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Special Issue

Uncertainty, path dependence and the financial sector in post-Keynesian models

Editorial to the Special Issue

Angel Asensio and Dany Lang**

The last few years have been characterized by a significant renewal and development of post-Keynesian modelling (PKM hereafter). For obvious reasons, this growing interest has been reinforced since the 2007 crisis, a tragic event that has confirmed the relevance of PKM. The papers gathered in this issue are amongst the most stimulating ones that were presented at a conference dedicated to this issue, organised by the Center of Economics of Paris North (CEPN), University of Paris 13, on November 20–21, 2009.

Post-Keynesian models have at least three features in common. The first one, underlined by Lang and Setterfield (2006), is the desire to better match what we perceive as the relevant features of the real world, while neoclassical economists prioritize the mathematical ›beauty‹ of the models. Second, competitive markets in mainstream models always have self-adjusting properties, based on the hypothesis that there is enough ›structural stability‹ for intertemporal optimization to make sense. For Keynes (1936), on the contrary, there is no such thing as a ›natural‹ anchor for expectations in the presence of ›true uncertainty‹. Past events never give enough information about what the future will be. The last common feature is the leading role of effective demand, in the short as well as in the long run. As argued in Asensio (2008), there can be market failures owing to imperfect competition in the models framed by the mainstream economists (especially in the so-called ›New Keynesian‹ literature), but aggregate demand can never constrain aggregate supply in the long run, that is, once relative prices have adjusted.

The six papers of this special issue, which share the three general features of PKM, deal with two crucial and specific features both related to uncertainty in PKM: path dependency and the critical role of money and finance.

The three papers about path dependency are proposed, respectively, by Sawyer, by Setterfield, and by Cross and Lang. Sawyer explores methodically how the interactions of demand and supply involve path dependence features in post-Keynesian theory. He first

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questions the mainstream's rational expectations hypothesis, which denies the »unknowability of the future«. The author puts forward the irreversibility of economic decisions, »a pervasive feature of (almost) all economic activity«. Several sources of path dependency are identified in the labour market and in the goods market, where aggregate demand and supply do interact with each other in the dynamic process. Sawyer's simple framework for growth analysis offers suggestive and thorough support to the discussion. A key issue of the discussion is about the way the growth rate of demand and the growth rate of the supply potential could interact with each other.

Setterfield's contribution is very close in spirit to Sawyer's, as it discusses »the substance of post-Keynesian claims to model growth as a path-dependent process«. The originality here lies in the fact that the paper questions whether the mainstream's recent developments on endogenous growth theory do encroach on the post-Keynesian treatment of growth as a path-dependent demand-led process. Setterfield interestingly distinguishes two different issues. The first one is the possible feedbacks on the future equilibrium rate of growth that may result from disequilibrium between the current and the (provisional) equilibrium rate, in which case the long-run outcomes are path dependent. The second issue is the one also considered in Sawyer's paper about the possible difference between the potential rate of growth and the »actual« equilibrium rate of growth. Setterfield proposes both a theoretical justification and the related formal »mechanism« that can solve the problem and thereby allow for sustainable long-run path-dependent outcomes.

Cross and Lang re-examine the concept of the NAIRU framed by Layard, Nickell and Jackman, which is still embedded in the so-called »New Consensus Model«. Cross and Lang deal with »genuine hysteresis«, in contrast with the NAIRU approach, which implies that, in the long run, unemployment is supposed to revert to some »natural rate« only determined by supply-side factors. They suggest the »DESIRU« (dominant *extrema*, steady inflation, rate of unemployment) as an alternative concept to the natural rate hypothesis. The DESIRU is determined both by supply and demand factors, in the short as well as in the long run.

The contribution by Asada et al. opens a second set of three papers, more focused on the role of money and financial factors in PKM. Asada et al. start considering that, when markets are incomplete and expectations »non-rational«, the inflation targeting strategy may not be sufficient for achieving macroeconomic stabilisation. They propose a model with a dynamic multiplier representing the goods market and a structured portfolio choice where money holdings and equities are not perfect substitutes. Such a formal approach is viewed as descriptively much more accurate than the mainstream's seminal model in which these assets are perfect substitutes. In both models, an unstable financial sector is coupled with a stable real sector, but while in the mainstream model the instability problem requires the »jump variable technique«, in the author's model local stability of the equilibrium becomes possible, though instability may still be considered the normal case. Hence, this type of instability can be overcome if actual capital gains are taxed to a sufficient degree, while an interest rate policy of the Taylor rule type cannot tackle this issue unless it is interpreted as reflecting the state of confidence for the current situation of the economy so that it influences the stock market.

In the paper by Le Heron, confidence is the main channel through which the US subprime crisis affects countries like France. Although there was no bubble in the French housing market and banks (as well as household incomes) had moderate exposure to US speculative markets, the country suffered the deepest depression since World War II. The author points out that expectations can become self-fulfilling in the presence of 'true uncertainty', thereby offering a suggestive focus on the role of the financial system with respect to path dependency. Le Heron's stock-flow consistent (SFC) model has a complete private banks sector with borrower and lender's risks *à la* Minsky, and four assets. Banks examine the firms' expected production and demand for financing (which integrates the firms' borrowing risk), lender's risk and liquidity preference, and then decide whether or not to provide credit. The model delivers an endogenous interest rates curve, with a variable spread between the long-term rate and the central bank rate. Based on this framework, Le Heron considers three types of confidence-shocks. The simulations replicate the path taken by the French economy during the last financial crisis rather well. Le Heron therefore concludes that confidence is a fundamental transmission channel of financial crises to the real world. An important feature in this contribution is the endogeneity of the long-term interest rate: the interest rate spreads with respect to the central bank rate is subject to unpredictable shifts in the state of confidence, with the result that monetary authorities cannot be certain to reach their objectives.

This endogeneity is usually considered as incompatible with the post-Keynesian endogenous money approach. Asensio's paper shows that, far from being incompatible with a post-Keynesian approach, this is on the contrary a very feature of Keynes's *General Theory*. Keynes (1936) defines the long-term interest rate as a 'highly conventional phenomenon' on which the monetary policy may have more or less influence. Accordingly, in order to exert control over the long-term interest rate effectively, authorities must be able to change the market's conventional expectations – and not only banks' refinancing conditions. The paper also explores some issues related to the way financial transactions are dealt with in post-Keynesian simple macro-models. It turns out that, when the supply of goods adjusts to the aggregate demand below full employment, there is a perfect symmetry between the money market and the financial market. Therefore, insofar as money supply endogenously sticks to money demand, the financial market cannot but clear together with the money market. Hence, as regards the market for 'loanable funds', the critical point is not whether or not the rate of interest is involved in the financial market – of course it is. The point is that, because of uncertainty and liquidity preference, the rate of interest at which borrowers can get funds to finance their investments may be too high for reaching full employment.

As editors of this issue, we really hope that the six stimulating papers published in it will contribute stimulating future PKM on path dependency as well as on the crucial role of money and finance in modern capitalist economies.

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