

International Economic Policy Institute

·Working Paper Series ·
2008 – 01

THE POLITICAL ECONOMY OF INTEREST-
RATE SETTING, INFLATION AND INCOME
DISTRIBUTION

Louis-Philippe Rochon
Laurentian University
and
Mark Setterfield
Trinity College, USA



www.iepi.laurentian.ca
Laurentian University / Université Laurentienne
Sudbury (Ontario)
P3E 2C6

THE POLITICAL ECONOMY OF INTEREST-RATE SETTING, INFLATION AND INCOME DISTRIBUTION

I. INTRODUCTION

Despite the seemingly apparent convergence over the endogeneity of money in recent years with the rise of New Consensus models, there is still considerable disagreement over the nature and role of interest rates in monetary theory and policy, both within the mainstream as well as among heterodox approaches.

Conventional theory suggests that the rate of interest is the price of money, which equilibrates the demand for and supply of money. In this context, the analysis of money is similar to that of any other good, where any excess supplies or demands lead to either a decrease or an increase in the price. Indeed, the purported role of the rate of interest is to clear the money market and, in so doing, contribute to the regulation of economic activity.

Yet, the theory of endogenous money necessarily challenges this vision. By stipulating that the supply of money adapts to the demand for credit, there is no longer an equilibrating role for the rate of interest: since supply adapts to demand, there cannot be an excess supply of money. Instead, the rate of interest is deemed an exogenous variable, bureaucratically-determined by the central bank, according to its various economic goals. And while there is a necessary relationship between the rate of interest and economic activity, it is more complex than assumed by orthodox economists.

While heterodox economists generally accept the endogenous money story, there is still some disagreement over the precise nature and more specifically the role of interest rates in the overall macroeconomic framework. In particular, two questions arise: first, how should central banks use interest rate policy to influence macroeconomic performance? Second, at what level should the central bank set the rate of interest to best serve the economic interests of society? The first question concerns both the nature of the rate of interest as well as the transmission mechanism of monetary policy, while the second question addresses an area of research which, until recently, has been virtually unaddressed by heterodox economists and post-Keynesians in particular.

Both questions, which need to be analyzed separately, concern the fundamental idea of the transmission mechanism of monetary policy. On this issue, there is a fundamental difference between mainstream economists and post-Keynesians. Indeed, as this article will show, a proper understanding of the transmission mechanism and of how changes in the rate of interest affect macroeconomic performance leads inextricably to a reinterpretation of monetary policy. One of the conclusions that we will reach is that in the last two decades, paralleling the growing power of the rentier class and financialization in general, economic policy has been dominated by monetary policy in the belief that monetary policy alone can regulate cycles and attenuate inflationary pressures. We propose an alternative interpretation of interest rates and the monetary transmission mechanism.

II. INTEREST RATES AND THE TRANSMISSION MECHANISM

Interest rates are an important component of economic theory and policy. Their role and importance, however, are not well understood. Indeed, while they are used extensively by central bankers to regulate the economy, there does not seem to be a clear grasp of how interest rates actually affect economic variables, such as unemployment, inflation and economic growth. In other words, the understanding of how changes in the rate of interest affect the overall economy is rather weak, and as a result, there is considerable disagreement over the extent to which they should be relied upon to regulate economic activity, both real and nominal.

In fact, very different approaches to the rate of interest reach very different conclusions. The various approaches agree on neither the meaning of interest rates nor the purpose of interest rate policy. In orthodox theory, the purpose of interest rate policy, as exemplified by the Taylor Rule, for instance, is to regulate the economy such that, in the end, inflation is maintained at a target level. In fact, inflation is always and everywhere the purpose of central bank policy, irrespective of whether the central bank chooses to control money supply growth or interest rates.¹

¹ Although the central bank can only determine the rate of inflation in contemporary orthodox macroeconomics, if it chooses to do this by manipulating the interest rate rather than the quantity of money in circulation, it must also act as the economy's servo-mechanism in the absence (due to endogenous money) of real balance effects. Ironically, then, the stability of the fabled natural or non-accelerating inflation rate of unemployment – the core of orthodox real

For heterodox economists and post-Keynesians, however, the aim of policy is ultimately to affect the real economy, in particular unemployment, income distribution and growth. Moreover, post-Keynesians see little correlation between aggregate demand and price inflation and, as such, any attempt by central banks to regulate aggregate demand via interest rates in the pursuit of an inflation target appears misguided.

To be clear, criticism here centers on two separate issues: on the one hand, heterodox economists would argue that the orthodox analysis of inflation is misguided; on the other hand, orthodox economists have not made it clear why monetary policy should aim to control inflation in the first instance. In other words, there does not seem to be much justification for treating price or inflation stability as the main goal of monetary policy.

Given this lack of consensus on the rate of interest and its implications for economic policy and the real world, the emphasis placed on monetary policy in macro stabilization exercises is troublesome. And yet, the economics profession seems to be clear on one thing: the days of a policy mix seem to be all but over. Today, there appears to be a rather large, and unsettling consensus amongst economists that fiscal policy is to be avoided at all costs, and monetary/interest rate policy alone should be used to alleviate the ails of the economy. In a previous article, Rochon and Setterfield (2007) refer to this approach as monetary policy dominance: in orthodox theory, there is no room for fiscal policy in policy discussions. It is assumed simply that fiscal policy is destabilizing and inflationary.² Indeed, fiscal policy is commonly conceived as an external shock and, as such, something that needs to be “reigned in”. In the end, policy makers must give up on any use of activist fiscal policy and rely instead on monetary policy. As Kelton and Wray (2006, p. 101) have argued, “this instinctive turn towards monetary policy for stabilization represents the culmination of a long-term trend away from ‘Keynesian’ reliance on fiscal policy.”

sector analysis – depends on the machinations of state bureaucrats rather than the “invisible hand” of the market.

² In fact, it need be neither. Hence it is well known that, even in the context of orthodox macro theory, appropriately designed fiscal policy rules are capable of playing the same role in macroeconomic stabilization as monetary policy. See, for example, Taylor (2000) and Setterfield (2007).

The Transmission Mechanism and the Mainstream

For orthodox economists, the transmission of monetary policy seeks to explain how changes in the rate of interest affect inflation. Inflation is always seen as an excess demand phenomenon. The purpose of monetary policy, therefore, is to regulate output so as to minimize the output gap, as exemplified by New Consensus models (see Meyer, 2001). This view of inflation as an excess demand phenomenon is an integral component of the mainstream approach to monetary policy and the transmission mechanism. What needs to be discussed then is how changes in interest rates will affect aggregate demand.

There are several channels of transmission. First, according to the interest rate channel, changes in the rate of interest will affect investment and consumption. This works as follows: lower short-term nominal interest rates lower the real rate (assuming sticky prices), which in turn lowers long-term rates. In turn, assuming interest-sensitive functions, investment and consumption will increase thereby increasing output.

Second, the exchange rate channel assumes that changes, say a decrease in the domestic rate of interest, will also lower the real rate, making domestic assets less attractive than foreign assets. As a result, the demand for domestic currency decreases. The depreciation of the currency then acts in two ways: foreign goods are therefore made more expensive, leading to “imported inflation”, that is, an increase in the price of foreign, imported goods. Simultaneously, the relative price of exported, domestic goods decreases, thereby leading to an increase in exports and output. Inevitably, this increase in output will prove to be inflationary.

Third, in addition to the interest rate channel, there is the credit channel, which contains two separate, though related, channels: the bank lending channel (Bernanke and Blinder, 1988) and the balance sheet channel (Bernanke, Gertler and Gilchrist, 1996) (see Rochon, 1999, for a full discussion; Black and Rosen, 2007), although empirically mainstream economists often cannot distinguish one from another. These channels have been more prominently discussed in recent years. Both channels are rather similar but operate on different ends of the lending spectrum: the bank lending channel concerns itself with the ability of banks to lend, while the balance sheet channel emphasizes the ability of firms to obtain credit.

Given this lack of consensus on the rate of interest and its implications for economic policy and the real world, the emphasis placed on monetary policy in macro stabilization exercises is troublesome.

Both channels are the result of market imperfections or failures, notably information asymmetries. For instance, according to the bank lending channel, borrowers and lenders cannot easily find each other as there are costs associated with matching borrowers with lenders – in particular search costs, but also the costs associated with evaluating potential borrowers. As a result, banks play a special role and are thus ‘special’. As Morgan (1992, p. 32) says, “Bank loans are *special*.” The channel is initiated by an expansionary monetary policy, that is an increase in central bank reserves, resulting in a lower rate of interest: a lower demand, which banks can meet given the increased central bank reserves. The balance sheet channel, also through bank loans, economic activity is increased, resulting in an increase in the ability of borrowers to secure a loan rather than the ability of banks to supply loans (Black and Rosen, 2007). Here, a change in interest rates may affect the balance sheet of firms, influencing their creditworthiness. For instance, a decrease in the rate of interest may lead to increased cash flow, reduced agency costs, increased bank lending (especially to smaller firms), increased economic activity and output and finally, more inflation.

There is one consistent theme in orthodox theory: inflation is considered a monetary phenomenon, the result of an expansionary monetary policy, which encourages output growth.

The bank lending and balance sheet channels are certainly interesting arguments from a post-Keynesian perspective, as they correctly place the role and importance of banks at the heart of the transmission mechanism. Yet, we need to remember that they operate on the basis of market imperfections or failures. For example, the bank lending channel is based on information asymmetries between borrowers and lenders, which make banks important financial intermediaries, bringing borrowers and savers together. Moreover, the transmission mechanism assumes that the inflationary process begins with an increase in bank reserves, leading to an increase in banks’ supply of loans. This is why Rochon (1999) calls this approach to credit-money ‘credit-led but supply-determined’: there is no discussion of the demand side of the equation. Yet, as horizontalists have argued, bank reserves are not causal in the bank-lending story (Lavoie,

1992; Rochon, 1999), and as such there can be no bank lending channel. From an endogenous money perspective, banks will always lend to creditworthy borrowers (Lavoie, 1992; Moore, 1988). There are no supply constraints. Of course, what banks consider creditworthy will change over the course of the cycle (Wolfson, 1996; Rochon, 1999), and this explains credit crunches. Yet, this is not the result of any market failure, asymmetries or central bank constraints, but rather the lack of perceived creditworthy borrowers.

Overall, and irrespective of the specific channel, there is one consistent theme in orthodox theory: inflation is considered a monetary phenomenon, the result of an expansionary monetary policy, which encourages output growth. In other words, inflation is the result of excess demand. This is the fundamental idea in the orthodox explanation of the transmission mechanism of monetary policy.

III. POST-KEYNESIANS AND THE RATE OF INTEREST

Post-Keynesians take issue with the argument that inflation is demand-determined. Hence, a full discussion of the post-Keynesian story of interest rates and the transmission mechanism begins with an understanding of inflation. At the very least, this will allow us to reject the mainstream rationale for monetary policy.

Post-Keynesians consider price inflation to result from supply shocks, specifically, increases in the costs related to production. From there, however, a number of post-Keynesians (see Rochon and Setterfield, 2007; Lavoie, 1992) go a step further and consider more specifically the role played by class conflict over the appropriate share of income (Hein and Truger, 2008). According to this approach, the emphasis is placed on ‘conflict inflation’, that is a struggle over the target wage, with demand conditions playing only a limited role. Viewing inflation from the perspective of distributional conflict carries important consequences for the transmission mechanism of monetary policy and indeed the nature and role of the rate of interest itself.

With respect to the rate of interest, within the context of an endogenous money framework, it should be clear that its role is not to equilibrate the money or credit markets. Rather, the interest rate is set exogenously, determined by the policy objectives of the central bank. It is a bureaucratically-determined variable (Moore, 1988). Yet, beyond that,

post-Keynesians have had little to say, raising questions with respect to the post-Keynesian view of the monetary transmission mechanism.

Recently, Rochon and Setterfield (2007) have proposed a post-Keynesian analysis of the rate of interest that specifically addresses this policy void. They argue that within post-Keynesian theory, two distinct approaches to the rate of interest and the transmission mechanism have emerged, which they call respectively the ‘activist’ and the ‘parking-it’ views. Both approaches recognize the endogenous nature of credit-money, yet they differ with respect to the proper use of monetary policy and the specifics of the transmission mechanism.

In what follows, we argue that the post-Keynesian theory of the transmission mechanism rests on two components: endogenous money and banks, and income distribution. For the most part, post-Keynesians are generally in agreement over these components, although there is nonetheless some disagreement over how much to emphasize the distributional role of the rate of interest.

Banks and the transmission mechanism

While post-Keynesians place the banking system at the heart of the transmission mechanism, the latter does not rely in the first instance on the central bank supplying reserves. Indeed, the post-Keynesian version of the bank lending channel recognizes that bank reserves are wholly endogenous. This is because the role of the central bank is foremost to guarantee the stability of the banking system, thus supplying reserves on demand.

In this sense, the supply of bank credit is determined by the demand for credit, as in most accounts of endogenous money. This being said, banks themselves can agree to supply more or less credit, not because of some external central bank-imposed constraint, but rather because of their optimism or pessimism regarding the creditworthiness of potential borrowers (Wolfson, 1996; Lavoie, 1992; Rochon, 1999, 2006). What banks consider creditworthy will likely change over the course of the cycle and as such, will have an impact on macroeconomic performance.

Banks are primarily concerned with the ability of borrowers to pay back their loans, which is easier when demand is strong: a growing economy implies growing revenues from which firms can reimburse banks and cancel their debt commitments. When the outlook is poor, however, banks will cut back their loans and, as a result, demand will fall. To be clear, banks can never lend without a pre-existing demand, which is why the mainstream version of the bank lending channel does not hold. Yet, banks can decide

whether to lend more or less based on their changing creditworthiness criteria.

The question that remains is: how is the rate of interest determined? The answer to this question – which we discuss in the following section – leads us directly to consideration of the role of the distribution of income in the monetary transmission mechanism.

Post-Keynesians and interest rate rules

As discussed above, the first element of the post-Keynesian theory of the transmission mechanism rests on the endogenous nature of credit-money and the role banks play. This argument requires very little discussion as there is considerable consensus in post-Keynesian circles on this matter. However, the second component, the role played by income distribution, requires a more detailed discussion as it necessitates consideration of the two distinct approaches to interest rate policy in post-Keynesian theory: the activist and parking-it approaches.

The activist approach as we describe it relies on the use of nominal (or real) interest rates to fine-tune economic activity, in particular output, employment and growth. It rests on the notion that there exists a direct relationship between interest rates and economic activity in the short run: consistent with the theory of endogenous money, the central bank controls the short-run nominal interest rate and uses its power over them to change it frequently in accordance with its overall economic objectives. This practice is consistent with most central banks’ practices, as well as the spirit of the Taylor Rule. According to this approach, central bank policies would simply replace or augment inflation targeting with other targets or central bank objectives, such as unemployment or even capacity utilization. The purpose is to change the rate of interest whenever the economy deviates from the central bank’s stated objectives.

The activist approach is defended by a number of post-Keynesians, in particular Moore (1989, p. 487) who argues that:

- A 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.

Moreover, Moore (1994, p. 123) argues that “In pursuit of their macroeconomic stabilization goals central banks ordinarily vary interest rates procyclically, in response to the perceived state of the economy.”

This position is also defended by Palley (2006) whose approach to central bank policy makes use of a central bank reaction function to regulate the economy. According to Palley, central bank policy should aim at targeting the minimum unemployment rate of inflation, or MURI. Palley’s argument rests on a backward-bending Phillips curve. According to this approach, at low levels of inflation, workers in depressed industries accept inflation-induced reductions in real wages in order to increase employment levels. But further increases in inflation eventually encounter greater real-wage resistance. As a result, unemployment begins to increase. The point is to use monetary policy rate of unemployment resulting backward-
In other words, Palley “from a Post-Keynesian monetary authority its inflation target.”

Finally, Fontana and also defend the activist authors, a post-the New Consensus an ‘asymmetrical They argue that central to increase the rate of inflation is above target, to decrease rates below the central bank target. For the authors, the contemporary Phillips Curve would justify decreases in the rate of interest whenever inflation falls below target. Indeed, for the authors, “the short-run output-inflation trade-off has a (relatively wide) flat section or range of output values for which inflation is roughly constant” (2006, p. 55). In other words, in the short-run output can vary without generating inflation. Accordingly, when inflation is below the central bank target, the central bank should “exploit the flat section ... by reducing real interest rates instead of keeping them constant.”

Given the discussion above, there is a number of post-Keynesians for whom the use of interest rates to regulate economic activity is a misplaced

Ultimately, the parking-it approach recommends that central banks refrain from using interest rates as a way of fine-tuning the economy.

to seek out the minimum permitted by the bending Phillips curve. (2006, p. 87) claims that perspective, the should set the MURI as

Palacio-Vera (2006) approach. For these Keynesian alternative to rests on what they call opportunistic’ approach. banks are all too ready interest whenever but seem to be reluctant whenever inflation is

exercise. Indeed, for proponents of the ‘parking it’ view of monetary policy, while recognizing money’s endogeneity and the exogenous nature of short-run interest rates (nominal or real), they nonetheless move away from a reaction-function type of analysis. Indeed, according to this approach, monetary policy and the reliance on interest rates has become too prevalent in today’s economy. Indeed, as Rochon (2008) argues, contemporary central bank behaviour is fundamentally misguided. Since reaction functions rely on fine-tuning the economy as needed, the central bank’s policy obsession with inflation often translates into repeated increases in the rate of interest until the economy finally deflates (or collapses), in the misguided pursuit of a “soft-landing”. And while it is true that central banks may be reluctant to reduce rates when inflation is low or below target, an asymmetrical opportunistic approach may not be the ideal approach to central bank policy.

Ultimately, the parking-it approach recommends that central banks refrain from using interest rates as a way of fine-tuning the economy. There are two important reasons for this. The first reason is the perceived ineffectiveness of interest rate policy as a method of regulating economic activity. This is reflected in Davidson’s (2006) questioning of the wisdom of using monetary policy to fight inflation, and Wray’s (2007) argument to “reject discretionary policy and doubt the veracity of conventional views of central bank ability to achieve traditional goals such as robust growth, low inflation, or high employment.” The second reason concerns itself with the notion that interest rates should be seen primarily as a distributional variable. From this analysis flows the notion that if interest rates are an income distributional variable, then they must play a role in the transmission mechanism of monetary policy. Here, an important observation emerges. The purpose of monetary policy is two-fold: first interest rates should not be used to regulate output or inflation, but to target income distribution. Second, central banks should not concern themselves as much with regulating the economy than with regulating the financial system and ensuring the stability of the banking system.

Hence in line with Smithin’s warnings about the ‘revenge of the rentier’, an emerging post-Keynesian consensus on central bank policy aims at downgrading the importance of interest rate policy in regulating cycles due in large part to the realization that interest rates are first and foremost a distributional variable that affects the income shares of various social groups (Lavoie, 1992; Rogers, 1989). In other words, central banks should stop changing interest rates in pursuit of short-run macro stabilization, and instead attend to the long run distributional consequences of monetary policy. This does not, in general, mean that the central bank becomes

completely inactive, never undertaking to adjust the nominal interest rate. Instead, the approach involves identifying a benchmark rate of interest and then only seldom changing the actual rate in conformity with any discrete (and infrequent) changes in the benchmark rate itself. This approach to monetary policy can be contrasted with the activist approach described earlier, which will give rise to very much more frequent changes in the nominal interest rate.

According to the parking-it view, then, what is required is an interest rate policy for long-run purposes: a rule that establishes a “proper” value for the real rate of interest (in the absence of a Wicksellian natural rate) that is invariant to economic fluctuations over the course of the business cycle. But if this is the case, then as Smithin (2004, p. 63) asks, “If the level of the real rate of interest finally boils down to a target chosen by the central bank ... what should the target be?”

While placing long-run considerations at the heart of central bank policy is a central focus of the parking-it view, there is nevertheless some disagreement as to what the exact value of the interest rate ought to be. This specific value is of particular importance: if the rate is a distribution variable, then choosing the proper value reflects a particular view with respect to the proper or optimal distribution of income.

Within the ‘parking it’ approach, there are three distinct approaches although we can group two of these rules under a single heading. Indeed, what distinguishes one group from another is their perception and respective treatment of the rentier class within economic analysis. Specifically, the question at the heart of the parking-it view is whether we should euthanize the rentier class?

Lavoie (1996, pp. 536-7) summarizes the various parking-it approaches as follows:

Two points of view may be proposed at this juncture. One may be of the opinion that rentiers are parasites and that, as a consequence, interest rates should be kept as low as possible, even at negative real rates, to get rid of this useless economic class. ... Another approach is to view rentiers as a necessary evil, a class the ranks of which are constantly replenished by the arrival of new retiring generations. Under these circumstances, the elimination of the rentier class is a utopia. ... This amounts to finding a fair share for those earning interest income.

As discussed above, there are three distinct approaches to the parking-it view. The first approach, or what we call the ‘Smithin rule’, stipulates that the central bank should pursue a policy of “low but still positive” real interest rates. According to Atesoglu and Smithin (2006, p. 686), “As a practical matter, this would likely involve adjusting the nominal policy rate

one-for-one with observed inflation.” Their policy of low, but positive, real rates is analogous “to an incomes policy of a sort, albeit an incomes policy for rentiers rather than for workers or entrepreneurs.” Hence according to Smithin (2007, p.113), while profit is the reward for enterprise and wages reward labor, the role of interest is simply to “preserve or enhance the value of accumulated financial capital.” The case can be made, therefore, that “the theoretical ‘optimum’ value of the real interest rate is probably actually zero” (Atesoglu and Smithin, 2006, p. 686, fn. 7). This is because, at a zero real interest rate, “the real value of existing sums of money, representing *past* effort in the form of work and enterprise, would be preserved, but there would be no increase in their value arising from the mere possession of money. Further accumulation would only be possible by contributing further work or enterprise, or assuming further risk” (Smithin, 2007, p.114. Emphasis in original).³

The second rule, which we call the Kansas City rule as its proponents are centered within the department of economics at the University of Missouri, Kansas City, proposes a monetary policy where the central bank sets the nominal rate to zero, thereby letting the real rate adjust endogenously (becoming, in most cases, negative given inflation). The Kansas City Rule should be considered a two-prong argument. First, it is argued that the ‘natural’ nominal rate of interest is zero; in other words, as fiscal deficits swell bank deposits and thus increase bank reserves, this will in turn bid down the nominal rate. This suggests that rates will naturally tend to zero, unless the central bank follows a defensive policy and sells securities in order to drain reserves from the system – which they will normally do given that the central bank nominal interest rate target is positive – or pays interest on bank reserves. As Mosler and Forstater (2004, p. 10) argue, “In a state money system with flexible exchange rates running a budget deficit – in other words, under the ‘normal’ conditions or operations of the special institutional context – without government intervention either to pay interest on reserves [or] to offer securities to drain excess reserves to actively support a non-zero, positive interest rate, the natural or normal rate of interest of such a system is zero.”

But there is an additional argument involved here. In addition to the notion that the natural value of the rate is zero, the Kansas City Rule also argues that central banks should allow nominal rates fall to zero by explicitly targeting a zero nominal rate. This is what Wray (2004, p. 27)

³ Smithin (2007, p.14, fn 8) emphasizes that because financial wealth retains its real value even at the “optimal” real interest rate of zero, the Smithin rule does not involve the euthanasia of the rentier.

calls a 'neutral rate' policy. According to the author (2004, p. 10), "indeed, a very good case could be made that the neutral rate is a Japan-like zero." Moreover, according to Mosler and Forstater (2004, p. 10), "the central bank clearly controls short-term interest rates in a state currency with flexible exchange rates, and there are a number of good reasons for setting the overnight rate at its natural or normal rate of 0%, and allowing markets to factor in risk to determine subsequent credit spreads." They then add that "allowing the rate of interest to settle at its natural rate of zero makes good economic sense" (p. 14). As Wray (2007, p. 138) makes clear: "A monetary policy rule is preferred: set the overnight rate at zero, and keep it there.

Although the rationale for a zero nominal interest rate above does not appeal directly to distributional concerns, it would have clear implications for the functional distribution of income. If the nominal interest rate is set at zero then as intimated above, the real rate will be negative in an inflationary environment – as a result of which the real income streams of rentiers will steadily decline over time, *ceteris paribus*. This *would* seem to involve a euthanasia of the rentier. In practice, however, this last result will depend on *which* nominal interest rate is set equal to zero. It is common for macroeconomic models (orthodox and heterodox alike) to speak of *the* interest rate, when there is, in fact, a term structure of interest rates, reflecting different rates of return on financial assets of differing maturities. If, per Mosler and Forstater (2004), the central bank sets the nominal *overnight* interest rate at zero and then allows "markets to factor in risk to determine subsequent credit spreads", it is quite conceivable that the real rate of return to financial wealth will, in the aggregate, be non-negative. This observation draws attention to two important issues for the parking-it approach to monetary policy. The first is the question as to *which* interest rate is (or should be) the object of the postulated benchmark interest rate rule? The second is the fact that as long as there exists a term structure of interest rates, any explicit distributional aspirations of benchmark interest rate rules are unlikely to be realized by monetary policy alone. Fiscal policy – more specifically, the tax treatment of conceptually different sources of income – will also need to play a role.

The transmission mechanism of monetary policy operates through changes in income distribution, that is the relative shares of income among classes. This is significant not only because of equity issues, but also because the parking-it approaches share a common conception of the growth process (in both the short-run and the long-run) as being dominated by demand, and hence influenced by distribution.

Finally, the last view within the parking-it approach is the Pasinetti Rule, also known as the 'fair' rate of interest rule. It is advocated notably by Lavoie and Seccareccia (1999). The specific argument here is that the 'fair' interest rate is the rate at which the distribution of income is unchanged. Indeed, as they argue, the fair rate leaves "unchanged the distribution of income between interest and non-interest income groups, regardless of lending and borrowing activities" ((1999, p. 543). In order to achieve this, the central bank ought to set the real interest rate equal to the rate of growth of labour productivity: "Under those conditions, an amount of money equivalent to one hour of labor time, if lent at that normal rate of interest, will still be worth one hour of labor time when recovered with its interest payments ... The relative situation of the rentiers in the social hierarchy stays the same, whatever economic conditions" (Lavoie, 1996, p. 537).

Note that the explicit ambition of the Pasinetti rule as stated above – namely, maintaining or preserving (but not enhancing) the position of rentiers in society – is identical to that of the Smithin rule discussed earlier. But how, then, can it be that these two different interest rate rules identify two *different* "optimal" values for the real interest rate (zero, and a rate equivalent to productivity growth) when they are designed to achieve the *same* stated objective? The answer lies in the different conceptions of fairness that motivate the Smithin and Pasinetti rules – and hence exactly what it means to preserve the position of rentiers. Specifically, the Smithin rule preserves purchasing power in terms of goods and services: the ability of rentiers to *consume* remains constant. The Pasinetti rule, meanwhile, preserves purchasing power in terms of labour time: it is, in a sense, the ability of rentiers to *produce* that remains constant under this rule.⁴ Technically, the difference between the Smithin and Pasinetti rules amounts to no more than the choice of *numeraire* (the general price level versus the nominal wage) used to measure the "real purchasing power" of rentiers. But as noted above this "technical difference" is best understood as involving

⁴ We say "in a sense" here because what remains constant is the quantity of labour time that rentiers can purchase: with labor productivity growth, the productive potential of this constant amount of labor time will, of course, be increasing. Nevertheless, it is rentiers access to a factor of production (labour time) that is being maintained as constant by the Pasinetti rule.

value judgements with respect to what constitutes fairness, in the context of an otherwise identical “incomes policy for rentiers” designed to preserve the relative position of rentiers in society.

As should by now be obvious, at the heart of the parking-it approaches to monetary policy is a consistent theme: the transmission mechanism of monetary policy operates through changes in income distribution, that is the relative shares of income among classes. This is significant not only because of equity issues, but also because the parking-it approaches share a common conception of the growth process (in both the short-run and the long-run) as being dominated by demand, and hence influenced by distribution. For instance, if the relative share of workers, who have a higher propensity to consume, decreases, then growth will likely be thwarted. Similarly, if income distribution favors the rentier class, with a low propensity to consume and no direct involvement in the process of accumulation, then this will once again likely diminish growth prospects.

The innovative contribution of the parking-it approach is precisely to tie income distribution and macroeconomic performance to interest rate policy and the monetary transmission mechanism. The objection to the activist approach is that using short-run interest rates as a policy tool distorts income distribution and (at least in the case of macroeconomic orthodoxy) relies on engineering economic slowdowns to regulate the economy. Indeed, according to Lavoie (1996, p. 537), “It ... becomes clear that monetary policy should not so much be designed to control the level of activity, but rather to find the level of interest rates that will be proper for the economy from a distribution point of view. The aim of such a policy should be to minimize conflict over income shares, in the hope of simultaneously keeping inflation low and activity high.”

Moreover, the parking-it approach suggests that by minimizing the dominance of monetary policy, governments should rely more on fiscal policy and incomes policies to regulate economic cycles and inflation. It thus heralds a return to Keynesian policy making in the fullest sense. Further discussion of the proper use of fiscal and incomes policies designed to achieve macro stabilization is certainly required, as is research into the empirical effects of different parking-it rules, their interaction with fiscal and incomes policies, and their consequent effects on the efficacy of these policies. But these issues are beyond the immediate scope of this paper.

IV. CONCLUSION

In this paper, we argued that there is a need to understand the proper mechanism by which changes in the rate of interest affect the real economy, especially if economic policy is dominated by monetary policy.

According to the mainstream, changes in the rate of interest will trickle through a number of channels, including the interest rate channel, the exchange rate channel, or the bank lending and balance sheet channels. Yet, we believe that these channels do not capture the true nature of the rate of interest and the way that changes in the rate actually affect economic activity. Here, two criticisms can be raised against the mainstream account of these channels. First, post-Keynesians question the relationship between changes in interest rates and price or inflation targets. This mechanism relies on the notion that price increases are the result of excess demand, which we reject in favour of a conflict approach. Second, in order to achieve price stability, changes in interest rates must affect demand and output. We question the strength of these channels: rather than being direct and powerful, they are weak and complex, such that to have a final effect on output, employment and growth, policy makers must rely on several contentious changes in order to achieve their desired result.

While united in their rejection of the mainstream account, however, two different post-Keynesian approaches to interest rate policy have emerged, which we call the activist and parking-it views. While both approaches embrace the first criticism above, they differ with respect to the second criticism. Whereas the activist approach still recognizes a strong relationship between interest rates and output, the second approach is more critical. Accordingly, the parking-it view argues that the rate of interest is foremost a distributive variable and only by affecting the distribution of income can interest rates ultimately impact on employment, output and growth. Seen in this light, the parking-it view argues that the rate of interest should not be used as a counter-cyclical policy variable. Ultimately, we argue that post-Keynesians should rely on fiscal policy to achieve macroeconomic stabilization objectives.

BIBLIOGRAPHY

Atesoglu, S. and J. Smithin (2006), “Inflation Targeting in a Simple Macroeconomic Model”, in *Journal of Post Keynesian Economics*, 28 (04), Summer, pp. 673-688.

- Bernanke, B.S. and A. Blinder (1988), "Credit, Money, and Aggregate Demand", *American Economic Review*, Papers and Proceedings, May, **78**, 435–9.
- Bernanke, B., M. Gertler and S. Gilchrist. (1996), "The Financial Accelerator and the Flight in Quality", *Review of Economics and Statistics*, February, **78** (1), 1–15.
- Black, L. and R. Rosen (2007), "How the Credit Channel Works: Differentiating the Bank Lending Channel and Balance Sheet Channel", Federal Reserve Bank of Chicago, Working Paper 2007-13.
- Davidson, P. (2006), "Can, or should, a central bank inflation target?", *Journal of Post Keynesian Economics*, 28 (4), Summer, pp. 689-703.
- Fontana, G. and A. Palacio-Vera (2006), "Is there an active role for monetary policy in the endogenous money approach?", in Gnos, C. and L.-P. Rochon (eds), *Post-Keynesian Principles of Economic Policy*, Cheltenham: Edward Elgar, pp. 49-56.
- Hein, E. and A. Truger (2008), "Fiscal policy in the macroeconomic policy mix: A critique of the New Consensus Model and a comparison of macroeconomic policies in France, Germany, the UK and Sweden from a Post-Keynesian perspective", in Gnos, C. and L.-P. Rochon (eds), *Credit, Money and Macroeconomic Policy A Post-Keynesian Approach*, Cheltenham: Edward Elgar (forthcoming).
- Kelton and Wray (2006), "What a Long, Strange Trip It's Been: Can we Muddle Through Without Fiscal Policy? In Gnos, C. and L.-P. Rochon (eds), *Post-Keynesian Principles of Economic Policies*, Cheltenham: Edward Elgar, pp. 101-19.
- Lavoie, M. (1992), *Foundations of Post-Keynesian Economic Analysis*, Aldershot, UK: Edward Elgar.
- Lavoie, M. (1996), "Monetary policy in an economy with endogenous credit money", in E. Nell and G. Deleplace (eds), *Money in Motion*, London: Macmillan, pp. 532-45.
- Lavoie, M. and M. Seccareccia (1999) "Interest rate: fair", in O'Hara, P. (ed), *Encyclopedia of Political Economy*, vol. 1, London: Routledge, pp. 543-545.
- Meyer, L.H. (2001), "Does money matter?", *Federal reserve Bank of St Louis Review*, 83 (4), pp. 1-15.
- Moore, B. (1988), *Horizontalists and Verticalists: The Macroeconomics of Credit-Money*, Cambridge: Cambridge University Press.
- Moore, B. (1989), "On the endogeneity of money once more", *Journal of Post Keynesian Economics*, Spring, 11 (3), pp. 479–87.
- Moore, B. (1994), "The demise of the Keynesian multiplier: A reply to Cottrell", *Journal of Post Keynesian Economics*, Fall, 17 (1), pp. 121–33.
- Morgan, D. P. (1992), "Are Bank Loans a Force in Monetary Policy", *Federal Reserve Bank of Kansas City Economic Review*, Second Quarter, 31–41.
- Mosler, W. and M. Forstater (2004), "The Natural Rate of Interest is Zero", Working Paper No. 37, University of Missouri, Kansas City.
- Palley, T. (2006), "A Post-Keynesian Framework for Monetary Policy: Why Interest Rate Operating Procedures are Not Enough", in Gnos, C. and L.-P. Rochon (eds), *Post-Keynesian Principles of Economic Policy*, Cheltenham: Edward Elgar, pp. 78-98.
- Rochon, L.-P. (1999) *Credit, Money and Production: An Alternative Post-Keynesian Approach*, Cheltenham: Edward Elgar.
- Rochon, L.-P. (2006), "Endogenous Money, Central Banks and the Banking System: Basil Moore and the Supply of Money", In M. Setterfield (éd), *Complexity, Endogenous Money and Macroeconomic Theory: Essays in Honour of Basil J. Moore*, Cheltenham: Edward Elgar Publishing, pp. 220-243.
- Rochon, L.-P. (2008), "Central Bank Governance, the Euthanasia of the Rentier and Interest Rate Policy: A Note on post-Keynesian Monetary Policy after Taylor", in Gnos, C. and Rochon, L.-P. (eds), *Monetary Policy and Financial Stability*, Cheltenham: Edward Elgar Publishing, pp 48-67.
- Rochon, L.-P. and M. Setterfield (2007), "Post Keynesian Interest Rate Rules and Macroeconomic Performance: A Comparative Evaluation." *Journal of Post Keynesian Economics*, Fall, 30 (1), pp. 13-41
- Rogers, C. (1989), *Money, Interest and Capital: A Study in the Foundations of Monetary Theory*, Cambridge: Cambridge University Press.
- Setterfield, M. (2007) "Is there a stabilizing role for fiscal policy in the New Consensus?" *Review of Political Economy*, 9, 405-18
- Smithin, J. (2004), "Interest rate operating procedures and income distribution", in M. Lavoie and M. Seccareccia (eds), *Central Banking in the Modern World: Alternative Perspectives*, Aldershot: Edward Elgar, pp. 57-69.
- Smithin, J. (2007) "A real interest rate rule for monetary policy?" *Journal of Post Keynesian Economics*, 30, 101-18
- Taylor, J.B. (2000) "Reassessing discretionary fiscal policy," *Journal of Economic Perspectives*, 14, 21–36
- Wolfson, M.H. (1996), "A Post Keynesian Theory of Credit Rationing", *Journal of Post Keynesian Economics*, Spring, 18 (3), 443–70.
- Wray, R. (2007), "A Post Keynesian View of Central Bank Independence, Policy Targets, and the Rules Versus Discretion Debate", in *Journal of Post Keynesian Economics*, Fall, 30 (1), pp. .119-141.



International Economic
Policy Institute

Institut international des
politiques économiques