



## **(Post) Keynesian alternative to inflation targeting\***

**Angel Asensio**

**CEPN, University Paris 13**

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### Abstract

While the mainstream policies can not be surpassed in the enchanted ‘optimizable’ world, (Post) Keynesians have to resign themselves to manage without magic wand in the uncertain real world. The paper discusses the monetary rules proposed in the recent Post Keynesian literature. It argues that the long-term interest rate is too imperfectly controlled for such rules being feasible. Consequently, the quest for credibility is irrelevant, for it makes not much sense to wonder whether authorities will honour their commitment on an unfeasible ideal target. The right question is whether authorities pursue convincing objectives so as to move the conventional expectation of the future (and the related interest rate) towards full employment. It is a matter of confidence. The basic principles involved in such an approach to economic policy are discussed.

*Keywords:* interest rate rule, inflation targeting, Post Keynesian, monetary policy

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

## 1. Introduction

The Old ‘Keynesian’ economic policy 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 stable<sup>1</sup> and therefore optimizable) regimes, as stipulated within the new standard DSGE modelling (see Benassy 2007 for a recent stylized version).

Echoing a reassessment of monetary and fiscal policy by Arestis and Sawyer (2003a,b,c), a collective reflection has been recently engaged with the aim of conceiving a Post Keynesian alternative to the mainstream’s economic policy (*Journal of Post Keynesian Economics* 30(1), 2007, Fontana/Palacio Vera 2007, Setterfield 2007b, Setterfield/Lima 2008, 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. More ambitious proposals aim at designing an integrated monetary-fiscal policy mix (Arestis/Sawyer 2003b, Camara Neto/Vernengo 2004, Setterfield 2007a), sometimes including income policy (Hein/Stockhammer 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).

Though they contain stimulating ideas, these contributions however overlook the fact that the central bank control over the long run (and sometimes the short run) interest rate is very imperfect, because of the shifting nature of the liquidity preference and demand for money. There is some remaining ‘hydraulic Keynesianism’ in assuming that the central bank can freely set the rate of interest at a 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 must resign themselves to manage without magic wand over the uncertain and imperfectly malleable real world.

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

Section 2 first considers the (Post) Keynesian methodological roots so as to put forward both the inadequacy of the mainstream policy recommendations and the need for a (Post) Keynesian alternative. Section 3 discusses the mentioned alternative interest rules. It is argued that central bank control over the long-term interest rates is too uncertain, as well as the effects on effective demand, for such rules being really feasible. This section also draws some general principles aiming at improving the effectiveness of (Post) Keynesian macroeconomic policies.

## 2. General vs. special theory of equilibrium

### 2.1. The essence of (Post) Keynesian macroeconomics

A central point of Keynes's theory is that firms hire until the level beyond which the expected proceeds would be lower than the supply price of output, and that this employment level may or may not be the full employment level.

Of course, the mainstream also can explain market failures. General competitive equilibrium theorists have shown for long that imperfect competition and incomplete markets may cause dysfunctions. But, in this approach, such dysfunctions stem from structural defects, not from insufficient demand, at least in the long run. Solutions therefore hold in reinforcing competition and creating more markets, not in stimulating the demand for goods, except when it is possible to take advantage of some nominal stickiness so as to speed up the relative prices adjustment, by means of some temporary increase in the price of goods. 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 in the mainstream's view, for it would trigger a decrease in the rate of interest which simultaneously would clear 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 therefore freely decide to hire as long as the marginal product of labour exceeds the real factor cost. Note that in the monetary version of the theory, where the fourth market, namely the money market, is considered, the real balance or Pigou's effect and the so called 'Keynes effect' contribute to the support of aggregate demand as well.

Let us now consider how uncertainty interferes with the functioning of competitive markets. In the face of uncertainty, the interest rate decrease caused by a depressed aggregate demand ('Keynes's effect'), as well as the real balance effect, may meet various obstacles. First, if the money supply decreases along with the demand for money (as stated in the endogenous money literature), which depends on the banking system behaviour, the rate of interest remains unchanged. Second, 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). Furthermore, the worsening business climate could deter investment projects despite the (possible) decrease in the interest rate. Thus, without considering possible destabilizing forces (as the effects of changes in money-wages pointed out in *The General Theory*, chapter 19, or the 'Fisher effect'), it appears at this point of the discussion that stabilizing forces may fail.

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 and optimal level of investment either. The point is that, even in competitive markets, 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 operate in the long run so as to anchor the economy in a 'natural' position.

As it does not restrict the future to a predictable trajectory, Keynes's theory is basically more general than the mainstream's. In a flex-price competitive system, it 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 assumed optimal intertemporal choices<sup>2</sup>. 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. As for the effect of money-wages decreases that could be triggered by a situation of unemployment, chapter 19 of *The General Theory* clearly stated the reasons why "There is, therefore, no ground for the belief that a flexible wage policy is capable of maintaining a state of continuous full employment" (Keynes 1936: 267). These reasons hold in the fact that money-wages decreases are likely to have pernicious effects on the effective demand and are closely related to uncertainty as well.

## 2.2. Economic policy of the magic wand

Insofar as it is assumed that competitive forces drive the system to a 'natural' anchor, macroeconomic policy at best can help stabilizing the economy 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). As such governance principles work symbiotically within the mainstream approach (Dixit/Lambertini 2003), they stabilize the macroeconomic system perfectly.

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<sup>2</sup> Note that 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. But as far as uncertainty makes it impossible to have a complete market structure, gross substitution can not be defined completely. A supplementary condition, which comes out to restrict the definition of uncertainty, is therefore required to ensure stability: that the market structure is rich enough, though not complete, so that Arrow-Debreu properties hold. See Malinvaud (1993: 173).

The same rules, however, may produce severe drawbacks if they are implemented in a Keynesian economy (Asensio 2006, 2007a,b, Atesoglu/Smithin 2006, Palley 2007, Sawyer 2007, Setterfield/Lima 2008). As Asensio pointed out, in the absence of a spontaneous return towards 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 full employment (provided the central bank effectively controls the long term interest rate). That situation 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 which the mainstream uses to refer to as hysteresis<sup>3</sup>: 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, wages pressure relative to productivity gains, fiscal taxes to be paid by firms<sup>4</sup>). 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. Indeed, higher interest rates increase unemployment and reduce the workers capability to obtain wages increases in proportion to the increase in the price index, which releases inflationary pressures. Higher interest rates and lower economic activity could temper other sources of cost push inflation as well (the control of the long-term 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 (Post) 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)<sup>5</sup>.

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

<sup>4</sup> Fiscal taxes paid by firms influence the unit cost, given the mark up and unit labour cost, which conflicts firms interests. Fiscal taxes paid by workers also may induce wage pressures aiming at preserving the purchasing power. In an open economy, the prices of oil and imported intermediate goods should also be taken into account as an international distributive conflict. Notice that even pure inflation, which results of an excessive money supply, arises because of a distributive conflict: the attempt of authorities to get some real wealth from the private sector (or, equivalently, to reduce the real public debt) in exchange of money.

<sup>5</sup> See Palley (1997, 2001) for an empirical discussion.

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

Post Keynesian alternatives to inflation targeting have been made recently in two directions: ‘parking it’ rules and ‘activist rules’ (Rochon/Setterfield 2007a).

#### 3.1. ‘Parking it’ and ‘activist’ monetary rules

‘Parking it’ rules actually are a response to both the idea that ‘inflation is first and foremost the result of conflict over the distribution of income’ (Rochon/Setterfield 2007b), so that monetary policy is not the appropriate tool to fight inflation, and the idea that the wisdom of active monetary policy is questionable owing to many transmission obstacles (Wray 2007, Bateman 2003). ‘Parking it’ rules therefore are to be understood as full policy mix proposals which are based on the following principles:

- fiscal policy works countercyclically
- income policy aims at fighting inflation;
- monetary policy parks the interest rate with an explicit distributional objective;

#### *Real interest rate based 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’ (Smithin 2007: 116).

Both rules aim at setting the real rate at a determined level, but it is not discussed how a central bank could 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 or disguised monetary version); it is the difference between the price of liquidity (the long-term nominal rate) and the expected inflation rate. How could a central bank go about things with only one instrument (the short-term interest rate)? Even assuming that an inflation target allows for controlling the expected inflation rate, it is not ensured at all that the central bank could set the long-term interest rate at any desired level independently of the expected inflation rate, so as to set the real rate at the desired level. There are two possible obstacles: first, the central bank control over the long-term interest rate is questionable, and second, the expected inflation rate is not independent of the nominal rate of interest, which implies that an official target would not anchor expectations if the nominal interest rate differed from the one agents



think it would reach the target. Thus, either the central bank anchors the expected inflation, but it can not set the nominal rate independently, or the central bank sets the interest rate, but it can not anchor the expected inflation rate independently. In both cases, the central bank hardly controls the real interest rate.

#### *Nominal interest rate rules*

On the other hand, as the short-term nominal interest rate is very closely related to the central bank's overnight rate, the central bank control over the short-term inter-bank nominal rate is hardly questionable. The 'Kansas city rule' call for the 'euthanasia of the rentier' by means of a zero short-term nominal rate (Wray 2007)<sup>6</sup>. Lets us first consider Keynes's argument on the issue. The social philosophy towards which the General Theory might lead (chapter 24, section 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 fixed low level; it 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. As these variables may change according to the rate (and the state) of capital 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 too low to avoid inflation, while possibly too high to allow for full employment.

The 'Kansas city' version of the short-term nominal rate parking rule 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<sup>7</sup>, 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 in money. It is a decision which belongs to the community.

The dilemma could vanish if, as recommended in Setterfield (2007b, see also Setterfield/Lima 2008, Rochon/Setterfield 2007a,b), the income policy could pacify

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<sup>6</sup> 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.

<sup>7</sup> As suggested in section 2.2, inflationary distributive tensions develop provided the central bank allows them, that is, when, under the CB refinancing conditions, banks accommodate a money demand which is inflated by inflationary expectations (of the user cost for ex.), beside investment in productive activities. In this case, the additional money does not feed the demand for commodities or capital-goods. It only feeds user cost inflation.

the distribution of income. It is however questionable whether a zero-rate rule is really feasible, besides being not so easy to pacify all distributive conflicts, for there are some events which may force the central bank to adjust the overnight rate. Wray (2007) notably invokes the case for exchange rate stabilisation in fixed peg regimes, though its discussion then overlooks the problem by assuming flexible exchange rate. But such an assumption does not really discard the problem either, notably in the case of a large or medium country. Such a country indeed can not really have an independent interest rate policy for there are negative externalities, some of which pass through the exchange rate, which normally trigger interest rate policy responses in foreign countries, aiming at cancelling the externalities (and exchange rate variations)... Hence, anticipating the foreign reactions, the former country may be conducted to set the interest rate in accordance with an 'acceptable' exchange rate, instead of implementing a 'parking it' rule blindly.

A zero short run interest rate is also inadequate when easy money obviously does not finance sound economic activities but inflationary distributive tensions. The stronger the inflationary pressures that could result from a low short-term rate are, the less feasible the low rate policy is. In the case of the Subprime episode, the necessary accommodating policy of the U.S.A during the crisis is likely to have generated or reinforced inflationary expectations, which are prompting the Fed to increase its rate.

Advocates of the 'parking it' approach have prudently suggested that the central bank could deviate from the rule in 'extreme' circumstances (Rochon/Setterfield 2007b, Smithin 2007). Note however that the type of situations which could justify such deviations may hardly be considered 'extreme' circumstances, and therefore the theoretical examination of the policy which is adequate in these situations should be part of the (Post) Keynesian alternative to inflation targeting.

#### *'Activist' rules*

According to Palley (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' (Palley 2007: 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 effects of monetary policy (see also Orphanides/Wilcox 1996, Palacio-Vera 2002, Fontana/Palacio-Vera 2005, Sawyer 2007). The original proposal for 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. The flexible



opportunistic approach may be does not need to be specified in terms of real interest rate rule, but ‘activist’ rules nevertheless rest on the questionable assumption that the interest rate can easily be adjusted so as to reach the ideal target. The point is that the shifting nature of the state of confidence has heavy implications on the monetary policy capacity of controlling the long-term interest rate, especially if interest rates decreases are considered. When the monetary base is increased through lower short term interest rates, lower long-term bank rates in principle boost the demand for credit, but if, in the same time, the liquidity preference increases, banks may be 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 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", it would be "limitations on the ability of the monetary authority to establish any given complex of rates of interest for debts of different terms and risk..." (Keynes 1936: 205, 207).<sup>8</sup> Some of these limitations (see Keynes 1936: 207-208 for a detailed discussion) can be considered theoretical, as far 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 flight from the currency or financial crisis); but others work in normal circumstances (intermediate cost of bringing the borrower and the lender together, allowance for risk required by the lender, that is, liquidity preference). Changes in the liquidity preference may be triggered by the central bank policy, according to the general context. Indeed, let us suppose that the cut in the short-term rate starts having some effect on the long-term rate. According to Keynes’s theory of interest, if the market believes the ‘conventional’ long rate is higher, it will expect a future increase, and agents will prefer increase their portfolio liquidity (this point is discussed further in section 3.2), thereby limiting or possibly inhibiting the long term rate decrease. 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.

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 objectives<sup>9</sup>, though they can express intentions. The future instruments responses can not be summarized in a simple or even complex rule, for the future effects of these responses are simply unpredictable.

### 3.2. Towards a (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

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<sup>8</sup> On monetary policy and debt management, see also Tily (2006).

<sup>9</sup> The term ‘discretionary’ is taken as opposed to a commitment on some automatic rule. Hence, our argument actually rejoins Bateman (2003) observation that Keynes rejected the hold ‘hydraulic’ acceptance of discretionary policies (not discretionary policies in general).

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 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 their questionable feasibility, the (Post) Keynesian proposed interest-rules have not really won the argument against the mainstream’s inflation targeting rule. (Post) Keynesian 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.’ (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 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 that the long-term 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 understanding of the term, with the result that both the control over the long-term interest rates and the final effect on effective demand may be disturbed (see Figure 1).

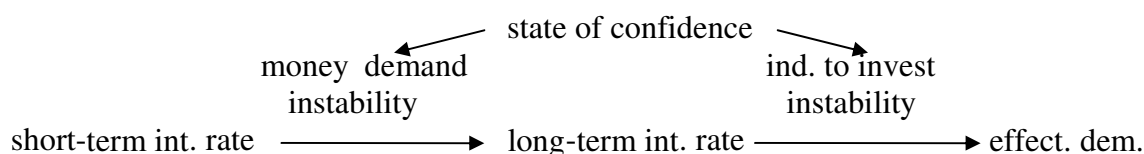


Figure 1

The policy problem all the more is complex as short-term interest rate variations may interfere with the state of confidence, thereby provoking shifts in the macroeconomic relations, and making uncertainty endogenous to the monetary policy itself (see Figure 2).

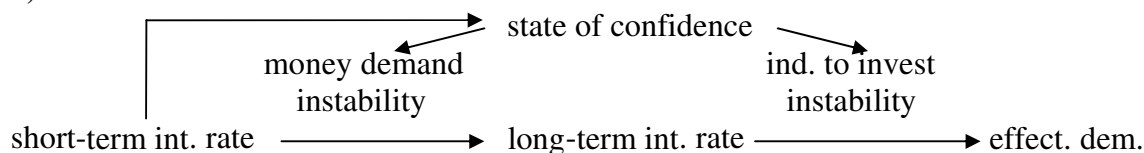


Figure 2

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’ (Bateman 2003: 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  $M_2$  may tend to increase almost without limit in response to a reduction of  $r$  below a certain figure’ (Keynes 1936: chapter 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’ (Keynes 1936: 203-304).

But the way may be narrow. If the central bank behaves so as to decrease gradually the long-term 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-term interest rate immoderately, the liquidity preference may raise (and the marginal efficiency of capital may decrease)<sup>10</sup>. 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

As the mainstream basically provides the optimal economic policy when possible, (Post) Keynesians could hardly produce a fresh alternative to the mainstream’s inflation targeting if economic systems were ‘optimizable’. But, as the world is uncertain, there is room for a genuine (Post) Keynesian economic policy with superior performance in the real world.

The recent (Post) Keynesian reflection on economic policy produced different types of alternatives to inflation targeting. Although they are not mutually consistent, it has been possible to identify consensual views about the social philosophy behind the theoretical debate on economic policy, about the normative role of monetary policy in

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<sup>10</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).

the ground of income distribution, and about the monetary policy effects on the long run economic growth.

In spite of these positive contributions to the debate, the proposed alternative rules come up against feasibility, especially as concerns the 'parking it' or 'activist' rule based on the real rate. The zero short-term interest rate seems to be feasible technically, but it can hardly be recommended as a rule, for it would produce undesirable effects. A generic difficulty is that central banks do not control perfectly the long-term rate of interest rate, with the result that they may be unable to implement any long-term interest rate rule. This is a consequence of the demand for money instability caused by strong uncertainty.

The (Post) Keynesian challenge therefore 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 confidence<sup>11</sup>. Obviously, this is a harder task, compared with the invariability of simple rules, all the more so as 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 or optimal rule of doing it.

The success of such policies rests on their capacity to move the interest rate convention in accordance with a feasible employment target. The mainstream concept of credibility is irrelevant in such a world. In the face of uncertainty, it makes little sense to wonder whether authorities will or will not honour their commitment to an unfeasible ideal target. The question is whether the authorities pursue feasible objectives that have been pragmatically defined in accordance with the context, and whether these objectives have been widely understood and accepted. It is a matter of confidence, rather than credibility<sup>12</sup>. Driving cautiously the interest rate convention as close as possible to the full employment level in an uncertain world is quite different from stabilizing the economy round the 'natural' position in a fundamentally stable system. Definitely, hydraulic policy recipes have changed sides.

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<sup>11</sup> A formal first attempt is suggested in Asensio (2006, 2007a).

<sup>12</sup> See Le Héron (2006, 2007) for an analysis of Greenspan's strategy in terms of confidence versus credibility.

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