

A PRIMER ON MONETARY POLICY AND ITS EFFECT ON INCOME DISTRIBUTION: A HETERODOX PERSPECTIVE

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Abstract:

Monetary policy is not often associated with income and wealth inequality. Since the 2007-8 financial crisis, however, the mainstream has slowly turned its attention to the link between changes in the rate of interest and income/wealth distribution. Of course, post-Keynesians, and heterodox economists in general, have been aware of this relationship for many decades. In this paper, we wish to explore further this relationship and focus on the direct and indirect transmission mechanisms, in particular in order to reveal the true nature of an inflation targeting monetary policy as a *de facto* long-term incomes policy. Finally, we wish to discuss these views briefly also in the context of open economies, as is the case of developing and emerging economies, such as Argentina.

Key words: interest rates, monetary policy, income distribution, incomes policy

JEL codes: E12, E24, 43,

Introduction

While most Canadians know of the existence of the Bank of Canada, what precisely it does remains a mystery to many. One possible reason may be the many confusing and often contradictory discussions economists and policy makers have around monetary policy, interest rates, money, and inflation.

This short chapter aims to shed light on this confusion, by looking at the intricacies of monetary policy and by offering another view over what central banks really do when they change the interest rate. When the media talks about central bank policy, it normally describes how monetary policy decisions affect the cost of financing one's mortgage or the impact on credit card payments, which may affect one's creditworthiness both as a consumer or a small firm that needs to finance business working capital. While this may be true, the media do not normally discuss how a change in interest rate also affects the income flow of some group, often at the expense of others. Nor do they discuss its effect over time on your own regular paycheck if, say, you are an average wage earner holding no financial assets and managing household debt.

Contrary to popular belief, therefore, monetary policy, by which we mean primarily changes in the central bank-administered rate of interest – the 'overnight rate' in Canada – may not do what central banks think it does, or at least not without imposing possible collateral damages on the economy. Again, the media is often silent on this issue. We will argue that, while central bank policy does have an impact on economic activity – the so-called 'transmission mechanism' – it

operates primarily on income distribution. Indeed, the rate of interest in itself must be seen as not only a cost to the public for borrowing funds from financial institutions, but also as generating income for some group, namely recipients of investment income, who may hold, for example, a corporate bond or government securities. Seen in this way, changes in the rate of interest benefit some, while harming other income groups. In other words, when central banks raise or lower the rate of interest, they will have both a direct and, as we shall see, an indirect impact on income distribution, and there will inevitably be winners and losers.

This chapter begins with a brief discussion of what central banks do, and how they believe their policy affects the economy. We then proceed to discuss the success of their policies, and the wisdom of their current policies. Finally, we discuss a new way of looking at monetary policy that emphasises its income distributive nature – a topic that has grown in interest since the global financial crisis of 2008, and during the COVID-19 crisis.

What central banks believe they do

The mainstream story with respect to monetary policy is quite simple: central banks want to maintain a low and stable rate of inflation for the ultimate wellbeing of all Canadians, regardless of whether you are a wage earner or a recipient of investment income, and uses the rate of interest to achieve this. Indeed, in an ‘inflation targeting’ regime, central banks raise or lower the rate of interest to affect aggregate spending and the overall economy, which, in turn, presumably, will lower or raise the rate of inflation. What is important to note is that interest rates are considered a cost: the cost of borrowing for the purposes of consumption or investment: as the rate of interest increases, the cost of borrowing money from banks increases, and this should slow down consumption and investment plans.

In Canada, the Bank of Canada aims for a rate of inflation between one and three per cent – essentially meaning an official target of two per cent, right at the midpoint of its one-to-three per cent band. When inflation – or expected inflation – is above two per cent, the Bank of Canada increases the rate of interest. According to the mainstream view, this lowers consumption and investment, and slows down economic activity. Assuming inflation and economic activity move together, a slowdown of economic activity should bring the inflation rate down to target. This ‘fine tuning’ of economic activity continues until inflation reaches its target.

Monetary policy relies on two important relationships: first, the relationship between interest rates and overall spending (or ‘aggregate demand’); and second, the relationship between aggregate demand (as reflected in the level of unemployment) and inflation: those two relationships must hold for monetary policy to be effective, otherwise, monetary policy cannot do what it claims to do, with the conclusion that it is ineffective.

Over the years, there has been considerable research done on those two relationships. Unfortunately, the conclusion has not been very kind to the mainstream view. For instance, Cynamon, Fazzari and Setterfield (2013, p. 13) claim that:

“The transmission mechanism from monetary policy to aggregate spending in new consensus models relies on the interest sensitivity of consumption. It is difficult, however, to find empirical evidence that households do indeed raise

or lower consumption by a significant amount when interest rates change. Some authors have generalized the link to include business investments (see Fazzari, Ferri, and Greenberg, 2010 and the references provided therein) but a robust interest elasticity of investment has also been difficult to demonstrate empirically.”

This suggests that the first relationship between aggregate private spending and interest rates may not be very significant, especially for small, incremental changes, which do not appear to have the intended effects: consumption and investment do not seem to respond all that well to changes in the rate of interest, what the authors refer to as ‘interest elasticity’. Of course, if inflation is higher than two per cent, and the central bank raises interest rates several times, eventually, of course, it will collapse the economy. Unfortunately, this is often what happens: central banks raise interest rates several times until the economy simply comes crashing down. This is because the Bank of Canada is searching for just the ‘right’ interest rate to keep the inflation at two per cent, what it calls officially the ‘neutral’ rate of interest. Much like modern oracles, monetary policymakers interpret this ‘neutral’ rate, which is really unobservable, largely through its manifestation on the rate of inflation. The logic is the following: if inflation is above target, then it must be that policy interest rates are below the neutral rate, and the central bank should therefore raise interest rates.

However, if this quest to bring down the inflation rate by raising its overnight rate to its ‘neutral’ level ends up collapsing the economy, because of the discontinuous/non-incremental relationship between private spending and interest rates, then there is nothing neutral about this rate. Examples abound historically both in Canada and internationally about the devastating consequences of combating inflation through excessively high interest rates on modern economies. For instance, there is the famous Volcker high interest rate shock that triggered the catastrophic 1981-82 recession in the U.S., which had direct ramifications on Canada, since the Bank of Canada followed closely the U.S. sky-high interest rate policy: short-term interest rates reached over 20 percent by 1981! Moreover, there is a consensus among Canadian economists on the direct role of former Governor John Crow’s overzealous policy of combating inflation through double-digit interest rates during the late 1980s, thereby triggering the so-called ‘Made in Canada’ recession of 1990-91.

Now, what about the second relationship, namely, between unemployment and inflation? Unfortunately, the conclusions are no better. In fact, over the last three decades or so, the relationship has completely collapsed. For instance, the chief economist for the Bank for International Settlements (BIS), Claudio Borio, has recently argued that “the response of inflation to a measure of labour market slack has tended to decline and become statistically indistinguishable from zero. In other words, inflation no longer appears to be sufficiently responsive to tightness in labour markets” (Borio, 2017, p. 2). In other words, inflation no longer seems to move in response to changes in the unemployment rate (or economic activity), except perhaps in a non-incremental way, whereby only extremely low or high rates of unemployment can trigger inflation or deflation in wages and prices. This led Arestis and Sawyer (2003, p. 5) to argue, correctly, that “It is a long and uncertain chain of events from an adjustment in the interest rate controlled by the central bank to a desired change in the rate of inflation.” This conclusion was also expressed by Nobel laureate, Paul Krugman (November 15, 2018, *NYTimes* blog), calling it a “dirty little secret of monetary analysis ... [that] any direct effect on business investment is so small that it’s hard even to see it in the data.”

These are devastating conclusions for anyone who still believes in the mainstream view of monetary policy, and its expected transmission mechanism. It leaves the conduct of monetary policy in question. In other words, the policy of targeting inflation is in doubt. Yet, this has not stopped central bankers to continue this policy, or some version of this policy, despite the empirical evidence against its capacity to control the inflation rate through simple changes in the cost of borrowing. This is not to say that the pursuit of an inflation target does not have consequences or implications, as we explain below. However, it is primarily through an alternative mechanism, which is somewhat different from what we are told.

In turn, this also leads to another important question: “What then does monetary policy do?” This is the question that the rest of this article attempts to answer.

What central banks do

As we discussed the limited success of monetary policy above, we deal in this and following sections with the nature of monetary policy, or, rather, the dual nature of interest rates, and how changes in them affect the distribution of income and wealth among social classes. We wish to argue that this is the primary way that monetary policy actually affects income and wealth distribution. As readers will note, this is an entirely different explanation than the mainstream perspective.

There are two ways that monetary policy can affect income and wealth distribution: (i) through the income channel; and (ii) through the wealth channel.

The income channel can be divided into a direct and an indirect channel. The direct channel begins with the notion that interest rates should not as much be seen as merely a cost of borrowing, but rather they are also an income for those who own interest-bearing assets. We can call them investment income recipients or rentiers: individuals whose incomes arise not from work, but from simply owning classes of financial assets, such as government bonds and corporate securities. Admittedly, some of us may be both receiving an employment income but also an investment income, either directly or via our accumulated contributions, say, to a group pension fund. However, given the current saving rate of most North American households, only those in the highest quintile of income groups can actually save and live sufficiently well from such accumulated savings (see Costantini and Seccareccia, 2020). Moreover, outside of the unionised sector, most elderly Canadians must rely primarily on direct government transfers, or demogrants, in the form of Old Age Security that are not dependent on interest rate policy.

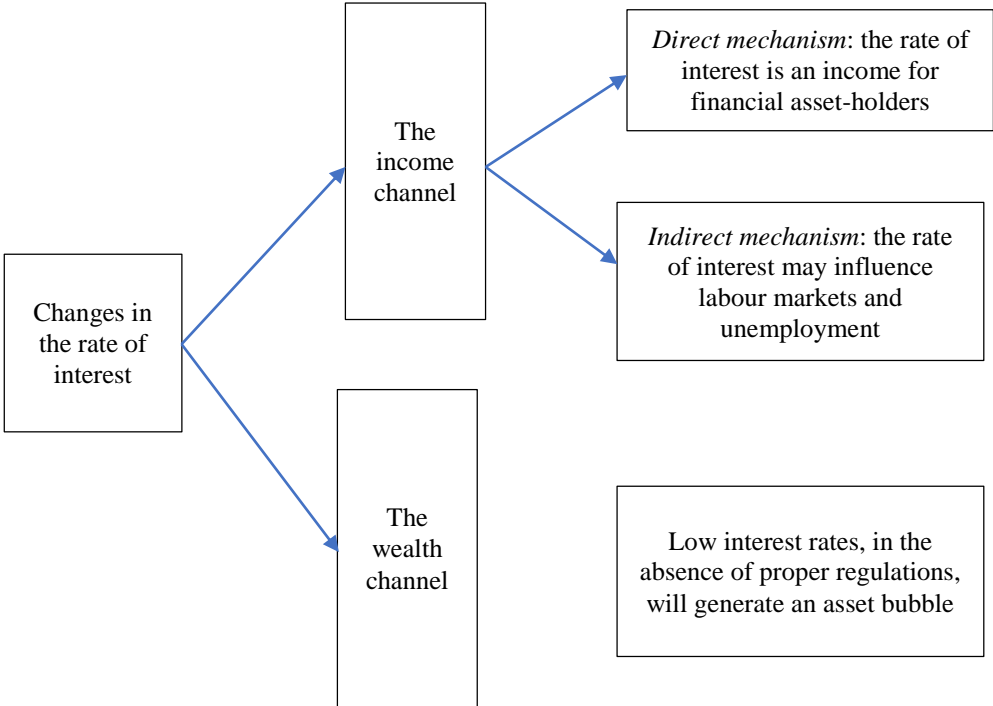
In light of this fact, changes in the rate of interest affect *directly* the distribution of income: the higher the rate of interest, the higher the income from holding these financial assets, as the complete spectrum of returns tends to follow changes in the central-bank controlled interest rate. Hence, financial asset-holders from the higher quintiles of the income scale benefit from higher interest rates, and as such from policies that are based on raising interest rates when inflation increases. On the other hand, the policy is detrimental to those in the lower end of the income scale who constitute the most indebted as a proportion of their incomes. This suggests that inflation-targeting policies that have been adopted, by, say, the Bank of Canada since 1991, will benefit financial asset-holders whenever the Bank of Canada increases interest rates, but is

detrimental to these rentiers when interest rates fall. Canadian economist John Smithin has called the many years of monetary austerity, especially during the last two decades of the last century ‘the revenge of the rentiers’ precisely because central banks were very kind to financial asset-holders. Throughout that pro-rentier era, interest rates rose more quickly than the inflation rate, with a reversal occurring only after the global financial crisis of 2007-2008.

The indirect channel is related to what was discussed above: changes in the rate of interest may affect incomes, but through their impact on labour markets. In pursuing their inflation targeting strategy, central banks will raise the rate of interest, which may then (eventually) have effects on labour markets, unemployment, and thus the income of workers. For instance, as the rate of interest falls significantly in a recession, this may encourage the hiring of workers, a drop in unemployment, and thus an increase in total wages, not to mention that as unemployment falls, workers may also be able to demand higher wages by strengthening their bargaining position. Increases in interest rates will have the opposite effects.

As for the wealth channel, consider, for instance, when policy rates of interest diminish, as in the aftermath of the global financial crisis that erupted in 2007-2008, or during the COVID-19 crisis, with the aim of supporting economic activity and employment levels. In fact, as already pointed out, neither firms nor households will be induced to increase their borrowing from the banking sector if they fear being unable to repay their debt (and the relevant interest) when it matures. Rather, this reduction in interest rates will spur financial transactions, thus inflating an asset price bubble that is further reinforced by the so-called ‘wealth effect’, which consists in feeling richer when one’s assets are priced more on the relevant market. Clearly, wealthy individuals whose assets are priced more because of a reduction in policy rates of interest will not increase their spending to buy a series of consumption goods, thereby supporting economic activity, but rather increase their spending on real estate and financial markets, thus increasing the relevant asset prices. Holders of these assets will therefore feel richer, giving rise to an upward spiral that could inflate a bubble, threatening the financial stability of the whole system.

Figure 1: The income distributive effects of monetary policy





The immediate conclusion to be drawn from this short analysis is that monetary policy may work first and foremost through income and wealth distribution, and then eventually on aggregate spending and economic activity. Incremental changes in interest rates affect the distribution of both income and wealth between rentiers and workers, and among households. Since we know that poorer individuals spend a greater proportion of their income than wealthier ones, a policy that redistributes toward workers may encourage greater growth. In this sense, a permanent policy of low interest rates is to be considered. Indeed, this is what Rochon and Setterfield (2008) have advocated in their work on interest rate rules. Of course, this policy would then require governments to adopt a proper regulatory framework to prevent financial bubbles.

Yet the past three decades have shown the fragility of our economic system when monetary policy is not accommodative to workers. Seccareccia and Lavoie (2016) showed that monetary policy has consistently favoured rentiers until the global financial crisis, thereby exacerbating an already unequal distribution of income and wealth. In other words, monetary policy has acted as an incomes policy that protected rentiers, except over the last decade where the focus has been on preventing the collapse of asset prices in the financial markets. These are the issues to which we now turn.

Understanding the true nature of Canada's Inflation Targeting regime

As we have suggested above, monetary policy is akin to what economists have traditionally referred to as an incomes policy. This is because, at its core, monetary policy uses a key lever, in this case, the central bank-administered rate of interest, which directly determines the income of one group, the rentiers. Ultimately, this is to effect changes in wages and prices that impact on the incomes of other social groups in an economy, both wage earners and business profit earners.

To be sure, incomes policies are hardly a new idea: government authorities have often sought to adopt some form of wage and/or price controls to prevent runaway inflation, as during wartime, for instance. However, there are essentially two types of incomes policies, which governments have adopted historically: the voluntary and the compulsory forms.

The most well known of these voluntary forms in the North American context of decentralized wage bargaining systems were the Kennedy-Johnson Guideposts from 1962 to 1966 in the United States, as well as the federal Prices and Incomes Commission from the end of 1968 to 1972 in Canada. Under this voluntary form, government authorities would communicate a norm or "target" for prices and incomes growth, which would normally be justified on income distributional grounds and equity considerations.

In the case of compulsory incomes policies, there were some similar features. While they often were met with legal challenges from trade unions for the obvious fact that they overrode the right to free collective bargaining, the best example of this compulsory form of incomes policy is the federal Anti-Inflation Board (AIB) that lasted in Canada from 1975 to 1978. Under the AIB, the announced maximum allowable income growth imposed by the federal government was based on the principle of compensating workers for at least two important factors: the inflation factor and the national productivity factor. The maximum allowable annual wage increase permitted workers: (i) to recoup loss of purchasing power due to the expected inflation (an extrapolation based on the previous year's inflation rate); and (ii) to obtain an inflation-adjusted increase in incomes linked to the long-term annual growth rate in national labour productivity. Hence, such a policy was justified on the underlying policy principle of preserving income distribution 'neutrality, which linked after-inflation (or "real") wage growth to overall productivity growth, to insure that individual income earners would be maintaining their relative share of a growing national income.

The reason why we have found it important to mention briefly these experiences with incomes policy is that there is an aspect of the practice of a monetary policy regime of inflation targeting that is somewhat similar to a policy of voluntary guideposts in how central banks dabble with income distribution. While the government announces some guideline for wage growth in industries, including the public sector, so that workers and employers incorporate that norm into their negotiating practice, central banks have used a different vocabulary. Yet, the logic of the 'monetary' policy is essentially the same. Every time the federal government announces, via its Minister of Finance, an agreement with the Bank of Canada, by defining its mandate to attain its five-year annual inflation target (as it did in 2016 and now in 2021), what it is doing is officially shaping expectations of inflation of Canadian workers.

Indeed, central bankers are very fond of saying that a monetary policy of inflation targeting has an impact on inflation primarily via the announcement effect of inflation targets to modify psychologically the public's inflation expectations. If the inflation targets are 'credible' and provided they are marketed and repeated frequently enough, this will eventually align the public's expectations to those announced by the central bank. As a result, workers will demand wage compensation increases compatible with the expected rate of inflation. In contrast to the legal squabbling resulting especially from compulsory incomes policies, the objective of inflation targeting is to inspire public 'confidence' through a communication strategy of 'credibility' that the central Bank is serious and committed to its inflation target, thereby anchoring expectations. As former Governor David Dodge (2005, p. 5) put it so succinctly:

"With inflation targeting, our policy is more focused, our communications are clearer, and Canada's inflation expectations are more solidly anchored."

Hence, what we have been seeing since the adoption of inflation targeting in Canada since 1991 is a slow aligning of wage and price changes gravitating around the 2 per cent anchor. However, unlike the old types of incomes policy as under the AIB, this veiled form of incomes control does not need legal/coercive actions of the state to achieve its goal. The Bank does it primarily through a simple communication/marketing strategy of 'repetition' as used in commercial advertising. When one disentangles and tries to cut through all of the Bank's mainstream jargon about why achieving its 2 per cent goal brings about maximum efficiency and welfare for participants in both

the labour and product markets, the sole explicit objective is to get Canadians to accept voluntarily the Bank's 2 per cent norm to fulfill the government's five-year objective.¹

However, what if the marketing strategy does not quite work and both workers and businesses are not complying, because the inflation rate begins to exceed the inflation target? The central bank cannot legally enforce compliance, as was the case with compulsory incomes policies during the 1970s. What the central bank does, instead, is use its interest rate lever to get workers and firms to comply through an incomes policy of 'fear', as Canadian economist John Cornwall once described central bank anti-inflationary measures. Through the income channel of the transmission mechanism previously described in Figure 1, once interest rates rise enough, we are told that this will eventually slow down the economy, create unemployment, and reduce wage growth and the overall rate of inflation. Unlike the older varieties of incomes policy that were often concerned about distribution neutrality, this inflation-targeting form of incomes policy is hardly neutral on equity principles. Indeed, if workers do not abide by the guideline, the central bank raises the income of one group, the recipients of investment income (or rentiers), through higher interest rates, while simultaneously seeking to reduce the income growth of the others, both wage earners and even business profit income earners.

This perverse and highly biased form of incomes policy that, until the global financial crisis, sustained the income of rentiers at the expense primarily of wage earners is perhaps the most salient feature of this monetary policy regime that placed combating inflation above all other possible goals. It is only after 2008, in a desperate attempt to sustain asset prices from complete collapse, that we have seen central banks trading off a cut in the rate of return on financial assets to stabilise and sustain asset values.

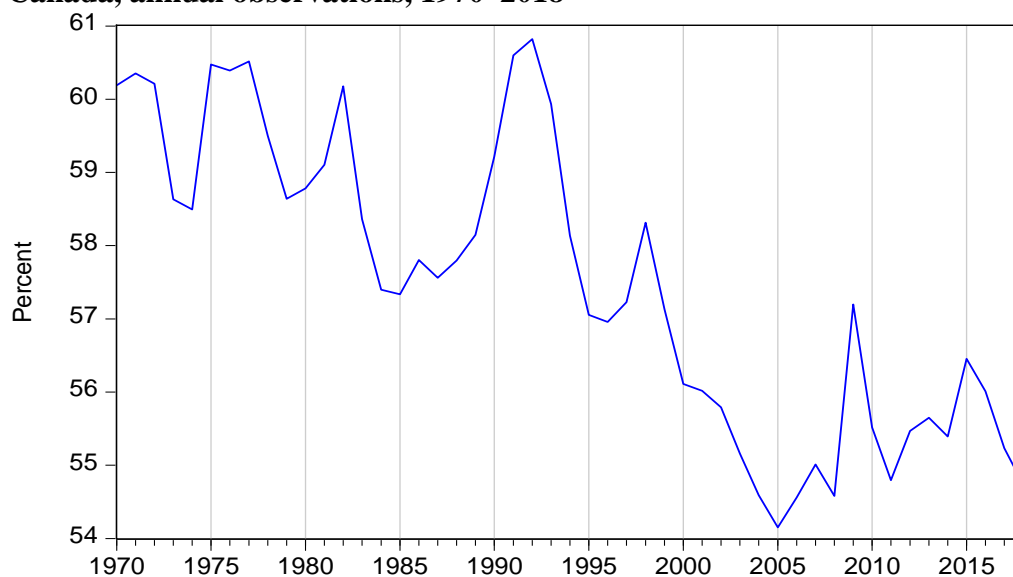
Inflation Targeting in practice and what needs to be done

Has this monetary/incomes policy of inflation targeting been successful? It depends on how you measure success. When looked at through the mainstream lenses of the Panglossian world of the Bank of Canada, Voltaire's famous expression still resonates that '*tout va pour le mieux dans le meilleur des mondes*'! With the exception of the global financial crisis of 2007-2008 and the COVID-19 crises, we have indeed witnessed an era of 'wage moderation' with the rate of inflation gravitating around the 2 per cent target rate. As well, with wages and prices moving more or less in tandem, this has been associated with a relative stability of real wages over the last 30 years. In that narrow sense, we can argue, or at least the Bank of Canada can, inflation targeting has been a success.

¹ By the way, readers may wonder about why 2 per cent was chosen as a goal. This is a good question, with no obvious answer. When one of the authors of this chapter asked John Crow in 1989 what he meant by achieving price stability, he suggested simply 'zero inflation'. However, because of measurement bias of quality change in the Consumer Price Index, some would argue that a number slightly greater than zero might be compatible with 'price stability'. However, we have never been able to find a meaningful answer to why 2 per cent became the norm. As Benjamin Friedman claimed recently, "there is the arbitrariness surrounding the current 2 percent target. In retrospect, the paucity of serious empirical research underlying the identification of the 2 percent norm, now quite some time back is a professional embarrassment." Friedman (2018, p. 187).

However, as we have been arguing all along, monetary policy has important income distributive properties. What then has happened to the distribution of income and, more precisely, labour's share of national income? The answer is displayed in Figure 2 below.

Figure 2: Total economy labour compensation as percentages of GDP at market prices, Canada, annual observations, 1970–2018



Source: AMECO Database. Data accessed from the website: <https://ec.europa.eu>

From its local peak in the early 1990s at close to 61 per cent of GDP, the share bottomed at around 54 per cent just before the global financial crisis of 2007-2008 (recall Canada adopted inflation targeting in 1991). Hence, while wages did keep up more or less with the rate inflation throughout, all the gains in average labour productivity went to non-labour income, with real wage growth being continually outstripped by productivity growth (see Seccareccia and Kahn 2019). After hitting the bottom immediately before the financial crisis, the local peak of 2009 in Figure 2 has more to do with the fact that the rate of inflation fell below wage growth and also the fact that labour productivity growth collapsed during the recession of 2008-2009. It was certainly not because money wages were rising more quickly during the financial crisis era. In addition, although some of this decline can be attributed to other factors as well during that era, namely the spread of globalisation that weakened wage growth especially of unskilled workers, much of the collapse of the share of labour income must be attributed to the nature of monetary policy in Canada.

Conclusion

As we have shown, the sole focus of keeping a lid on inflation over other goals, such as full employment, in the context of inflation targeting has led to a weakening of labour's bargaining position. Higher wage growth will be met with resistance not only by profit-seeking employers, as would normally be so, but also with a response of the central bank that stands ready to raise interest rates whenever the actual rate of inflation exceeds the Bank's target rate of inflation. With money wages moving only commensurate with prices, which our monetary authorities display as a trophy of the success of current monetary policy, the whole incomes policy framework of inflation

targeting is highly problematic since the policy is inherently biased against labour's share of income. A declining share of labour in a society that would value more and more unearned to earned income is surely unacceptable. Moreover, since workers' wages sustain the bulk of consumption spending in an economy, a pattern of a falling share of labour income can only render future growth ever more vulnerable and dependent on the whims of the international market for source of growth.

This is why a good number of economists in Canada who do not subscribe to the mainstream perspective have asked either to change the Bank's five-year mandate by including other objectives, such as full employment, or completely to revamp the Bank of Canada Act that dates back to 1934. We cannot have an important arm of the federal government, its central bank, whose monetary policy regime is structurally biased against labour. As we have seen, central bank policy tends to reduce the share of labour and, by implication, also keeps rates of unemployment much above a meaningful 'full employment' rate of unemployment because of its sole concern with keeping the inflation rate capped at 2 per cent. Are there not other social goals that such an important public institution should also be mandated to address? Instead of seeing these negative consequences as merely collateral damages in its pursuit of a superior goal, its inflation target, a declining share of labour should be of concern to a central bank, just as high a unemployment rate should not be seen merely as a 'natural' or necessary consequence of its actions. After three decades of this monetary policy regime and after the global financial crisis and, most recently, the COVID-19 crisis, it is now time for a policy change that widens the social purpose of central banking.

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