A POST-KEYNESIAN APPROACH AS AN ALTERNATIVE TO NEOCLASSICAL IN THE EXPLANATION OF MONETARY AND FINANCIAL SYSTEM

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Abstract

The aim of this paper is to provide a Post-Keynesian view to economic theory as an alternative to traditional theory. Keynesian economics consists of an approach to economics derived mainly from the work of Keynes. It is grounded on the fields of observations of stylized facts of the economy and attempts to provide solutions to arising problems, which cannot be adequately explained and resolved by mainstream theory. We wish not in this paper to contradict the conventional with Keynesian and Post-Keynesian theory, but instead to provide an alternative and complementary view. However, we highlight the differences between traditional neoclassical theory and Post-Keynesian macroeconomics. Therefore, we shall focus on Post-Keynesian analysis on the operation of monetary and financial system in the endeavour to fill gaps on the explanation of relative phenomena. The main scope is the explanation of the financial system and financial stability.

Keywords: Post-Keynesian, neoclassical theory, monetary policy, financial system, financial instability

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1. Introduction

The recent phenomena of financial distortions and crises have highlighted the inability of the mainstream theory to provide adequate explanations of the causes and their frequency. Alternative economic theories could provide addable insights to the existing traditional theory

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in order to result to a coherent and solid theory. Emphasis is given on the differences between neoclassical theory and Post-Keynesian approach, particularly in the fields of monetary and financial sector. The latter has become a matter of serious consideration among Post-Keynesians because they consider that the financial sector and real economy are inextricable intertwined. As soon as we present the main differences between theories, we proceed to an explanation of main Keynesian and Post-Keynesian contributions, regarding the monetary and financial sector within the concepts of expectations, uncertainty, speculative demand, interest and exchange rates. Thereby, we review Post-Keynesian theory in international economy, displaying its monetary targets and finally we deduct the main conclusions and questions about the relevance of the conventional theory and the Post-Keynesian approach. The method used in this paper is a common-sense approach to realize the processes of economy and finance. It is a rather complex combination between observed facts with theory that would derive from deductive methods. But the gist is that theory should be accorded with facts. The above argument constitutes a fundamental axiom to begin any endeavour so as to reach to certain useful conclusions. As Myrdal pointed out when the observations of facts do not agree with a theory, i.e. when they do not make sense in the frame of the theory utilized in carrying out the research, the theory has to be discarded and replaced by another (Myrdal, 1957, p. 160).

2. Differences between Post-Keynesian and Neoclassical approach

We may distinct three main features of neoclassical economics in terms of monetary policy. Firstly, the preference on flexible rate regimes than fixed rates. Secondly, the “efficient market hypothesis”, according to which all best possible information is contained within the price of an asset. Thirdly, the famous Say’s Law and the neutrality of money, making the role of effective demand useless. The implication of the above features is that regulation is unnecessary. Traditional theory deems financial system as stable and efficient, and whenever it turns unstable, that is due to an exogenous shock, where only monetary policy will be enough to restore its stability. However, there is a strong opposition debate on this view.

Buiter (2009) believes that the obsession on efficient market hypothesis has disorientated financial economics where the emergence of recent financial crises and the inability to provide necessary explanations has raised serious questions concerning the relevance of neoclassical economics. Similar views have been shared by other economists (Krugman 2009, Stiglitz 2010, Allen and Gale 2007).

The important aspect in Post-Keynesian analysis is the role of effective demand, where its scarcity and not the scarcity of resources have to be faced in order to increase total output. On the other hand, traditional theory indicates the perception that operation of competitive market forces will tend to reduce inequalities and always move towards equilibrium positions, attributed by the efficient allocation of the available resources. That contention of market operation is the key to the potential growth of economy. Keynes mentioned that money-making process is the aim of market operations and therefore production is linked with money. It commences with money to result in more money, and in that sense, efficient allocation of resources is not consistent with production and investment decisions. Post-Keynesians discard the notion of economic equilibrium, a fundamental axiom of the neoclassical theory. They believe that either the economy is permanently in disequilibrium or that there is no equilibrium at all. There is no empirical proof that “the market” as it functions is seeking to equilibrium point. There are arguments coming from economists (Borio et al 2016) who suggest that the economy is always in a transition mood, or in a repeated cycle. There is also the Minskyan (1986) view, that instead of equilibrium, the economy simple experiences some periods of tranquillity.

Thirlwall (1993) had distinguished the main aspects of Post-Keynesian macroeconomics that bring up the arguments against mainstream economics. First of all, the employment depends on product market rather than labour market. Secondly, Post-Keynesian theory in contrary to mainstream economic, argues that involuntary unemployment does exist due to lack of effective demand. As far as the relation among investment and saving is concern, thirdly, causation flows from investment to saving. Fourthly and most relevant to this paper, money, finance and debt issues are essential part of economy, whereas money is not neutral discarding thus the quantity theory of money because money is endogenous[1].

[1] *The quantity theory of money equation sets (MV=PT). However, in post-Keynesian view causation runs from right to left, not from left to right; changes in liquidity preference mean that V is not constant.*

Similarly, macroeconomics is viewed as an aggregate of microeconomics in traditional theory which also underestimates the role of financial sector into real economy. Post-Keynesians object that view and give equal importance to the financial sector. They also suggest the existing of two pricing systems. The first concerns prices of labor and current output and the second the prices of financial and capital assets. The traditional theory pays no attention to the second pricing system, including it just as a variable to the trade sector.

Another important issue is the introduction of mathematical models to validate a theory. The tendency on mathematics has transformed political economy as a part of social science to core independent science of economics. Neoclassical economists are obsessed with the use of complex mathematical models, incomprehensible to anyone without relative training, based to questioned assumptions and thus warding off their conclusions from reality. The inclination to mathematics has been criticized by Post-Keynesians and other schools of economic thought for not paying the proper attention to relative phenomena. Even Adam Smith was not keen on mathematical models in political economy, but he rather preferred common sense, “the scientist could use mathematical tools or models to propose laws, but they should subordinate to observed phenomena” (Fleischacker 2004, ch.2). Accordingly, Minsky stated that any theory detached from observations should not be accepted since in sciences “theory is a servant of observations, contrary to neoclassical economics, where “theory determines the acceptability of observations” (Minsky 1985, p.1). Hence, this methodological issue is at great significance so it must be cleared under what terms credit must be given to any upcoming theory.

3. The contribution of Post-Keynesian economics

The essence of Post-Keynesian economics is the importance of effective demand. The primary target for the well function of the economy as Keynes (1936) suggested is the maintenance of full employment, which will be attained by an increase in aggregate demand, which in turn entails an increase in total output. The mean to obtain the target, contrary to classical approach, is through some kind of intervention. There are market imperfections that cannot be fixed on their own, and hence, intervention is needed to restore the economy back to the track of full employment. A key feature of Post-Keynesian economics according to Lavoie (2015) is the claim that aggregate demand is the determining variable, both in the short-run and in the long run, contrary to neoclassical view that in the long run only supply-side determinants matter. Kaldor (1972) points out that a self-sustained growth is determined not by exogenous factors but by the growth of demand, which will be increased at the simultaneously operation of merchants, manufacturers, and a monetary and banking system, allowing the money supply to grow in automatic response to an increased credit demand. The above argument could also be applied on the basis of financial stability. He also believed that economic theory went on a wrong path, as soon as it focused on the theory of the value and the market allocation operations rather than on creative operations. In general, Arestis (1996) states that Post-Keynesian economics has moved on from the stage of criticizing mainstream theory to the phase of forming a reliable juncture described by endogenous consistence.

3.1. Money and credit

Post-Keynesians disagree with the neoclassical theory in terms of money and credit, issues not fully incorporated by neoclassical school, but they have vital role in economy. Post Keynesians reject the view that money is neutral, since in uncertain conditions, money can be hold as a safety asset. Therefore, money plays a significant role in portfolio choices and in financial system, inasmuch as it consists of an option, rather a safe one, with its own implications. It should not be forgotten that money is the outcome of transforming the value of assets into liquidity, and again, in an incalculable uncertain world with unpredictable expectations, money or liquidity preference can generate speculative activity. In the financial markets, we can deduct an observation that there is a trade-off between speculation activity and liquidity preference.

Post-Keynesians argue that the financial sector has often been a destabilizing factor of the economy. It is not possible to separate real from monetary factors. Credit creation, the nature of money, the role of debt, are among other aspects more concerned by Post-Keynesians. They incorporate an explicit monetary approach to economic theory. The stylized facts and observations of real world are needed to be taken into account, whereas production, money, interest and investment are connected through the financial system. Post-Keynesian economists also reject Say's Law, since employment and total output are determined by aggregate demand. A single representative agent and the efficient market hypothesis do not seem to explain the complex phenomena we observe in the economy. Davidson (1994) states that financial markets cannot be deemed as the efficient market theory implies, since expectations are heterogeneous and often irrational that influence financial markets, and in reality, are grounded on psychological predictions that are certainly not statistically or mathematically reliable.

Post-Keynesians stress the importance of uncertainty to the function of the economic system. Economic agents deal with uncertainty. There cannot be a trustworthy prediction on future conditions and perceptions. Thus, probability distributions for the future can only be compiled from past distributions, which are non-stationary. Furthermore, money, in conditions of uncertainty, is non-neutral and is associated with the law of contracts (Davidson 1978, Minsky 1975, Kahn 1958). It consists of one main factors of the fluctuation of the economic system and the financial instability. Uncertainty is viewed as the sufficient condition for the existence of money. Money is not exogenously determined as it is traditionally believed, but endogenously and demand determined. A rise in demand of credit entails a rise in its supply. The game therefore stems from entrepreneurs who must guess the pattern of effective demand and the required cash flows. Thus, the credit demand is settled, and then central and commercial banks set their discount and interest rate thresholds, in order to grant loans to meet entrepreneurs' requirements. Uncertainty is related to insufficient effective demand. Firms and households whenever they decide to acquire assets, they compare the marginal efficiency of capital with the yield-curve of financial assets. Thus, their decisions depend on expectations and risky perceptions. Whenever negative expectations increase then demand for money in relation to capital increases, hence shifting economic growth and employment.

3.2. The speculative demand for money

Keynes in his liquidity preference theory suggests that money is an asset used as a medium of exchange, store of value and unit of account. It is well known that three motives explain money demand. Firstly, the transactions-motive, necessary for transactions where liquidity serves as a medium of exchange. Secondly, the precautionary demand for money motive, which is attributed as a safety net against unpredictable events. The precautionary motive is negatively related to effective money demand since liquidity demand converts money as a store of wealth. Thus, insufficient effective demand emerges when precautionary money demand increases. Thirdly, the speculative motive, where demand for money is increased by the desire of agents to buy financial assets. The first two motives are understandable in the nature of the economy but the third is a crucial one for the monetary policy as whole. As Keynes quoted "it is by playing on speculative motive that monetary management is brought to bear on the economic system" (Keynes 1936, p.196). Despite the importance of the speculative motive, the supply and demand for liquidity in financial markets also emanate from the other two motives and to a certain degree by the money supply.

The key factor to explain the speculative money demand is expectations, either in general terms, that is, conventions prevailing in the financial system, or in particular, regarding the difference, which agents expect between actual and future interest rates. The speculative behaviour of agents and banks constitutes the supply and demand for liquidity in financial markets. Hereby, it establishes the interest rate paid by an asset in particular as well as the economy's interest rate, i.e., the yield-curve of the financial system. Thus, the yield-curve determination depends, on one hand, on the interaction between the expectations of banks and agents, and on the other hand, on how the central bank accounts for those expectations in its attempt to manage the demand and supply of money in order to influence expectations, and finally, the own yield-curve.

Therefore, we consider the expectations and the uncertainty in order to assess the speculative motive for money demand. Economic agents derive expectations concerning, for instance, the difference between the current and future interest rates, or various conventions and risk perceptions that dominate in the financial system. In a demand-led economy, investment determines employment and output. Due to the presence of uncertainty, investment decision-making depends on expectations. Thus, in case of positive expectations there is a rise in capital goods, instead of money holding and liquid financial assets, boosting growth and employment or vice versa.

Certainly, among the Post-Keynesians it is believed that the supply of money can be demand - determined up to an extent (Dow and Dow 1989, Wray 1990). Thence, there is a plausible combination of liquidity preference theory and endogenous money supply theory. Financial institutions are actually operating a variety of financial products and portfolio choices implying that they could also set their liquidity preference, and thus the money stock, according to their limits and margins of safety that new products would allow them to fluctuate. However, the above argument highlights an implicit indication, that supply of money would surely satisfy its demand but not necessarily in equal terms. It might be less credit supply fuelled to the economy or even more in certain overoptimistic risk perception periods.

It should not be forgotten that in actual period banks through credit and innovations can create money. Indeed, there are profit-maximizing enterprises, meaning that higher effective demand offers greater margins of profits for their services as well. Thus, the banking system will encourage and seek financial innovations to give more flexibility to their balance sheet management and also to avoid from regulatory measures.

3.3. The role of Central Banks and the interest rates transmission channels

Central banks play a vital role in the design and implementation of monetary policy through discount and interest rates' determination. Therefore, central banks should focus on prevention of the emergence of money-demand for speculative and even precautionary purposes and to provide price stability, stable expectations and eventually financial stability. Central banks' attitude could be explained by the manner they evaluate the notion of expectations and conventions. The control of money supply and the degree of steady liquidity in the market is therefore essential.

Central banks act as lenders of last resort which moderates agents' concerns about the overall solvency of the financial system and finally it refrains from confining investment. Central banks should not be a passive institution, but also to give equal emphasis to transparency and credibility, transmitting these characteristics to the rest of the financial system. The current operation of the international financial system has shown its limits by encouraging implicitly high-risk positions. Controlling inflation policies by central banks accompanied by low interest rates have indirectly led financial intermediaries to expand their risky activities in an internationalized deregulated free capital movement environment. Therefore, it seems that the only vital role left for central banks is the one of lender of last resort. Nevertheless, central bank is the anchor of financial stability, mainly through surveillance and efficient interventions. Hence, the question is not to assess the well-known role of central banks but to focus on their actions by re-assessing their priorities.

It is interested to develop the function of interest rates through the transmission channel mechanisms. Interest rates are deemed to be the most important tool of monetary policy. Keynes considers it as “the governor of the whole system” (1930, pp. 189). Once the interest rate is set, then central bank uses the discount window to provide to banks the necessary liquidity, determining in this way the relative amount of liquidity the financial system requires in that specific rate of interest. The interest rate furnishes to effective demand through portfolio, credit, wealth, exchange rate and expectations.

Portfolio management alters through interest rates changes, since expected rate of returns will differentiate. Agents will respond to a shift in interest rate by reallocating their portfolio choices. The credit channel is highly associated with the interest rate. It serves as the rate that financial institutions will charge on their granted loans. The lower interest rate entails to relative lower credit rate, influencing investment and employment. Credit market rate influences on households and firms through consumption in the first case and the relation between costs and profits of firms. As far as the wealth channel is concern, Keynes recognizes it as “perhaps the most important influence, operating through changes in the interest rate, on the readiness to spend out of a given income” (1936, pp. 94). It is evident that a change in interest rate will result to a shift on the price of assets as well as on consumption of households. Whenever households consume according to their accumulated wealth, then the impact of the wealth channel is greater.

The exchange rate transmission channel operates in an open economy. In this case, external agents are entering in the concept of the shift of interest rate. International investors are usually on the search of differences between internal and external interest rates in order to decide their investments. However, in an open economy there is interdependence between domestic interest rate, exchange rate and capital mobility. Consequently, a local interest rate change in an open economy ensues movements in domestic production, due to the cost of inputs, in the imports and exports of the country and thus in its balance of payments. Moreover, the financial status of firms with foreign liabilities is directly affected. Capital flows change in the line with the shift of exchange rate and so does the liquidity of money market, since in an open economy conversion of foreign to domestic currency is required. Afterwards, what is happening is a rise in the level of external flows that change money market liquidity and eventually the financial system's yield curve. In this case, intervention is required to moderate the impact of the external flows to the stability of the financial system.

The final transmission channel is expectations, which in general terms need to be stable in order to avoid fluctuations. However, agents interpret differently the future financial stance and decide accordingly. Monetary authorities should promote prudency, solvency and mainly credibility to encourage positive expectations, keeping therefore liquidity preference to normal levels. Otherwise, if expectations for liquidity rise then the speculative demand for money motive will emerge making it difficult for the authorities to conduct an efficient monetary policy. The expectations channel is the one that precedes the other channels since expectations on forthcoming interest rates will eventually drive interest rates to change, activating then the other channels.

3.4. Post-Keynesian approach in international level

We have seen the exchange rate transmission channel and we wish to stress the significance of the exchange rate stability globally. In the case of open economies, interest rates are also influenced from main events that occur in a foreign country. Thereby, the level of interest rates is set by domestic monetary authorities in line with the foreign monetary authorities. There is a mixture combination of the internal and external monetary ambiance. The external factor brings up the importance of balance of payments through the examination of capital and current accounts.

Following the domestic price stability target, the forthcoming goal in international level, is the achievement of exchange rate stability, meaning the stability of value money in the international standard. If we wish to proceed to the stability of international financial system, we need to state that any change in the national interest rate, will eventually entail to at least some difference within its relation with international interest rate. This shift is globally vital because that may lead to changes in the exchange rates and in capital mobility. Arestis and Sawyer (1998) argue that any policy on interest rates is inevitable delineated by global financial markets.

Changes in the exchanges rates present numerous implications. They affect the effective demand, both domestic and foreign, the expectations of agents as well as their financial status. The latter is at great importance, regarding firms and governments that borrow from foreign financial institutions, where a decrease in the exchange rate entails to burdens in domestic balance sheets and budgets, hence increasing the financial instability. Also inflation will probably rise, due to devaluations, since domestic prices will start to increase.

4. Post-Keynesian monetary targets

According to Keynesian approach, monetary policy should aim at the promotion of full employment and economic growth. To do so, investment encouragement policies are required to maintain the level of employment. Post-Keynesian economics deem that a successful monetary policy needs price stability, exchange rate stability, good and stable expectations, credibility and transparency. All the above targets can be achieved through interest rates and regulation. A success of the Post-Keynesian monetary policy means an expansion of the effective demand, thus boosting output and employment. The challenging target for authorities is to ensure price stability on the assets value that will facilitate investment. In other words, inflation must be under surveillance to limit fluctuations of expectations and to sustain the general wealth.

Thus, price stability is essential for the well function of economy and can be mainly implemented by precautionary measures on the potential causes of inflation. Price stability generates financial stability and hence a stable financial system. In general, financial stability is the ultimate aim of the Post-Keynesian monetary policy. According to Buiter (2008) financial stability is the absence of asset price bubbles, illiquidity, and insolvency, whose occurrence threatens the financial markets and the real economy. Financial stability is the maintenance of a steady-state financial status that produces no significant fluctuations in the real economy. It does not permit radical and sharp changes in asset prices nor does it encourage excessive borrowing and lending. It ensures a stable capital flow to sound agents (firms, households, governments), who are in need to finance their investment projects in order to result to greater output and employment and certainly to be able to validate their debts in due time.

5. Concluding remarks

It is evident that neoclassical economics have prevailed in the interpretation of economic phenomena and more importantly in the implementation of economic policy. The traditional theory, notwithstanding, has been insufficient to cope with recent events mainly in the financial sector. Among many defending views of traditional neoclassical theory, one of the most popular is the argument that there is no alternative. This argument of no other policy option forms an overoptimistic stance and perhaps implies a narrow-minded perception to overcome the alternative theories or to diminish their credibility. Despite its weaknesses, it continues to be the dominant policy, whilst inner and international inequalities are rising. Nevertheless, alternative theories could at least serve as contributors to an overall effort to resolve major global economic and financial issues such as unemployment, inequalities and financial crises.

Conventional theory could integrate the aspects of money and finance, apart from utility preferences, production function, goods and services. Output and production should be linked with the monetary system. Keynes in his theory integrated money and finance with total output, employment and investment. Firms, governments, and households have debts, which are assets to financial institutions which in turn have liabilities. Consequently, we observe a price system for capital assets and outputs that is highly determined by expectations and credit conditions. In other words, there are endogenous powers that arise within the monetary system and ergo in the real economy. The endogenous process unsettles the economy and, not necessarily always, could lead to crises.

The emergence of recent crises and the general instability of the system postulate the pertinent interpretations and policies acts. The prevailed neoclassical approach to monetary policy has been rather confined during the last thirty years. The main stance of the empirical policies in terms of monetary policy has been the overconfidence to the operation of free financial markets with a slight surveillance by monetary authorities. Central banks have considerably loosened the ropes of monetary control. They seem to have a passive role with limited interventions, unable to keep up the pace of excessive money supply creation that financial institutions have adopted. Additionally, commercial and investment banks have been the main players of monetary policy, since they respond to money demand and are capable of adding money supply through credit. Therefore, the role of central banks should be reassessed and redirected from price stability target to the stability of the entire financial system. They should act as real lenders of last resort, absorbing potential risks at early stage and maintaining liquidity levels and profitability.

There are some fundamental axioms in economics and finance that has been beyond any doubt during the last century, but notwithstanding, could not fill the gaps in unquestioned matters. The financial sector has equal role as the market economy. The growth of the financial system by means of indebtedness and credit expansion does provide an average GDP growth and aggregate demand increase. However, is the credit expansion process simply a period of robustness that enables investment and reinvestment leading to even more credit? We could not personally dare to provide a sound answer. On the other hand, mathematics and econometrics have always served as an undisputed tool to prove right or wrong, everything and anything in economics and finance. But how could this conception avails us to discover the reality in what is going on in the economy? What we seek in the world of business, economics and finance is nothing but the truth. A method that traditionally, or even from the ancient times, could be applied is definitely that of observation of true events.

Counter to the widely held belief, Post-Keynesian approach to economic theory provides us an alternative to comprehend how the economy and thereafter financial system actually work. Generally, we could argue that Post-Keynesian economics tend to explain the performance of the financial system through time and how it develops and changes under new circumstances. It emphasizes the endogenous developments of a financial system that could easily be fragile and unstable. Post-Keynesian approach is inter-temporal and due to the fact that the financial system in international level has currently become more integrated and interdependent, this instability could constitute a global threat. By contrast, traditional economic theory neglects that approach and attempts to explain how markets function at any moment in time. We could not support that Post-Keynesian economics offers a panacea and integrated theory. Also, it does not provide all the answers to the arising economic and financial issues we could recognize. Nevertheless, it asks the right relevant questions and seeks the right answers. Post-Keynesian economics seem to be more relevant to the explanation of global economic and financial issues and to the rising global income inequality.

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