

**BETWEEN THE CUP AND THE LIP:
INTEREST RATE RULES AND LONG-TERM
INTEREST RATES**

Angel Asensio

WP-2009-14



International Economic
Policy Institute
Institut international des
politiques économiques

WWW.IEPI.LAURENTIAN.CA

MISSION STATEMENT

The International Economic Policy Institute is a bilingual, non-partisan, non-profit policy research group (the creation of this Institute is pending university approval) at Laurentian University, Ontario (Canada), which seeks to offer critical thinking on the most relevant economic and social policies in Canada and around the world. In particular, the institute's mission is to explore themes related to macroeconomic policies, globalization and development issues, and income distribution and employment policies. Our overall concern is with the social and economic dignity of the human being and his/her role within the larger global community.

We believe that everyone has a right to decent work, to a fair and equitable income and to equal opportunities to pursue one's self-fulfillment. We strongly believe that it is the role of policies and institutions to guarantee these rights.

In accordance with its mission, the Institute is constantly seeking to create international research networks by hosting conferences and seminars and inviting other thinkers around the globe to reflect on crucial economic and social issues. The Institute offers ongoing, honest, and critical appraisal of current policies.

DIRECTOR

Hassan Bougrine, Laurentian University

ASSOCIATE DIRECTOR

Corinne Pastoret, Laurentian University

THEME DIRECTORS

David Leadbeater, Laurentian University
Director of Income Distribution and Employment Policies

Corinne Pastoret, Laurentian University
Director of Globalization and Development

Louis-Philippe Rochon, Laurentian University
Director of Macroeconomic Policies

DISTINGUISHED RESEARCH SCHOLAR

Louis-Philippe Rochon, Laurentian University

RESIDENT RESEARCHERS

Bruno Charbonneau, Researcher, Laurentian University
John Isbister, Senior Researcher, Laurentian University
Aurélie Lacassagne, Researcher, Laurentian University
Brian MacLean, Senior Researcher, Laurentian University

SENIOR RESEACH ASSOCIATES

Amit Bhaduri, Jawaharlal Nehru University (India)
Paul Davidson, New School University (USA)
Robert Dimand, Brock University (Canada)
Roberto Frenkel, University of Buenos Aires (Argentina)
Robert Guttman, Hofstra University (USA)
Claude Gnos, Université de Bourgogne (France)
Marc Lavoie, University of Ottawa (Canada)
Noemi Levy, Universidad Nacional Autonoma (Mexico)
Philip A. O'Hara, Curtin University (Australia)
Alain Parguez, Université de Franche Comté, (France)
Sergio Rossi, University of Fribourg (Switzerland)
Claudio Sardonì, University La Sapienza (Italy)

Mario Seccareccia, University of Ottawa (Canada)
Mark Setterfield, Trinity College (USA)
John Smithin, York University (Canada)

RESEACH ASSOCIATES

Mehdi Ben Guirat, The College of Wooster (USA)
Fadhel Kaboub, Drew University (USA)
Dany Lang, National University of Ireland, Galway (Ireland)
Joelle Leclaire, Buffalo State University (USA)
Jairo Parada, Universidad del Norte (Colombia)
Martha Tepepa, El Colegio de Mexico (Mexico)
Zdravka Todorova, Wright State University (USA)

BETWEEN THE CUP AND THE LIP: INTEREST RATE RULES AND LONG-TERM INTEREST RATES MANAGEMENT

ANGEL ASENSIO

Angel Asensio is a lecturer at the University Paris 13, and a researcher at the CEPN (Univ. Paris 13-CNRS). He is a member of the ADEK (Association pour le Développement des Etudes Keynésiennes). He has recently published research papers on post-Keynesian theory, monetary and fiscal policies interactions, international interdependences and economic policies coordination. This paper was originally presented at the conference on “*The Political Economy of Central Banking*,” in Toronto, 27-28 May, 2009. The conference was organised by the *International Economic Policy Institute*, and financed by *Laurentian University* and the *Social Sciences and Humanities Research Council Canada* (SSHRC).

INTRODUCTION

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

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

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

The Post Keynesian approach to monetary policy is exemplified by the various interest rate rules that have been proposed recently¹. However, contrary to the mainstream, which is still concerned with the design of a mythic 'optimal monetary rule', the Post Keynesian

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

rules should not be thought of as automatic responses to any interest rate or output gap regarding a supposed 'natural' position. They rather have to be considered a device aimed at approaching normative, ideal objectives which maybe will not be reached, depending on how strong uncertainty and the related 'state of confidence' impact monetary/financial decisions and, thereby, the monetary transmission channels.

The paper consequently is organized as follows. Section 2 emphasizes the positive contribution of these interest rate rules to the Post Keynesian modern theory of monetary policy. Section 3 considers several hindrances the rules may come up against. As we are not really concerned in this paper with the policy ultimate objectives², the discussion will mainly focus on the control authorities have on the intermediary objectives, namely the short-term and long-term interest rates. Section 4 focuses on the way confidence can be introduced within the recent Post Keynesian literature on monetary policy theory. It starts from Keynes's definition of the interest rate as a conventional variable, subject to the changing 'views about the future', and investigates how monetary authorities should manage to have a chance of moving the market convention toward the desired level. The section also considers specific difficulties central banks are faced with in the current troubled situation. It is argued that a 'cheap money' policy, along with an offensive fiscal policy, is much better adapted to the situation than inflation targeting and fiscal orthodoxy. Section 5 summarizes the main findings and concludes the paper.

POST KEYNESIAN INTEREST RATE RULES AND THEIR OPERATING CHANNELS

Rochon & Setterfield (2007a) have proposed an enlightening classification of the Post Keynesian proposals in terms of "activist" and "parking it" rules. While both kinds of rules are aimed at taking advantage of the potential effects of monetary policy both in the short run and in the long run, the former focuses on policies which are aimed at operating through the short run relation between the long-term interest rates and the effective demand (Atesoglu, 2007, Palley 2007, Fontana & Palacio-Vera 2003, 2007, Sawyer 2007, Tily 2009), while the latter focuses on policies which are aimed at operating through the relation between the 'parked' (short/long-term) interest rates and the income distribution (Pasinetti 1981, Lavoie 1999, Rochon & Setterfield, 2007a,b, 2008, Smithin 2007, Wray 2007)³.

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

The rule proposed in Atesoglu (2007) is based on Keynes's definition of the 'neutral rate' (1936: 243), the interest rate which is consistent with full employment. It is aimed at adjusting the central bank rate at a neutral level, that is, in such a way that the long-term interest rate is adjusted to its own neutral level as well. Although Atesoglu's proposal

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

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

does not deal explicitly with the long-term effects of monetary policy, his approach does not discard these effects of course.

Tily (2009) advocates low long-term interest rates ('cheap money'). This general statement however does not seem to be concerned with the 'parking it' type of rules, for two reasons: first, his proposal is not oriented toward any distributive objective, and, second, 'cheap money' may refer to different levels of interest rate, according to the economic situation and the policy objective⁴. The 'cheap money' objectives actually consist in smoothing the economic cycle at a high level of employment and in reducing the related risk of debt inflation/debt deflation (which is likely to be higher in 'dear money' regimes, pp 105-106).

The innovative proposal for a 'flexible opportunistic approach' developed by Fontana and Palacio-Vera (2003, 2007) seeks explicitly to stimulate the growth rate of output and employment, besides stabilizing the output in the short run and achieving price stability in the long run (see also Sawyer 2007)⁵. In the standard opportunistic approach (Orphanides & Wilcox 1996), it is suggested that, in order to be able to take advantage of a possible exogenous adjustment of the inflation rate towards the long-run target, the central bank should not adjust interest rates as long as the actual inflation rate remains within some predetermined upper and lower limits around the target. By contrast, the flexible opportunistic approach puts forward that the possible long-run effects of the monetary policy on the potential output is in favour of a policy loosening when the actual rate of inflation is below the target but above the predetermined lower bound. In a similar way, if the actual rate of inflation is above the target but below the predetermined upper bound, the flexible opportunistic approach states that the monetary policy should moderately decrease the interest rate so as to take advantage of a possible positive effect on the potential output, which would subsequently offset possible inflationary pressures.

According to Palley (2007), inflation targeting 'biases decisions toward low inflation by obscuring the fact that policy also affects unemployment, real wages, and growth' (Palley 2007: 61). Taking these effects into account, Palley calls for setting the rate of interest so as to balance the possible advantages that may follow from accepting an increased inflation rate with the advantage of low inflation. In his model, when unemployment is sufficiently high, the only cost to monetary stimulus is increased inflation. The authorities in that case may reduce the rate of interest so that unemployment decreases towards the 'MURI' (minimum unemployment rate of inflation, beyond which further inflation increases might have a counterproductive effect on employment⁶). However, under certain conditions, a trade-off between employment and growth may arise as

⁴ Although nothing is said about the 'right' interest rate, the author notably recall Keynes concern with inflation.

⁵ Sawyer (2007, pp 12-13) actually suggests a mixed rule based on the Pasinetti's 'fair' long-term real interest rate proposal (which is of the 'parking it' type; see below) and on the recognition that the underlying trend, which estimation is problematic, 'may itself be influenced by demand policies' (which rejoins 'activists' rules).

⁶ This is related to the backward-bending Phillips curve of the model: as real wage resistance increases as inflation increases, the 'grease effect' on employment, which is associated with the negative effect of inflation on real wages, erodes as inflation increases. See Palley (2007) for details.

unemployment falls. Indeed, 'lower unemployment raises economic growth if the economy is in the wage-led region, [but] lowers growth if it is in the profit-led region' (Palley 2007: 75). Hence, if the economy becomes profit-led while unemployment decreases (as the profit rate is negatively affected by unemployment), the trade off arises.

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

Rules operating through the relation between the rate of interest and the income distribution

Rules that aim at operating through the relation between the interest rates and the income distribution do not deny that the interest rate policy impacts the economy trajectory in the short run and in the long run, although they focus on the sharing of the income growth in a long run perspective. Basically, it is asserted that, owing to the many uncertainties in the transmission mechanism (Wray 2007, Bateman 2003), monetary policy can hardly get much success in the 'activist' way of setting interest rates. It is therefore recommended that the interest rate is set so that undesirable distributive effects are avoided. The resulting 'Parking it' rules divide into short-term nominal rate and long-term real rate rules.

Let us first discuss the 'fair rate' rule, understood in the spirit of (Pasinetti 1981; see also Lavoie 1999), and the 'low real rate' proposed in Smithin 2007 (also Atesoglu & Smithin 2006, Hein & Stockhammer, 2007). Both are real rate based rules and share the normative purpose of providing economic policy with an 'explicit distributional objective'. The 'fair rate' rule consists in equalizing the real interest rate with the productivity growth rate, so that the rentiers' share in the national income is constant. Smithin's rule, on the other hand, aims at setting the real interest rate at a low level (again a 'cheap money' policy, but in the 'parking it' approach this time). The distribution effect here differs essentially because 'it does not [...] guarantee a share for *existing* wealth holders (as opposed to entrepreneurs or workers) in *current* productivity increases, as would the notion of the "fair" interest rate [...]. This omission might be justified on the grounds that it is the latter, rather than the former, who are actually responsible for the productivity increases' (Smithin 2007: 116).

As Wray (2007: 120) also rejects "discretionary policy and doubt[s] the veracity of conventional views of central bank ability to achieve traditional goals such as robust growth, low inflation, or high employment", the 'Kansas city' rule recommends a constant zero short-term nominal rate⁷ which aims at returning 'to Keynes's call for low interest rates and euthanasia of the rentier'⁸.

⁷ Camara Neto and Vernengo (2004) also advocate a low interest rate policy so as to make it easier for the government to implement a sound countercyclical fiscal policy.

⁸⁸ According to Keynes, 'The social philosophy towards which the General Theory might lead' (Keynes 1936: 374-377) focuses on our ability to manage the rate of interest so as to rise the inducement to invest to the level where, given the aggregate propensity to consume (including the State), full employment holds.

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

Table 1 – Post Keynesian interest rate rules and operating channels

Op ^{ing.} channel Interest rate of the rule	Income distribution (parking it rules)	Output gap (activist rules)
Nominal interest rate (NIR)	<p>(Short-term nominal rate)</p> <p>* 'Kansas city rule' - Wray NIR=0, 'Euthanasia of the rentier'</p>	<p>(Long-term nominal rate)</p> <p>* 'Neutral rate' - Atesoglu NIR adjusted to full employment</p> <p>* 'Picks a quadruple'^{a)} - Palley NIR adjusted to the MURI^{b)} (or, if need be, to the trade off employment/growth)</p> <p>* 'Cheap Money' – Tily NIR set so as RIR is 'low', investment is high and financial risk is low</p>
Real interest rate (RIR)	<p>(Long-term real rate)</p> <p>* 'Fair rate'-Pasinetti/Lavoie RIR=prod^{ly} growth</p> <p>* Smithin's rule RIR=0</p>	<p>(Long-term real rate)</p> <p>* 'Flex. opport^{tic} rule' - Fontana & Palacio-Vera (decrease RIR even if inflation is slightly above the target, for it might increase the prod^{ly} growth)</p> <p>* Flexible 'fair rate' - Sawyer RIR adjusted so that its possible influence on the prod^{ly} growth is not overlooked</p>

a) In Palley's model, 'the monetary authority is picking a quadruple consisting of inflation, unemployment, real wages, and growth'.

b) MURI: 'minimum unemployment rate of inflation'

Now, insofar as the accumulation of capital decreases the marginal efficiency of capital, a decrease in the interest rate will be necessary in the long run. That is the essence of Keynes's prediction of the euthanasia of the rentier. According to his argument, the ideal policy is not to maintain the interest rate at a low fixed level unconditionally; it is to adjust the interest rate to the level that ensures full employment, given the marginal efficiency of capital and the aggregate propensity to consume. As these variables may change in response to changes in the rate (and the state) of capital accumulation, in productivity growth or in the government's propensity to consume, among other factors, it could be imprudent to adopt a rule that could not take account of such developments.

UNCERTAIN TRANSMISSION MECHANISMS

The success of interest rate rules rests on the condition that the transmission mechanisms do work, which is often implicitly assumed in this literature, although it is questionable.

Do central banks control long-term interest rates?

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

The central bank influence on the long-term rates however is not the only force which determines the level of interest rates, as stated in Keynes's liquidity preference theory. The point is that the shifting nature of the state of confidence has serious implications for the ability of monetary policy to control the long-term interest rate, especially in the case of interest rate reductions. In order to make this clear within the Post Keynesian approach to endogenous money, let us suppose that the monetary base is increased as a result of lower short-term interest rates, and that consequently, lower long-term bank rates boost the demand for credit. If, at the same time, the liquidity preference increases, banks may be able to sell more credit without reducing their interest rates, for non-bank loan and bond rates tend in this case to rise in order to compensate for the increasing liquidity preference. Even if 'the monetary authority were prepared to deal both ways on specified terms in debts of all maturities, and even more so if it were prepared to deal in debts of varying degree of risk', there would be 'limitations on the ability of the monetary authority to establish any given complex of rates of interest for debts of different terms and risk...' (Keynes 1936: 205, 207) Some of these limitations (see Keynes 1936: 207-208 for a detailed discussion) can be considered purely theoretical, insofar as they would only arise in extreme circumstances (virtually absolute liquidity preference when rates are considered too low; breakdown of stability in the rate of interest – owing to a flight from the currency or other financial crisis); but others apply in normal circumstances (the intermediate cost of bringing the borrower and the lender together, the allowance for risk required by the lender, including liquidity risk)⁹.

Changes in the liquidity preference may be triggered by the central bank policy itself. For example, let us suppose that the cut in the short-term rate starts to have some effect on the long-term rate. According to Keynes's theory of interest, if the market belief is that the 'conventional' long-term rate is higher than the actual, that is, if a future increase is expected, the liquidity-preference increases as well (this point is discussed further in section 4), thereby limiting or possibly preventing the reduction in the long-term rate.

Hence, the Post Keynesian endogenous money approach is right when it states that banks do deliver the amount of credit money that is demanded at the current interest rate

⁹ See however the optimistic views on the subject presented in Tily (2006).

structure. It is also correct to say that the rate of interest is exogenous in the sense that it does not result from a market clearing process. But this is not to say that the central bank has enough control in general as to set the rates at the level it decides (contrary to what is sometimes suggested)¹⁰.

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

Conflicting objectives and short-term interest rate rule sustainability

If the rule is specified in terms of the policy instrument, or in terms of a rate strongly related to the policy instrument, as in the 'Kansas city rule', things go differently. Although a zero short-term nominal interest rate is recommendable in the current context of economic depression, Wray's 'parking it' rule feasibility might be questionable in others contexts.

The question of the feasibility of the rule here is not to be taken in the strict sense of the word, since the central bank can reasonably be said to have a good control over the short-term rates in general; it rather relies on both the relevance or sustainability of the rule and its effectiveness with respect to the 'euthanasia of the rentier'.

As for effectiveness, the transmission between the short-term interbank interest rate and the long-term interest rates of the economy is subject to the limitation discussed above. Sustainability on the other hand requires that no prior objectives could normally lead authorities to renounce to implement the rule. But there are recurrent forces in our economics systems which could give raise to such prior objectives if the 'Kansas City' rule was maintained unconditionally. In the face of distributive tensions aimed for

¹⁰ See Smithin (1994: 172-173), Lavoie (1996: 277, 1999: 2, 7), Tily (2006:657), Rochon & Setterfield (2008: 6). According to Lavoie (1999: 2), 'monetary authorities have the ultimate say on the convention', but the author also pointed out that the spreads between the long-term rates and the overnight rate vary according to the liquidity preference of the commercial banks and the participants in the financial markets: 'As Smithin (1996: 93) puts it, a role for Keynesian liquidity preference can be retained in this scenario, in that liquidity preference considerations may well periodically insert a wedge between those rates of interest which are more or less directly under the central bank control and rates elsewhere' (Lavoie 1999: 2).

example at increasing the share of profits or wages, a zero refinancing rate would allow for monetary accommodation of the resulting inflationary pressures¹¹. It is no doubt a good thing that the central bank accommodates banks when they need to refinance themselves as a result of the credit-money they have created in response to viable activities, but when the demand for credit-money results from the kind of distributive inflationary pressures mentioned above, the central bank faces a dilemma: either it accommodates inflation, so that unemployment does not rise, or it fights the distributive conflict by means of higher interest and unemployment rates¹². Such a dilemma has no objective solution that could be picked out from economic theory, especially if inflationary pressures are strong and threaten confidence in the purchasing power of money. It is a political decision, a matter for the community as a whole.

The dilemma would vanish if, as recommended in Setterfield (2007, see also Hein & Stockhammer 2007, Setterfield & Lima 2008, Rochon & Setterfield 2007a,b), an incomes policy could harmonise the distribution of income. But even in that case, it is doubtful whether a zero-rate rule is really sustainable, for there are events which may prompt the central bank to adjust the overnight rate. For example, Wray (2007) points out the problem of exchange rate stabilization in fixed peg regimes, although his discussion then abstracts from the problem by assuming flexible exchange rates. Yet such an assumption does not really solve the problem, especially in the case of a large or medium country. Such a country indeed cannot really have a totally independent interest rate policy even in the case of a flexible exchange rate, for there are negative externalities, some of which pass through the exchange rate variations (as in the case of 'competitive depreciation'), which normally trigger interest rate policy responses in foreign countries, aimed at offsetting the externalities and the related exchange rate variations¹³. Hence, anticipating the foreign reaction, the policy of the home country may be to set the interest rate in accordance with an 'acceptable' exchange rate, instead of unilaterally implementing a 'parking it' rule.

¹¹ Hein and Stockhammer (2007:17) suggest that low real interest rates rather reduce inflationary pressures and that it is, on the contrary, high interest rates that fuel inflation, based on a cost push argument. Although such a mechanism must of course be considered, there are many cost push channels which could feed distribution conflict even when interest rates are low (as the mentioned wage or profit pressures, but also government taxes, oil and raw material), and in these cases, the monetary policy induced by the 'parking it' rule would certainly allow for inflation.

¹² This dilemma between inflation and what Davidson (2006) called "income policy of fear" shows that inflationary distributive tensions develop when the central bank allows for it, that is, when the central bank refinancing conditions do not remove inflation pressures completely, so that banks deliver the additional money demand that results from the rising nominal prices, wages... In this sense, it can be said that a monetary policy may feed inflation, even though the primary cause is an income distribution conflict.

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

COPING WITH CONFIDENCE

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

Although the long-term interest rate does not result from any market clearing process, it can nevertheless hardly be considered a pure exogenous variable that monetary authorities could put at their desired level,¹⁴ as argued in the previous section. Keynes actually considered the rate of interest a 'highly psychological phenomenon' which level cannot diverge durably from the market convention. Consequently, the essential problem for the monetary policy is to have some influence on the market convention; this is a precondition for being able to adjust the long-term rate of interest towards a desired level.

The long-term interest rate as a convention

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

'is a highly conventional [...] phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be. *Any* level of interest which is accepted with sufficient conviction as *likely* to be durable *will* be durable; subject, of course, in a changing society to fluctuations for all kinds of reasons round the expected normal.' (Keynes 1936: 203)

Therefore unemployment develops 'because people want the moon', that is, because the long-term equilibrium interest rate is not low enough when liquidity preference is too high, given the marginal efficiency of capital and the aggregate propensity to consume. According to this view, the challenge for monetary policy does not amount simply to put the short-term rate at some desired level; it is also necessary to have some influence on the convention so that the long-term interest rate adjusts in a way which allows for full

¹⁴ Assuming an exogenous interest rate may make sense in the field of macroeconomic modeling, as conventions are necessarily considered exogenous for those models being tractable, but it should be recognized that such a simplification cause severe limitations to the models conclusions, insofar as the possible interactions between the interest rate policy and the market convention is merely overlooked.

employment. The task is difficult because the state of confidence is volatile and makes the liquidity preference and inducement to invest shifting variables, with the result that both the control over the long-term interest rate and the final effect on effective demand are erratic.

Things turn out especially delicate when it is considered that the short-term interest rate variations themselves may influence the state of confidence as well, thereby producing shifts in the macroeconomic relationships and making uncertainty endogenous to the monetary policy itself. Successful policies therefore have to ‘take into account the unpredictable reactions of businessmen to those policies’ (Bateman 2003: 82). Quoting Keynes again, we are led to the conclusion that ‘[...] a monetary policy which strikes public opinion as being experimental in character or easily liable to change may fail in its objective of greatly reducing the long-term rate of interest, because M_2 may tend to increase almost without limit in response to a reduction of r below a certain figure’ (Keynes 1936: 203).

Can monetary policy change the convention?

A prudent monetary policy, on the other hand, can take advantage of the conventional nature of the interest rate:

‘if it appeals to public opinion as being reasonable and practicable and in the public interest, rooted in strong conviction, and promoted by an authority unlikely to be superseded ... Public opinion can be fairly rapidly accustomed to a modest fall in the rate of interest and the conventional expectation of the future may be modified accordingly; thus preparing the way for a further movement□up to a point. The fall in the long-term rate of interest in Great Britain after her departure from the gold standard provides an interesting example of this;□the major movements were affected by a series of discontinuous jumps, as the liquidity function of the public, having become accustomed to each successive reduction, became ready to respond to some new incentive in the news or in the policy of the authorities’ (Keynes 1936: 203-204).

Notice that if the central bank acts to decrease the long-term interest rate gradually, the expected reductions may have a negative impact on the marginal efficiency of capital¹⁵ and if, on the other hand, the central bank attempts a sharp adjustment in the long-term interest rate, the liquidity preference may rise and the marginal efficiency of capital may decrease¹⁶. Hence, there are conditions for the success of a monetary policy. The key element is that, at any time, the policy which is being implemented meets the market

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

¹⁶ ‘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)

convention, so that pernicious effects on the liquidity preference and on the marginal efficiency of capital are avoided.

Although the way is narrow and the success is not ensured, four conditions for a successful monetary policy can be made explicit¹⁷.

- 1) As the variation in the long-term interest rate that authorities are seeking for must correspond to the public opinion expectation, authorities should announce a long-term interest rate target in accordance with the normative objective the public opinion has debated and agreed on.
- 2) Logically, such a *conventional target* cannot be very distant from the current rate, for otherwise it could not meet the convention, since it would require the short-term rate being adjusted immoderately (which would "strike the public"), or, if the short run is moved gradually, the long-term rate would decrease gradually (which would be harmful for the marginal efficiency of capital).
- 3) Once the target is set, authorities should adjust the short-term rates they controls gradually, so that it does not look "experimental or easily liable to change...", and it allows for checking whether the policy is working well or not, if there are undesired outcomes..., so that authorities may adapt their policy to the unforeseeable changing context.
- 4) Notice that adjusting the short-term interest rates gradually does not mean slowly, for the long-term interest rate must adjust rapidly to the new convention rather than gradually, so that the above mentioned negative effect on the marginal efficiency of capital is avoided.

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

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

Prudential measures, even determined measures, are necessary conditions of the economic recovery, but they are not sufficient, for lots of bad debts are weakening the state of confidence and the monetary policy effectiveness. Several causes of concern will be lasting until bad debts have been massively reduced and the private and public sectors balance sheets have been made safe.

- 1) The current depression is damaging the public accounts both because of the expenditures that are automatically and/or deliberately triggered by the economic slump and because of the decrease in government fiscal revenues. This is impacting the state of confidence both directly (for increases in public debts make

¹⁷ Although the discussion deals strictly with monetary policy, remember that authorities may also have some influence over the long-term interest rates by means of a debt management policy.

economic agents expect possible future taxes and/or inflation¹⁸ aimed at reducing the real value of the debt) and indirectly (for authorities capacity to support the economic activity will be harmed by a higher public debt).

2) Firms and households' financial situation are being severely affected, with the result that debts which were safe in the context before the financial crash will turn out bad debt in the depressed context.

3) The loss of confidence, in turn, tends to offset the ability of the central bank to get lower long-term interest rates and support the economic activity. As far as it is expected (so that agents do not trust the central bank capacity to support the economy), this enforces the market convention according to which long-term interest rates will remain at high levels.

4) Important amounts of credit-money have been created in exchange of private debts that cannot be recovered, as debtors have failed, or are going to fail. According to the Fisher's identity, increases in the money quantity are concomitant with real income increases and stable prices in a safe economic context (given the velocity of money). In the current context however, large amounts of money have been (endogenously) created which have no real counterpart (to which we refer as 'bad money'). Until now, no serious inflationary pressures have been observed because of the very strong decrease in the velocity of money (increase in the liquidity preference). But, when the depression ends, holders will seek to substitute real assets, financial assets and speculative commodities for money. The money velocity then will probably return towards the pre-crisis level much more rapidly than the increase in real income, thereby allowing for nominal prices inflation (unless the central banks rapidly get an improbable massive withdraw of the excess money; see below)¹⁹. As one can hardly imagine that the excess money will be allowed to feed a new financial bubble in a hurry (but who really knows?), it is the price of real assets and speculative goods (like gold, oil...), rather than financial assets, which is likely to be pushed up first, possibly followed by a wage-indexation effect.

5) Banks have accumulated important reserves at low cost during the rescue episode. Although authorities claim that they will withdraw these liquidities in due time without any trouble, there is some doubt left, for a proportion of these liquidities have been pumped in exchange of bad debts that are likely to turn out unrecoverable. Central banks could therefore hardly withdraw the total amount of high powered money they have injected without seriously harming the financial system again (remember that the U.S. banking system collapsed in February 1933

¹⁸ The case for inflation is discussed below.

¹⁹ Excess money here does not refer to an excess of the supply over the demand for money which would be inconsistent with the Post Keynesian approach to endogenous money (where the money supply sticks to the demand); it refers to the notion of 'bad money', as defined above. The mechanism of inflation in this case is similar to the one which is involved in financial bubbles, although real assets and speculative goods are concerned, rather than financial assets. Of course, at the macroeconomic level the factors costs must be impacted (capital goods, oil, indexed wages...) if the production prices are to be increased.

owing to the problem of bad debts). The good thing is that banks will be able to create credit-money at low rates when private agents start borrowing again to finance new projects; the thorn of the rose is that they will thereby accommodate the additional demand for money involved by the increasing factor cost when inflation develops.

These 'mechanisms' are self-enforcing, for they result from the financial crisis and, at the same time, they make it more serious, insofar as they weaken the state of confidence, thereby pushing up the liquidity preference and long-term interest rates, and pushing down the expected return on capital and inducement to invest... In addition, they harm the capacity of authorities to deal successfully with the crisis, for, on the one hand, the central banks control over long-term interest rates is made much more uncertain, and on the other hand, after the phase of depression, central banks will be faced with the hard choices we have mentioned regarding excess money and the related inflationary pressures. Of course, central banks have technically the capacity of removing inflationary pressures, but as argued above the social cost of such a policy could hardly be supported in a context of financial fragility and high unemployment.

To strike at the root of the problem

The magnitude of the inflationary pressures will depend on the effective capacity of authorities to withdraw the excess money that has been pumped in exchange of private bad debts. The optimistic scenario is that bad debts become good debts, thanks to a general economic recovery which would improve substantially the private financial situations. In this case, meanwhile bad debts become safe, authorities (including central banks, governments and the ad hoc institutions that have been created in order to withdraw and recycle bad debts) can withdraw liquidities, in exchange of the (not so bad) debts they hold, without hurting the financial system²⁰.

Unfortunately, there is place for less optimistic views. The spontaneous response of the authorities has been to collectivize the problem by means of money pumping, financial support, nationalizations and ad hoc institutions aimed at recycling bad debts. But these necessary decisions have transferred the problem to the public sector, in order to rescue the financial system. How then will authorities deal with the problem? As regards central banks, the collectivization process could develop along two different ways. The first one consists in letting the inflation process going on (rather than implementing an 'income policy of fear'), until the real value of debts has depreciated enough as to compensate for the value of the stock of irrecoverable debts (to the detriment of creditors). This solution would preserve the economic activity and employment, while the alternative solution of a monetary policy aimed at stabilizing the price index would put the burden of the losses

²⁰ In accordance with the discussion above, if the liquidities withdrawing process is not rapid enough as to offset for the decrease in liquidity preference, temporary inflationary pressures may develop until it is achieved.

collectivization on unemployed (and debtor, as interest rate would increase)²¹, until the unrecoverable debts are definitively recognized as losses.²²

The process of collectivization of private losses itself, along these lines, would therefore induce policy responses that would not support economic activity at all. Even if inflation was the chosen solution, it would only spare short term interest rates increases. Economic recovery therefore requires offensive policies. In this perspective, 'cheap money' should be welcomed provided the credit-money finances safe (non inflationary) economic investments rather than doubtful speculative operations. The danger would rather be that a restricted credit policy put the burden of past mistakes on current safe economic projects. However, as short-term interest rates have already been reduced close to the minimum, and as the monetary policy control over long-term rates will be difficult as long as the state of confidence has not recovered, an offensive fiscal policy, rather than a defensive one which would be aimed at limiting the public deficit, should be encouraged. In both cases public deficits have to reach historical peaks, but the former could stimulate recovery and let some hope that a substantial amount of bad debts turn out recoverable, while the latter would work pro-cyclically and might therefore make the bad debts troubles still more serious.

CONCLUSION

Although the Post Keynesian interest rules discussed in the paper may be feasible and sustainable in favourable circumstances, there is a difficulty as for the setting of long-term interest rates. According to Keynes theory of the rate of interest, the problem amounts basically to manage to have some influence on the market convention; this is a precondition for being able to adjust the long-term rate of interest towards a desired level. It is a matter of confidence between markets and authorities²³. As Keynes put forward, for a monetary policy to be effective, the variation in the long-term interest rate authorities are seeking for must correspond to the public-opinion's expectations. Authorities should therefore announce a long-term interest rate target in accordance with the normative objective the opinion has debated and agreed on. We have argued that such a *conventional target* cannot be very distant from the current rate, and that authorities should adjust the short-term rates they control gradually, but not slowly, so that it does not look "experimental or easily liable to change..." and so that authorities can adapt their strategy according to the observed effectiveness and to the unforeseeable changing context.

Moving the interest rate convention is harder to get in the context of the current crisis, because of the deleterious effects on private and public accounts that bad debts have carried. To restore the 'state of confidence', authorities will have to get rid of the poison

²¹ This solution also could damage further the financial system, as discussed above.

²² Notice that this type of inflation also appears to be dependent on whether the monetary policy accommodates a distributive conflict or not.

²³ See Le Héron (2006, 2007) for an analysis of Greenspan's strategy in terms of confidence versus credibility.

of potentially irrecoverable debts without throwing the baby out with the bath water. In this perspective, there are strong arguments in favour of monetary accommodation and temporary public deficits (which is not to say permanent large deficits and inflationary policies), even though long-term interest rates do not respond much to the short-term impulses of central banks. Fortunately, this is the kind of response authorities have implemented rather promptly around the world, instead of the mainstream recommended monetary and fiscal orthodoxy.

REFERENCES

Atesoglu, H.S. (2007): The neutral rate of interest and a new monetary policy rule, *Journal of Post Keynesian Economics*, 29: 689-697.

Atesoglu, H.S., Smithin, J. (2006): Inflation targeting in a simple macroeconomic model, *Journal of Post Keynesian Economics*, 28: 673-688.

Bateman, B.W. (2003): The End of Keynes and Philosophy?, in: Runde, J., Mizuhara, S. (eds.), *The Philosophy of Keynes's Economics: Probability, Uncertainty, and Convention*, London and New York: Routledge.

Câmara Neto, A.F., Vernengo, M. (2004): Fiscal policy and the Washington consensus: a Post Keynesian perspective, *Journal of Post Keynesian Economics*, 27: 333-343.

Davidson, P. (2006): Can, or should, a central bank inflation target?, *Journal of Post Keynesian Economics*, 28: 689-703.

Fontana, G., Palacio-Vera, A. (2003): Is There an Active Role for Monetary Policy in the Endogenous Money Approach? *Journal of Economic Issues*, 37(2), 511-17.

Fontana, G., Palacio-Vera, A. (2007): Are long-run price stability and short-run output stabilization all that monetary policy can aim for?, *Metroeconomica*, 58: 269-298.

Hein, E., Stockhammer, E. (2007): Macroeconomic policy mix, employment and inflation in a Post-Keynesian alternative to the New Consensus Model, *IMK Working Paper 10/2007*, Düsseldorf: Macroeconomic Policy Institute (IMK), Hans Böckler Foundation.

Keynes, J.M. (1936): *The General Theory of Employment, Interest and Money*, London: Macmillan.

Lavoie, Marc (1996): Horizontalism, Structuralism, Liquidity Preference and the Principle of Increasing Risk, *Scottish Journal of Political Economy*, 43(3):275-300.

Lavoie, M. (1999): Fair Rates of Interest in Post-Keynesian Political Economy, University of Ottawa, <http://aix1.uottawa.ca/~robinson/english/wp/fairratecla.pdf>.

Le Héron, E. (2006): Alan Greenspan, the confidence strategy, *Brazilian Journal of Political Economy*, 26: 502-517.

Le Héron, E. (2007): The New Governance in Monetary Policy: A Critical Appraisal of the Fed and the ECB, in: Arestis, P., Hein, E., Le Héron, E. (eds.), *Aspects of Modern Monetary And Macroeconomic Policies*, London: Palgrave Macmillan.

Orphanides, A., Wilcox, D. W. (1996): *The Opportunistic Approach to Disinflation*, Washington, D.C.: Board of Governors of the Federal Reserve System.

Palley, T.I. (2007): Macroeconomics and monetary policy: Competing theoretical frameworks, *Journal of Post Keynesian Economics*, 30: 61–78.

Pasinetti, L. (1981): *Structural Change and Economic Growth*, Cambridge: Cambridge University Press

Rochon, L.P., Setterfield, M. (2007a): Interest rates, income distribution, and monetary policy dominance: Post Keynesians and the “fair rate” of interest, *Journal of Post Keynesian Economics*, 30: 13-42.

Rochon, L.P., Setterfield, M. (2007b): Post Keynesian interest rate rules and macroeconomic performance: a comparative evaluation, paper presented at the Eastern Economic Association Conference, New York, February 2007.

Rochon, L.P., Setterfield, M. (2008): The political economy of interest-rate setting, inflation, and income distribution, *International Journal of Political Economy*, 37(2), 5-25.

Sawyer, M. (2007): Seeking to reformulate macroeconomic policies, 3rd bi-annual conference of the CEMF: Post Keynesian Principles of Economic Policy, Dijon (France): University of Burgundy, December 2007.

Setterfield, M. (2007): Is inflation targeting inimical to employment?, <http://www.trincoll.edu/~setterfi/Is%20Inflation%20Targeting%20Inimical%20to%20Employment%20-%20Cambs%20conf%20vol.pdf>.

Setterfield, M., Lima, G.T. (2008): Inflation targeting and macroeconomic stability in a Post Keynesian economy, *Journal of Post Keynesian Economics*, 30: 435-461.

Smithin, John (1994), *Controversies in monetary economics*, Edward Elgar.

Smithin, John (1996): *Macroeconomic Policy and the Future of Capitalism: The Revenge of the Rentiers and the Threat to Prosperity*, Aldershot: Edward Elgar.

Smithin, J. (2007): A real interest rate rule for monetary policy? *Journal of Post Keynesian Economics*, 30: 101–118.

Tily, G. (2006): Keynes's theory of liquidity preference and his debt management and monetary policies, *Cambridge Journal of Economics*, 30: 657-670.

Tily, G. (2009): The *General Theory* and monetary policy – Investment versus inflation, *Intervention*, 6 (1), 97-118.

Wray, R. (2007): A Post Keynesian view of central bank independence, policy targets, and the rules versus discretion debate, *Journal of Post Keynesian Economics*, 30: 119-141.

WORKING PAPERS

WP – 2008-01

The Political Economy of Interest-Rate Setting, Inflation and Income Distribution
Louis-Philippe Rochon and Mark Setterfield

WP – 2008-02

The sustainability of sterilization policy
Roberto Frenkel

WP – 2009-01

Financing Development: Removing the External Constraint
Hassan Bougrine and Mario Seccareccia

WP – 2009-02

An Institutional Perspective on the Current U.S. Government Bailouts
Zdravka Todorova

WP – 2009-03

The Sustainability of Fiscal Policy: An Old Answer to An Old Question
Claudio Sardonì

WP – 2009-04

The Collapse of Securitization: From Subprimes to Global Credit Crunch
Robert Guttman

WP – 2009-05

A Minsky Moment? The Subprime Crisis and the 'New' Capitalism
Riccardo Bellofiore and Joseph Halevi

WP – 2009-06

Asset Bubbles, Debt Deflation, and Global Imbalances
Robert Guttman

WP – 2009-07

Remittances: Political Economy and Development Implications
Ilene Grabel

WP – 2009-08

Central Bank Responses to Financial Crises: Lenders of Last Resort in Interesting Times
Robert Dimand and Robert Koehn

WP – 2009-09

Central Bank Behavior in Time of Financial Crisis
Paul Davidson

WP – 2009-10

Fiscal Policy in Columbia: Procyclical or Countercyclical?
Jairo J. Parada and William R. Baca

WP – 2009-11

A Theory of Minsky Super-Cycles and Financial Crises
Thomas Palley

WP—2009-12
International Payment Finality Requires a Supranational Central Bank Money
Sergio Rossi

WP—2009-13
Monetary Policy in a Period of Financial Chaos: The Political Economy of the Bank of Canada in
Extraordinary Times
Marc Lavoie and Mario Seccareccia

WP—2009-14
Between the Cup and the Lip: Interest Rate Rule and the Long-Run rate of Interest
Angel Asensio

STUDENT WORKING PAPERS

WP – 2009 – 01
Prebisch and the Situation of Bolivia Today
Florine Salzgeber

MEMOS

Memo 1
A Note in deficits and functional finance expenditures
Louis-Philippe Rochon
Mario Seccareccia

Memo 2
John Maynard Keynes
Louis-Philippe Rochon

Memo 3
Understanding the financial crisis
Amit Bhaduri