Reasserting the Role of Keynesian Policies for the New Millennium'

by

Philip Arestis*
Malcolm Sawyer**

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*University of East London
**University of Leeds and The Jerome Levy Economics Institute

I. INTRODUCTION

It is often asserted that, whatever role Keynesian policies may have played in underpinning the long post war boom[2], those policies are no longer relevant. In contrast this paper seeks to reassert the need for Keynesian policies in order to secure full employment. In doing so, as will be seen below, we interpret Keynesian economic policies in a rather broad sense, and specifically wish to distance ourselves from treating Keynesian policies as virtually synonymous with fiscal demand management designed to fine tune the economy. We also recognizethat. there are manyconstraints. on the pursuit of full employment, arising from the demand and the supply sides,- and that the key objective of Keynesian policies is to alleviate those constraints in the pursuit of full employment.

This paper puts forward an approach to economic policy which could be described as post Keynesian. Since the term Keynesian policies has been variously defined, we indicate in section II what we mean by the term, which is broader than most usages. The case for Keynesian policies arises out of, and can only be appreciated by reference to, a conception of the operations of a market economy, and we briefly outline the conception underlying this paper in section III. This is further elaborated in section IV by a consideration of the constraints on the achievement on full employment in a market economy. This leads into section V in which we outline the nature of Keynesian policies which relate to both the demand side and the supply side of the economy. The final main section, section VI, considers some of the constraints on the implementation of the type of Keynesian policies which we are advocating.

II. WHAT ARE KEYNESIAN POLICIES

The term Keynesian policies tends to be associated with demand management, especially those seeking to fine tune the economy using fiscal policy. Our concept of Keynesian policies (and one could debate the rather fruitless issue of whether this concept is really Keynesian) is rather different, and would not generally include attempts to fine tune. It would though include some 'coarse tuning', namely the idea that the government use budget deficits (or rather less likely) surpluses in order to underpin a level of aggregate demand sufficient for the generation of the highest sustainable levels of employment (and to use monetary policy to achieve the lowest possible level of interest rates), and this follows from our denial of the relevance of Say's Law for a monetary economy with a sophisticated financial sector. On the demand side, Keynesian policies are likely to include measures such as the encouragement of investment designed in part to raise aggregate demand (as well as to boost productive capacity.[3] It would also include a variety of supply-enhancing policies designed to lift constraints on the achievement of full employment (such as those derived from the foreign trade position, shortages of productive capacity, etc). While the focus in this paper is on policies designed to raise the level of employment, similar but not identical considerations arise in relation to growth

of output and of productivity. Whilst these supply-enhancing measures can be described as supply-side, they are fundamentally different from what are often described as supply-side measures: we would view those latter measures as broadly seeking to create the resemblance of a perfectly competitive market by the removal of perceived imperfections. In contrast, we would view supply-enhancing policies (as put forward below) as seeking to ease constraints such as any inflation barrier.

There are two basic insights of Keynes for the workings of industrialized market economies upon which we draw. The first is that a laissez-faire market economy (that is one without significant government economic intervention, and not synonymous with an approximately perfectly competitive economy) will not usually generate full employment. The essential cause of that failure to create full employment is not some rigidities or 'imperfections' of monopolistic competition, trade unions etc. which could potentially be removed through government action (cf. Shapiro, 1996, Arestis, 1992). It is rather that a laissez-faire market economy would exhibit elements of instability and does not usually generate a level of aggregate demand-consistent with full employment.

The second is that whilst full employment is a prime objective of Keynesian economic policy, a more equal distribution of market power, income and wealth, is another desirable goal in its own right and as a vehicle for increasing general prosperity. As Keynes (193 6) remarked, "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes" (p. 372). More recently, similar sentiments have been expressed, "The future prosperity of OECD countries depends", an influential report (OECD, 1996) asserts, "on reducing social and economic exclusion in the forms of high unemployment, non-participation in the labour market...and, in some instances, growing inequalities in earnings and incomes." Meanwhile research at a global level seems to have identified a positive correlation between economic growth and income equality (United Nations Development Programme, 1996).

III. OPERATION OF MARKET ECONOMIES

In a decentralized monetary economy there is no automatic market mechanism which ensures that aggregate demand is sufficient to purchase full employment aggregate supply (even in the absence of other constraints such as balance of trade, insufficient capital equipment). Thus inadequate aggregate demand may prevent the achievement of full employment. The problems of co-ordination between aggregate demand and potential aggregate supply can be viewed as an inevitable consequence of a decentralized monetary economy, even if some of the problems can be reduced by appropriate policies and institutional arrangements. There are benefits from the existence of money and of exchange, but there are also some inevitable costs, arising from failures of co-ordination in a decentralized economy (Clower, 1965), and more importantly, from the existence of liquidity preference and the uncertainty which causes it, preventing co-ordination of aggregate demand and supply at full employment (Chick, 1983; Davidson, 1994).

This basic Keynesian idea on the importance of aggregate demand operates in a range of ways additional to those analyzed by Keynes, most notably that the supply side (of labor and of capital equipment) is influenced over the long haul by the demand side. For not only are additions to the stock of capital equipment (investment) influenced by the general level of demand, but also the

effective supply of labor is likely to be influenced by the demand for labor. High levels of demand for labor draw people into the work force, whilst low levels of demand push people out of the measured workforce. Thus it is not only ratios such as the rate of unemployment and capacity utilization which are influenced by aggregate demand, but also the scale of the economy (labor force, capital stock).'

We begin from the empirical perspective that full employment has been a rare peace time occurrence in market economies, which suggests that the forces creating unemployment are powerful ones. We observe that at the time of writing around 18 million of people (11 per cent of the workforce) are reported as unemployed within the European Union, and 33 million in the OECD area (and many estimates would put actual unemployment much higher). Most would agree that levels of unemployment have been significant for at least the past quarter of century (and during much of the inter-war period before that). Many would view market economies as potentially approximating perfect competition in which full employment occurs when markets clear. From this perspective unemployment would be seen as-arising from those 'imperfections' where those 'imperfections are measured against what would occur in a perfectly competitive economy (and this we would view as an important aspect of the new Keynesian approach, e.g. papers in Mankiw and Romer, 1991). The removal of 'imperfections' can then become a major objective of government economic policy in order to construct the Nirvana of perfect competition. Whilst many would agree on the unrealism of perfect competition, it still, in our view, has a strong influence over thinking on macroeconomic policies.

The view of the operation of market economies which under-pins our approach has three strands. Fii competition within a market economy is a process of rivalry with winners and losers. There are significant economic, social and political forces which generate and reinforce disparities and inequalities, whether between individuals, between regions or countries etc.. This is an application of the notion that success breeds success and the corollary failure breeds failure.' In the economic sphere, the operation of market forces generate cumulative causation (Myrdal, 1957) and centrapetalism (Cowling, 1987, 1990). An economically successful region generates profits which enable further investment; it can attract mobile, often highly skilled, labor from other regions; it can benefit from static and dynamic economies of scale (Kaldor, 1972). Unemployment and low wages are both characteristics of relatively less prosperous regions, and full employment in the more prosperous regions would still entail unemployment in the less prosperous regions.[6] Any further attempts to reduce unemployment through demand stimulation is likely to cause problems of insufficient capacity, shortages of skills and inflationary pressures in the more prosperous regions. One part of the significance of the forces of cumulative causation is that the relatively backward regions will experience not only lower levels of per *capita* income but also face higher levels of unemployment and severe constraints on their ability to grow. The consequence of this is that whilst there are forces for convergence between regions and countries, there are also strong forces for divergence. Regions which are relatively backward will display both lower levels of per capita income and higher levels of unemployment, and find considerable difficulty in catching up with more prosperous regions.' A related aspect of this general view concerns international trade. In a world of primary products it is reasonable to argue that international trade will (or should) be governed by comparative advantage, arising from the endowments of nature. But in a world of manufactured goods and of services, where new products are being continuously developed, where economies of

scale, dynamic as well as static, operate and in which investment in equipment, research and people is recognized as important for economic success, *competitive* advantage comes to the fore (Porter, 1990). The notion of competitive advantage contains a strong element of cumulative causation for clearly success in one time period generates the surplus which can be used to build success in subsequent periods. The availability of that surplus does not guarantee that it will be used to build future success. The surplus can be used in other ways ranging from high levels of luxury and conspicuous consumption through to military expenditure which may eventually lead to economic and political decline (Kennedy, 1988). But the availability of a surplus is a pre-requisite for growth and competitive success. Competitive advantage can to *some* degree be created (as is clear from the Japanese economic success over.the past fifty years) whereas comparative advantage is given by nature. This line of argument also interacts with our next group of obstacles in that a lack of competitive advantage shows up as a balance of trade constraint on growth.

Second, many of the factors which would be labeled as 'imperfections' according to the benchmark of perfect competition (ii. the sense that they would -be absent from perfect competition) do have a positive role to play in the operation of a market economy. A particular example of this would be the use of long term contracts in the labor market, which would be absent from a so-called flexible labor market which mimics the spot market of perfect competition. Long term contracts can help to promote training, the involvement of workers in the working of the enterprise and the reduction of an adversarial relationship between employees and employers, all of which could be reasonably expected to have a positive impact on productivity. Similar arguments can be applied to trade unions, minimum wages etc..

Third, there are a variety of constraints on the achievement of full employment, though not all of them are biding ones at any specific time. The recognition of these constraints is a statement that market forces are not sufficient by themselves to generate full employment. In the next section, we discuss those constraints in some detail.

IV. CONSTRAINTS ON FULL EMPLOYMENT

There are six potential constraints on the achievement of full employment on which we focus here: the list is probably not exhaustive but contains those we feel to be particularly important. The constraints are not binding all of the time, and in particular the foreign trade constraint does not (indeed cannot) apply to all countries.* The constraints are:

Aggregate Demand Constraint

There is, in our view, a notable lack of automatic forces within a market economy working to ensure that the level of aggregate demand is compatible with the full employment of labor and the existing capital stock. There may be times (and perhaps the 1950s was such a period for most capitalist market economies) when investment demand is high relative to savings, and there is sufficient aggregate demand. But in the absence of 'enthusiastic animal spirits' and when savings tend to exceed investment expenditure, the forces bring savings and investment into line at full employment are weak

to non-existent. Two mechanisms are usually suggested, namely the real balance effect operating through a lower price level and interest rates bringing (ex ante) savings and investment into balance. The effect of lower prices on real wealth is minimal in industrialized economies where the money supply consists overwhelmingly of credit money so that the real value of financial assets and liabilities vary together.[9] The generation of lower prices must involve at some point falling prices, but whilst the former can be analyzed within the conventional static framework, the latter cannot. Yet, falling prices generate expectations of further falls (thereby reducing demand) and undermine the ability of debtors to service their liabiities and thus threatening the stability of the financial system (Davidson, 1994, pp. 193-i'%).

Interest rates are determined more by liquidity considerations than by the forces of productivity and thrift. Specifically interest rates do not act to bring savings and investment into line. Planned savings are determined by a quite different set of variables than those determining planned investment, and there are no strong forces which ensure their equality at full employment income."

Fun&g Budget Deficits

When full employment income would generate an excess of savings over investment, what are the limits on the use of budget deficits to fill the gap. There are two possible (though to some degree related) limits on the abiity of governments to run a budget deficit sufficient to underpin full employment. The first arises from the argument that continuing budget deficits are unsustainable, and the second from the reaction of the financial markets. A budget deficit may be seen as unsustainable in a variety of ways but it is suggested here that three are particularly significant : namely a budget deficit would be seen as unsustainable if it lead to a spiraling national debt to GDP ratio (and hence to rising interest payments on the debt relative to GDP), or that the level of interest payments whilst not rising (relative to GDP) may nevertheless be perceived as placing a heavy burden on taxpayers, or there are limits on the willingness of wealth holders to absorb government bonds into their asset portfolio without the payment of higher interest rates. However, whilst interest payments may in some sense be high, they are in effect paid by further borrowing (since in this analysis, although the primary budget' deficit is being held constant, the deficit including interest payments is rising but is beiig financed by borrowing). The debt to GDP ratio will not rise provided that $g \geq r$, with g the growth rate of the economy and r the (post tax) rate of interest (Sawyer, 1995a; Pasinetti, 1996). The difficulty for budget deficits which has arisen in recent years is simply that real rates of interest have been at historically unprecedently high levels whilst economic growth has been sluggish." The higher interest rates can be attributed to the pursuit of tight monetary policies in the belief that tight money and high interest rates will (eventually) dampen down inflation. In so far as government, like individuals, face the 'principle of increasing risk' (Kalecki, 1937) then higher deficits (relative to GDP) would entail higher interest rates and hence the maximum sustainable budget deficit would be determined by g = r(d) where d is the debt to GDP ratio . Since if $(g - r)$ is positive and likely to be rather small, i.e. of the order of 0.01 or 0.02, the debt to GDP ratio will stabilize at a large multiple of the primary budget deficit to GDP ratio (clearly with numbers *given* previously at multiples of 100 or SO). Further, any lack of willingness of the private sector to absorb government debt as an increasing proportion of their wealth portfolio is another limit on governments to run perpetual deficits.

The financial markets are often viewed as placing limits on the use of fiscal policy (notably budget deficits) and they do so through two channels. First, interest rates (particularly on bonds) rise with a budget deficit thereby limiting the government's ability to borrow. It could be argued that high interest rates arose from high levels of government borrowing. But the evidence linking budget deficits and interest rates is weak. For example, Cunningham and Vilasuso (1994/95) have to concede that `[u]nfortunately, empirical studies examining the relationship between interest rates and fiscal deficits are far from conclusive'(p. 190) and that 'whether fiscal deficits are associated with higher interest rates has yet to be resolved in the economics literature' (p. 191). Second, adverse reactions by the foreign exchange markets to particular policies can lead to fall in the value of the currency. The distinction made by Sayer (1992) in his discussion of the power of the City of London as to 'whether market prices are based on *economic* fundamentals or bubbles, fads and herd behaviour' is useful. Even if the actions of the financial markets are based on bubbles, fads etc. they may nevertheless influence the economic fundamentals. Clearly, if the fad raises interest rates, investment may be thereby effected and hence the fundamentals of the economy changed. Similarly, a falling exchange *rate* would stimulate domestic inflation which would change the fundamental value of the (nominal) exchange rate. Even when financial asset prices reflect fundamentals, the operation of financial markets may still pose a constraint on the economic policies pursued. The 'fundamentals' of interest to the financial markets may be quite different from the 'fundamentals' of concern to others: for example, the financial markets may focus more on the rate of inflation whilst others may feel that unemployment is of more importance.

The financial markets pose a different type of constraint on the pursuit of sustainable fiscal policies when the 'bubbles, fads and herd behaviour', rather than 'fundamentals' come to determine movements in prices (notably interest rates and exchange rates). There is now an extensive literature which indicates that financial market prices are 'excessively volatile' (and casual observation of the movements in the exchange rates in the past twenty years would be supportive of that view; see, also, Shill&, 1981, 1984, 1990, and his 1989 collection, where it is strongly suggested that there is excessive volatility in the stock and bond markets). Further, there are theoretical literatures (surveyed by, for example, Camerer, 1989) which provide models in which individual rational behaviour can generate 'bubbles'. In a world of uncertainty where knowledge of the economic fundamentals is given to few, it is perhaps inevitable that asset prices will fluctuate and follow fads and fashions. The significant question here is whether the adoption of a Keynesian demand reflation would set off adverse reactions in the financial markets, and whether those reactions undermine the reflation. The reactions are likely to create an air of crisis and strong political pressures to abort the reflation.

We view the financial markets as a source of instability which can be transmitted to other sectors of the economy and the participants in those markets as able to impose their objectives on economic policy-making. The pursuit of Keynesian policies (and more generally the achievement of full employment) require restrain the power and influence of the financial markets and elsewhere we have made some 'modest proposals' in this regard in respect of European monetary institutions and the imposition of a tax on financial transactions (Arestis and Sawyer, 1996, 1997b, 1997c).

Inflation Constraint

It may be useful to consider the nature of the constraint which inflation poses for the achievement of full employment in three stages. First, we can consider whether the NAIRU (non-accelerating inflation rate of unemployment) as it is conventionally conceived forms an inflation barrier to full employment. Many of the estimates of the NAIRU (see, for example, Layard, Nickel1 and Jackman, 1991, chap 8) would suggest inflation can only be held in check when unemployment is well in excess of anything which would be regarded as full employment.[12] Further, the NAIRU is viewed as an essentially supply-side phenomenon, with aggregate demand having to adjust to the NAIRU.[13]

In this regard, we can first note that the concept of the NAIRU (rather than any NAIRU itself) may form a barrier to full employment when policy makers and others believe (or act as though they believe) that it exists.' For example, 'I have become convinced that the NAIRU is a useful analytic concept. It is useful as a theory to understand the causes of inflation. It is useful as an empirical basis for predicting changes in the inflation rate. And it is useful as a general guideline for thinking about macroeconomic policy' (Stiglitz, 1997, p.3).. In such a case, a fall in unemployment- below the estimated NAIRU produces a policy response to reduce demand and raise unemployment because of the fear of rising inflation. We would, though, cast doubt on the concept of the NAIRU on two counts (for a much extended discussion see Sawyer, 1997a, 1997b, 1997c). First, there is a degree of theoretical incoherence to the models. The manner in which the equilibrium would be reached is not spelt out. The underlying relationships (usually price and wage determination) could be shifted through, for example, increases in capacity, thereby shifting the NAIRU. Multiple equilibria are not ruled out (see, for example, Manning, 1992). These problems have been summarized by Hahn (1995) in the following. 'Under imperfect competition there is no compelling reason to suppose that the 'demand' for labor is negatively sloped nor is there any reason to suppose that it has only one intersection with the 'supply' curve. Increasing returns are quite sufficient to give us what we want here. . ..Of course if there are multiple equilibria then even if we can be sure of convergent dynamic processes, initial conditions (history') will play an important role in which equilibrium is eventually established.' (p.47). We would concur with Frank Hahn when he writes that 'Theories of the natural rate are amongst the class of shaky and vastly incomplete theories.' (Hahn, 1995, p.54). Further, recent contributions (Rowthorn, 1995; Arestis and Biefang-Frisancho Mariscal, 1997, Sawyer, 1997d) emphasise both the theoretical and empirical relationship between unemployment and investment in fixed capital and in education and training.

Second, the estimates of the NAIRU (even when produced after much econometric effort) change over time, tend to move in line with actual experience of unemployment and are sensitive to the model specification and methods of estimation. Nickel1 (1990) and Layard, Nickel! and Jackman (199 1) provide estimates of the actual and the equilibrium rate of unemployment (equivalent to the NAIRU) in the UK and in 19 other countries respectively for each of the last three decades to conclude that the two types of unemployment move together. Lombard (1995) reports three estimates for the NAIRU in France for the early 1980s to suggest a high level of NAIRU and some sensitivity to methods of estimation. Further estimates covering a wide range of countries are given in OECD (1994, p.22) and ECE (1992, Table 5.7). Setterfield, Gordon and Osberg (1992) suggest that "estimates of the NAIRU [for Canada] are extremely sensitive to model specification, the definition of variables and the sample period used. [Further] . . . the final range of all NAIRU estimates . . . is about 5.5 percentage points. Indeed, the size of this range is so great that it covers virtually the entire

range of male unemployment rates in Canada since 1956" (p. 134). The Directorate-General for Economic and Financial Affairs of the European Commission concluded that the concept of the NAIRU is 'unusable operationally' because "empirical studies on both sides of the Atlantic have shown that large variations in NAIRU may be caused by apparently small differences in sample, retained explanatory variables and analytical formulation. Furthermore, the confidence interval around these estimates is so large that it generally contains the whole historical range of unemployment rates observed in the last 15 to 20 years" ***(European Economy,*** January, 1995, p. 2). But as UNCTAD (1995) observes "natural rate estimates are still used to assess and guide macroeconomic policy, thereby contributing to rising unemployment" (p. 172).

The second stage of our discussion relates to the case where the NAIRU may be shiftable through a variety of policy measures and/or there is evidence of genuine hysteresis effects." The policy measures would include, for example, the stimulation of investment, which thereby increases capacity and permits a higher level of employment (Sawyer, 1997c). However, starting from a high level of unemployment, any stimulation of demand may well lead to some increase in inflation, whichbecomes embedded into the system. Suppose, for example, that the 'equilibrium' unemployment rate is initially 10 per cent, but that through demand stimulation policies (which increase capacity, re-integrate people back into the work force etc.) it could be reduced to 5 per cent. The initial fall in unemployment to 9 per cent, to 8 per cent etc., would be associated with some rise in inflation, which is then built into people's expectations. After some time both actual and equilibrium unemployment settle at 5 per cent: inflation would no longer accelerate, but it would have reached a ***higher level.*** In such a case there would be many pressures to halt the fall in unemployment to restrain inflation, and a higher level of inflation would have to be accepted for the lower unemployment.

Third, there could be inflationary pressures associated with full employment itself In these circumstances inflation is likely to be the expression of some other underlying constraints, and should perhaps be more appropriately assigned elsewhere. However, it may be useful to list them here and we identify three. First, inadequate capacity to be able to employ the full workforce at an acceptable real wage. This shortage of capacity may be in terms of the overall level of capital equipment, but other important dimensions would be regional distribution of the capital stock and the skill capacity of the workforce. Second, productivity and work effort at full employment may begin to fall. In Kalecki's words 'profits would be higher under a regime of Ml employment than they are on the average under ***laissez-faire*** ; and even the rise in wage rates resulting from the stronger bargaining power of the workers is less likely to reduce profits than to increase prices, and thus adversely affects only the rentier interests. But 'discipline in the factories' and 'political stability' are more appreciated than profits by business leaders.' (Kalecki, 1943). This is further considered below under the high productivity constraint, but it would also exhibit itself in terms of inflation. For example, if productivity were to fall, then for given money wages, prices would begin to rise. Further, the lack of 'factory discipline' would also be reflected in pressure for rising'money wages, which also relates to our next point. Third, the various claims which are made on national income at full employment may be incompatible. In one sense, it should be easier to reconcile conflicting claims on national income at full employment simply because there is more income to share out. But, the constraints on the pursuit of the competing claims are also reduced. There is the added problem that as full-employment is reached, the distribution of income may become so skewed in favour of profits that

the conflict between wages and profits intensifies.

Our approach to inflation is to see it as arising from imbalances on the real side of the economy, although inflation has to be validated by corresponding increases in the money supply. However, the financial and banking systems are such that money is created to meet the nominal 'needs of trade' (Arestis, 1987-8, Arestis and Howells, 1996 and references therein). Effective control over the stock of money has long slipped from the grasp of the Central Bank and other State institutions, and any inflationary pressures would be little constrained by the stock of money which can evolve in response to price and wage changes. Thus, even if limiting the growth of the stock money would constrain inflation (rather than reducing output), such a monetary policy is no longer available to *governments in* a deregulated internationalized monetary system.

Balance of Trade Constraint

The balance of trade constraint has a level-and a growth dimension. A difference between imports and exports has to be covered by borrowing from overseas, and hence creates obligations for future interest payments. A persistent trade deficit would involve a growing current account deficit as the interest payments on borrowing builds up. However, provided that the growth of the domestic economy exceeds the rate of interest on foreign borrowing, the ratio of liabilities to domestic income, and hence the interest payments to income, would eventually stabilize (Sawyer, 1995a).[15] However, the condition of the domestic growth rate exceeding the rate of interest may not be met, leading to the debt trap situation. The growth aspect of the balance of trade constraint arises if there is a tendency for the growth of imports to exceed the growth of exports. Simply when the (domestic) income elasticity of demand for imports is greater than the (world) income elasticity of demand for the country's exports, then the maintenance of a non-exploding trade deficit requires that the domestic growth rate is sufficiently below the world growth rate so that actual imports and exports grow in line with one another (Thirlwall, 1979; McCombie and Thirlwall, 1997a, 1997b, and Symposium in *Journal of Post Keynesian Economics*, 1997). Clearly the balance of trade constraint is not one which impacts on all countries, simply because whilst some countries run trade deficits, others must run trade surpluses. Further, the constraint can be eased by devaluation of the currency, though such a route is often resisted because of its perceived effect on inflation and the reduction of domestic living standards (not to mention national pride). The effects of devaluation are more complex, of course: devaluation can stimulate exports and hence production, often leading to lower unit costs; importers need not respond to devaluation by raising price (in terms of the domestic currency) as they strive to maintain market share (Arestis and Milberg, 1993; Cowling and Sugden, 1989).

High Productivity Constraint

The attainment of high levels of productivity requires an appropriate work intensity and commitment on the part of the labor force as well as the provision of sufficient capital equipment, training, skills and management. In many market economies, unemployment (and more particularly the threat of it) serves as a significant mechanism for imposing a high level of work intensity (Kalecki, 1943). The idea that unemployment may be required to impose a 'no shirking' condition on workers is formalized in Shapiro and Stiglitz (1984) and Bowles (1985). The level of unemployment is not chosen by the

firms but rather it provides the background against which the firms operate. Unemployment is seen as performing a systemic function (of aiding the disciplining of workers). This is not to argue that unemployment is *necessmy* to ensure work effort; indeed unemployment heightens fear and brings demoralization which serve to undermine it, and different market economies have drawn on mechanisms other than unemployment. Weisskopf (1987), for example, examines the extent to which countries use unemployment as a disciplinary device, and concludes that only some economies use it. This raises the 'important question of an institutional framework which maintains labor discipline and does not blunt incentives, even when the economy sustains full employment..... The problem is not insoluble in principle or in practice, as indicated by the experience of large Japanese firms offering lifetime employment to their workers and a renumeration package based largely on seniority' (Singh, 1994, p.489). A sustained high level of employment would of course require the development of other mechanisms to underpin high levels of productivity. These mechanisms are likely to include forms of worker involvement and participation in decision-making, job enrichment etc.

Lack of Capacity

The factors which influence investment and thereby the size of the capital stock (such as profitability, capacity utiliition) are generally rather different from the factors which determine the size of the work force (mainly demographic). From that crude observation, we could say that there is no particular reason to think that the capital'stock will be adequate for the provision of full employment. There are rather limited opportunities, especially in the short run, for substitution between labor and capital stock. We would expect that after a period of prolonged slow growth (such as the past two decades) investment may have fallen short of what would be required to sustain full employment.

v. KEYNESIAN POLICIES

We begin by a consideration of demand oriented policies. In doing so, we recognize that the current level of demand has numerous effects on the future supply potential of the economy, through, for example, the effects of current investment on future capital stock and productive capacity, the effects of current employment levels on the future potential labor force.[16] A major aspect of Keynesian policy remains fiscal policy, but that which is of interest here is not the use of fiscal policy for fine tuning (for there is inadequate up to date information and forecasting ability to enable fiscal policy to be used successfilly in that regard), but rather fiscal policy should be set for the medium term to underpin high levels of aggregate demand. As an aside, it can be noted that ironically in recent years fine tuning has been associated with monetary policy with frequent changes in interest rates. We are fully aware that there are many theoretical arguments to the effect that fiscal policy will be impotent, but we would argue that those theoretical arguments begin from a position of full employment equilibrium (the clearest example beiig the 'natural rate of unemployment') and hence are in effect assuming what is to be proved. Not surprisingly, models which do not impose such constraints find fiscal policy can be potent. We would then focus on two issues. Fii what evidence is there that fiscal policy can have an effect? Arestis and Bain (1994) review the literature and provide evidence (at least for the UK case) which suggests that there is no crowding out of private expenditure by public expenditure. Moreover, as discussed above, the evidence linking budget deficits and interest rates is weak.

Second, what are the limits to fiscal policy?, or alternatively is the present obsession with reduction of budget deficits warranted? A major limit to budget deficits does not arise from the size of the deficit *per se* but rather from the relationship between the (post tax) rate of interest, r, and the rate of growth of national income, g. It is well known that the debt to national income ratio will explode for any initial deficit if $r \geq g$. Whereas for much of the postwar period this condition did not apply, more recent experience with higher real (and nominal) interest rates and lower growth rates has been in the other direction. Even ifr is slightly below g, nevertheless the debt to income ratio which results may be in some significant (political) sense large, for the sustainable debt ratio is equal to the primary deficit to income ratio times the reciprocal of $(g - r)$. This raises the issue of why interest rates have been so high in the past fifteen years, and we would largely ascribe that experience to widespread attempts to operate tight monetary policies.

The national income accounting counterpart of a budget deficit is some combination of net private savings (savings minusinvestment) and trade deficit (capita1 inflow). In effect, the alternative to running a budget deficit to secure aggregate demand compatible with the desired level of employment, is some combination of a reduction in private net savings and in the trade deficit. Whilst the achievement of such reductions is not a straightforward matter (but may be desired on other grounds), such macro economic planning would be an alternative to budget deficits. The encouragement of investment is clearly one possibility in this regard, though ultimately the ratio of net investment in national income is limited by the rate of growth of national income itself (which may be enhanced by investment) and of the (incremental) capital output ratio (for otherwise the capital to actual output ratio would decline with some combination of falling capacity utilization and rate of profit).

Monetary policy can also have a significant impact on the level of economic activity, and we would not dismiss its role. We would though wish to argue that the stock of money is no longer (if it ever was) readily controllable by the authorities, and that monetary policy now is effectively interest rate policy (Goodhart, 1989). Any policy on interest rates is inevitably circumscribed by global financial markets, and interest rate changes are politically sensitive. Interest rate variations may be more potent than hitherto with the spread of consumer credit and variable interest rate borrowing (Arestis and Howells, 1996). A monetary policy is required which pitches interest rates as low as possible (bearing in mind international constraints) for this may give some (possibly slight) stimulus to demand but also relieves the constraint indicated above *on* the use of fiscal policy.

High levels of employment would be enhanced by an acceptable international monetary system. The first is that it should ensure a degree of stability in exchange rates which encourages trade. This would rule out a flexible exchange rate system with the considerable volatility of exchange rates observed during the late 1970s and the 1980s. On the other hand, a rigid fixed exchange rate system generates pressures which ultimately blow it apart (as illustrated by the experience of the ERM in the early 1990s). This suggests an adjustable peg system with arrangements for deficit countries to overcome their deficit position without deflationary biases (Davidson, 1992, on the international monetary system; Arestis, 1994, on the European monetary system). The major requirement for any international monetary system in the context of the pursuit of full employment is the avoidance of deflationary biases, and the ability of countries to adjust to trade deficits without reducing demand.

A further requirement is that the system serves the requirements of trade rather than to encourage financial flows which tend to increase the volatility of exchange rates. The role of domestic financial institutions should be viewed as serving the needs of production for it is from production that income and wealth are generated. Specifically, institutional arrangements and regulations are required which. channel savings into productive investment and which ensures that the fragility of the financial system does not spill over into instabiity with adverse effects on the productive economy. This may require, for example, the imposition of lending ratios to prevent the overexpansion of credit as happened in the UK in the late 1980s, especially where the rapid growth of credit spills over mainly into asset price inflation (rather than any stimulation of production). The essential problem which lies at the heart of financial arrangements, whether domestic or international, is that the creation of money can help finance an expansion of real output or an increase in prices. Similarly, the provision of finance for countries experiencing trade deficits can be used to make changes in the economy which will lead to improved international competitiveness or it can be used for (unsustainable-levels of) consumption.

In terms of lifting supply-side constraints through what we have termed supply-enhancing policies,. . *we* first consider the problem of inflation. There are a number of routes through which inflationary pressures can be restrained, some of which are more socially acceptable than others. One route is low levels of demand which limit the ability of firms to raise prices and workers to increase wages, but that would, of course, conflict with the aim of fill employment. Another route is the generation of a consensus over the distribution of income." The worsening of inequality which has been particularly apparent in the UK and USA since the late 1970s (cf. Atkinson, Rainwater and Smeeding, 1995) has made the prospects for the creation of a consensus on the distribution of income (which would include the division between wages and profits, and relative eamings) more diicult. A consensus is obviously not something that can be switched on and off. Thus policy proposals in this direction have to focus more on institutional arrangements which minimize the inflationary consequences of pay and pricedetermination. There is no particular reason to think that decentralized wage determination with an emphasis on performance-related pay would be non-inflationary at or near full employment. If atomistic bargaining involves frequent price and wage adjustments, then it is likely to speed up the inflationary process, whereas a degree of institutional rigidity places some brake on upward price and wage adjustments. Further, the more negotiating units there are, the less each one pays attention to the overall impact of their own settlement, and the less effect will any call for wage restraint have. The literature *on the* impact of institutional arrangements (including wage bargaining structures) on economic performance has focused on the effects on unemployment (e.g. Calmfors and Drifiill, 1988; Calmfors, 1993). Our concerns, however, are different in that we are mindful whether the wage and price setting arrangements are consistent with the absence of inflationary pressures at full employment. We suggest that some degree of centralization and of coordination of pay setting will be required.

A second aspect of supply enhancing policies arises from the requirement for something approaching a balance on the overseas current account at an acceptable level of unemployment which means an abiity to compete in (relatively) high technology sectors. The current account requirement means that roughly speaking the growth of imports and of exports must be aligned. The growth of the domestic economy is then set by the growth of the world economy, and the relative (marginal) propensities to import with the rest of the world. A relatively high propensity to import by the domestic country

and/or a low propensity to import from the country by the rest of the world generates a low growth rate in the country relative to the rest of the world. Further if that growth rate is below the growth of productivity in the domestic country then rising unemployment would be the consequence. What the domestic country needs under these circumstances is the development of new products and processes which require not only investment in research and development but also the formation of linkages between companies to develop the whole production system. In other words, an industrial strategy is required. The essence of an industrial strategy is a commitment by government to the support of industrial development. It springs from the view that government can play a key strategic role in fostering such development. An industrial strategy does not involve detailed central planning but rather the development of an overall coherent strategy, so that detailed decisions on, for example, support of research and development can be made on an informed basis. It is well known that economic activities such as provision of training and skills, the undertaking of research and development are likely to be under-provided by an unfettered market. Whilst the case for an industrial strategy would draw on such arguments, it involves more than correcting 'market failures'. It provides a framework for decision-making by government and by private enterprise, and commits the government to a developmental role in economic policy.

The final aspect of supply-enhancing policies to be considered is that of the organization of work. The point has been made above that unemployment serves as a control mechanism on workers to enforce work intensity, and that full employment would require the development of alternative 'control mechanisms'; There is substantial evidence that worker participation in decision-making enhances productivity (see, e.g., Levine and Tyson, 1990; Sawyer, 1989, pp. 66-73). Further, many enterprises have used various forms of worker involvement in the search for higher levels of productivity. But this is not universally the case. for other enterprises do not have any such involvement and make undisguised use of the threat of job loss. Whatever mechanism an enterprise uses (and a combination may be used and/or different. ones may be used for different types of workers), it does so against a background of unemployment. It remains an open question whether there has to be some external pressures on workers to ensure work intensity. This external pressure may be exercised through the threat which competition from other firms poses for the survival of the workers' own firm. Competition will always involve winners and losers, and major losers will be the workers in the firm which does not survive. Temporary unemployment for the individual will remain a feature of any dynamic economy in which there is competition between independent firms. The challenge raised here is to find ways of organizing work such that the economic system does not require unemployment as a 'back-up' threat. The participation of workers in decision-making and a drive to eliminate 'dirty' and uninteresting jobs through technological change may help in this regard. At relatively high levels of productivity, degrees of technical inefficiency may be a price worth paying for full employment. But the view expressed here is that the development of a range of ways which encourage technical efficiency is necessary if unemployment is to be removed.

A number of authors (Gordon, 1996, Singh, 1996, Pfeffer, 1994") have talked in terms of two different roads which an economy can follow (though no doubt there are many in-between roads) which they label the 'high road' and the 'low road'. The use of such terms is (perhaps deliberately ?) pejorative for high is generally preferred to low. The significance for this paper of this dichotomy is that the two 'roads' come from alternative views of how a market economy could work. The 'low

road' broadly corresponds to an economy based on competition, incentives and rivalry in which intensity of work and productive efficiency are enforced through unemployment and competition for work. However, there is a sharp distinction between the (perhaps) prevailing (right of centre) orthodoxy on how competitive markets work and the view which is implicit in the writings of the above mentioned authors. For the orthodox, competition (especially in its perfectly competitive guise) promotes full employment, a degree of equality (at least the elimination of 'unwarranted' inequalities) and provides incentives for growth. Whilst the above mentioned authors would not share every detail of the analysis of markets which we have put forward above, they would, we believe, share its general thrust in seeing unfettered markets as leading to unemployment and inequalities.[19] In contrast, the 'high road' seeks to build an economy in which there are high levels of investment and technological change (as the basis for high levels of productivity) in which there is substantial worker involvement. 'The successful implementation of the high road approach requires important institutional changes which emphasize cooperative relationship between workers employers and governments in individual countries as well as between nation states in both the North and the South' (Singh, 1996).

VI. SOME REMAINING ISSUES

There are two major issues which a Keynesian analysis must face, and which we only have space here to note. Fii there is the question of globalization (including transnational foreign direct investment, the cross-border integration of production and the international operations of financial markets). We would argue that these factors, especially unregulated capital flows and the dominance of financial markets resulting from the lack of economic co-ordination between the leading industrial countries, tend to induce a deficiency of aggregate demand. This leads to a situation where the balance of payments disequilibria between countries can only be resolved at a lower rate of growth of world aggregate demand than that which is compatible with full employment in all countries. What is, therefore, needed to achieve the required rates of growth of real demand are deep institutional changes at both the national and international levels (see, also, Singh, 1997).

Keynesian policies have become associated with national policies pursued by independent governments with little attempt at coordination as in the Bretton Woods era with some potential for using exchange controls. That era has been vividly described by Singh (1997) in the following manner: it was based on "cooperative relationships between employees, employers and the government at a national level and between nation states at the international level. . . . At the international level ... the world trade and financial system worked in a stable and predictable way under the hegemony of the U.S., the dominant economic power for most of this period". By contrast, the current economic order "emphasises the supremacy of market forces; it eschews government regulation of labour, product or capital markets, as well as non-market co-operative relationships between governments, employees, and employers such as 'income policies'. Similarly, at the international level, instead of co-operation between nation states, economic relationships are increasingly dominated by market forces unleashed by liberalisation and globalisation" (p.6).

We have not specified the level of government-at which Keynesian policies should be applied (though the balance of payments constraint operates at the national level). We would accept that national governments are more constrained than during the Bretton Woods era in their pursuit of monetary

and fiscal policies, not least because of the greater openness of economies and the consequent greater leakages abroad of demand and the much increased scale of financial markets. In some areas of supply-enhancing measures, the appropriate level of government may be below the national level (though that would depend to some degree on the size of the nation). Demand management policies within a European economy would face less by the way of demand leakages than the individual countries would but obviously the absence of a European federal authority rules such policies out for the present (though European monetary policy will come into effect when the European Central Bank is in place). And yet policies of international cooperation are paramount. Such policies should embrace trade as well as fiscal and monetary policy, and should also aim at the level of production (for example building an international system of small firm production networks as an antidote to the giant international firm).

Second, the implementation-of policies requires a competent and committed: State as well as a supportive electorate (or perhaps more accurately supportive `powers that be'): Of equal importance, if not more though, is the wider institutional framework in place, which gives rise to the new concept of 'good' governance. The same kind of policies may work very differently in diierent countries because of differences in the effectiveness of the institutions which implement them. An effective and uncorrupt civil service is in a better position to design and implement policies which address market failure than an ineffective and corrupt one which is seen as acting as a tax on the productive activities of the economy (World Bank, 1993b). For example, bribing officials to obtain permits and licenses by investors, giving passages through customs, prohibiting the entry of competitors etc., become the focus of activity in corrupt economies. Corruption is both 'pervasive and significant' in both developing and developed countries and is costly to economic development for two reasons: the weakness of the central government which allows corrupt bureaucrats to stop productive projects from materializing, thus hampering investment; and the necessary secrecy of corruption which can entail shifts in investment away from high-valued projects to 'useless' projects if these provide better opportunities for secret corruption.

VU. SUMMARY AND CONCLUSIONS

The argument of the paper may be briefly summarized. Government intervention is necessary in principle to achieve and maintain full employment. The increased power of trade unions and workers at full employment along with the resulting inflationary pressures must be addressed. Social consensus on the distribution of income along with wage and prices setting mechanisms which are 'friendly' to low inflation should be considered seriously. There could very well arise a serious balance-of-payments constraint well before full employment is reached. Policies to enhance the supply side of the economy may be necessary to alleviate this problem. Even with sufficient demand, full employment might still be difficult, if not impossible, to maintain, if there is inadequate or unbalanced supply potential. The paper has attempted to demonstrate the potential of these *economic* policies and in doing so it has touched upon the constraints and obstacles that may be present in their implementation.

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2. It is our general view that the perceived commitment by many governments to the use of reflationaty measures to maintain high levels of employment was an important ingredient, amongst many others, of the causes of the post war boom up to 1973. During that period, the high levels of investment reduced the requirements for budget deficits to underpin high levels of demand, and it is notable that it is only since the mid 1970s that there have been substantial budget deficits run on a continuous basis, an irony induced by the fact that these are caused by attempts to increase unemployment to control inflation !.

3. Many contributors to Arestis and Sawyer (1997a) focused on the role of government in reducing uncertainty which would foster investment (see, also, Federer, 1993).

4. It is worth noting here that the supply-side does influence aggregate demand, mainly through capital accumulation influencing employment and unemployment. See Rowthom (1995) for a recent contribution and Arestis and Biefang-Frisancho Maniscal(l997) for evidence for the UK.

5. There is a great deal of evidence on the ***persistence*** of economic disparities and the role of markets in perpetuating inequality. See Sawyer (1989) for a recent contribution in this respect, and Skott (1985) on cumulative causation.

6. Blanchflower and Oswald (1994) conclude for their large empirical study across a range of countries that ***'A worker who is employed in an area of high unemployment earns less than an identical worker in a region with low joblessness.*** The nature of the relationship appears to be the same in different countries. . . . As a crude characterization of the data . . . the wage curve is described by the formula

$$\ln w = -0.1 \ln U + \text{other terms},$$

where ln w is the log of the wage, $\ln U$ is the log of unemployment in the worker's area . . . . A hypothetical doubling of unemployment is then associated with a drop in pay of 10 % (that is, a fall on one tenth)' (p. 5: emphasis in original). They postulate three ways of interpreting these results. 'First, the relationship might be the equation of a contract curve. Second, it might be a no-shirking condition. Third, it might be a kind of bargaining-power locus' (p.93). Whilst not dismissing those possibilities, we would add (and stress) the roles -of aggregate demand (whereby higher wages generate higher demand and lower unemployment) and of cumulative causation (across regions).

7. For a brief discussion on inequality between regions see Sawyer (1989; p.425). There has been a considerable debate over whether there has been convergence between countries in terms of level of economic development. Baumol(l986) observes convergence of income levels amongst the richest group of countries but divergence within the poorest group, which also fell behind the rest. Amable (1993) finds a general pattern of divergence rather than convergence in productivity levels (amongst 59 countries over the period 1960-1985). During the 1980s, low-income countries grew (in terms of GNP per capita) at an annual average rate of 1.0 per cent (excluding India and China which averaged 5.6 per cent), lower middle income countries declined by an average of 0.1 per cent per annum, upper-middle-income grew at 0.6 per cent and high-income countries at 2.3 per cent. The world average was 1.2 per cent (World Bank, 1993a).

8. For further discussion on these constraints see Arestis (1992, 1996, 1997) and Sawyer (1995a,b,c).

9. For example, the ratio of cash and reserves with the Central Bank to national income is around 6 per cent in the United States (and even that figure means that the average holding of cash amounts to $1500 per person). A fall of prices by 10 per cent would raise the real value of cash by the equivalent of 0.6 per cent of national income, and perhaps stimulate demand by the order of 0.03 per cent (assuming the coefficient on wealth in a consumption function to be of the order of 0.05).

IO. The evidence on the determinants of savings and investment is very supportive of the views expressed in the text (see, for example, Arestis and Demetriades, 1997, pp.792-3).

11. ' Since modem capital markets came into existence, there have never been such high long-term rates as we recently have had all over the world' (Homer and Sylla, 1983, p. 1, quoted in Pasinetti, 1996). Relevant estimates can be found in Tease et al (1991).

12. It can be noted that if the 'natural rate of unemployment' (hereafter NRU, Friedman, 1968) formed this inflation barrier we could be quite relaxed for the NRU is similar to a notion of full employment. The difference between a Keynesian analysis and a Friedmanite analysis would be that the former would view the NRU as a 'weak attractor' for the actual rate of unemployment in a laissez faire economy and the achievement of NRU would require demand management policies, whereas Friedman and others would view real wage adjustments as leading to labor market equilibrium and the NRU.

13. Sawyer (1997a) argues that models of the NAIRU do not address the issue of how aggregate demand would adjust, and appear to rely on the operation of Say's Law and/or on the **real** balance effect.

14. Hysteresis is often used to mean that there is some persistence of the effects of a specified change but those effects gradually fade away. For example, increased unemployment appears to generate a degree of persistence. However, we would view hysteresis as meaning that the final outcome is influenced by the path which is taken, and hence that a specified change has a permanent effect (which may be quite different from any initial effect).

15. This stabiity condition for the balance of payments position is more severe than the corresponding on for the budget deficit since the balance of payments condition refers to the pre tax rate of interest whereas the budget deficit refers to. the post tax rate of interest.

16. ***The*** concern here is with employment of labor rather than capacity utilization. We would largely accept the argument that there will not be a strong tendency towards perpetual excess capacity , other than which firms wish to hold for reasons of meeting demand fluctuations, erecting barriers against new entrants, and building ahead of demand when there are economies of scale.

17. Arestis and Skott (1993) discuss the possibiity of inflationary pressures arising from distributional conflicts and provide empirical evidence in the case of the United Kingdom.

16. Pfeffer (1994) argues that 'It seems almost axiomatic that the work force is unlikely to be used efficiently and effectively in an atmosphere of distrust or adversarial relations.' (p. 113) and that 'the system for regulating the employment relation in the United States is in many respects disastrous, providing neither efficiency nor equity, nor fostering change in employment practices in ways consistent with achieving competitive success through people.' (p. 138). Further, 'achieving competitive success through people involves fundamentally altering how we think about the work force and the employment relationship. It means achieving success by working ***with*** people, not by replacing them or limiting the scope of their activities. It entails seeing the work force as a source of strategic advantage, not just as a cost to be minimized or avoided.' (p. 16)

19. Further, Pfeffer (1994) is written from a management perspective and concerned with advocating an inclusive participatory management style. Singh (1995, 1996) is particularly concerned with international macroeconomic issues.