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# MACROECONOMICS AFTER KALECKI AND KEYNES

Post-Keynesian Foundations

(Edward Elgar 2023)

## Chapter 6

### 'A POST-KEYNESIAN MACROECONOMIC POLICY MIX'

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- 6.2 Monetary policy
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## 6.1 INTRODUCTION



- From our post-Keynesian models presented in Chapter 5, it follows that the NCM policy framework has to be completely revised in order to achieve a high and stable medium- to long-run employment rate with stable inflation rates and inflation expectations
- The following elaborations are based on Hein and Stockhammer (2009, 2010, 2011b). A similar post-Keynesian economic policy mix has been advocated by Arestis (2010, 2013) and Arestis and Sawyer (2010a).
- Historically, it can also be found in Kalecki (1943b, 1943c, 1944, 1945) and Kalecki and Schumacher (1943).
- Applications to EMU: by Arestis (2011b), Arestis and Sawyer (2011, 2013), Hein (2018a), Hein and Detzer (2015b, 2015c), Hein and Martschin (2020), Hein et al. (2012b) and Sawyer (2013)



<b>Table 6.1: Macroeconomic policy recommendations: New Consensus models (NCM) and post-Keynesian models (PKM) compared</b>		
	<b>NCM</b>	<b>PKM</b>
<b>Monetary policy</b>	Inflation targeting by means of interest rate policies, which affects unemployment in the short run, but only inflation in the long run	Target low interest rates which mainly affect distribution, and stabilise monetary, financial and real sectors by applying other instruments (lender of last resort, credit controls, ...)
<b>Fiscal policy</b>	Supports monetary policy in achieving price stability by balancing the budget over the cycle	Real stabilisation in the short and in the long run with no autonomous deficit targets; affects distribution of disposable income
<b>Labour market and wage/incomes policy</b>	Determines the NAIRU in the long run and the speed of adjustment in the short run; focus should be on flexible nominal and real wages	Affects price level/inflation and distribution; focus should be on stable nominal wages, steady nominal unit labour cost growth and compressed wage structure
<b>International economic policies</b>	Free trade, free capital flows and flexible exchange rates	Regulated capital flows, managed exchange rates, infant industry protection, regional and industrial policies
<b>Economic policy co-ordination</b>	Clear assignment in the long run; co-ordination at best only in the short run	No clear assignment; economic policy co-ordination required in the short and the long run, both nationally and internationally
Source: Based on Hein (2017a, p. 154)		



## 6.2 MONETARY POLICY



- Interest rate policies have short- and long-run real effects
- activist vs. parking it (Rochon and Setterfield 2007)
- activist: use interest rate to stabilise, but be aware of limitations
- parking it: refrain from fine tuning inflation or employment but target a constant rate of interest
- CB has responsibility for stability of financial system
  - definition of credit standards and creditworthiness
  - reserve requirements and capital controls to prevent bubbles
  - ‘lender of last resort’ in the case of systemic crises
  - guarantor of public debt



## Parking it targets (or rules):

- zero nominal overnight rate (Kansas City rule, Wray (2007))
- (close to) zero real long-term rate of interest (Smithin rule, Smithin (2007))
- real long-term rate equal to productivity growth (Pasinetti rule, Lavoie (1996))

Central bank long-term interest rate target ( $i^T$ ):

$$(6.1) \quad i^T = i_r^T + \hat{p} = i_r^T + \hat{p}^e + \hat{p}^u,$$

$i_r^T = \hat{y}$  given by medium-run productivity growth.

Pragmatic target long-term nominal interest rate ( $i^T$ ) for central banks,:

$$(6.2) \quad \hat{p} \leq i^T \leq \hat{Y} + \hat{p} = \hat{Y}^n \quad \Leftrightarrow \quad 0 \leq i_r^T \leq \hat{Y}.$$



$$(6.3) \quad i = (1 + m_B) i_{CB}.$$

Since (6.3), central banks also need to assess the mark-up applied by commercial banks and set the short-term rate of interest accordingly:

$$(6.4) \quad i_{CB} = \frac{i^T}{(1 + m_B)} = \frac{i_r^T + \hat{p}}{(1 + m_B)} = \frac{i_r^T + \hat{p}^e + \hat{p}^u}{(1 + m_B)}$$

- Changes in mark-up may prevent central banks from reaching their targets
- Way out: quantitative easing, i.e. central banks purchasing government and corporate bonds, thus raising bond prices and bringing long-term interest rates on bonds down.
- May stabilise financial sector and deficit units, but may also raise risk taking and financial instability
- Little effects on economic activity in a slump



## 6.3 INCOME AND WAGE POLICY



Nominal and real wage, or rule and rule (distribution) variations generate instability

Wage & incomes policies should target nominal stabilisation and stable distribution

→ nominal unit labour costs should grow at a rate similar to the country's inflation target

→ only if other distribution claims (profits, state, external sector) are reduced, redistribution via wage policy is possible without triggering unexpected inflation and instability

Target nominal wage growth:

$$(6.5) \quad \hat{w} = \hat{y} + \hat{p}^T .$$

$\hat{y}$  : long-run productivity growth



Flatten the Phillips curve by reducing  $h_2 + \Omega_2$  :

$$(6.6) \quad \hat{p}^u = \frac{h_0 + \Omega_0 + \Omega_1 e - 1}{h_2 + \Omega_2}.$$

Introduce a horizontal part:

$$\Omega_W^T = (1-h)_W^T = (1-h)_F^T = h_0, \text{ if: } e_1^N < e < e_2^N$$

(6.7) and

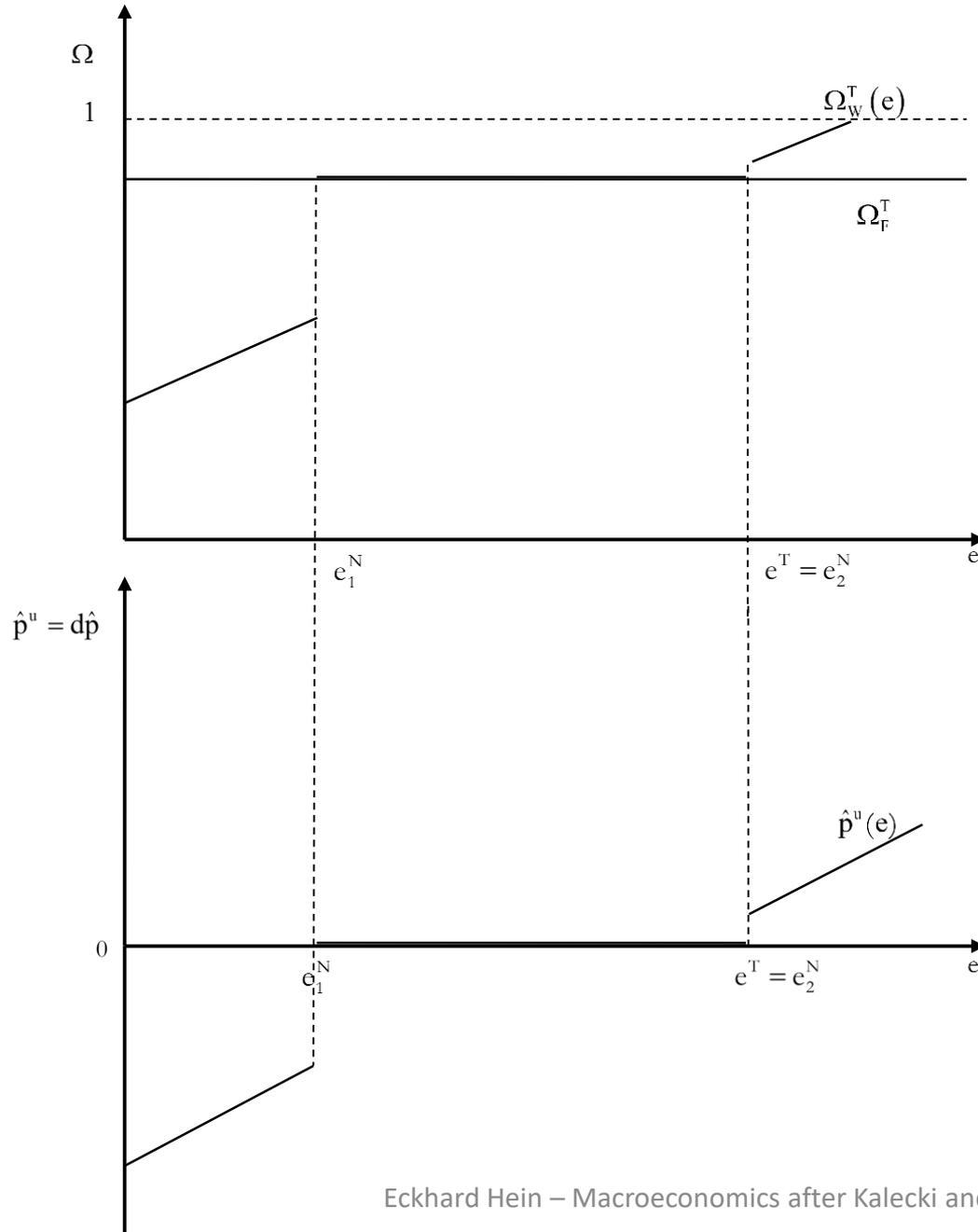
$$\Omega_W^T = (1-h)_W^T = \Omega_0 + \Omega_1 e, \text{ if: } e < e_1^N \text{ or } e_2^N < e$$

$$\hat{p}_t^u = \frac{\Omega_0 + \Omega_1 e + h_0 - 1}{\Omega_2 + h_2}, \text{ if: } e < e_1^N \text{ or } e_2^N < e,$$

(6.8) and

$$\hat{p}_t^u = 0, \text{ if: } e_1^N < e < e_2^N.$$

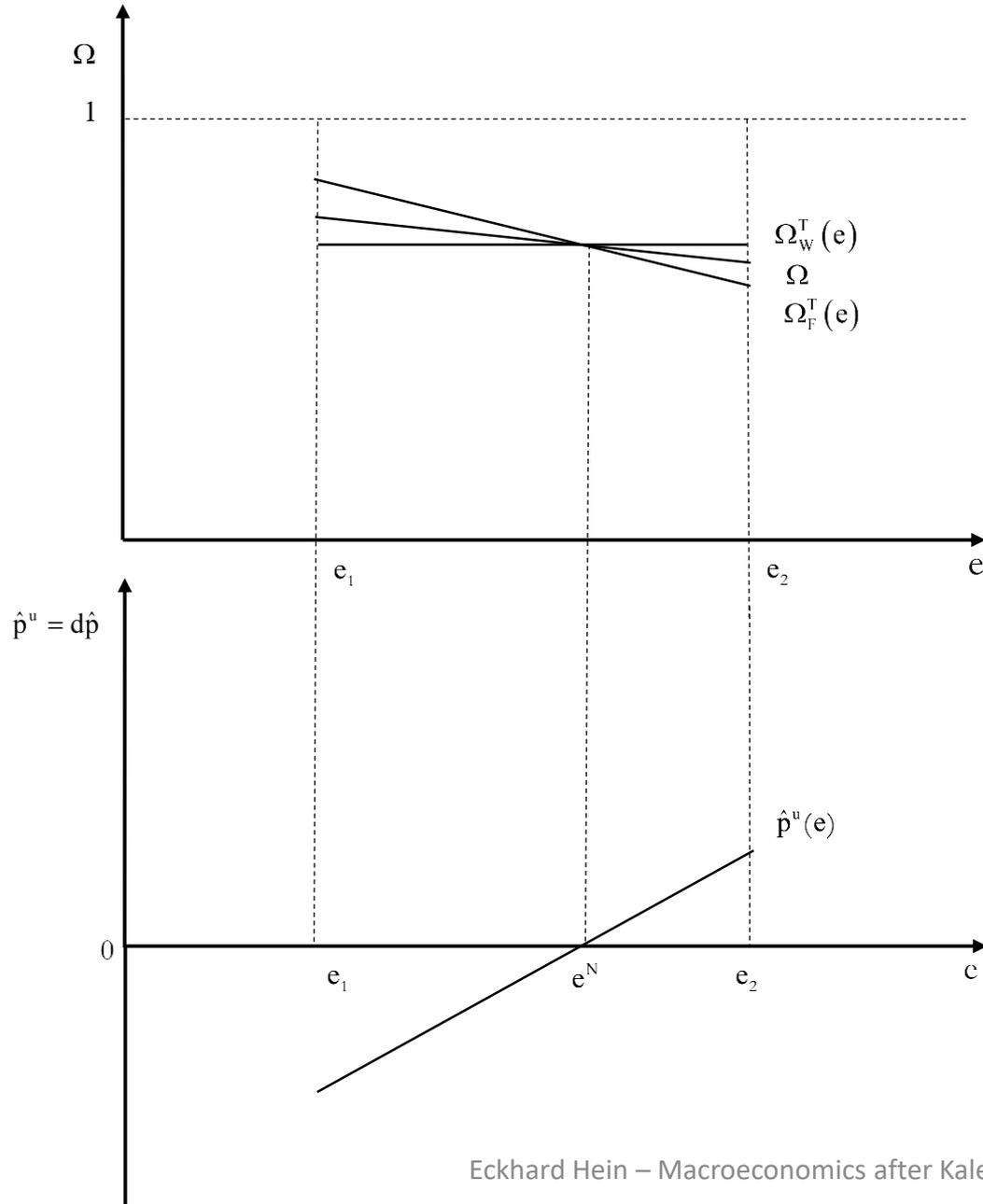
Figure 6.1: Results of a post-Keynesian macroeconomic policy mix





- With pro-cyclical target and actual profit share, wage norm is stabilising in a wage-led economy:
  - If inflation exceeds (falls short of) target inflation, following the wage norm means lowering (raising) the wage, aggregate demand, employment and thus inflation.
- Trend productivity growth or actual productivity growth?
  - Following trend productivity growth is stabilising in a wage-led economy, because wage share will fall (rise) in upswing (downswing).
- National productivity growth or firm or industry productivity growth?
  - Following economy wide productivity growth facilitates structural change

**Figure 6.2: Constant target wage share of workers and pro-cyclical target profit share of firms**





## Institutional requirements:

- wage bargaining coordination focussing on consistent distribution targets
  - high coordination at national level,
  - strong trade unions and employer association,
  - government involvement in bargaining
  - statutory minimum wages, declaration of general applicability of bargaining results
- Phillips curve becomes (partly) horizontal
- Demand management can choose high level of employment without triggering unexpected inflation



## 6.4 FISCAL POLICY



- Arestis and Sawyer (2003, 2004a, 2004b): arguments against activist fiscal policies and government deficit spending, like crowding out and the Ricardian equivalence hypothesis, presuppose the stability of full employment equilibrium and the dominance of rational model-consistent expectations of economic actors, and thus ignore fundamental uncertainty, aggregate demand failures and Keynesian unemployment.
- Effectiveness of fiscal policies with regard to stabilising aggregate demand and economic activity, in particular in economic downswings when interest rate policies of central banks face severe limitations (zero lower bound, weak animal spirits of firms), has been supported recently again by orthodox and heterodox authors, using different types or empirical methods
- Fiscal multipliers have been shown to be time varying, with higher values in a downswing and recession than in an economic upswing. Government expenditures have higher multiplier effects than variations in taxation, with highest multiplier values for government investment.



## Activist fiscal policy in the short and the long run:

- First, lack of aggregate demand for reaching non-inflationary full employment output levels may not only be a short-run deep recession phenomenon, but may be a medium- to long-run problem, in particular in mature monetary production economies.
- Second, fiscal policy does not only affect aggregate demand in the short and the long run, but it also has an impact on the supply conditions and thus on potential output and potential growth in the long run.



Government expenditure rule:

$$(6.9) \quad G_r = G_{r0} + G_{r1} (e^T - e), \quad G_{r0} \geq 0, G_{r1} > 0,$$

with  $G_{r0}$  as the expenditure level to reach the target employment rate and  $G_{r1}$  as the reaction coefficient towards deviation of the employment rate from the target rate.

The employment target should, of course, be the maximum employment rate achievable without triggering unexpected inflation.

This is equivalent to a ‘functional finance’ Lerner (1943):

$$(6.10) \quad D = G + iB_G - T = S - pI.$$

Cooperation of central banks keeping interest rate low is required to stabilise government debt-capital ratio without primary surplus.



- Governments should vary expenditures and not the tax rate, to avoid short-run asymmetric and long-run detrimental effects
- Structure of tax rates, together with government social transfers, will affect the distribution of disposable income and thus aggregate demand and employment in the short and in the long run.
- Progressive tax and social benefit system improves automatic stabilisers

## Similarities with MMT

Theoretical roots: G.W. Knapp, J.M. Keynes, A.B. Lerner, H. Minsky, W. Godley, ...

Modern proponents: Kelton (2020), Mosler (1997/98), Mitchell et al (2019), Tcherneva (2006), Wray (1998, 2002, 2012)

### Main topics:

- Money is a creature of the state (tax drives money)
- State should act as employer of last resort (ELR)
- Sovereign state does not face a spending constraint and can apply functional finance approach ( $G-T = S-I$  in a closed economy)
- Current account imbalances can be avoided by an international system of flexible exchange rates



## MMT applies to countries with a **sovereign currency**:

- Domestic currency is the unit of account
- Taxes and government expenditures are paid in that currency
- Public debt is issued in the domestic currency
- Private agents wish to hold financial assets in that currency
- Central bank can issue the currency without constraints
- There are no financial constraints on government deficits and debt; no crowding out or else; government deficits rather reduce overnight interest rates
- Simple model consolidates government and central bank and has caused confusion!
- No exchange rate target, floating exchange rates, are problematic for countries with foreign debt in foreign currency
- Exchange rate fluctuations may also cause instability for other countries!!



## 6.5 THE INTERNATIONAL DIMENSION



- Variations in the nominal and the real exchange rate do not have unique effects on domestic output and employment, if distributional effects are taken into account.
- Depreciation may also lead to the acceleration of conflict inflation in the domestic economy
- Thirlwall's (1979) law and empirical studies on that law: non-price competitiveness may be more relevant than price competitiveness for exports and imports in the long run.
- post-Keynesian macroeconomic policies should aim at stabilising or 'parking' the exchange rate at a level which is consistent with a balanced current account



Post-Keynesians seem to agree on a rejection of orthodox theories of purchasing power parity and uncovered interest rate parity (Lavoie 2014, Chapter 7).

According to uncovered interest rate parity theory, the difference between the domestic interest rate ( $i$ ) in financial markets and the foreign interest rate ( $i_f$ ) compensates for an expected appreciation (depreciation) of the domestic currency vis-à-vis the foreign currency, i.e. an expected increase (fall) in the nominal exchange rate (Carlin and Soskice 2015, p. 316):

$$(6.11) \quad i - i_f = \frac{a^e - a}{a}.$$

➔ no domestic control over interest any more?

➔ Lavoie (2000): causality is the other way round, interest rate differential causes differential between spot and future exchange rate.



Several Monetary Keynesians have presented a variant of this theory, including currency risk and a relative currency premium ( $\alpha$ ) into the explanation of the long-term equilibrium interest rates consistent with constant exchange rates (De Paula et al. 2017, Fritz et al. 2018, Herr 1992, Herr and Priewe 2006, Priewe 2008, Priewe and Herr 2005):

$$(6.12) \quad i - i_f = \frac{a^e - a}{a} - 0.$$

Reversed hierarchy of interest rate, i.e. countries with a high currency premium have a low interest rate.

Currency risk and the currency premium may negatively depend on the accumulated net foreign debt (Smithin 2002/3), and positively on low domestic inflation rates, stable exchange rates, as well as the liquidity and the openness of the financial market (Harvey 2019, Herr 1992).



- Lowering the domestic interest rate may trigger capital outflows and the depreciation of the domestic currency
- However, this may stimulate domestic activity and thus capital inflows which might make the domestic currency appreciate again
- Crucial: motivation and type of capital flow, i.e. short-run profitability vs. long-run growth
- Role of expectations and speculation (Harvey 2007/8, 2009, 2019)



## Policy implications

- Domestic macroeconomic policies aiming at domestic demand generation at SIRE levels should also be conducive to stable exchange rate
- Central banks should target domestic long-term interest rates slightly below trend GDP growth, and should thus not aim at directly manipulating the exchange rate by interest rate policy
- Wage policies should contribute to achieving a stable target inflation rate, having nominal wages grow at trend domestic productivity growth plus the domestic target rate of inflation. The latter should be in line with the target inflation rates of the main trading partners.
- Fiscal policy is then free to manage domestic demand such that the SIRE is reached – without constraints given by deficit or debt targets or ceilings.



- Policy mix should be conducive to avoiding ‘beggar-thy-neighbour policies’
- To the extent that full employment at the SIRE level is associated with a current account deficit and the accumulation of debt in foreign currency, the required improvement of the current account should be gained by raising non-price competitiveness (Arestis 2010, 2013, Arestis and Sawyer 2010a, Hein and Detzer 2015b, 2015c).
- Active industrial and regional policies, linked with public investment in infrastructure, education and R&D, are essential, but also for overcoming regional and sectoral supply side bottlenecks, as Arestis (2010, 2013) and Arestis and Sawyer (2010a) have pointed out.



- International framework: system of managed exchange rates with symmetrical adjustment obligations in case of current account imbalances, in line with Keynes's (1942) proposal of an International Clearing Union (see also Davidson 1982, 2009, 2011, Chapter 17)
- Furthermore, capital controls would be needed in order to reduce speculation, uncertainty and volatility.
- Amendments towards providing stable finance of medium-run current account deficits for investment purposes in catching-up emerging capitalist economies: Kalecki and Schumacher (1943) for the post-World War II world economy, Hein and Detzer (2015b, 2015c) recently for overcoming the imbalances in the Eurozone



## **6.6 SUMMING UP: A POST-KEYNESIAN COORDINATED MACROECONOMIC POLICY MIX**



**Table 6.1: Macroeconomic policy recommendations: New Consensus models (NCM) and post-Keynesian models (PKM) compared**

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Source: Based on Hein (2017a, p. 154)



Finally ...

- Don't take maximum SIRE or minimum NAIRU as given
- Test the waters ...
- Make use of long-run endogeneity channels of expansionary policies ...

Figure 6.3: Expansionary macroeconomic policies raising the SIRE through the labour market persistence mechanisms and a lower target wage share of workers

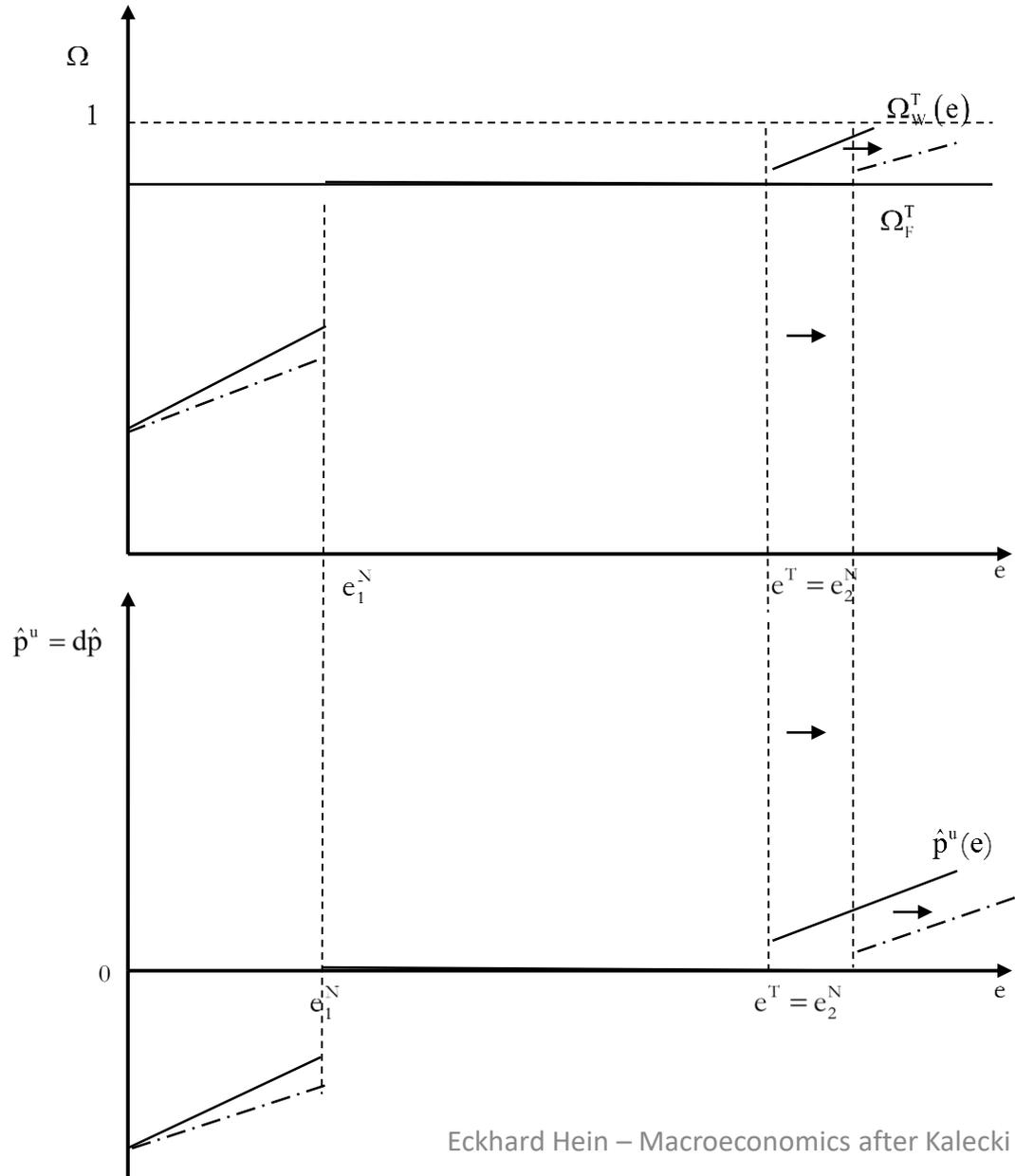


Figure 6.4: Lower interest rate and/or expansionary fiscal policies raising the SIRE through a lower mark-up and a higher target wage share of firms

