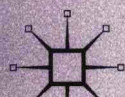


INTERNATIONAL PAPERS IN POLITICAL ECONOMY

New Economics as Mainstream Economics

Edited by Philip Arestis and Malcolm Sawyer



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Philip Arestis

University of Cambridge and University of the Basque Country

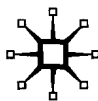
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Preface

This is the seventh volume of the new series of *International Papers in Political Economy (IPPE)*. The new series will consist of an annual volume with five to six papers on a single theme. The objective of the *IPPE* will continue to be the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993 until the new series began in 2005 and was published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from the editors: Philip Arestis (e-mail: pa267@cam.ac.uk) and Malcolm Sawyer (e-mail: mcs@lubs.leeds.ac.uk).

The theme of this seventh volume of six papers is New Economics as Mainstream Economics in terms of both theory and applications. The papers in this volume were initially presented at a two-day conference in Cambridge, UK, 28–9 January 2010. The conference was organised by the Department of Land Economy under the aegis of the Cambridge Trust for New Thinking in Economics; the latter fully supported and financed the conference. The papers were subsequently presented at the 7th International Conference, entitled ‘Developments in Economic Theory and Policy’, held at Universidad del País Vasco, Bilbao, Spain, 1–2 July 2010, which fully supported and funded the special session to which the papers included in this volume were presented. We are grateful to the organisers of the Bilbao conference and to the Cambridge Trust for all the help and funding provided.

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1

Economic Theory and Policies: New Directions After Neoliberalism

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Abstract

This contribution attempts to go beyond the recent and current trends in terms of economic theory and policy. It is the case that the New Consensus Macroeconomics theoretical framework has dominated macroeconomic analysis in recent years and has in effect underpinned many macroeconomic policies. However, given the current experience with the 'great recession' crisis, the question arises whether there is not a better paradigm and set of economic policies that can lead the economy to an improved economic performance. This is precisely the focus of this contribution. Our response is very much that there is. In this contribution we propose another theoretical framework before moving to economic policy questions. The general background to the theoretical framework is that the analysis is of a monetary production economy in which finance and credit play a significant role. It relates to an economy, which has degrees of instability, and there is often inadequacy of aggregate demand. The level and distribution of productive capacity can often be inadequate for underpinning the full employment of labour.

Keywords: Economic theory, economic policy, new directions, after neoliberalism

JEL Classifications: E12, E60, E61

1 Introduction

Economic policies arise out of and can only be understood by reference to the theoretical framework that underpins the analysis undertaken and the

ways in which the economy operates and works in the real world (Arestis and Sawyer 2010a, 2010c; see, also, Arestis, 2010). The links between the mainstream policies of the past two decades (in the areas of macroeconomics, inflation targeting by an 'independent' Central Bank and fiscal consolidation with labour market 'flexibility' and financial liberalisation) and the 'New Consensus in Macroeconomics' (NCM for short; see, for example, Arestis, 2007, 2009b; Arestis and Sawyer, 2008) are one confirmation of that. But the financial crisis and the 'great recession' have thrown the NCM and the associated policies into disarray, and we would suggest that important and significant changes are paramount. This is precisely the focus of *this contribution*. Given the experience with the 'great recession' crisis, the question arises whether there is not a better paradigm and set of economic policies that can lead the economy to a better economic performance. Our response is very much that there is. In this contribution we propose to discuss further our theoretical framework before moving on to economic policy questions. In terms of the latter we argue that an important policy dimension, which has been ignored in the past is financial stability.

Our purpose here is to set out an alternative macroeconomic framework and draw out a range of macroeconomic policy implications. The general background to the theoretical framework is that the analysis is of a monetary production economy in which finance and credit plays a significant role. It relates to an economy which has degrees of instability in the sense of being subject to the ups and downs of the business cycle and prone to crisis. There is often an inadequacy of aggregate demand (relative to what would be required for full employment of labour). The level and distribution of productive capacity can often be inadequate for underpinning the full employment of labour.

We begin our discussion with the essential elements of the theoretical framework that underpins relevant economic policy proposals, before we turn our attention to the economic policies themselves. So after this short introduction we turn our attention in Section 2 to the theoretical background of what might replace economic theory after neoliberalism. We discuss in Section 3 the economic policies that follow from this theoretical framework. In the final part of this contribution, Section 4, we summarise and conclude.

2 Theoretical background¹

The theoretical framework, which underpins the analysis of this contribution, draws on a number of ingredients and we turn our attention to them in what follows in the next subsection.

2.1 Main theoretical elements

The general background to the theoretical framework outlined here is the emphasis on an economy of a monetary production type in which finance and credit play a crucial role, and the analysis of macro-economies cannot be reduced to studies of economies without money and finance. It relates to an economy which has degrees of instability in the sense of being subject to the ups and downs of the business cycle and prone to crisis.² The theoretical framework which underpins this analysis draws on five main elements. This model is constructed by putting together five building blocks which form a coherent whole; we outline and discuss these five building blocks below. The focus of all five blocks is on four propositions: (i) aggregate demand is always important for the level of economic activity though the supply potential of the economy has to be fully incorporated; (ii) distributional effects matter; (iii) money is endogenous, credit driven; and (iv) (appropriate) government deficits do not present financial risks. We discuss the five blocks to begin with, followed, in Section 3, by a discussion of the economic policy implications of the model that emerge.

The theoretical framework, put forward in this contribution, draws on the following main elements. In terms of the demand side of the economy, which relates to expenditure, income and employment, the focus is on the level of economic activity, which is set by aggregate demand. There is no existing market-based mechanism to propel the level of aggregate demand to any specific level of output. Investment has a dual characteristic in this model: it is a relatively volatile component of aggregate demand, and it is also a promoter of future productive potential. This establishes interdependence of the demand side and the supply side, which is closely related to ideas on path dependency (see, Arestis and Sawyer, 2009). The foreign sector is viewed as another relevant and significant constituent element of the model. A relevant aspect of this importance is that imports and exports are included in the aggregate demand equation, reflecting the effects on demand (and hence employment) of variations in the exchange rate.

The supply side is reflected in a range of ways. The level of economic activity (as set by the level of demand) relative to the supply potential of the economy impacts on investment and pricing decisions. The supply potential depends on the size and structure of the capital and the labour force, and that supply potential evolves over time as investment occurs. The relationship between wages and prices, and the inflationary forces in the economy depend on the nature of what may be termed the supply side of the economy and how that supply side interacts with demand.

In an inflationary process inflation is viewed as multi-causal and the sources of inflationary pressure vary over time and economy. The range of factors, which impact on the rate of inflation, includes: struggle over income shares; the level and rate of change of the level of aggregate demand and cost-push factors emanating notably from the foreign sector (change in import prices and the exchange rate).

The money, credit and finance sector is also an important element to this way of thinking about the macroeconomy. Money is endogenously created within the private sector with loans provided by banks themselves generating bank deposits. The central bank sets the key policy interest rate, which governs the terms upon which the central bank provides the 'base' money to the banking system.

Cycles and fluctuations in economic activity occur frequently and full employment is at best a rather infrequent occurrence. Changes in economic activity impact the rate of change of prices and wages, and consequent changes in the distribution of income between wages and profits. Changes in the distribution of income have effects on the level of aggregate demand, with the nature of the effects depending on whether there is a wage-led or a profit-led regime. These interactions contribute to the generation of cycles.

The constituent elements of the model we put forward are discussed below, along with the functional relationships implied by the description provided. The model is divided into five blocks for convenience of exposition. With these general principles as the necessary background we turn our attention in Section 2.2 to discuss and develop more extensively the macroeconomic model that underpins the general principles just put forward.

2.2 Main ingredients of the model

The main ingredients of such a model are discussed below, along with the relationships implied by the description provided. The model is divided into five blocks as follows.

2.2.1 *Block I: aggregate demand and aggregate supply*

This block is based on the idea that the level of economic activity, as proxied by the level of national income, is set by the level of aggregate demand, which is the sum of intended consumer demand, investment demand and government expenditure plus net exports, as in equation (1):

$$Y = C + I + G + (X - Q) \quad (1)$$

where Y is national income, C is consumption, I is investment, G is government expenditure, X is exports and Q is imports, and thus $(X - Q)$ is net exports (NE). Aggregate demand is important in both the short run and in the long run for the level of economic activity and for the evolution of the economy. There is no mechanism whereby market forces would propel the level of aggregate demand to any supply-side determined equilibrium. Investment expenditure in this model has a dual role. It is a relatively volatile component of aggregate demand; and it is also a creator of productive potential (see, for example, Arestis et al., 1985–6).

We examine the components of aggregate demand next, beginning with consumption as in (2):

$$C = C[(W \cdot E(1-tw), \Pi(1-t\pi), B, R, \Delta BLP_h] \quad (2)$$

where W is wage rate, E employment so WE is the wage bill, tw is the tax rate on wages, Π is total profits, $t\pi$ is the tax rate on profits, B is social security benefits and other transfer payments, R is the rate of interest on loans, and ΔBLP_h is changes in bank lending to households. The availability of credit to households influences consumer expenditure since expenditure has to be financed and households are credit constrained. With the equations presented, the independent variables are presumed to have a positive effect on the dependent variable unless otherwise stated. In the case of equation (2), R has a negative effect.

Investment expenditure is taken to be:

$$I = I(\Pi/K, Y/Y_a, R, \Delta BLP_f) \quad (3)$$

where the symbols are as above with the addition of K , which is capital stock, ΔBLP_f is changes in bank lending to firms and Y_a , which is a measure of desired capacity output (discussed below). For simplicity the rate of interest on loans to households and to firms are taken as closely related such that the use of a single rate of interest on loans in equations (2) and (3) is justified. In equation (3), R is anticipated to have a negative effect on investment.

Government expenditure is treated as a policy variable, and in the formulation of the model treated here as exogenous.

Net exports in demand terms are taken to be

$$NE = X(WT, RER) - Q(Y, \Pi, RER) \quad (4)$$

where WT is world trade, RER is real exchange rate, and the rest of the symbols are as above with all these variables in real terms, with RER having a negative effect on exports and a positive effect on imports.

The allowance made for the cost and availability of finance should be noted. It has generally been assumed that banks would supply loans to creditworthy firms and individuals, but ideas of credit rationing, application of the 'principle of increasing risk' (Kalecki, 1937), and the recent 'credit crunch' experience, indicate that some allowance should be made for the availability of finance and the degree of credit rationing. The cost of finance is also important and is reflected in the interest rate term. The rate of interest on loans is linked with the key interest rate set by the Central Bank as in equation (15) below.

On the supply side of the economy, the potential level of output at the level of the firm depends on, in a production function manner, the inputs of labour, capital and so on which can be deployed by the firm and the state of technology. At the aggregate level, it is assumed that there is a comparable relationship, but it must be recognized that there are severe issues of aggregation and that the structure of the capital stock will also influence the supply potential. This aggregate supply output Y_s which could be produced depends on employment of labour, capital stock and state of technology: in conventional form this can be written as: $Y_s = Y_s(E, K, T)$, where E is employment (in person hours), K some measure of capital stock, and T is state of technology. Actual output produced is taken to be demand-determined, and the production equation can be inverted to give employment for a given level of (demand determined) output as in equation (5):

$$E = E(Y, K, T) \quad (5)$$

In this formulation, the capital stock and technology have a negative effect on employment for a given level of demand. It is useful to define a benchmark level of output from a supply perspective, and Y_a , which is a capacity measure corresponding to the 'desired' level of operation is used, and $Y_a = Y_a(K, T)$, and would change over time as capital stock and technology change. There is a level of employment corresponding to Y_a which would be $E_a = E(Y_a, K, T)$. Y_a is taken as a benchmark for firms' investment decisions; and as indicated above: when $Y > Y_a$ firms feel themselves to be working at over-capacity and encouraged to invest, when $Y < Y_a$ they are thereby discouraged from investment. For a given level of K and T , it is envisaged that the relationship between productivity Y/E and E is such that Y/E initially rises as E rises, then flattens out, and eventually declines.

In the model presented above there is no market mechanism which can be taken to ensure that the level of demand is consistent with any specified level of output such as the one which corresponds to the full employment of labour or to the non-accelerating inflation rate of unemployment (NAIRU). By contrast, we follow the tradition that suggests that aggregate demand and aggregate supply are not necessarily moved towards each other in the long run by the market mechanism. Indeed, and as Hein and Stockhammer (2007) indicate, how aggregate demand evolves over time depends on the parameters involved. The latter are influenced by a number of factors, such as: wage and price changes, along with the consequent changes in the distribution of income between wages and profits. In addition, the differential effects of wages and profits on the level of demand, and whether that is a movement towards or away from any supply-side equilibrium, are all-important determinants of the parameters involved. As noted above, aggregate supply also evolves over time and depends on the parameters as shown in equation (5), and discussed therein, in a way that is completely independent of those of aggregate demand.

In this analysis distributional aspects are thereby relevant and important. We turn to this aspect next.

2.2.2 Block II: distributional aspects and the inflationary process

The interaction of price and wage determinants produces the distributional aspects of the theoretical framework put forward in this contribution (Arestis, 1986). Four observations are important: (i) the interaction of prices and wages does not take place in the arena which is labelled the 'labour' market, and specifically the real wage cannot be taken as determined by an equilibrium between the demand for and the supply of labour; (ii) the emphasis is on the role of the productive capacity in the price-setting mechanism; (iii) any supply-side equilibrium does not act as an attractor to the actual level of economic activity; and (iv) the pricing of the supply of output is influenced by the prices of the factors of production and the level of demand, and the costs of production will vary with the level of output, and by the rate of change of demand.

Wages are determined in a variety of ways, and there are numerous theories on the determination of wages. For macroeconomic analysis we seek a relatively simple representation, which summarises the main factors involved in the determination of wages. However, in terms of the algebraic representation of an underlying relationship between real wages and employment, many of the approaches that are compatible with ours lead to similar outcomes – for example, trade union