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The New Consensus and Post-Keynesian Interest Rate Policy

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ABSTRACT This paper outlines the fundamental arguments of the New Consensus, critiques it from a Post-Keynesian perspective, and offers a Post-Keynesian alternative to the Taylor Rule. While Post-Keynesian economics provides a theory of endogenous money with exogenous interest rates, it has no clear description of a central bank reaction function. We attempt to remedy this oversight by identifying some of the difficulties attached to developing a Post-Keynesian reaction function, and suggesting an approach to the setting of interest rates that is more consistent than the Taylor Rule with Keynes's General Theory.

1. Introduction

In the last few years, a New Consensus has emerged among central bank policymakers and among a growing number of economists who see in its simple rule a realistic representation of central bank policy. Recently however, a number of Post-Keynesians have taken a closer look at the theoretical foundations and policy implications of this New Consensus and found nothing new. Rather, they see only the newest incarnation of mainstream theory.1

Resting on an interest rate rule (the Taylor Rule) and an inflation targeting policy, the New Consensus appears to resemble Post-Keynesian theory in several respects. It is true that both approaches advocate an exogenous interest rate set by the central bank and endogenous money; but the genuine similarities stop there. When subjected to scrutiny, the surface similarities are revealed to be rooted in very different theoretical approaches. As Palley (2006, p. 80) writes, the New Consensus ‘is a conception of endogeneity that is fundamentally different from the Post Keynesian conception, which is rooted in the
credit nature of money.’ Palley calls the New Consensus approach ‘central bank endogeneity,’ which is close to what Rochon & Rossi (2008) call the ‘evolutionary’ approach. Palley (2006, p. 79) rightly asks, ‘what distinguishes the Post-Keynesian justification of interest rate operating procedures from a mainstream neo-classical justification?’ We argue below that the Post-Keynesian theory of endogenous money derives from the idea that money originates in debt relationships among various agents in the context of a monetary economy of production. In the New Consensus however, endogenous money is the result of the instability and unreliability of the demand for money. The central bank simply chooses to allow money to be endogenous, hence Palley’s apt reference to ‘central bank endogeneity’.

In Section 2, we describe the fundamental arguments of the New Consensus. Section 3 offers some criticism from a Post-Keynesian perspective. Sections 4 and 5 offer some Post-Keynesian alternatives to the Taylor Rule. It has often been suggested that while Post-Keynesians have a theory of endogenous money with exogenous interest rates, there is no clear description of a central bank reaction function. Sections 4 and 5 address this oversight by offering several Post-Keynesian solutions. In those sections we point to some difficulties in developing a Post-Keynesian reaction function, and suggest an alternative that is more consistent with the perspective of Keynes’s General Theory.

2. The New Consensus

The emergence of a New Consensus in macroeconomics has, in many ways, redefined the mainstream’s approach to monetary policy, and has generated a large consensus on the specific role of the central bank. The New Consensus has two key features, each carrying important implications for macroeconomic policy. The first feature is an interest rate rule, the Taylor Rule, which emphasizes the exogenous nature of the short-run (real) interest rate (see Taylor, 1993, 2000). The second is an inflation targeting policy where the central bank aims to keep inflation at a given level or within a given range. The central-bank-controlled interest rate is, in a sense, the intermediate target, while the inflation rate is the ultimate objective of monetary policy. Although the Taylor Rule may appear to represent a departure from the mainstream approach to monetary theory and policy, which has traditionally emphasized the ability of central banks to target the rate of growth of the money supply, we shall see below that the inclusion of an inflation target in fact serves to re-establish the conclusions and underlying hypotheses of the ‘old (neoclassical) consensus.’

The New Consensus is essentially a continuation of the ideas advocated in recent years by proponents of the New Keynesian school and, in many respects, by the Neoclassical Synthesis Keynesians before them. In a sense, New Consensus macroeconomists are ‘second-generation’ New Keynesians. We can find in the New Keynesian literature of the late 1980s and early 1990s glimpses of the current New Consensus views (see for instance Blinder, 1987; Bernanke & Blinder, 1992; for a review of these earlier New Keynesian views, see also Rochon, 1999). Like their first-generation counterparts, adherents of the New Consensus emphasize the importance of the credit channel
(balance sheet effect) in the monetary transmission mechanism, although they target interest rates rather than the money supply. Some key elements of the New Keynesian literature, like credit rationing and asymmetric information, have been dropped, or at any rate have yet to be integrated within a fully coherent model. But the New Keynesian model does not stand or fall on asymmetric information or credit rationing. Rather, its core element is the credit channel, that is, the notion that monetary policy, irrespective of whether this means control of the money supply or of the rate of interest, affects output through the supply of bank credit (see Kashyap & Stein, 1994; Bernanke, 1993; Gertler, 1988; Rochon, 1999).

2.1. The Taylor Rule

In a 1993 paper, John Taylor proposed that central banks adopt a ‘leaning-against-the-wind’ interest rate rule in which they set the short-run nominal interest rate, yet target the short-run real interest rate. The central bank would change the real rate whenever current output diverges from its long-run natural level (the output gap), or when current inflation diverges from the central bank’s target inflation rate (the inflation gap).

The simplest way to present a Taylor Rule is by the following equation:

\[
r = r^* + γ₀(\pi - \pi^*) + γ₁(Y - Y^*)
\]

where \( r \) is the short-run real rate, \( π \) is the current inflation rate, \( π^* \) is the central bank’s inflation target, \( Y \) is current output, and \( Y^* \) is the natural rate of output, approximating the full employment NAIRU; and \( r^* \) is the Wicksellian natural rate, which is set independently of monetary policy.² Carlstrom & Fuerst (2003, p. 1) define the natural federal funds rate as the rate that is ‘consistent with “neutral” monetary policy. That is if the real funds rate is equal to the natural real rate, the monetary policy will be consistent with both the inflation and output targets. This natural [Wicksellian] rate undoubtedly moves through time.’

Under the Taylor Rule, the central bank reacts to specific economic indicators: whenever output grows beyond its target long-run value, central banks raise the rate of interest. Similarly, whenever inflation grows above its inflation target, interest rates rise as well. This increase in the rate of interest, it is argued, slows down the economy thereby allowing central banks to hit their inflation target. The stability of the system is guaranteed by the countercyclical role of the central bank in setting interest rates.

In a simplified model, which omits the output gap, a horizontal monetary policy (MP) curve, depicting the Taylor Rule, replaces the traditional LM curve. While it is drawn for a specific level of interest rate, it also reflects a particular level of inflation. Whenever inflation increases, the central bank will raise

²Rochon (2004) explores the close similarities between the New Consensus and Wicksell’s monetary economics; see also Seccareccia (1998).
the rate of interest, which then corresponds to an upward shift in the MP curve (see Romer, 2000; Blinder, 1997; Abraham-Frois, 2003). 3

If the interest rate is exogenous, the ‘supply of money’ becomes an endogenous phenomenon that responds to the needs of the economic system (Villieu, 2004; Allsop & Vines, 2000; Abraham-Frois, 2003). One of the most remarkable features of the New Consensus, and of the Taylor Rule argument in particular, is the total absence of any monetary aggregates. Indeed, the Taylor Rule focuses exclusively on the determination of the rate of interest; there are no references to the money supply, or any discussion of how changes in the money supply might affect the economy. As McCallum (2001, p. 146) explains, adding a money equation or reference to money would be ‘superfluous, in the sense that it would not affect the behaviour of our dependent variables.’ Hence, as Romer (2000, p. 154) confirms, ‘most central banks pay little attention to the money supply in making policy. … [Monetary aggregates] play at most a minor role.’

The abandonment of monetary aggregates in itself is a considerable departure from orthodox monetary theory in two very important ways. First, economists once argued that changes in central-bank-controlled money supply contained important information regarding the future course of price movements. Second, interest rate policies themselves were criticized for leading to an indeterminate price level. In this respect, it would appear that the New Consensus model leaves the price level up in the air.

Regarding the first argument, proponents of the New Consensus model argue that price expectations themselves contain information about future price movements. We may note here that with or without monetary aggregates in the New Consensus model, the objective of the old and new approaches is the same: to anchor price expectations to allow better monetary (or interest rate) policy in the medium-term. With respect to the second argument, Smithin (2004, p. 57) points out that interest rate targeting policies were once believed to lead to the indeterminacy of the price level. Woodford (2001, p. 232) argues, however, that the Taylor Rule is not the same as an arbitrary exogenous interest rate because it is based on an endogenous feedback rule: ‘determinacy is instead possible in the case of feedback from an endogenous state variable such as the price level … owing to the dependence of the funds-rate operating target upon recent inflation and output-gap measures.’ The Taylor Rule can lead to a determinant price level precisely because it ‘incorporates feedback of a sort that suffices to ensure determinacy, owing to the dependence of the funds rate operating target upon recent inflation and output-gap measures’ (Woodford, 2001, p. 232).

The Taylor Rule, therefore, seems at first glance to incorporate some key features of Post-Keynesian theory. As we argue below, however, the endogeneity of money in the New Consensus model is not the same as in the Post-Keynesian

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3In a more complicated model, which includes the output gap, the MP curve would be an upward-sloping curve in interest-rate/output space. This reflects the fact that interest rates increase not only with inflation, but with growing output as well.
model. Before addressing this point, however, let us consider the second element of the new Consensus model, that is, inflation targeting.

2.2. Inflation Targeting

The second component of the New Consensus model is an inflation target, where an independent central bank commits to an explicit target inflation rate or ‘tolerance band’ (target range). To date, more than 21 countries have formally adopted inflation targeting policies, beginning with New Zealand in 1989, and then Canada in 2001, the United Kingdom in 2002 and Sweden in 2003. A number of emerging economies as well as transition economies have also adopted it.

Proponents argue that inflation-targeting regimes do not preclude central banks from pursuing other goals; they cite many such regimes that also pursue output stabilization, for instance. Yet, the primary commitment of the central bank is foremost to control inflation; transparency is thus an essential component of any inflation-targeting system. Given the lags in monetary policy, many central banks operate not only against current inflation but also against expected inflation in the near future; price expectations are therefore often incorporated into the Taylor Rule. The goal of such a system is to reduce current inflation by anchoring inflationary expectations.

Advocates of inflation targeting (see in particular Mishkin, 1999) list three important advantages to inflation targeting. First, the adoption of an inflation target provides a nominal anchor for policy. A nominal anchor may be required in floating exchange rate countries, or where, as in Taylor Rule regimes, central banks no longer target the growth of the money supply. In such cases, central banks’ inflation target can serve as an anchor to stabilize inflation and price expectations.

Second, proponents of inflation targeting claim that such a policy leads to more transparency and accountability. If economic agents know with certainty the policy of the central bank, then all economic actors are now better informed about the explicit goals of monetary policy. This reduces uncertainty concerning the ultimate goal of policy. More transparency implies better policy.

Third, central banks gain credibility when they hit their inflation target; credibility is eroded, according to advocates of inflation targeting, whenever inflation rises. Hence, lower inflation is better than higher inflation. The central bank announces its target, and markets expect the central bank either to hit its target over a reasonable period, or to adjust its policy with a view to hitting the target.

For these reasons, advocates of inflation targeting see it as a better economic policy, which promotes stability in both output and prices (Bernanke et al., 1999). As a result, they claim, countries that have adopted inflation targets have performed better than other countries.

\[4\] This statement can be challenged from various standpoints. For starters, how do we define economic performance? Do we, for instance, include income distribution? Usually, proponents of such regimes refer only to inflation. But the low inflation prevailing in many countries today cannot be attributed solely to inflation targeting: inflation had been coming down before inflation targets were adopted. See Rochon & Rossi (2006) for a critical review.
Yet, the adoption of inflation targeting and especially the Taylor Rule changes very little in terms of practical policy and theory. An overview of central bank policy in different countries over the last 40 years reveals that the ultimate objective has consistently been price stability, it is only the choice of intermediate targets that has changed. Hence, while central banks have traditionally targeted inflation, they used a variety of intermediate targets to attain their goal: money supply growth, exchange rates or NAIRU. The choice of interest rates as an intermediate target is simply the latest in a long list of intermediate targets, adopted after the realization that there is no observable or reliable relationship between past intermediate targets and inflation.

If this is the case then, how can we explain the transmission mechanism of interest rate policies? In other words, how do New Consensus models explain the effects of interest rates on inflation and real output?

Let us consider the full (simplified) New Consensus model:

\[
\begin{align*}
(Y - Y^*) &= -\alpha_1(r - r^*) + \epsilon_1 \\
(\pi - \pi^*) &= \beta_1(Y - Y^*) + \epsilon_2 \\
(r - r^*) &= \gamma_0(\pi - \pi^*) + \gamma_1(Y - Y^*)
\end{align*}
\]

In equation (1), an IS curve, deviations of the market rate of interest from its equilibrium long-run (natural) value explain deviations of output from its long-run level (the output gap); \(\epsilon_1\) is a random demand shock. Equation (2) is a price equation or a Phillips curve (aggregate supply curve). The output gap explains the deviation of inflation from its target inflation rate, as determined by central bank policy. Equation (3) is the familiar Taylor Rule.

As equation (2) dictates, the output gap determines inflation. But how do changes in output translate into higher prices? This is a particularly important question within a model where references to monetary aggregates are absent, and money is endogenous. Indeed, is inflation a monetary phenomenon in the New Consensus model? The bigger question is whether we can have a monetary explanation of inflation within an endogenous money framework. In the New Consensus model, while inflation is caused by the output gap, the output gap itself is caused by interest rate policies. Irrespective of whether inflation is caused directly by money, the common denominator of both situations is that demand plays a central role in determining prices. In fact, there is very little room in the New Consensus model for a cost-determined explanation of prices. Except for possible shocks, prices are largely determined by demand considerations.

Yet, if changes in output affect prices, how do changes in rates of interest affect output? In other words, what is the transmission mechanism of interest rate policy in the New Consensus model?

First-generation New Keynesians have discussed a number of channels, the primary one being the balance sheet channel (for a more thorough discussion, see Rochon, 1999). According to this view, high interest rates affect the financial condition of business firms directly and indirectly through the net worth or balance sheets of firms. Changes in a borrower’s balance sheet will affect the firm’s investment and production decisions, and its ability to secure new or ongoing credit, thereby with consequent impact on the economic cycle. As Bernanke & Gertler

The direct way in which the balance sheet channel operates can be divided into two different transmission mechanisms. First, if borrowers have outstanding short-term debt, or even if they have a floating-rate debt, then a rise in the rate of interest will raise the interest payments on their debt, thereby lowering the firms’ cash flow and weakening their financial position. So as the loan rate of interest increases, default risk increases as well because higher loan rates increase a borrower’s total burden of debt, which, all else equal, increases the likelihood that the borrower’s profits will not cover its debt payments. To compensate for the higher default risk, banks must raise loan rates more than is required simply to cover the higher cost of funds.

The second direct way in which the balance sheet channel operates is through asset prices and the collateral of firms. A rise in interest rates will also lower asset prices, which will then contribute in lowering the value of borrowers’ collateral (see Borio et al., 1994).

The balance sheet channel operates indirectly through its effects on capital-goods firms. After an increase in interest rates, investment spending by non-capital goods producing firms will decline. This will translate into lower net worth for capital-goods firms since their revenues would have fallen with their costs remaining the same in the short-run. A fall in collateral once again implies a rise in the loan rate to compensate for the increased riskiness of the loan. In all cases, firms have less collateral for their loans. As a result, they will be less likely to secure a loan (or to renew an existing one).

New Keynesians see this phenomenon – the financial accelerator – as the source of the business cycle. Monetary policy can therefore affect the growth cycle independently of credit rationing. The New Keynesian/New Consensus model does not stand or fall with credit rationing. Increases in the rate of interest will endogenously affect the net worth of firms, and hence the loan premium (see Bernanke & Gertler, 1989, 1990; Calomiris & Hubbard, 1990; Gertler, 1992).

Changes in interest rates would therefore affect the cost of borrowing and thus credit demand, but would also affect the balance sheet of borrowers by making existing debt more difficult to honor. This in turn may affect firms’ ability to secure new loans. Irrespective of the channel of transmission, the

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5Bernanke & Gertler (1989), for instance, have shown that investment is positively linked to the firm’s balance sheet position, defined as the ratio of net worth to liabilities. If the ratio is high, then there are more resources to use either as internal funds or as collateral to obtain outside funds. Hence, the market equilibrium level of investment will vary positively with the borrowers’ balance sheet position, as the net worth of firms increases, and negatively with the rate of interest (Calomiris & Hubbard, 1990; Fazzari et al., 1988). Bernanke & Gertler (1995, p. 37) have suggested a way of measuring this loss of net worth, by computing what they call the ‘coverage ratio’: the ratio between the interest payments over the interest payments plus profits. They argue that ‘Increases in the funds rate translate almost immediately into increases in the coverage ratio, and hence, ultimately, into weaker balance sheet positions.’ An increase in the rate of interest will affect both components of the coverage ratio: it increases interest payments and it also reduces profits through its impact on costs and revenues.
primary channel remains the credit market. The credit market thus is a central component of the New Consensus model.

In this sense, this is very similar to the Wicksellian story. If decreases in the rate of interest encourage borrowing and raise output, changes in output then lead to higher prices. Inflation can thus still be explained by a growth in the money supply that corresponds to excess output.

In the end, the New Consensus model is an attempt to ground realistic central bank policies within an otherwise orthodox model. On the practical side, there is the collapse of the relationship between base money and prices, the cost of attempting to control money, and the adoption of new operating procedures. On the theoretical sense, we can summarize the New Consensus model by the following six characteristics.

1. A production function determines potential (natural level) output; the latter acts as a center of gravitation. The supply conditions of the model determine the capacity of the economy. The growth of the labor force and the rate of technical progress dictate long-run growth, given by the Solow growth equation.

2. A vertical long-run Phillips curve characterizes long-run potential output (consistent with the NAIRU); there is no long-run trade-off between inflation and unemployment. Monetary policy (interest rate policy) is neutral in the long run: it does not affect real variables, only nominal ones (inflation).

3. Changes in aggregate demand determine short-run deviations from potential output. These can be induced by lending rates different from the natural rate, or by fiscal policy. After an appropriate lag, the economy gravitates toward its long-run values. With price fixity, the model generates all the more conventional short-run Keynesian conclusions (Romer, 2000).

4. There are important inflation-expectation effects. This means that expectations of possible inflation will affect output and employment, primarily through adjustment in the central bank nominal rate.

5. An exogenous rate of interest is set by the central bank according to a given policy rule (the Taylor Rule), thereby implying a rejection of the LM curve (Blinder, 1997; Romer, 2000). In this sense, the money supply is adjusting to the needs of trade: money is endogenous (Allsopp & Vines, 2000, p. 7). While the central bank sets a nominal rate, it targets the real rate.

6. In addition to an exogenous short-term rate of interest, the forces of productivity and thrift determine a natural rate of interest, at which the economy will operate at full employment (the natural rate of unemployment).

3. A Post-Keynesian Critique of the New Consensus

In the above section, we emphasized the ways in which the New Consensus, and the Taylor Rule in particular, represents a departure from more mainstream theories of money. In this section, we wish to show the many ways the Taylor Rule along with an inflation target are simply a restatement of orthodox ideas. It is therefore no surprise to learn that some economists refer to the new Consensus as the ‘new neoclassical synthesis’ (Goodfriend & King, 1997; Linnemann & Schabert, 2003) a telling reference to a previous attempt of combining some
Keynesian insights into an otherwise conventional framework. In fact, Meyer (2001, p. 3) is quick to point out that we ‘can still clearly see the influence of monetarism in the consensus model. The consensus model may bypass money, but it has retained the key conclusion that central banks ultimately determine the inflation rate.’

There are six specific criticisms that raise concerns about the New Consensus model from a Post-Keynesian perspective.

3.1. The Natural Rate of Interest

The first striking feature of the New Consensus model is the adoption of a natural rate of interest as an integral part of their model. Many central banks base their interest-rate policies around this natural rate. Here we need to address two specific arguments.

First, since policies depend on this rate, the value of the natural rate matters greatly. As a center of gravitation for the market-determined or central bank-determined rate of interest, a higher value for the natural rate will have powerful implications for macroeconomic performance. Moreover, if central banks set the real rate at a rate different from the natural rate when output and inflation are at their natural levels, this will jeopardize the stability of the model (Woodford, 2001).

But how can we identify this natural rate? In theory, it is the rate that brings together investment and saving in real terms, but finding its actual value in not a simple task. In fact, in his original 1993 paper, Taylor simply chooses an arbitrary value of 2%, because it corresponded to an average real interest rate over a long-time horizon of several years. Smithin (2004, p. 3) is correct in pointing out the arbitrary nature of the natural rate: ‘These are, after all, just the postulates of one particular type of economic theory and do not necessarily correspond to anything extant in reality.’ Faced with the impossible task of finding the value of the natural rate, the Taylor Rule, in its present incarnation, seems to be a perfect example of the triumph of ideology over reality.

Second, assuming we can indeed find a value of the natural rate, is its value unique? Proponents of the New Consensus assume that for a given value of the natural rate of interest there exists a unique relationship between interest rates and output, so that any deviations from full employment would signal that the interest rate is not at its equilibrium level. In reality, however, there is little evidence of this; Post-Keynesians argue that we can achieve full employment at any level of interest rates, especially by making appropriate use of fiscal policy.

Post-Keynesians therefore reject Wicksell’s natural rate of interest, and its references to the long run as a center of gravitation. Post-Keynesians view the natural rate of interest as groundless in both theory and policy. There is, accordingly, no place for the natural rate in any Post-Keynesian reaction function. We

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6In a question and answer session following his key address at a chartalist conference in Kansas City, Goodhart readily admitted that the natural rate is virtually impossible to calculate. Central bankers, he claimed, recognized this yet still insisted on the ‘usefulness’ of the natural rate.
may now answer Palley’s question. As Smithin (1994) has argued, various schools of thought recognize that money is endogenous, but the fundamental difference between Post-Keynesians and other schools is the acceptance or rejection of Wicksell’s natural rate.

3.2. The Output Gap

In a Post-Keynesian setting of hysteresis, in which actual output acts as a ‘center of gravitation’ for potential output, how can potential output serve as a reliable policy variable? In mainstream macroeconomics, including New Consensus models, monetary policy affects actual output only in the short-run, with actual output gravitating toward potential output in the long-run (and unemployment gravitating toward NAIRU). In a hysteresis context, however, the economy is demand-determined in both the short- and long-run, and the value of NAIRU depends on actual output (see Setterfield, 2002; León-Ledesma & Thirlwall, 2002). This suggests that monetary policy affects the level of potential output through its effects on actual output. Money and monetary policy are not neutral in the long run: they have both short-run and long-run effects on output and unemployment. It follows that potential output and hence the output gap cannot serve as a reliable tool for monetary policy.

3.3. Fiscal Policy

The New Consensus is interesting for its absence of any serious discussion of fiscal policy; it is rooted in the belief that fiscal policy is at best inflationary, at worst destabilizing, and neutral in the long run. This has led Arestis & Sawyer (2002, p. 2) to argue that ‘fiscal policy is no longer viewed as a powerful macroeconomic instrument.’ We would go even further. For proponents of the New Consensus, not only is fiscal policy seen as inefficient for macroeconomic goals, it is outright dangerous, as deficits will eventually have to be monetized, with obvious impacts on interest rates. Governments are too easily tempted to pursue ‘irresponsible’ deficit-generating policies, thereby threatening macroeconomic stability and leading to the breakdown of inflation targeting altogether (see, for example, Mishkin, 1999). It is for this reason that proponents of inflation targeting propose the ‘absence of fiscal dominance.’ Hence, there is neither the need nor the desire for fiscal policy, especially in the context of inflation targeting. Within the New Consensus framework, monetary policy is the only credible policy, and the central bank the only credible institution, that can achieve price stability (the inflation target).

In reality, however, fiscal policy is just as effective at containing inflation as monetary (interest rate) policy (see Setterfield, 2004).

3.4. Endogenous Money

There is no denying that money is endogenous in the New Consensus model. However, the model seems to lack a theory of endogenous money; in this respect the New Consensus approach to endogenous money is not the same as the approach advocated by Post-Keynesians. Whereas Post-Keynesians argue...
that money is endogenous because of its very nature (see for instance Lavoie, 1992; Rochon, 1999), proponents of the New Consensus do not equate the endogeneity of money with the nature of money. As Setterfield (2004, p. 41) puts it, ‘whereas the stock of money is endogenous in practice in NC macroeconomics, it is endogenous in principle in PK macroeconomics.’ Palley (2006, p. 8) agrees, noting that ‘the shift by central bankers to interest rate operating procedures is fully consistent with the exogenous money supply models that have historically dominated macroeconomics.’

Hence, we find that in New Consensus models, there is an implicit recognition that the central bank could effectively control the supply of high-powered money and a narrow definition of money if it chose so. But, New Consensus adherents argue, given the instability of the demand for money, it is more effective simply to target the rate of interest. This position is clearly expressed by Cecchetti (2000, pp. 44–45): ‘Evidence indicates that in most countries, short-run money demand functions are unstable and that meaningful measures of money, such as M2 or M3, are very difficult to control. As a result, monetary targeting alone is no longer viewed as a viable strategy for stabilizing prices.’ Friedman’s approach is now generally discredited because shocks in the demand for money and an unstable transmission mechanism imply that stable growth of monetary aggregates could lead to quite unstable behavior for prices and real incomes. It is in this sense that we interpret Fontana & Palacio-Vera (2005, p. 5): ‘In the ‘new consensus’ view the endogeneity of the money supply is grounded on the “targets-and-instrument approach.” . . . The endogeneity of money is thus an historical accident rather than a logical necessity of capitalist economies.’ In the same way, Setterfield (2004, p. 37) concludes ‘that this is . . . a policy choice on the part of the central bank. Interest rate targeting is simply preferred to money supply targeting, because the instability of the demand for money, disintermediation and so forth, are believed to make control of the money supply difficult in practice in the contemporary monetary environment.’ Following Palley (2006), we call this ‘central bank’, or model-specific, endogeneity.

### 3.5. Inflation Targeting

Inflation targeting is based on the supposition that almost all price inflation is of the demand-pull variety. It not only cannot explain cost-push inflation but it cannot remedy it. An increase in the rate of interest, as stipulated by the Taylor Rule, will not lower the inflation rate unless excess demand is the main source of inflationary pressures. If costs are the principle determinants of inflation, then monetary policy may not be the best policy to achieve lower inflation. As Arestis & Sawyer (2004, p. 73) conclude, monetary policy is ‘ineffectual’ in combating inflation in the real world.

In fact, if costs determine prices, then an increase in the rate of interest may in the short-run lead to an increase in prices given the increased cost of borrowing. This is Gibson’s Paradox: interest rates and prices may not move in opposite directions; at the very least, their precise correlation is unknown.

This view appears to undermine the validity of the Phillips curve. Increases in output, or in economic growth, may or may not lead to higher prices. In traditional
depictions of the Phillips curve, there is no room for cost-related increases in prices. Indeed some recent research depicts the Phillips curve as horizontal (see Kriesler, 2005; a study of the UK economy by Haldane & Quah, 2000; and the contribution of Kriesler & Lavoie to the present symposium).

If, as Post-Keynesians believe, inflation is primarily a supply-side phenomenon, the Taylor Rule is wholly incompatible with such situations.

3.6. The LM Curve

As discussed above, the $LM$ curve has disappeared from the New Consensus model, and has been replaced with the $MP$ (monetary policy) curve. This is hardly surprising, since the $LM$ curve, which is based on an exogenous money stock controlled by the central bank, becomes an irrelevant device when the money supply is recognized to be endogenous and an interest rate policy rule, rather than money supply target, is adopted.

Yet, in contrast to Post-Keynesians, who also reject the $LM$ curve, New Consensus models maintain the underlying causality between output and interest rates inherent in the upward-sloping $LM$ curve. Hence, we contend that the a priori rejection of the $LM$ curve is simply an illusion; for the emphasis on inflation targeting in fact restores the exact same conclusions (see Monvoisin & Rochon, 2006).

To understand this better, consider the case where the $LM$ curve is well behaved, that is upward sloping. An increase in fiscal policy leads automatically to an increase in output and an increase in the rate of interest. This is the standard short-run Keynesian result with price stickiness. In the New Consensus, however, we find that an increase in fiscal policy leads to an increase in output, which then eventually increases inflation (equation (2)). As a result, the central bank raises the rate of interest to eliminate the source of the cumulative inflation bias (equation (3)). The only difference, so to speak, is that under a Taylor Rule system, the rise in the rate of interest is an administrative decision, rather than being market-determined. Nevertheless, the Taylor Rule endogenizes central bank policy in a way that reproduces the standard conclusions of orthodox macroeconomic models. The New Consensus model has not broken the relationship between output and interest rates.

4. A Post-Keynesian Reaction Function?

The New Consensus offers nothing new, but it does give Post-Keynesians an opportunity to develop their own version of an activist central bank reaction function. This work remains to be done, but some important groundwork has been laid. For instance, Moore (1988, p. 266) suggests that the nominal rate of interest depends on

the techniques of monetary policy, the sensitivity of economic behavior to interest rate changes, the size of openness of the economy, the degree of capital mobility, the extent to which the central bank is willing to allow foreign exchange reserves and exchange rates to fluctuate, the expected domestic and foreign inflation rate, the willingness of the government to regulate and impose controls on the economy, and the extent to which policy is coordinated across countries.
In a later work, Moore (1989, p. 487) emphasizes that the central bank reaction function with short-term interest rates as the dependent variable, includes the authorities’ estimates of:

1. the future state of the domestic economy (demand factors),
2. the responsiveness of system behavior to interest rate changes,
3. their ultimate goals (full employment, price stability, growth, balance of payments, terms of trade, exchange rates, the distribution of income),
4. the effects of interest rate changes on the viability, prosperity, and liquidity of the financial system and,
5. in democracies at least the implication of interest rate change for the governing party in the next election.

Consequently, ‘In pursuit of their macroeconomic stabilization goals central banks ordinarily vary interest rates pro-cyclically, in response to the perceived state of the economy’ (Moore, 1994, p. 123).

It may be worth asking, at this point, whether a reaction function is a valuable tool for central banks to follow. Indeed, one of the criticisms Post-Keynesians can levy against proponents of the New Consensus is that while they have adopted exogenous interest rates, the adoption of the Taylor Rule endogenizes interest rate policy. Would a Post-Keynesian reaction function not suffer the same fate? While this question certainly deserves further scrutiny, it must be emphasized that Post-Keynesians recognize that the economy is a complex system and that central banks should not use interest rate policies narrowly with only one objective – the containment of price inflation – in mind. Many factors influence the central bank’s decision to raise or lower interest rates. Exchange rates, unemployment, growth, productivity, may all force the central bank to change interest rates. Yet, these variables pull interest rates in opposite directions. Any decisions of the central bank to change rates must therefore be carefully weighed against multiple objectives. In this sense, the setting of interest rates remains a true administered decision, purely exogenous. If a reaction function endogenizes interest rate policy, this is not the same as saying that interest rates are endogenous.

Moreover, Post-Keynesians see monetary and fiscal policies as having far-reaching real effects, both in the short run and the long run, on a number of economic variables. Monetary policy will have an impact on income distribution, for instance, which will then affect aggregate demand, output and growth, both in the short and long-run.

5. Long-run Post-Keynesian Monetary Policy

Moore is not the only advocate of a Post-Keynesian reaction function (see for example, Fontana, 2007; Palley, 2007). But apart from advocating the setting of interest rates, Post-Keynesians have had little to say about the level at which rates ought to be fixed.

In discussing a Post-Keynesian reaction function, we may want to consider the following. First, Post-Keynesians recognize that central banks would typically have many objectives, not just a single goal, and that in pursuing a particular goal the central bank may face many constraints in achieving it. Interest rate policy carries
many repercussions, the world is an uncertain one, and the actions of banks, households, entrepreneurs, the State and economic agents in the rest of the world, will have repercussions beyond the reach of the central bank. Second, fiscal policy would still need to be emphasized. Indeed, in discussing monetary policy and endogenous money, Post-Keynesians often seem to neglect the role played by fiscal policy.

A reaction function poses three obvious challenges. First, if we accept, as Moore (1988) suggests, that interest rates ought to move pro-cyclically, then how high ought they be allowed to rise? If interest rates are set too high, the distribution of income will be skewed and rentiers will have their ultimate revenge (Smithin, 1994). In addition, with the collapse of aggregate demand, some firms will fail to recover all of their initial outlays. As a result, they will be unable to reimburse their initial loan. Firms become less creditworthy and may not be able to secure additional credit.

Second, what should be the target of monetary policy? Possibilities include exchange rates, capacity utilization, aggregate output and income distribution. Irrespective of the target, a clear explanation of the transmission mechanism from interest rates toward the chosen target must be provided.

Third, if interest rates are set according to output, unemployment, capacity utilization or income distribution, interest rates would inevitably move pro-cyclically, which re-establishes the neoclassical correlation between output and rates of interest, as embodied in the IS-LM model. This is precisely the criticism Lavoie (1996) made against the structuralist approach.

It is therefore obvious, that while a Post-Keynesian reaction function deserves greater scrutiny, there may be some problems in developing such an approach. On another note, Post-Keynesians may want to ask whether such an approach is the most appropriate one to follow.

A number of Post-Keynesians have recently proposed a central bank interest rate policy that differs greatly from a reaction function. These various approaches have recently been explored in some detail by Rochon & Setterfield (2007a, b). Rather than emphasizing short-run policies, these approaches emphasize the long run by proposing a value for the real or nominal rate of interest. Rochon & Setterfield (2007a) identify three variations of this approach in the Post-Keynesian literature, which they label respectively as the Kansas City Rule, the Smithin Rule, and the Fair Rate Rule.

According to the Kansas City Rule, the nominal rate of interest should be set to zero, leaving the real rate most probably in negative territory (see Wray, 2007). According to the Smithin Rule (see Smithin, 2004, p. 65; 2007), an ‘optimal’ interest rate policy is achieved when real interest rates are set at or very close to zero, leaving nominal interest rates positive and moving in step with inflation. A more practical policy would have real rates be a ‘small positive constant.’ Finally, for Lavoie & Seccareccia (1999, p. 543), a ‘fair’ interest rate rule, also known as the Pasinetti Rule, leaves ‘unchanged the distribution of income between interest and non-interest income groups, regardless of lending and borrowing activities.’ They claim that this scenario is achieved only when the central bank sets the real interest rate equal to the growth rate of labor productivity.

These approaches appear to reflect an emerging consensus in favor of a Keynes’s ‘euthanasia of the rentier’ (Rochon, 2005), although it is clear that the Fair Rate Rule sees the rentier class as a necessary evil. In a sense, all of these
policies, their minor differences aside, advocate abandoning what Rochon & Setterfield (2007a, 2007b) have called ‘monetary policy dominance’ by taking monetary policy out of the job of fine-tuning the economy. By setting real or nominal rates at or close to zero, they neutralize interest rates as a tool of economic policy. The argument rests on the notion that interest rates’ effects on real variables are slow and unpredictable, reflecting Post-Keynesian skepticism about the underlying causality imbedded in the IS curve (see Lavoie, 2006).

If monetary policy is taken out of the picture, then Post-Keynesians ought to rely on fiscal policy to achieve their objectives regarding employment, growth and income distribution. This, of course, is reminiscent of a famous passage at the end of the General Theory (Keynes, 1936, p. 376), which advocates letting the rate of interest fall to a low level. Such a policy, Keynes wrote, ‘would mean the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity value of capital.’ Regarding investment, Keynes writes that ‘the State will have to exercise a guiding influence’ through fiscal policy (Keynes, 1936, p. 378). We could therefore rely on the State, rather than the central bank, to take an active role in regulating output, inflation, income distribution, and growth, thereby returning Post-Keynesian monetary theory to its Keynesian fiscal roots.

6. Conclusion

There may be a consensus in the new macroeconomics, but it is certainly not new: we have seen that it is essentially a restatement of the old consensus of the neo-classical synthesis. In response to the New Consensus model, we have presented two Post-Keynesian alternatives: the activist rule, which favors a reaction function based on unemployment, output or capacity utilization, and a ‘parking it’ approach, which favors parking interest rates at some long-run value.

Irrespective of the preferred approach, Post-Keynesians should not overlook fiscal policy, which can be as effective as monetary policy in stabilizing output. Indeed, in contrast with New Consensus models, where fiscal policy is strikingly absent, we advocate an active fiscal stance. This paper argues that if central banks are to follow a reaction function, several important questions need to be addressed. One alternative is for Post-Keynesians to take Keynes’s advice to heart and work toward one form or another of the euthanasia of the rentier.

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