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The state of Post Keynesian interest rate policy: where are we and where are we going?

The history of Post Keynesian monetary and interest rate theory and policy has always been a “long struggle” of defining itself against neoclassical and mainstream theory, while simultaneously trying to contribute positively to the development of a genuine Post Keynesian alternative. Indeed, many Post Keynesians claim that we are united primarily in our opposition to neoclassical theory. For instance, Eichner once claimed that “it is less controversial to say what post-Keynesian theory is not than to say what it is. Post-Keynesian theory is not neoclassical theory” (1985, p. 51). Arestis writes similarly that “post-Keynesians tend to define their program in a negative way as a reaction to neo-classical economics” (1990, p. 222), whereas Sawyer stated that “the unifying feature of post-Keynesians is the dislike of neoclassical economics” (1988, p. 1).

To be sure, this intellectual tension between policy reaction and proaction is a permanent feature of Post Keynesian theory, and of monetary theory in particular. It is present even today as Post Keynesians react to the rise of new consensus macroeconomics (NCM) and the monetary policy based on versions of the Taylor rule.

Yet Post Keynesians’ tendency toward reaction must not be viewed solely in a negative light. First, it is a normal component of any research program, and characterizes any school of thought, mainstream and heterodox alike. Second, although it is true that “much of the Post Keynesian literature of the last two decades . . . is devoted primarily to criticizing destructively the analytical foundations of neoclassical theory” (Davidson, 1990–91, p. 298), we need to remember that reaction is often the spark of some innovative ideas and, in this sense, serves a purpose and plays “an important function”: This “negativity” has always

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generated some positive benefits that we too often forget. As early Post Keynesians reacted to the rise of monetarism, it has allowed us to lay the theoretical foundation of money’s endogeneity, which, in turn, is at least partially conceded by some economists in the mainstream of the profession today. Now, in reaction to the rise of NCM, it has allowed Post Keynesians to considerably develop the policy side of central banking, which was largely underdeveloped. In the past few years, there has been a rather large amount of published articles on this topic (for just a sample of these, see a forthcoming symposium in the *Review of Political Economy*, with articles by Gnos and Rochon, 2007; Kriesler and Lavoie, 2007; and Setterfield, 2007; see also Smithin, 2004).

And, although it is difficult to truly point to an exact date or publication for the beginning of a Post Keynesian alternative to the mainstream tradition, in hindsight, the mid- to late 1950s was a particularly fruitful period, showing promising signs and a clear direction: we can see some of the key arguments, albeit still underdeveloped in many respects, slowly taking form. For instance, Joan Robinson published *The Accumulation of Capital* (1956), which pays considerable attention to credit, money, and banking, and Nicholas Kaldor and Richard Kahn were busy with the Radcliffe Commission (Kahn, 1972; Kaldor, 1958). On another level, Minsky (1957a; 1957b) was publishing some important articles, which later influenced a number of Post Keynesians—in particular, structuralists. A few years later, Rousseas (1960) presented an interesting article on the variability of the velocity of money.

Since then, the Post Keynesian position on monetary policy developed slowly into what it is today. Now there is a large consensus on the fundamental elements of horizontalism: the endogeneity of money in relation to the financial needs of production; the unconstrained ability of banks to meet the financing needs of private agents as long as they are deemed creditworthy by the banks; the exogeneity of the rate of interest, dictated by policies of the central bank; and the necessity of central banks to meet the needs of the banking system in order to maintain interest rates at their desired level and to guarantee the stability of the banking system in general.

The development of a Post Keynesian theory of endogenous money can be seen in the following four stages. In the first stage, as described above, Post Keynesians largely reacted and responded to Friedman and monetarism. As such, the focus was, in this sense, “negative,” and early Post Keynesians (for instance, see Kaldor, 1958, and also the Radcliffe Report (1959) were primarily interested in showing that the money–inflation link was not entirely stable given the
variability of the velocity of money resulting from financial innovations: “Changes in the money supply do not exert any direct influence on the level of monetary demand for goods and services as such, but only through the consequential changes in interest rates which are induced by them” (Kaldor, 1958, p. 134). Many Post Keynesians in this period still accepted the money–inflation link, but argued that it was unreliable for policy. As Moore writes: Kaldor’s “implicit acceptance of $M$ to $Y$ causality is revealed by his repeated attempts in 1958 to demonstrate the weakness of the $M$ to $Y$ linkage” (1991, p. 237). As a result, monetarist policies were misguided. As such, the focus was not really on putting forth a detailed account of the monetary process and money’s endogeneity, although it is certainly possible to piece together such a story based on a selective reading and interpretation. Perhaps we can interpret this period as a “strategic” period in order to get a “better hearing.” For whatever reason, the seeds of endogenous money were certainly present.¹

The second stage would come some years later with Kaldor’s (1970; 1982) and Davidson’s (1972) important contributions to the endogeneity of money. Kaldor introduces clearly the concept of horizontalism, whereas Davidson develops the main ideas about the role of uncertainty and the importance of money and the finance motive in the income-generating process. These represented important first steps toward a positive contribution by Post Keynesians who, for obvious reasons, have always been interested, first and foremost, in fiscal policy. In a rudimentary way, Kaldor was arguing that the central bank had little control over the growth of the money supply and that, as such, interest rates were the control variable. Similarly, Davidson was arguing that the supply of money was dependent, not independent, on its demand. As a result, the central bank would stand ready to supply the necessary supply of high-powered money to the banking system.

The third stage came with the famous (or infamous?) horizontalist–structuralist debates that were essentially concerned with hammering out the details left unanswered by Kaldor (1970), and pushing on with further developments, and was initiated with Moore’s (1988) seminal book. Although two camps clearly emerged, there was nonetheless some underlying agreement over a whole range of issues. Even though there are certainly some unresolved issues (see the forthcoming edited book

¹ This conclusion is also reached by King, who argues that, at least in the case of Kaldor, although always an opponent of monetarism, “monetary endogeneity was never the central question for Kaldor, whose critique of the Quantity Theory was always much broader than this” (2008).
by Moore and Rochon, 2008, for some recent development), overall, Post Keynesians agree on the fundamental role of the central bank in setting interest rates and supplying needed liquidity to the banking system.

The fourth and current stage of endogenous money theory is a fascinating development of horizontalism, and how this might be applied in practical policy terms, in a world with no natural rate of interest. With much agreement over the fundamental tenets of horizontalism and endogenous money, there are a few details left unresolved, and these form much of the focus of this issue of the *Journal of Post Keynesian Economics*. In a way, the rise of the NCM has forced Post Keynesians to deal with issues surrounding the natural rate of interest. Indeed, even though we always assumed it did not exist, Post Keynesians never really asked the obvious question: What do we replace it with?

The papers in this symposium aim at ushering in this fourth stage. As such, two overall questions are the focus of this symposium. First, if agreeing on the exogeneity of interest rates, how should interest rate policy be set? Although Post Keynesians generally reject the (direct) link between interest rates and inflation, should the central bank advocate an activist stance, thereby using interest rates in a countercyclical manner with the hope of regulating output or unemployment? This is certainly one possibility, defended by some Post Keynesians—notably by Fontana (2007, this issue), Moore (1988), and Palley (2007, this issue). For many years, Post Keynesians have advocated such a discretion-based, activist approach to interest rate policy. As Smithin (2007, this issue) reminds us, Post Keynesians are activist by nature, and the idea of an activist central bank regulating business cycles seems a natural extension of Post Keynesian theory. In fact, for monetary activist Post Keynesians, the emergence of the “new consensus” on monetary policy is considered a positive move forward by the mainstream profession and, as such, should be applauded. After all, in the NCM, interest rates are exogenous and money is endogenized à la Wicksell (although not for the same reasons as Post Keynesians; see Monvoisin and Rochon, 2006, and Rochon and Setterfield, 2007a, this issue). As Wray observes, “Some Post Keynesians applaud the Fed’s move to the NCM, although they might disagree with the ultimate goals—preferring low unemployment over low inflation (Le Heron and Carre 2006). Hence, many critics urge the Fed to adopt a somewhat more relaxed monetary policy stance. Still, they do not question the wisdom of active policy” (2007, this issue, p. 137).

On the other hand, some Post Keynesians take Wray’s warning to heart and precisely “question the wisdom of active” monetary policy. They believe that this approach seems at odds with central bank performance
where persistent changes in interest rates have done more harm than good. Embedded within an otherwise austere framework, central banks have pursued overzealous policies of high interest rates in an effort to stem inflation and inflationary pressures. For these Post Keynesians, such as Lavoie, Seccareccia, Smithin, and Wray (and me), Keynes’s “euthanasia of the rentier” is certainly at the forefront of this approach. On this view, interest rates should be set low and changes made rather infrequently. Fiscal policy is then relied on to do the rest. They do not reject central bank activism, but for these Post Keynesians, the activism of the central bank is seen as operating on another level—supplying and managing reserves on a daily basis in order to maintain interest rates on target and overseeing the stability of the banking system.

Yet an interesting question arises: Should the central bank set nominal or real interest rates? “The question for Post Keynesians is whether the interest rate target should be nominal or real” (Wray, this issue, p. 124). On this issue, there is much disagreement, as the papers in this symposium will show. And although the current consensus among Post Keynesians is in favor of low interest rates (cheap money policy), at issue is the interpretation of Keynes’s euthanasia of the rentier. Recall that, for Keynes, there were no credible reasons for high interest rate policies, having disproved the “necessity of providing a sufficient inducement to save” (1973, p. 374). Rather, investment determined saving, and to promote greater investment, it was necessary to keep interest rates low. Now, we can reject Keynes’s logic on the interest rate–investment link and his contentious use of a marginal efficiency of capital schedule, but we can still promote the necessity of low interest rates for other reasons, such as for income distribution.

But how do we interpret Keynes’s policy of the “euthanasia of the cumulative oppressive power” of the rentier class (ibid., p. 376)? Was he speaking in terms of real or nominal rates? Are “bonuses” to the “functionless investor” paid in real or nominal terms? Alas, these are not easy questions to answer, and both Smithin and Wray, in this symposium, provide ammunition for both positions.

Structure of the symposium

The papers contained in this symposium share some similarities. Chief among these is the notion that, contrary to proponents of the new consensus, monetary policy alone cannot achieve full employment and price stability. Rather, fiscal policy has an important role to play in promoting full employment and price stability.
Each contribution in this symposium aims to expand discussion over Post Keynesian interest rate policy. The first paper, by Louis-Philippe Rochon and Mark Setterfield, sets the tone for the symposium, and sets out the key arguments in this debate. In examining Post Keynesian alternatives to the Taylor rule, the authors identify two distinctive approaches within Post Keynesian theory, which they label the *activist* and the *parking-it* rules. Whereas the first approach advocates the use of nominal (or real) interest rates as a tool of aggregate demand fine-tuning, the second approach moves away from reaction functions, claiming that monetary policy has become too dominant in economic discourse. The authors propose, instead, an interest rate policy whereby the central bank “parks” the interest rate (real or nominal) according to a specific rule. Three possible parking rules are examined—the Smithin rule, the Kansas City rule, and the Pasinetti fair rate rule. The paper then explores the macroeconomic consequences of a genuine Post Keynesian alternative to new consensus monetary policy along the lines of the fair rate rule.

The next two papers fall within the “activist” approach to monetary policy. In his contribution, Giuseppe Fontana argues that one of the greatest achievements of the modern mainstream approach to monetary policy is the rejection of the old quantity-theoretic framework, and the acceptance of the Wicksellian two-interest-rate analysis, which closely reflects the actual behavior of central banks around the world. Starting with a presentation of Wicksell’s two-interest-rate analysis and its policy implications, Fontana evaluates these recent developments in monetary thought and monetary policy in terms of the acceptance or rejection of the axiom of neutrality of money and monetary policy.

In his contribution, Thomas I. Palley argues that there is widespread agreement that monetary policy matters, but there is disagreement about how policy should be conducted. Behind this disagreement lies differences in theoretical understandings. The paper contrasts the new classical, neo-Keynesian, and Post Keynesian frameworks, thereby emphasizing their respective differences. In the new classical model, for instance, policy affects only long-run inflation, whereas in the neo-Keynesian model, policy affects inflation, and also unemployment and real wages in the short run. Finally, in the Post Keynesian model, policy also affects growth. Given this analysis, the author concludes that inflation targeting 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. The author also discusses, though briefly, the shortcomings with the Kansas City, Smithin, and Pasinetti rules.
The remaining three papers in this symposium explore, in their own way, the “parking-it” rules.

In their contribution, Wynne Godley and Marc Lavoie use a simple stock-flow consistent (SFC) model in order to examine various contentions regarding fiscal and monetary policy. It follows from the model that if the fiscal stance is not set in the appropriate fashion—that is, at a well-defined level and growth rate—then full employment and low inflation will not be achieved in a sustainable way. The authors also show that fiscal policy on its own could achieve both full employment and a target rate of inflation. Finally, they arrive at two unconventional conclusions: (1) an economy (described within an SFC framework) with a real rate of interest net of taxes that exceeds the real growth rate will not generate explosive interest flows, even when the government is not targeting primary surpluses, and (2) that it cannot be assumed that a debtor country requires a trade surplus if interest payments on debt are not to explode.

In his contribution, John Smithin carefully examines and compares four alternative types of guidelines for monetary policy: (1) stabilizing the real policy rate of interest at a “low” level (the Smithin rule), (2) pegging the nominal policy rate (the Kansas City rule), (3) employing a standard monetary policy reaction function to target inflation (the Taylor rule), and (4) invoking the notion of a “fair” rate of interest (the Pasinetti/fair rate rule). Not surprisingly, the author concludes that the first of these alternatives is the best option for monetary policy, and the most consistent with the traditional Keynesian advocacy of cheap money.

In his contribution, L. Randall Wray addresses three monetary policy issues—policy independence, choice of targets, and rules versus discretion. According to the NMC, the central bank needs policy independence to build credibility, the operating target is the overnight interbank lending rate, and the ultimate goal is price stability. An alternative view is presented, arguing that an effective central bank cannot be independent as conventionally defined, where effectiveness is indicated by the ability to hit an overnight nominal interest rate target. Discretionary policy and conventional views of central bank ability to achieve traditional goals such as robust growth, low inflation, or high employment are rejected. Thus, the paper returns to Keynes’s call for low interest rates and euthanasia of the rentier.

There is still some work to be done in this new area of research. In particular, two questions emerge. First, which approach is best for macroeconomic stability—the activist or parking-it approach? This could be
done empirically quite nicely. Second, if the parking-it rules are preferred for overall macroeconomic performance, then which rule is preferred? On this last question, Rochon and Setterfield (2007b) do precisely this and offer a comparative exercise of the three parking-it rules. We aim at comparing each rule and showing which rule “does best” in terms of its capacity to promote desirable (high growth, low inflation) macroeconomic outcomes and to assist the growth and inflation targeting objectives of the policy authorities. We find that together with distributional effects of the three different rules, their analysis should assist Post Keynesians in the process of choosing among these rules and thus answering the “Smithin question” (Smithin, 1994) about the appropriate benchmark rate of interest in a Post Keynesian economy in which there is no natural rate of interest. We hope other Post Keynesians will soon follow suit and expand in this new area of research.

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