Rethinking Heterodox Economics

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Insights to Understand the Economic World

Edited by

Serkan Künü and Murat Eren

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PREFACE

In a world where economic processes increasingly determine the conditions, operations, and progress of individuals, societies, and nations, the current state of affairs is largely based on economics. The approach known as mainstream or orthodox economics, representing the prevailing authority in the school of economics, is used to describe the dominant economic school and the ideas of its thinkers during a certain period. Predominantly based on assumptions of rationality, self-interest, and equilibrium, orthodox economic theories have long shaped our perceptions and analyses of economic phenomena. However, the inability to explain crises faced by the economic system, the complexity and subjective characteristics of real-world economies, often challenge the assumptions and limitations of orthodox theories. These challenges have led to new searches within the scope, content, and methodology of economic science, creating an alternative perspective known as heterodox economics.

The term "heterodox economics" within the school of economics denotes new approaches that adopt perspectives outside the assumptions and propositions of orthodox economics, offering different propositions. Unlike traditional economic theories, most heterodox approaches examine economic relationships by considering the multidimensional nature of economic facts, including historical, psychological, social, and political factors, while treating the individual as a social being who is irrational, fallible, and possesses incomplete information. The approach, shaped by the proposition that non-economic factors can influence economic factors, examines issues such as income and gender inequality, environmental sustainability, financial crises, and the role of authority in shaping economic outcomes, offering a broader perspective beyond the presuppositions of orthodox economics to understand the complexities of economic systems and their impacts on human welfare. From this perspective, the schools of Institutional Economics, Marxist Economics, Post-Keynesian Economics, Ecological Economics, Feminist Economics, Behavioral Economics, Experimental Economics, Evolutionary Economics, Neuroeconomics, and Complexity Economics are recognized as part of heterodox economics.

With "*The Rethinking Economics: Heterodox Insights for Understanding the Economic World*" we aim to bridge orthodox economic theory and heterodox perspectives, and offer a broader view to understand

the complexities of economic systems and their impacts on human welfare within the framework of heterodox economics. The esteemed authors contributing to this book deeply explore various dimensions of this topic. However, our goal is not to completely reject traditional economic theories, but rather to foster a critical perspective that encourages questioning of their debated assumptions.

Serkan KÜNÜ
Murat EREN

CHAPTER ONE

CENTRAL BANKING AND MONETARY POLICY IN POST KEYNESIAN ECONOMICS

MURAT AYKIRI AND ERKAN TOKUCU

Introduction

In recent years, there have been significant transformations in the field of economic thought, and alternative approaches that challenge traditional paradigms have become increasingly important. Post-Keynesian economics, one of these alternative approaches, draws attention to a framework that can provide better answers to today's economic problems. In this context, the different perspectives of Post-Keynesian Economics on central banking and monetary policies are noteworthy for providing an innovative perspective in the design and implementation of today's economic policies.

In the context of central banking and monetary policies, the current debate is whether the monetary authority can control the money that emerges because of credit expansion. Ultimately, central banking and monetary policies play a key role in achieving and maintaining price stability and economic stability. In this context, post-Keynesian economics addresses the policy instruments of central banks, considering the complexities and uncertainties of the economy in the real world. Within this framework, issues such as the effectiveness of monetary policy, the effects of interest rates on economic activity, and how financial stability can be achieved are addressed.

This study aims to examine the role of central banking and monetary policies from the perspective of post-Keynesian economics. In the following sections of the study, the basic principles of post-Keynesian theory, its criticisms of central banking and monetary policies, and alternative policy proposals in light of these criticisms will be discussed in detail.

Mainstream, Orthodox, and Heterodox

Recently, it has been observed that the discussions on the concepts of orthodox (traditional), heterodox, and mainstream economics have increased significantly. Considering that economics is also a social science, the changing world and the new conditions and new phenomena that emerge accordingly are the main indicators that the discussions in this field are the product of a natural and necessary process. Post-Keynesian economics is one of the most important sides of these debates. Considering the current debates, it is observed that the perspective on economics has started to evolve from the idea of strict rationality, selfishness, and commitment to equilibrium, which has been the dominant view for many years, to a more diverse position such as purposeful behavior, enlightened self-interest, and sustainability.

The terms mainstream, traditional, and heterodox are concepts that need to be carefully analyzed, and thought about. "Mainstream Economics" is a category that needs to be considered and defined on a largely sociological ground. In general, mainstream includes the ideas that prevail in leading research institutions, academic institutions, organizations, and journals at any given time. Rather than being a historically determined school, mainstream economics is a term that describes beliefs that are considered intellectually sound and worthy of study by the best schools and institutions in the profession. As such, mainstream economics often represents a broader and more diverse approach to economics than the more recent traditionalism of the profession (Colander et al., 2004).

Generally accepted views in the field of economics, in other words, approaches consisting of theories based on traditions, are called "Orthodox Economics" or "Traditional View" (Eğilmez, 2023). The term "traditional" is primarily an intellectual category. It is a retrospective term in which an ever-changing dynamic economic structure is analyzed from a static point of view so that changing economic conditions in the current situation can never be appropriately defined. Traditionalism usually refers to what historians of economic thought describe as the last dominant school of thought, which is now recognized as the "Neo-classical School of Economics". Therefore, it can be said that the modern mainstream economic perspective and the Neo-classical traditional economic perspective are quite different. To help us understand the concept of neo-classical traditional economics and get an idea of how it relates to mainstream economics, it is first important to specify what we consider neo-classical economics to be. In general, neo-classical economics is an approach that focuses on the optimizing behavior of perfectly rational and symmetrically informed

individuals and examines the equilibrium states that result from this optimization using traditional econometric methods based on statistical foundations. The neo-classical view is particularly associated with the marginalist revolution and its aftereffects. While Leon Walras and Alfred Marshall are among the most important representatives of this view, John Hicks' Value and Capital (1939) and Paul Samuelson's Foundations of Economic Analysis (1947) contributed greatly to the culmination of this view. Perhaps the most important feature of neo-classical orthodoxy is that axiomatic inference is the preferred methodological approach (Colander et al., 2004).

To better understand the difference between mainstream and traditional, it would be useful to pay attention to the following two points. The first is that the term "traditional" is a concept that is usually applied in the later period, not in the period in which it emerged. Therefore, the definition or definitions of "traditional" are necessarily retrospective and not current or prospective. Second, in economics, the label "traditional" usually comes from those who oppose these ideas, not from those who agree with or support them. For example, the economic view that emerged in the late 1700s and was led by Adam Smith was described by Marx (1847) as "Classical Economics" or, similarly, the term "Neo-classical" was first used in the early 1900s by Thorstein Veblen to characterize Alfred Marshall's marginalist economic theory (Aspromourgos, 1986). In both cases, the classification was made by an economist to provide a better target for his criticism.

Finally, regarding the term "heterodox", in a general sense, the term "heterodox" means "against the conventional". Economists with this perspective often define themselves not by what they are, but by what they are against. Economists with heterodox thinking disagree with the existing traditional school of thought and define themselves as outside the mainstream. On the other hand, heterodoxy refers to a system of thought that has both sociological and intellectual aspects. Heterodox economists therefore refuse to work within the framework of mainstream economics because of the nature of the modeling process used or the limiting assumptions made. In other words, they believe that by reducing macroeconomic theory to a mathematical form with assumptions, abstractions, and simplifications that are incompatible with real life, economic reality is distanced. Today; post-Keynesian economics, Marxist economics and Marxist schools of thought, Sraffian (Neo-Ricardian) economics, Austrian school, structuralist economics, and institutionalist economics are some of the schools of thought that are considered within the scope of heterodox economics (Bilir, 2019).

Post-Keynesian Macroeconomics: Fundamental Elements

The Post-Keynesian School is generally built on the ideas of J. M. Keynes and is based on the ideas of a group of economists who stand out for their opposition to the mainstream tradition (Lavoie, 2014: 4). The Post-Keynesian school, which started to develop after the second half of the 20th century, is considered to be a school built on the Keynesian perspective, but it can be said that it was influenced by some Classical economists who were influential before Keynes and on Keynes. Namely, the idea that the level of output and employment in an economy is determined by demand conditions rather than supply conditions was first articulated by Thomas Robert Malthus, and this idea formed the basis of Keynes' principle of effective demand and Michael Kalecki's theory of business cycles. Likewise, the idea put forward by David Ricardo that "the main determinant of growth is the surplus value above the costs of production and its distribution in the economy" paved the way for the development of neo-classical economics on the one hand, and laid the groundwork for the model of Piero Sraffa, who lived in the same period as Keynes. While Sraffa's theoretical model contributed to the Post-Keynesian understanding of the principle of effective demand, it also led to the formation of the group known as "Neo-Ricardians". Marx's influence on Post-Keynesian economics is mostly observed in the works of Kalecki. Although Kalecki agrees with Keynes on issues such as unemployment, market failures, and the nature of the capitalist system, he thinks like Marx and uses Marx's class framework to explain the current relationship between workers and capital owners (Dow, 1991: 178).

From this point of view, it can be said that Post-Keynesians are actually a heterogeneous group of economists who interpreted and developed the theories of Kalecki and Sraffa as well as Keynes, in short, under the influence of these three economists and led by economists known as the "Cambridge School" in the literature. Indeed, Joan Rabinson, one of the most important names of the Cambridge School, is considered the founder of Post-Keynesian economics (Kutlu & Horváth, 2017: 99). In her work, Robinson believes that Keynes' basic ideas have been misinterpreted by leading mainstream Keynesian economists (Robinson, 1972). In addition to Robinson, the Cambridge group includes well-known economists such as Geoff Harcourt, Richard Kahn, and Nicholas Kaldor. The second important group of the Post Keynesian School is known as the "American" group, which includes economists such as Victoria Chick, Alfred Eichner, Hyman Minsky, Sidney Weintraub, and Paul Davidson. Weintraub is considered to be the first important Post-Keynesian economist in the US, known for his

opposition to conventional thinking (Holt & Pressman, 2001). Another branch of Post-Keynesian economics is the "horizontalists/accommodationists" view pioneered by economists such as Kaldor, Moore, and Lavoie. Asserting that the money supply is based solely on credit, that the monetary authority sets the interest rate, and that an increase in the demand for reserves is inevitable due to increased bank lending, accommodationist economists also assume infinite elasticity of the money supply to the interest rate (Kaldor, 1970; Moore, 1988; Lavoie, 1992). This approach was developed in the 1970s and was supported by many economists. In particular, Kaldor and Moore argue that the money supply is based solely on credit, that the monetary authority sets the interest rate, that they have to meet the increase in the demand for reserves due to increased bank lending, and that the increase in the money supply cannot be controlled by central banks (Robert Pollin, 1991).

Post-Keynesians, whose most prominent feature is the rejection of the Neo-Classical synthesis, are generally interested in understanding how investment, saving, and financing decisions are determined in a money economy where the future is uncertain, production takes time, the capital stock cannot be shaped and there is no effective spot market for durable goods (Crotty, 1980: 21).

The Concept of Historical Time

The concept of time, which is crucial for understanding how economic processes work in the real world, is analyzed in Post-Keynesian economics in two different dimensions: historical and logical time. According to the Post-Keynesian perspective, historical or chronological time involves a sequence of events that can be described as a one-way sequence. Thus, the current situation cannot be assessed independently of the chain of events stretching from the past to the present. This also means that future events cannot be predetermined (Holt, 2007: 93). Time and events move in only one direction, and therefore what the current situation in an economy depends strictly on what has happened in the past. In this context, Post-Keynesian analysis is based on the concept of historical time and focuses on the causal relationships of the real world. Path dependence is, therefore, a characteristic feature of Post-Keynesian analysis (Hart & Kriesler, 2015).

Post-Keynesian economists view the evolution of the economy as a historical process, in which the past influences the present, but the future is inherently uncertain. The concept of historical time differs from that of logical time in that it is irreversible and unchangeable, but this important feature is often ignored by orthodox economic theory. Logical time is merely a concept that shows the sequence of events without concern for the

flow of real-time and is particularly important in the context of the traditional understanding of equilibrium. Equilibrium refers to a state in which variables are constant, i.e. their values do not change, and this state can only be perceived over time. Therefore, it is the logical concept of time without change that makes the understanding of equilibrium possible (Kutlu & Horváth, 2017: 109-110). From the historical time perspective, individuals are exposed to unpredictable changes in their knowledge and cognitive status over time, as well as their economic endowments, external environments, institutional structures, and perceptions of other individuals' behaviors. In this context, planned behaviors evolve continuously with these changes; therefore, it is not possible for behavioral variables to remain constant over time. For these reasons, for Post-Keynesian economists, the concept of equilibrium, especially in the traditional sense, becomes meaningless and inapplicable (Katzner, 2003: 127-28).

The concept of historical time is closely related to economic laws and in 19th century classical economics, the problem of uncertainty was ignored by assuming that all economic decision-makers have complete information. Classical economics envisions an external economic environment that is insensitive to changes caused by human behavior and considers this environment as static. In this context, the path of the economy is determined by immutable laws without the influence of time. According to this understanding, decision-makers have all the information about the past, present, and future of the markets determined by these fixed laws (Colander et al., 2004). According to Post-Keynesian economists, since knowledge about economic phenomena varies over time, a historical perspective is needed to understand these phenomena. Therefore, according to the Post-Keynesian approach, economic theories are not devoid of historical content; on the contrary, explaining economic phenomena from a historical perspective requires theories to be based on historical data. This also includes the fact that future economic phenomena cannot be predicted with complete certainty (Lee, 2002).

The Concept of Non-Ergodic Uncertainty

One of the issues on which Post-Keynesians and orthodox economics disagree is the issue of uncertainty (Fontana & Gerrard, 2004). The underlying assumption of the Post-Keynesian approach is that economic processes develop over historical time, which implies uncertainty about the future. When the economy is considered as a historical process, it becomes inevitable that expectations of the future affect the economic phenomena of the present. In contrast to classical economists who assume that economic

agents have perfect foresight of the future under the assumption of symmetric information, mainstream thought believes in the universality of a fixed economic reality in which all future movements and changes are predetermined by the system parameters. In this context, whereas in classical economics, economic decision-makers are assumed to know future outcomes in advance, modern economics emphasizes that decision-makers should form probabilistic expectations that mimic objective reality. The rational expectations model forms the basis of this probability analysis and argues that the subjective probabilities that decision-makers form by processing current and past information about markets coincide with objective probability functions (Davidson, 2002).

Davidson mentions the existence of three types of decision-making situations (Davidson, 1991: 130-131). The first one is the "Objective Probability" situation in which decision-makers accept the past as a reliable guide for the future. The second is the "Subjective Probability" situation, which assumes that the information formed in the minds of individuals about the future consequences of the choices made today will govern future outcomes. The third and final case is "Real Uncertainty", which assumes that there may be unpredictable changes between the time when individual decisions are made and the time when the consequences of those decisions are realized, and therefore the future cannot be predicted by various probability calculations. This is what Post-Keynesians accept.

On the other hand, Davidson (2002) argues that the concept of uncertainty can be expressed in the Post-Keynesian perspective according to the distinction between ergodic and non-ergodic processes. According to Davidson, the logical basis of the Rational Expectations Hypothesis is the axiom of ergodicity. Since the structure of the current system does not change over time in ergodic processes, information about the past is a very useful parameter in predicting the future. In this respect, ergodic processes provide a very suitable basis for the formal-mathematical representation and econometric analysis that orthodox economics is based on. This is not the case for non-ergodic processes. Because it is assumed that the relevant parameters of the system in non-ergodic processes will change over time and will not remain the same, the future may not be predicted by statistical parameters of the past (Pinkstone, 2003: 222). According to Davidson, the concept of uncertainty in the real world can only be explained by the existence of non-ergodic processes. On the other hand, ergodic processes are based on a logical understanding of time, while non-ergodic processes are based on a historical understanding of time that includes structural changes. Therefore, while the Rational Expectations Hypothesis makes sense in ergodic processes, it will lose its meaning and validity in non-

ergodic processes since it is not possible to predict the future with certainty based on past information. Therefore, Post-Keynesians focus on decision-making processes under uncertainty to understand how economic agents behave in the real world.

The Concept of Monetary Production Economy

The monetary theory of production defines the production process as a process that starts with the use of money and capital in the process of supplying the factors of production needed for production, continues with the realization and marketing of production, and finally ends with the conversion of the product produced into money by selling it. The aim of the monetary theory of production is to conceptualize this process. In this process, money comes to the fore as an element of capital rather than a medium of exchange (Dillard, 1987: 1625). The monetary production economy is a concept developed as an alternative to the barter economy. In the barter economy, factors of production are brought together for production within a certain organization (enterprise economy), and at the very beginning of the production process, the share of the factors of production that will participate in production is determined. The commodity-money-commodity relationship in barter economies takes the form of money-commodity-money in monetary production economies. Although the commodity-money- commodity relationship is valid for individual consumers, it is insufficient to understand and explain monetary practices within the capitalist economic order. In monetary production economies, the inclusion of money in the economic system is realized by entrepreneurs who make production decisions within the framework of future profit expectations and spend for the factors of production to be used in the production process (Devillers, 1990: 160). Since production is realized in historical time, entrepreneurs need money at the beginning of production. At the end of the production process, the payment to be made for each factor of production is determined by the expectations of monetary income. The economics of monetary production used by Keynes differs from the real analysis-monetary analysis distinction made by Schumpeter.

Real analysis uses the terminology of established economics and treats money as a veil. However, in the analysis of monetary production, as defined by Keynes, money is an integral part of the economic process (Smithin, 1994: 2). For Keynes, as well as for Post-Keynesian economists who are followers of Keynes, the concept of monetary production economy is an all-encompassing concept. The models developed and policies proposed in Post-Keynesian economics are only valid within the monetary

production economy. The most important feature of the monetary production economy is that it defines real economies and does not work within an economic framework that is abstracted from realities as in established economics.

Some basic features of the monetary production economy can be summarized as follows (Carvalho, 1992: 77):

- ✓ In a monetary production economy, production decisions and production activities are taken and organized by firms acting within the framework of future profit expectations. Firms acting with these expectations obtain the financing they need from the banking sector at the beginning of the production process and make payments to the factors to be used in the production process at the very beginning of production. Therefore, money is not a stock held at the end of the production process to facilitate exchanges.
- ✓ Firms consider the actual level of demand when determining their production capacity. Uncertainty about the future will cause fluctuations in firms' production capacities depending on changes in effective demand.
- ✓ The main determinant of consumer demand is the income of the factor. In this respect, factor incomes depend on firms' expectations for the future and the employment decisions shaped within the framework of these expectations.
- ✓ Within the economic system, sectors producing investment goods and sectors producing consumption goods are mutually interdependent. Since the expenditures made in one sector will constitute the income of investors and households operating in the other sector, production, and income movements in the sectors are interconnected and move together.

Endogenous Money Supply Concept

Although the idea that the money supply in an economy is endogenously created by the credit mechanism dates back to ancient times, it was only in the 1970s that this idea emerged as a monetary theory. In particular Post-Keynesian economists have put forward the endogenous money theory as the basic monetary understanding of their school of thought. In simple terms, according to the endogenous money supply approach, the credit demand of the private non-financial sector is the most important factor that increases the money supply in an economy, and the loans extended by banks to this sector lead to the formation of new deposits within the banking

sector. Banks, in turn, provide reserves from different sources for these newly created deposits, leading to an expansion in the money supply. In this process, although central banks are a part of this cycle, they cannot completely control the process itself (Özgür, 2008: 52).

The main axis of the Post-Keynesian endogenous monetary theory is the new credit demand and financial intermediaries. In orthodox economics, it is assumed that commercial banks passively accept deposits, build reserves with a portion of these deposits, and lend the remaining portion. Post-Keynesian economists challenge this assumption and argue that the causality between deposits and loans runs from the assets (assets) to the liabilities (liabilities) of commercial bank balance sheets, contrary to the orthodox view. In other words, banks meet the demand for loans from the market, and these new loans lead to the creation of new deposits within the banking system. With the emergence of deposits, banks will start to seek funds to meet their increasing reserve requirements. At this point, we can say that there is a disagreement among Post-Keynesian economists and two different approaches have emerged as a result.

The first of these approaches is the "accommodative money supply endogeneity" approach. According to this approach, when reserve needs of deposit banks arise, central banks provide the necessary funds to meet this need (to maintain economic stability); in other words, they adapt to the reserve needs of deposit banks. Otherwise, if banks do not have sufficient reserves, the stability of the economic system may be jeopardized. The central bank can meet the reserve requirements of deposit banks in two ways: it can increase the amount of debt-free reserves in the banking system through open market operations, or it can encourage banks to use rediscount credits. The second approach is the "structural money supply endogeneity" approach. According to this approach, central banks do not have to constantly meet the reserve needs of deposit banks. There is a quantity constraint on the funds that can be used as reserves in the market, and for this reason, central banks may not be able to meet the reserve needs of deposit banks from time to time (Pollin, 1991).

Monetary Policies in Post-Keynesian Economics

Post-Keynesian economics, which is a part of heterodox economics, challenges many assumptions of mainstream economics. The basic assumptions and policy recommendations of mainstream economics are largely rejected, and an alternative approach is tried to be developed. The same is true for Post-Keynesian monetary policies; Post-Keynesians are critical of the new consensus monetary policies, which is the dominant

monetary policy paradigm of today and is accepted by many central banks as a guide for monetary policy implementation. The inflation targeting approach, which constitutes the general framework of the new consensus monetary policies, and the Taylor Rule, which is the main model of this approach, are largely rejected. In particular, Post-Keynesians reject many sub-headings such as the emphasis on monetary policies and the relegation of fiscal policies to the background within the framework of the new consensus approach, the determination of the ultimate objective of monetary policies as price stability and the relegation of other objectives to a secondary role, and Wicksell's Two Interest Theory, which constitutes the theoretical background of interest rate policies, and try to develop alternatives to these. However, it can be said that the monetary policy approaches developed as alternatives by Post-Keynesians share the same views with the new consensus approach in some points, especially in the use of interest rates as a monetary policy instrument.

It would be an oversimplification to argue that economists belonging to the Post-Keynesian school of economics present a single homogeneous approach to explaining economic phenomena. The reason why Post-Keynesians appear to be a single school is that each approach within the Post-Keynesian school takes Keynes' work as a reference point. However, the Post-Keynesian school is not a homogeneous group, and there are even significant differences of opinion on some issues (Kregel, 1973: 187). This is also true for monetary policy.

Within the Post-Keynesian approach, there are two main approaches to monetary policy (Rochon & Setterfield, 2007, 2012), each of which is advocated by two main branches of Post-Keynesians: structuralist post Keynesians and horizontalist Post-Keynesians (Tokucu, 2008: 17). These two approaches to monetary policy are the "parking-it" approach, which suggests that real interest rates should be fixed near zero, and the activist approach, which argues that nominal interest rates can be used to achieve various macroeconomic objectives. The first approach is largely advocated by structuralist Post-Keynesians and the second approach by adjustmentist Post-Keynesians. More detailed information on these approaches will be provided below, but first a brief overview of the new consensus monetary policy, which is the dominant approach in current monetary policy theory and practice, will be given.

Today's Prevailing Monetary Policy Approach - New Consensus Monetary Policies

Today, many central banks conduct monetary policy within the so-called new consensus approach. The new consensus approach has been accepted by many central bankers and policymakers since the 1990s, as it institutionalizes monetary policy and enables the conduct of a disciplined monetary policy (Gnos & Rochon, 2007). The two main pillars of the new consensus approach to monetary policy are the inflation targeting strategy and the Taylor Rule, which serves as a guideline for monetary policy within this strategy (Gnos & Rochon, 2007). Within the framework of the general approach, which is mainly advocated by New-Keynesian economists and known as the new consensus, central banks use short-term policy interest rates to target inflation as a point or band in their monetary policies. The policy rate is at the center of monetary policy, and changes in the policy rate affect aggregate demand by affecting many variables such as market interest rates, bank loans, collateral offered for loans, the allocation of assets in the portfolio, etc., in other words, by activating transmission channels. The objective is to bring the level of aggregate demand in line with aggregate supply and thus eliminate inflation and deflation, i.e., to achieve price stability. For most central banks today, price stability is the ultimate goal of monetary policy (Taylor, 1993; Oktar et al., 2012; Fontana, 2006; Arestis & Sawyer, 2002).

Monetary policies conducted within the framework of the new consensus approach should have certain characteristics to achieve the set targets, that is, to be successful. First, central banks should be independent, especially policy-independent. What is meant by independence here is that the central bank should implement policies without depending on the government's directives and have instrument independence; central banks should not be the primary purchaser of public debt securities issued by the treasury, and the bank itself should decide which instruments to use in implementing monetary policies. Moreover, the central bank itself should choose the operational and intermediate targets for the conduct of monetary policy. Moreover, monetary policies should be conducted according to a rule, the so-called Taylor Rule. These features are the cornerstones of the new consensus monetary policies (Akalın & Tokucu, 2007; Oktar et al., 2012).

Wicksell's two interest rate theories form the basis of the new consensus monetary policies, and today's central banks use the short-term policy interest rate as the main policy instrument based on this theory. The first of these two interest rates is the natural rate of interest, which is determined by

the marginal productivity of capital and the savings rate. The other is the lending rate charged by banks to their customers. Central banks try to control the short-term interest rate and the lending rate charged by banks, that is, to bring it closer to the natural interest rate. The natural rate of interest may vary depending on some variables in the market, such as the marginal productivity of capital, but since the central bank cannot control these variables, it tries to determine the other variable that it can control: bank lending rates. The closer the bank lending rates are to the natural rate of interest, the smaller the real fluctuations in the economy will be. When loan interest rates fall below the natural interest rate, that is, when banks lower their loan interest rates below the natural interest rate, the aggregate volume of activity (aggregate demand) in the economy will increase, creating inflationary pressure. On the other hand, if loan interest rates rise above the natural interest rate, the economy will contract and deflation will set in. Therefore, if the central bank wants to ensure price stability in the economy, it should direct the loan interest rate in the market to be close to the natural interest rate through its exogenously determined policy interest rate (Fontana, 2006).

Post-Keynesians' Rejection of the New Consensus Approach and Alternative Approaches

Post-Keynesians oppose the new consensus approach, the inflation targeting strategy, the Taylor Rule, and Wicksell's two-interest rate theory, which is the dominant monetary policy model today. According to Post-Keynesians, the so-called new consensus approach, developed mainly by New-Keynesians, has nothing new to say; it is "only the newest incarnation of the old mainstream theory"(Gnos & Rochon, 2007).

Post-Keynesian economists largely oppose Wicksell's two-interest theory. As explained in the relevant sections, the analyses conducted in mainstream economics are real analyses; monetary factors have no effect on real variables. In other words, the classical dichotomy applies here as well; the economy is divided into real and monetary sectors, and developments in the monetary sector have no impact on the real sector. Inflation is a monetary phenomenon and can be fought with monetary policies conducted according to various rules. One of the main differences between the new consensus approach and the classical or monetarist approach is that the new consensus approach abandons the targeting of monetary aggregates and instead sets targets for the nominal interest rate (Vera, 2014). The real interest rate is determined by savings and investments and the efficiency of investments. According to Post-Keynesians, the explanations of the two

interest rate theories, especially for the real interest rate, are weak in explaining real life. The level reached by banking and financial markets, the daily volume of transactions in money and capital markets have mutually interconnected the relations between the financial and real sectors, and developments in financial markets have very serious effects on the real sector. Therefore, the real analysis that forms the theoretical background of Wicksel's two interest rate theories (the barter economy approach and the classical dichotomy approach) has little relevance in today's world (Smithin, 2007).

Post-Keynesians' view of money in the economy is based on Keynes' views. According to Keynes, money is important in a world where the future is uncertain, money is the main tool that establishes the link between the present and the future. The fact that money is the most liquid and least risky asset in terms of liquidity distinguishes money from other assets and makes money important (Kregel, 1973: 155). In addition to this importance of money, according to Post-Keynesians, monetary policies have effects on real variables such as production and employment. In other words, the real production economy approach or the classical dichotomy approach, which forms the theoretical background of the new consensus approach, is rejected by Post-Keynesians. According to Post-Keynesians, the economy cannot be divided into real and monetary sectors; changes in the quantity of money have very serious effects on production and employment. In fact, the main reason for the presence of money in the economy is not to eliminate the difficulties of the barter economy but to make production possible. In this context, Post-Keynesians adopt the "monetary production economy" approach, moving from Keynes' analysis. In a monetary production economy, money is the basic variable that starts the production process of goods and services and continues the production process. In a monetary production economy, money is not absolutely neutral; monetary policies certainly have an impact on real variables in this context (Wray, 2007). Although Post-Keynesian economists disagree on some issues, there is a consensus on the monetary production economy approach and the role of money in the economy. Again, for all Post-Keynesian economists, the money supply is endogenous (Harcourt, 2007); the interrelations between the real and monetary sectors ensure that the money supply is determined by the central bank and market actors.

From the above explanations, it can be seen that Post-Keynesians largely reject the new consensus approach, and in this context, they reject the Taylor Rule and Wicksell's two interest rate theories that underpin the Taylor Rule. What, then, are the alternative approaches that Post-Keynesians have

developed with respect to central banking, interest rate policy, and monetary policy more generally? This section will focus on these issues.

Structuralist Post-Keynesians' Perspective on Central Banking and Monetary Policy

Today, many mainstream economists and almost all central bank management teams agree that central banks should be independent. What is meant by central bank independence is that central banks should be able to conduct monetary policy away from government directives in such a way as to achieve the target policy interest rates and to choose the instruments to be used in the fight against inflation.

Structuralist Post-Keynesian economists are largely critical of the independence of central banks; central banks cannot implement monetary policy on a discretionary basis because the Treasury's actions on behalf of the government and banks' demands on the central bank prevent central banks from acting independently (Mitchell et al., 2016: 293-294). Structuralist Post-Keynesians base their views on the independence of central banks on Keynes' views on low interest rates and euthanasia of the rentier sector (Wray, 2007).

Wray (2007), one of the leading figures of the structuralist Post-Keynesian approach, objects to central bank independence on three points. First, he criticizes the mainstream view that the central bank and the treasury should act independently of each other and that the central bank should not directly purchase debt securities from the treasury. According to this view, it is not possible for a central bank trying to meet its target policy rate to act independently from the treasury's borrowing operations. Such independence is, in the words of Wray (2007), "a complete illusion". Since the Treasury's sale of government securities in the primary market has an impact on interest rates, it is unthinkable for the central bank not to participate in the Treasury's borrowing process. Prohibiting the central bank from buying treasury securities in the primary market will not prevent the treasury from continuing to borrow in local currency; the treasury will continue to borrow in local currency. It is important that the treasury and the central bank work in coordination to keep interest rates at targeted levels (Wray, 2007).

Wray's (2007: 121) second criticism of central bank independence concerns the political independence of the central bank. In an environment where the central bank governor and some of its members are appointed by political will, the idea that the central bank should be independent of the political will is absurd. It is inconceivable that the governor and members

appointed by the political will completely set aside their political views in their decisions.

The third criticism that Wray (2007) raises against central bank independence is that the central bank can set the policy interest rate exogenously. According to Wray (2007), there are various factors that affect the policy interest rate. These factors include the financial structure, institutions, regulations, and the degree of tolerance of the central bank toward disruptions in the economy. Therefore, the central bank is not free to set the policy interest rate based only on deviations in inflation and output as in the Taylor Rule. For instance, the central bank may change its policy interest rate due to various regulations affecting the markets or unforeseen changes in financial markets. Another variable that prevents the central bank from exogenously determining the policy interest rate freely is the exchange rate regime and changes in exchange rates. In a flexible exchange rate system, there may be a correlation between exchange rate movements and the policy interest rate. In other words, the central bank cannot set the policy interest rate exogenously at the level it wants without taking into account the reaction of exchange rates.

Structuralist Post-Keynesian Views on Monetary Policy: The Parking-It Approach

Structuralist Post-Keynesian economists oppose the Taylor Rule, which constitutes the main structure of the new consensus monetary policy, and the use of the short-term policy interest rate as a monetary policy instrument. According to the Taylor Rule, deviations in inflation and output are included in the central bank's reaction function and central banks increase or decrease the short-term policy interest rate depending on these deviations. Structuralist Post-Keynesians challenge this view with three alternative policy proposals and explain how the central bank's interest rate policy should be. These three proposals are Smith's Rule, Kansas City Rule, and Fair Rate Rule (Gnos & Rochon, 2007).

According to Smithin (2007: 103), "the optimal interest rate rule is the rule that stabilizes the real interest rate at a low level (theoretically at zero)". The interest rate that stabilizes the real interest rate is the optimal interest rate. The nominal interest rate should change as the inflation rate changes so that the targeted real interest rate can be stabilized. What is the reason for keeping the real interest rate low? According to Smithin (2007: 104-105), the reason is quite simple: low real interest rates increase the profitability of entrepreneurs by positively affecting growth and employment. Entrepreneurs do not earn rent income from higher interest rates, but they do earn a profit

from increased output. Smith argues that the rentier sector, which earns income from interest rates, will be deprived of this income, but the entrepreneurs who invest and produce will increase their profits, and the distribution of income will not deteriorate due to the low real interest rate. One of the first criticisms of Smith's Rule is the possibility that a low real interest rate may lead to inflation. Smithin (2007: 107) responds to this criticism by arguing that a low real interest rate will lead to a one-time increase in inflation but will not contribute to inflationary instability or accelerate inflation[1].

In the Kansas City Rule, the policy interest rate should be fixed at zero, and policies should be implemented so that it remains at that level. The aim is euthanasia of the rentier sector in line with Keynes' views. Wray (2007: 132) opposes discretionary interest rate policies against changes in inflation and output gap in the new consensus monetary policies for three reasons and recommends a policy to keep the interest rate at zero. These three reasons are as follows:

- ✓ There is no simple relationship between interest rates and inflationary pressures. In some cases, interest rate increases may stimulate spending through aggregate demand. Higher interest rates may even contribute to higher prices by increasing costs.
- ✓ Discretionary changes in interest rates can distort financial markets.
- ✓ The use of interest rates as a discretionary policy instrument is not compatible with Keynes' call for the euthanasia of the rentier sector.

For these reasons, an interest rate policy like the one in the new consensus is rejected, and interest rates are proposed to be fixed at zero. The Fair Rate Rule, also known as the Pasinetti Rule, is based on the view that changes in interest rates can affect the distribution of income. Based on Keynes' work, Post-Keynesians accept that interest rates are a variable that can affect the distribution of income. Since changes in interest rates may affect the distribution of income between wage earners and interest income earners, it is argued that care should be taken in determining interest rates. According to Lofaro et et al. (2023: 3);

> *"This interest-income redistribution mechanism would put forward the essential fact that the interest rate is not only a price (or a cost) but also a source (or a loss) of income for someone. Furthermore, Keynes pointed out that a continuous increase in interest payments could bring about a vicious*

[3] For detailed information on Smithin's Rule, see Smithin (2007).

> *cycle of low investment due to its perverse effects on the behavior of entrepreneurs. For instance, high interest rates convey large financial returns that would discourage current and potential entrepreneurs to venture their capital in investment projects and instead incentivize them to engage in speculative activities or rentier behavior".*

As can be seen from the quotation, high-interest rates will, on the one hand, adversely affect private sector investments and, on the other hand, open the door to speculative activities and rent-seeking behavior. Therefore, according to the Fair Rate Rule, interest rate policy should be conducted in such a way that it does not adversely affect real production in the economy and does not have any impact on the income distribution of those who earn interest income and those who do not earn interest income. In the context of income distribution, the main objective is to maintain the purchasing power of labor over time (Spotton & Lavoie, 1994). For this purpose, the real interest rate should be set equal to the growth rate of labor productivity and the nominal interest rate should be adjusted to match this real interest rate.

To summarize, structuralist Post-Keynesians propose a monetary policy in which the central bank keeps the nominal interest rate and the real interest rate very low. In cases where high-interest rates are required by the Taylor Rule, interest rates should be kept as low as possible in monetary policy implementations since these high-interest rates would have distortive effects on income distribution.

Monetary Policy Proposals of Accommodative Post-Keynesians: Activist Monetary Policies

According to Rochon and Setterfield (2007: 14-15), one of the two main approaches to the new consensus monetary policies based on the interest rate rule developed within the Post-Keynesian view is the aforementioned view expressed by Wray. The other is the view pioneered by Moore (1988), Fontana and Palacia-Vera (2006), and Palley (2006), according to which short-term interest rates can be used as an ***"adjustment mechanism***"[2].

This approach shares some aspects of the new consensus monetary policies based on the use of short-term interest rates. Basil Moore, one of the pioneers of the adjustmentist Post-Keynesian school, differs from Wray, who belongs to the structuralist Post-Keynesian school, in that he accepts that short-term policy interest rates can be set exogenously by central banks. The central bank can increase or decrease the policy interest rate according to its own reaction function to achieve macroeconomic end-goals such as

[2] Emphasis ours.

price stability, full employment, or growth. However, it has to provide the market with all the money in legal circulation demanded at the determined interest rate. In this approach, interest rates are not a variable that equalizes savings and investments or the supply of funds and the demand for funds. Banks set the interest rate for their loans slightly above the policy rate set by the central bank and meet all loan requests at this interest rate up to the credit limits of their customers (Moore, 1998: 348-349). To reiterate once again, within the horizontalist Post-Keynesian approach, short-term policy interest rates can be set exogenously by the central bank, i.e. interest rates are exogenous. However, just like the structuralist Post-Keynesians, the accommodative Post-Keynesians reject the view that there is a natural interest rate towards which the market interest rate will gravitate.

According to Moore (1989: 487), the use of short-term interest rates by the central bank in the reaction function will depend on some economic and political forecasts of the central bank. Accordingly, the central bank will conduct monetary policy by trying to make the following forecasts;

- ✓ The future state of the domestic economy, i.e. what the demand conditions will be.
- ✓ How the system behavior will react to changes in interest rates, i.e. sensitivity to changes in interest rates
- ✓ Ultimate objectives: full employment, price stability, growth, balance of payments, exchange rates, income distribution, terms of trade
- ✓ The effects of interest rate changes on the vitality and liquidity of the financial system
- ✓ The effects of interest rate changes on whether the ruling party can win in the next elections.

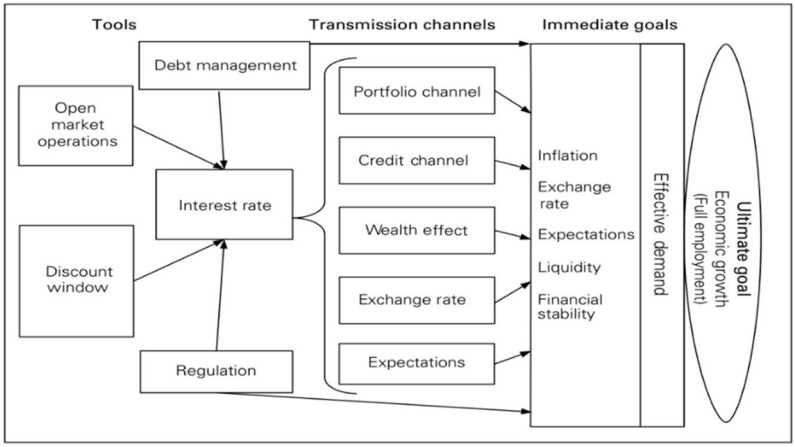
By making such forecasts, the central bank will use interest rates as a policy instrument. In Post-Keynesian activist monetary policies, there is no single mandate for monetary policy, such as price stability. Central banks can focus on more than one objective depending on the circumstances, but full employment is the foremost objective.

Building on Keynes' work, Terra and Arestis (2017) constructed Figure 1 below to illustrate how monetary policy works more clearly, what the intermediate and ultimate objectives are, and what the monetary policy instruments are in accommodative Post-Keynesian economics. The figure clearly shows how monetary policies work and through which transmission channels they affect the targets.

As can be seen from Figure 1, the main (ultimate) objective of monetary policies in Post-Keynesian economics is to achieve full employment. In contrast to mainstream economics, the full employment target ranks first in the list of ultimate objectives of monetary policies for both wings of Post-Keynesian economics. To achieve full employment, aggregate effective demand needs to be managed. As in fiscal policies, the aim of monetary policies is to achieve the targets by managing aggregate demand.

According to the figure, price stability, exchange rate stability, financial stability, maintaining stable expectations or, in short, managing expectations, and monitoring and controlling liquidity in the economy are the primary objectives that need to be achieved in order to reach the ultimate goal. In an economy with high inflation, high exchange rate volatility and its general level, financial instability, and deteriorating expectations for the future, it will be very difficult to manage aggregate demand and sustain growth and employment through aggregate demand. Therefore, monetary policies should primarily aim to control inflation, stabilize the exchange rate and financial markets, and properly manage liquidity and expectations in the economy.

Figure 1.1: The Functioning of Monetary Policies in Post-Keynesian Economics



Source: Terra & Arestis, 2017: 61.

The transmission channels of monetary policy are similar to the transmission channels in mainstream economics. The central bank tries to achieve its other primary objectives such as price stability and financial stability by affecting inflation, the exchange rate, liquidity, the level of