Introduction

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After a period of New Classical dominance in the 1980s, nowadays orthodox macroeconomics is dominated by the New Consensus view, in particular when it comes to economic policy analysis.[1] This view has New Keynesian features: similar to the old Neoclassical Synthesis and to Monetarism, there is a short-run impact of aggregate demand on output and employment. Due to nominal and real rigidities, for which 'micro foundation' is provided, the short-run Phillips curve is downward sloping. In the long run, however, there is no effect of aggregate demand on the 'Non Accelerating Inflation Rate of Unemployment' (NAIRU), which is determined by structural characteristics of the labor market, the wage bargaining institutions and the social benefit system. Therefore, the long-run Phillips curve remains vertical. Monetary policy applying the interest rate tool is able to stabilize output and employment in the short run, but in the long run it is neutral and only affects inflation (Fontana and Palacio-Vera 2005). The economic policy implications of modern orthodoxy are quite straightforward: prevent unemployment in the short run by means of applying appropriate monetary policies and reduce the existing NAIRU by means of structural reforms in the labor market and the social benefit system, which reduce laborers' nominal wage demands and hence inflation pressure and allow for more expansive monetary policies.

Allowing for short-run real effects of monetary variables, the New Consensus model can be considered as some progress compared to New Classical economics and the Real Business Cycle school with their short- and long-run neutrality of money, and economic policy inefficiency hypothesis. In the New Consensus models it is also conceded that it is the short-term interest rate which is the central bank's instrument variable and which is applied in order to target inflation. Modern theory has thus accepted what inflation targeting central banks have done in reality for a considerable period of time – and what Post-Keynesian authors have been arguing for a few decades now.[2]

But the New Consensus view still suffers from an inappropriate treatment of money and effective demand. And it has nothing to say on the relationship between functional income distribution, aggregate demand

and employment. Taking into account the features of a modern monetary production economy with distribution conflict, it is by no means clear how the short-run rate of unemployment affected by monetary policy should adjust to a stable long-run equilibrium rate, the NAIRU. There have also been advanced convincing arguments that the NAIRU, instead of being a strong attractor, rather follows the path of actual unemployment determined by effective demand and monetary policies.[3] The economic policy implications of the New Consensus model may therefore be seriously misleading.[4]

The present volume covers contributions which are critical of modern orthodoxy. They explore alternative approaches to macroeconomics and economic policy analysis. The volume is divided into three sections. Section 1 presents contributions dealing with the development of heterodox economic theory and the role of money in macroeconomics. Section 2 addresses the relationship between distribution and aggregate demand. Section 3 provides contributions on macroeconomic policy issues from a broader heterodox perspective.

I. HETERODOX ECONOMIC THEORY AND MONEY IN MACROECONOMICS

In the introductory chapter, G.C. Harcourt, who was brought up in the Cambridge tradition himself and who significantly contributed to it, reflects on 'What is the Cambridge approach to economics?'. He concentrates on the approaches and methods which are characteristic of economists steeped in the Cambridge tradition. Harcourt takes the Cambridge approach to economics to mean the approaches of the great days of the Faculty of Economics and Politics in Cambridge. Those days were principally associated with the development of Economics as a separate Tripos from 1903 on and ending with the retirement, then deaths of the first generation of Keynes's 'pupils' and/or close colleagues – Piero Sraffa, Joan Robinson, Austin Robinson, Richard Kahn, James Meade, Nicholas Kaldor, David Champernowne and Brian Reddaway – in the 1980s and 1990s.

'Heterodox economics: a common challenge to mainstream economics?': this question is addressed by Sheila Dow. According to her view, both orthodox and heterodox economics have been going through a process of change, which some have suggested spells the end of schools of thought as a useful construct. This chapter puts forward the argument that thinking of heterodox economics in terms of schools of thought can still play a constructive role in the development and communication of ideas. It need not detract from the challenge posed by heterodox economics to orthodox economics, but rather, as a way of organizing knowledge, contribute to that challenge. The discussion of schools of thought illustrates why it is useful to classify thinking in this way: different schools of thought attach different meanings to terms. Thus different understandings of the term 'schools of thought' have created some confusion. Sheila Dow uses a new diagrammatic framework to provide an account of how schools of thought have been understood in different ways in the past, and how they are understood differently now.

In the chapter 'Elements of a monetary theory of production', Trevor Evans, Michael Heine and Hansjörg Herr attempt to suggest a minimum consensus for an alternative to Neoclassical economics. This consensus first stresses the importance of money and the fact that the central dynamic of a capitalist economy involves advancing money with the aim of making more money. It argues that a modern banking system provides an extremely flexible supply of money that can be expanded as required by the rhythm of investment and growth. The authors hold that it is the decision by firms to advance money for investment that is decisive in determining the level of employment, and that attempts to increase employment by reducing the wage rate are misguided. Rather, since prices in a developed economy are largely based on costs plus a mark-up, this is more likely to carry the risk of deflation. The chapter rejects the idea that there is some pre-given long-term economic growth path, and argues that it is the pattern of the business cycle which determines the way the economy grows in the long term. Evans, Heine and Herr conclude with some comments on the limits of economic policy in a system where workers, but not employers have an interest in full employment, and where employers can refrain from investing if they do not consider economic conditions sufficiently favorable.

The chapter by Jean-Vincent Accoce and Tarik Mouakil presents 'The monetary circuit approach: a stock-flow consistent model'. In opposition to the Neoclassicals or the Neo-Keynesians, the Monetary Circuit approach rejects the idea of an economy based on exchange. The economy is rather analyzed as a monetary economy of production. Therefore, Accoce and Mouakil claim that the Monetary Circuitists can be seen as true heirs of the Keynesian theory. However, there are some problems with this approach: lack of formalism, omission of stocks and only basic analysis of the banking system. Applying a stock-flow consistent accounting framework developed by Wynne Godley and Marc Lavoie, which links stocks and flows together and integrates money in the best Cambridge Post-Keynesian tradition, Accoce and Mouakil tackle these problems and attempt to contribute to their solution.

II. DISTRIBUTION AND AGGREGATE DEMAND

In 'What drives profits? An income-spending model', Olivier Giovannoni and Alain Parguez investigate the relationship between the different types of income and their expenditure. As a case study they use the United States from 1954 to 2004. The authors employ an a-theoretical approach and estimate a large-scale error-correction system with particular attention to profits. The dynamics of the system are studied using the four different concepts of 'temporal causality', 'feedback causality', 'variance causality' and 'impact causality'. Special attention is paid to definitions and methodology. The main finding is that profits turn out as an adjusting variable, both in the short and in the long run. Giovannoni and Parguez obtain the result that profits are primarily driven by consumption-related and policy variables.

Stefan Ederer and Engelbert Stockhammer deal with 'Wages and aggregate demand: an empirical investigation for France'. They observe that in recent policy debates the suggestion of a reduction of wage costs as a means to increase employment and growth has figured prominently. However, other things being equal, an increase in wage incomes will have a positive effect on consumption and a negative one on investment and net exports. Therefore, the effect of a redistribution of income between capital and labor will depend on the relative size of these effects. The chapter applies a neo-Kaleckian growth model to France and estimates consumption, investment, export and import functions. The results indicate that the effect of a wage cut on consumption is larger than that on investment. Thus the domestic sector of the French economy is wage-led. However, the sensitivity of net exports to labor costs turns the open economy profit-led. This raises challenging policy issues. Wage coordination is proposed to avoid prisoners' dilemma situations.

III. ECONOMIC POLICY

Jesus Ferreiro and Felipe Serrano discuss 'New institutions for a new economic policy'. They argue that the inclusion of asymmetric information problems in the traditional models of economic equilibrium has enriched economic theory. Further on, it has put the analysis of the institutional framework surrounding markets in the focus of empirical and theoretical studies. However, one of the main problems faced by economic agents, the problem of fundamental uncertainty as defined by post-Keynesian thought, has not received the same attention in orthodox economic theory. Ferreiro and Serrano argue that the problems created by Post-Keynesian uncertainty cannot be ignored, but have to be at the centre of any theory that tries to understand the real working of market economies. The chapter focuses on the institutional implications of taking fundamental uncertainty seriously and argues that economic policy has to be closely related to the design of institutions.

Gustav A. Horn outlines the connection between 'Structural reforms and macroeconomic policies'. He starts with the observation that when growth declines, most orthodox economists tend to demand structural reforms to ensure a return to a stable growth pattern. Labor market reforms designed to increase the flexibility of labor supply are regarded as particularly appropriate for fostering growth. The basic hypothesis underlying all these efforts is that the growth path of an economy can be improved by structural reforms alone. By way of example, he presents an econometric simulation for Germany, a country particularly affected by this line of thought. He argues that structural reforms should be embedded in a favorable macroeconomic policy framework in order to avoid negative side effects. Otherwise these reforms may actually prove self-destructive in growth terms. In the light of these findings the reform process in Germany is seen as having been severely marred by neglect of the macroeconomic context. And the present dismal situation in that country, and by extension in a number of other European countries, is found to be at least partly attributable to this neglect, which, moreover, places in jeopardy all further attempts at reform.

The chapter by Douglas Mair and Anthony J. Laramie is on 'Theories of fiscal policies and fiscal policies in the EMU'. They argue that leading public finance economists have expressed reservations against the adequacy of the theoretical foundations of mainstream public finance, but continue to use the competitive general equilibrium model as their preferred medium. Rather than proposing a return to the Keynesian approach to public finance, the chapter advocates a new approach inspired by Kalecki. The basic framework of a dynamic Kaleckian model which identifies the macroeconomic effects and incidences of a balanced change in the structure of taxation is presented. This underlines the importance of tax-induced changes in the distribution of income as a factor in determining macroeconomic effects. The necessary conditions for a change in the structure of taxation to have a positive effect on an economy's long-term growth rate are identified. The chapter then explores the macroeconomic implications for the European Monetary Union (EMU) if one of its member states were to pursue the fiscal strategy proposed in this chapter. A positive fiscal stimulus to the growth performance of one member state could have beneficial effects in the rest of the EMU. The chapter concludes by arguing for a reappraisal of fiscal policy from a Kaleckian perspective.

'The link between fiscal and monetary policy lessons for Germany from Japan' is explored by Richard A. Werner. Monetary policy decision makers, such as the European Central Bank (ECB), often argue that responsibility for fiscal policy and other growth policies lies entirely with the government. This contribution examines these arguments. It is found that there is no evidence to support the argument that weak economic performance in Germany is due to problems with the economic structure. Instead, monetary policy carries a far larger responsibility for economic growth and the effectiveness of fiscal policy than is generally recognized. A macroeconomic model centered on credit quantities is employed, which clarifies the link between fiscal and monetary policy and the determinants of nominal GDP growth. Empirical evidence from Japan is used to test the model. Implications for other countries, especially Germany and the EU, are pointed out. These include the recommendation for the German government to implement monetization of fiscal policy via credit-based policies, which can be achieved even within the institutional setting of an independent and uncooperative central bank.

The final chapter by Eckhard Hein and Achim Truger is on 'Monetary policy, macroeconomic policy mix and economic performance in the Euro area'. In order to explain slow growth and high unemployment in the Euro area, in particular if compared to the USA, Hein and Truger suggest a macroeconomic policy view focusing on the more restrictive stance of monetary, fiscal and wage policies in the Euro area. In the present chapter they focus on the particular role of monetary policy, because the ECB seems to be the major obstacle to higher growth and employment. Wage policies and fiscal policies are taken into account at the outset, but then the determinants of ECB policies are assessed in more detail. The analysis confirms that it is the ECB's overemphasis on a too low inflation target which is a major problem for macroeconomic performance in the Euro area. And the ECB is too exclusively occupied with inflation and wage developments and puts insufficient emphasis on the development of real variables. It is finally argued that, in order to improve growth and employment, the ECB should raise its inflation target and pay more attention to real economic activity.

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NOTES

1. See for example Clarida *et al.* (1999), Romer (2000) and the textbook by Carlin and Soskice (2006).
2. See Fontana (2003) for a recent review of post-Keynesian monetary theory.
3. See Sawyer (2002), Arestis and Sawyer (2005) and Hein (2006) for a discussion of the NAIRU in a post-Keynesian/Kaleckian framework.
4. For a more extensive discussion of the New Consensus model from a post-Keynesian perspective see Arestis and Sawyer (2004), Lavoie (2004), Setterfield (2004), Fontana and Palacio-Vera (2005) and Palacio-Vera (2005).

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