are many cost push channels which could feed distribution conflict even when interest rates are low, and that in this case, the monetary accommodation induced by the 'parking it' rule would certainly fuel inflation.

¹² This dilemma between what Davidson (2006) called "income policy of fear" and inflation shows that inflationary distributive tensions develop when the central bank allows for it, that is, when, under the central bank refinancing conditions, banks accommodate the increase in money demand resulting from the rising nominal prices, wages... In this sense, it can be said that monetary accommodation feeds inflation, but the primary cause is the income distribution conflict.

doubtful whether a zero-rate rule is really sustainable, for there are events which may prompt the central bank to adjust the overnight rate. For example, Wray (2007) points out the problem of exchange rate stabilization in fixed peg regimes, although his discussion then abstracts from the problem by assuming flexible exchange rates. Yet such an assumption does not really solve the problem, especially in the case of a large or medium country. Such a country indeed cannot really have a totally independent interest rate policy even in the case of a flexible exchange rate, for there are negative externalities, some of which pass through the exchange rate variations (as in the case of 'competitive depreciation'), which normally trigger interest rate policy responses in foreign countries, aimed at offsetting the externalities and related exchange rate variations¹³. Hence, anticipating the foreign reaction, the policy of the home country may be to set the interest rate in accordance with an 'acceptable' exchange rate, instead of unilaterally implementing a 'parking it' rule.

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Rochon & Setterfield (2007b) comparative evaluation of the three 'parking it' variants corroborates the idea that interest rate rules that perform well in certain contexts may have lower performances in others contexts. As in the Post Keynesian tradition the economy is not attracted towards any natural or predetermined position, it follows quite logically that the adequate monetary rule depends on the current position as compared with the ideal one (full employment, high growth rate, low interest rates...). It is an advantage that Post Keynesians offer a range of policies from which the adequate one can be picked up in accordance with the context. The Post Keynesian approach in this perspective shows some flexibility in comparison to the mainstream strict definition. Keeping this positive contribution in the background, we must however turn to the delicate point of setting long-term interest rates effectively in a context of shifting liquidity preference and money demand.

### 3. Coping with confidence

As argued in the previous section, although the long-term interest rate does not result from any market clearing process, it can nevertheless hardly be considered a pure exogenous variable that monetary authorities could put at their desired level. The reason is that the liquidity preference is likely to change in response to the central bank decisions about the refinancing rate of interest<sup>14</sup>. Keynes therefore considered the rate

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<sup>13</sup> This is not to say that the short-term nominal interest rate is the appropriate instrument for achieving a specific exchange rate target; it is rather to say that monetary authorities may hardly disregard the effects that short-term rates may have on the exchange rate (through their effects on long term rates, international capital flows, balance of payments...).

<sup>14</sup> The debate on whether the long-term interest rate is exogenously or endogenously determined is a reductionist one. It may make sense in the field of macroeconomic modeling, as conventions are necessarily considered exogenous for those models being tractable. But, obviously, such a simplification cause severe limitations to the models conclusions, insofar as the possible interactions between the interest rate policy and the market convention are not considered.

of interest a 'highly psychological phenomenon' which level cannot diverge durably from the market convention. Consequently, the essential problem for the monetary policy is to have some influence on the market convention; this is a precondition for being able to adjust the long-term rate of interest towards a desired level.

#### *The long-term interest rate as a convention*

The idea that the success of monetary policy never is ensured is a recurring theme of Keynes's *General Theory*, especially in chapter 13 (section 3), chapter 15 (section 2), and chapter 19 (section 2 & 3). First, remember 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.' (Keynes 1936: 203).

Therefore unemployment develops 'because people want the moon', that is, because the long-term equilibrium interest rate is not low enough when liquidity preference is too high, given the marginal efficiency of capital and the aggregate propensity to consume. According to this view, the challenge for monetary policy does not amount simply to put the short-term rate at some desired level; it is also necessary to have some influence on the convention so that the long-term interest rate adjusts in a way which allows for full employment. The task is difficult because the state of confidence is volatile and makes the liquidity preference and inducement to invest shifting variables, with the result that both the control over the long-term interest rate and the final effect on effective demand are erratic.

Also, things turn out especially delicate when it is considered that the short-term interest rate variations themselves may influence the state of confidence as well, thereby producing shifts in the macroeconomic relationships and making uncertainty endogenous to the monetary policy itself. Successful policies therefore have to 'take into account the unpredictable reactions of businessmen to those policies' (Bateman 2003: 82). Quoting Keynes again, we are led to the conclusion that '[...] 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  $M_2$  may tend to increase almost without limit in response to a reduction of  $r$  below a certain figure' (Keynes 1936: 203).

#### *Can monetary policy change the convention?*

A prudent monetary policy, on the other hand, can take 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' (Keynes 1936: 203-204).

Notice that if the central bank acts to decrease the long-term interest rate gradually, the expected reductions may have a negative impact on the marginal efficiency of capital<sup>15</sup> and if, on the other hand, the central bank attempts a sharp adjustment in the long-term interest rate, liquidity preference may rise and the marginal efficiency of capital may decrease<sup>16</sup>. Hence, there are conditions for the success of a monetary policy, the study of which is crucial to the design of monetary policy from the Post Keynesian point of view. The key element is that, at any time, the policy which is being implemented meets the market convention, so that pernicious effects on the liquidity preference and marginal efficiency of capital are avoided.

It turns out that, for a monetary policy to be understood and accepted, and thereby for the policy being effective, the variation in the long-term interest rate that authorities are seeking for must correspond to the public opinion expectation. This is to say that authorities should announce a long-term interest rate target in accordance with the normative objective the public opinion has debated on and agreed with. Logically, such a *conventional target* cannot be very distant from the current rate, for otherwise it could not meet the convention since it would require the short-term rate being adjusted immoderately (which would "strike the public"), or, if the short run is moved gradually, the long-term rate would decrease gradually (which would be harmful for the marginal efficiency of capital). Once the target is set, authorities should adjust the short-term rates they controls gradually, so that it does not look "experimental or easily liable to change...", and it allows for checking whether the policy is working well or not, if there are undesired outcomes..., so that authorities may adapt their strategy to the unforeseeable changing context. To summarize, authorities have to manage in such a way that the convention moves, which requires strong argumentation, confidence, and the short-term interest rates being adjusted gradually (but not slowly, so that the long-term interest rate adjusts rapidly to the new convention).

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<sup>15</sup> This is a second-order argument, where the expectation that future investment will be content with a lower yield (because of the expected falls in the future rate of interest) depresses the prospective yield of current investment (Keynes 1936: 143). The argument is also developed in relation to expected money-wage decreases in Keynes (1936: 263), where monetary policy also is considered.

<sup>16</sup> '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...' (Keynes 1936: 266-267).

These conditions are probably harder to get in times of financial crisis, because of the various factors that weaken the state of the confidence, which is the point we have to examine now.

*Why the 'state of confidence' has been harmed for a long time*

Prudential measures, even determined measures, are necessary conditions of the economic recovery, but they will not be sufficient. Several causes of concern will be lasting until the stock of bad debts has been massively reduced. Some causes should appear soon or are already working, while the others are likely to appear later, and could therefore weaken the state of confidence and the monetary policy effectiveness for a long time.

First, the current deflation is going to damage the public accounts both because of the expenditures that have been automatically and/or deliberately triggered by the economic slump and because of the decrease in government fiscal revenues. This will impact the state of confidence both directly (for increases in public debts make economic agents expect possible future taxes and/or inflationary pressures aimed at reducing the real value of the debt) and indirectly (for authorities capacity to support the economic activity will be harmed by a higher public debt).

Second, firms and households financial situation will also be severely affected, with the result that debts which were safe in the context before the financial crash will turn out bad debt in the depressed new context.

Third, the loss of confidence, in turn, tends to offset the ability of the central bank to get lower long-term interest rates and support the economic activity by means of low short rates (which, as far as it is expected, is a self enforcing force of the conventional view that long-term interest rates will remain at high levels).

Fourth, in order to preserve the financial system and to push banks to finance economic activities with moderate interest rates, authorities have pumped huge amounts of reserves into the system by means of very weak refinancing rates and conditions. When the deflation-process ends, the liquidity bumped into the market in exchange of the irrecoverable part of private debts should feed inflationary tensions (unless an improbable strong economic recovery take place rapidly and the induced money demand absorb the excess liquidity), for the money demand will be lowered when the speculative and precaution motives return towards the pre-crisis level (albeit possibly to a higher level) and the transaction motive adjusts to the depressed level of economic activity. As we can hardly imagine that the excess money will be allowed to feed a new speculative bubble in a hurry (but who really knows?), it is the price of real assets and durable goods, rather than financial assets, which is likely to be pushed up, before a possible generalized indexation effect.

The magnitude of the forthcoming inflationary pressures will depend on the capacity of authorities to withdraw the amount of reserve that has been pumped in exchange of private debts. The optimistic scenario being that bad debts become good debts thanks

to a general economic recovery which would improve substantially the private financial situations. In this case, meanwhile bad debts become safe, authorities (including central banks, governments and the ad hoc institutions that have been created in order to withdraw and recycle bad debts) can withdraw liquidities in exchange of the debts they hold (whereas withdrawing liquidities in exchange of bad debts would have negatives consequences on the banks balance sheets and the whole financial system).<sup>17</sup>

*To strike at the root of the problem*

Unfortunately, there is place for less optimistic views, with long-lasting financial imbalances, inflationary pressures and, possibly, magnified economic depression if price stability and public finance orthodoxy were given priority in the conduct of monetary and fiscal policy. How could the state of confidence be recovered in this second scenario? The design of an appropriate response requires first of all to strike at the root of the problem, which is the huge amounts of bad debts that weaken private and public accounts. The spontaneous, necessary and urgent response authorities have given has been to collectivize to the problem by means of money pumping, financial support, nationalizations and ad hoc institutions aimed at recycling bad debts. But as long as bad debts remain bad, a reflection about how the burden of the collectivized share of private losses is to be distributed among economic agents. There are two sources of collectivization in this respect: the one possibly initiated by the central banks acceptance of bad debts as collateral in refinancing operations, and the one initiated by the governments (direct or indirect) purchases of bad debts.

As regards the central banks, the collectivization process may consist in letting inflation going on, until the real value of debts has depreciated enough as to compensate for the value of the stock of irrecoverable debts (to the detriment of creditors). This solution would preserve economic activity and employment, while the alternative solution of a monetary policy aimed at stabilizing the price index would put the burden of losses collectivization on unemployed (and debtor, as interest rate would increase), until the stock of unrecoverable debts is recognized as losses<sup>18</sup>. Thus, in the absence of an alternative solution, central banks could hardly continue denying the inflation/unemployment trade-off.

As regards governments, the collectivization process may consist in increasing taxes so that fiscal revenues balance the government purchases of irrecoverable private debts. As government purchases of irrecoverable debts do not support economic activity at all, while taxes certainly reduce the private demand for goods and services, this solution would eventually put the burden on unemployed (and taxpayers). If on the other hand current taxes did not compensate totally for bad debts purchases, unemployment would raise to a lesser extent, and some inflationary pressures would

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<sup>17</sup> In this scenario, if the liquidities withdrawing process is not rapid enough as to offset for the decrease in liquidity preference, temporary inflationary pressures may develop until it is achieved.

<sup>18</sup> Inflation again appears to be dependent on whether the monetary policy accommodates a distributive conflict or not.

remain. Again, in the absence of an alternative solution, the inflation/unemployment trade-off would prevail (but redistributive effects would differ).

The process of collectivization of private losses itself, along these lines, would therefore induce fiscal and monetary responses which could hardly support economic activity. Even if inflation and budget deficit were the chosen solutions, it would only spare restrictive measures like tax and/or interest rates increases. Hence, although authorities will show aversion towards deliberate stimuli as long as the collectivization process is not achieved (that is, as long as inflationary pressures and weakened fiscal revenues persist), it could be advantageous to anticipate such policies for several reasons. First, expansionary policies are likely to produce strong expansionary effects in a depressed system, by stimulating the expected demand directly and by strengthening the 'state of confidence'. Second, the share of irrecoverable debts is likely to be much lower in a context of economic recovery, which could reduce considerably the source of the trouble, including inflation pressures. Third, strong economic recovery induces fiscal revenues which may help the government to socialize private losses without having to increase tax rate. In a context of low economic growth, a temporary deficit may eventually induce higher economic activity, lower public deficit and lower inflation.

In this perspective, even though monetary policy will be at disadvantage in the ground of economic stimulus as long as the state of confidence remains weakened, monetary accommodation should be welcomed as far as credit-money finances safe economic investments rather than doubtful speculative operations. The danger would rather be that a restricted credit policy put the burden of past mistakes on current safe economic projects. In addition, the more central banks will effectively support the economic activity, the less government deficits will need to be; or, put in a negative form, the less central banks will impede the recovery, the more government deficits will benefit to the economy.

#### 4. Conclusion

Although the Post Keynesian interest rules discussed in the paper may be feasible and sustainable in favourable circumstances, we have emphasized the shared difficulty of setting long-term interest rates effectively in a context of strong uncertainty and shifting liquidity preference. According to Keynes theory of the rate of interest, the problem amounts basically to manage to have some influence on the market convention; this is a precondition for being able to adjust the long-term rate of interest towards a desired level. It is a matter of confidence between markets and authorities<sup>19</sup>. As Keynes put forward, for a monetary policy to be effective, the variation in the long-term interest rate authorities are seeking for must correspond to the public-opinion's expectations. Authorities should therefore announce a long-term interest rate target in

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<sup>19</sup> See Le Héron (2006, 2007) for an analysis of Greenspan's strategy in terms of confidence versus credibility.

accordance with the normative objective the opinion has debated on and agreed with. We have argued that such a *conventional target* cannot be very distant from the current rate, and that authorities should adjust the short-term rates they control gradually but not slowly, so that it does not look "experimental or easily liable to change..." and so that authorities may adapt their strategy according to the observed effectiveness and unforeseeable changing context.

Moving the interest rate convention is harder to get in the context of the current crisis, because of the deleterious effects on private and public accounts that the innumerable amounts of bad debts have carried. To restore the 'state of confidence', authorities will have to get rid of the poison of potentially irrecoverable debts, without throwing the baby out with the bath water. In this perspective, there are strong arguments in favour of temporary large public deficits and accommodating monetary policies (which is not to say permanent large deficits and inflationary policies), even though long-term interest rate do not respond much to the short-term impulses of central banks. Fortunately, this is the kind of response authorities have implemented rather promptly around the world. As a matter of fact, those who are in favour of unconditional anti-inflation monetary policy and fiscal orthodoxy have become inaudible nowadays, for politicians, when they become Keynesian, turn wiser than the mainstream-economics scientists.

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