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Australian School of Business Research Paper No. 2012 ECON 28

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John Nevile
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A Bright Future Can Be Ours! Macroeconomic Policy for Non-Euro-Zone Western Countries

John Nevile and Peter Kriesler*

Centre for Applied Economics, University of New South Wales.

Abstract

Radical changes in macroeconomic policy could produce a brighter future. The neoclassical myth that a free-market economy inevitably moves to an equilibrium position determined solely by supply-side factors must be rejected and replaced by the insight that the position of an economy in the longer-run is path-dependent. Fiscal policy in recessions should be biased towards increasing physical and human capital which will improve the productivity of an economy, raising living standards and hence taxable capacity, thus enabling future public debt to be reduced if this is desirable. Monetary policy should play a very minor role in aggregate demand policy, with interest rate settings largely used to help achieve long-term income distribution goals. All this is fundamental to Geoff Harcourt's vision of macroeconomic policy and this paper spells out how this vision can be implemented in 2012 in Western countries not hamstrung by Euro-zone rules and regulations.

Key words: macroeconomic policy, cyclical fluctuations, money and interest., monetary policy, fiscal policy

JEL Classification: E00, E52, E62

1. Introduction

Are things different this time? Capitalist economies have been subject to trade cycles and bubbles in asset prices for hundreds of years. It would be naïve to think they can be banished forever. But unless there are radical changes in the whole approach to macroeconomic policy slumps will be more severe, recoveries slower and asset price bubbles more frequent, at least compared to the last 70 years. Nevertheless, radical changes are possible, if unlikely, and if implemented could produce a bright future.

This paper is about macroeconomic policy in 2012 in advanced economies that are not in the Euro-zone, such as the United States and the United Kingdom¹. It also contains material specifically about Australia which is of interest both because of its notable success in dealing with the global financial crisis and because it is the native country of Geoff Harcourt. While

* The authors would like to thank Geoff Harcourt and Raja Junankar for their helpful comments on this paper, and for their continuing help and support.

¹ . This distinction is the result of the fact that Euro-zone countries do not have control over their monetary policy – which resides with the European Central Bank – and have limits imposed on their ability to control their fiscal policy, which is further hampered by the new Eurozone fiscal policy agreement.

the paper is not primarily about the history of economic thought some reference is made to the work of Keynesian and Post-Keynesian economists that points in the direction of the analysis in this paper.

Appropriate policy depends of course on the economic situation to which policy must respond. While there are significant differences between the relevant countries there is also a common core in the economic situation that they face. This common core is not controversial among Post-Keynesian economists and only a brief outline is given in this introductory section. As well there are some comments on perverse decisions made for political reasons.

The following two sections lay the foundations for the discussion of actual policy measures. First there is the integrated nature, for both financial and real variables, of cyclical fluctuations in both the short-run and the longer-run and the path-dependent nature of longer-run equilibrium positions and disequilibrium positions. These are discussed in the next section. Secondly, there is the short-run and the longer-run unemployment-inflation tradeoffs, which are discussed in Section 3. Sections 4 and 5 are on fiscal policy and monetary policy respectively, before the final section draws the threads together.

The international financial system in its present form is both conducive to global financial crises and accentuates the effects if such crises are triggered by other factors. Global financial crises follow a typical pattern. They are preceded by a period of increasing asset prices. Business balance sheets improve as a result of the increased value of their assets. This improved business confidence encourages investment. Banks, at the same time, are increasingly happy to lend money for this investment. Financial crises are often precipitated by banks reassessing their liabilities, and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets, and to significant asset price falls (Minsky 1985). This not only had a large part to play in 2007 but is still an important feature of the economic landscape today. It is discussed in more detail in the next section

While there were other contributing factors, the collapse in economic activity in 2007-2008 followed this basic pattern with two important differences. First, households, as well as firms, went into significant debt; and secondly there was an accumulation of so called 'toxic assets' associated with subprime mortgages. The role of credit rating agencies exacerbated the second factor. The new and very complex instruments were given triple A ratings, although in fact they were anything but triple A. When it became apparent that, despite the credit rating agencies statements to the contrary, the assets held by many enterprises were in fact worth substantially less than their current valuation and that many financial institutions were heavily exposed to such assets, the whole house of cards came tumbling down (Nevile and Kriesler, 2011).

After the downturn fiscal policy was widely used to stimulate economies but, in most countries, only as a measure to stimulate aggregate demand in the short-run, with no thought to how it could be used to improve the situation in the longer-run. In general it was assumed

that one of the stronger forms of the efficient markets hypothesis held. If traders know all the publicly available information about the likely future earnings of companies they will take this information into account when buying or selling on the stock exchange. Therefore the prices at which they trade will be the best judgment about the future values of the stocks traded. A “Chicago School” economist and noted finance theorist Eugene Fama went one step further and argued that the prices of stocks incorporate all information known to traders even if some is not known to the public (Quiggin, 2010).

If either of these two forms of the hypothesis is correct, crises could only occur in very unusual circumstances in which the information known to traders changed substantially and dramatically. The dotcom bubble of the latter part of the 1990s was only the most convincing of a number of demonstrations that crises could and did occur where these conditions were not present Quiggin (2010). Moreover, the efficient markets hypothesis is logically inconsistent. As Quiggin puts it:

“the Black-Scholes pricing rule shows how an option price ought to be determined in an efficient market. But traders can only make a profit using Black-Scholes and similar rules to value derivatives if the market price deviates from the ‘correct price’, that is, if the Efficient Markets Hypothesis is not satisfied” (2010, p.40)

Nevertheless, the Neoclassical and the so-called New Keynesian Schools of economics, which together dominate macroeconomic policy making, still hold that the efficient markets hypothesis holds in all but the short-run when due to wage and price rigidities, knowledge deficiencies and perhaps expectation factors, fiscal policy, as well as monetary policy, can influence output, employment and unemployment.

If this were not enough, in both the USA and the UK short-run domestic political rhetoric combined with ideology about the relative roles of the private market sector and the government in the longer-run have undermined any chance of appropriate reform. Similarly in Australia, the Federal Government, which wishes to establish its credentials as a conservative economic manager, plans to start the process of restoring its budget to a surplus in the financial year 2012-2013, although the running down of the stimulus measures implemented in 2008 and 2009 will cause a substantial increase in the structural deficit however that is measured.

This paper takes up some of the challenges laid down by Geoff Harcourt in his important paper “Finance, speculation and stability: Post-Keynesian policies for modern capitalism” (Harcourt 2010). In that paper, Geoff starts by reminding us of Keynes’s famous comment: “*In the long run we are all dead*”(Keynes, 1923, p.65 emphasis in original). However, he points out that, towards the end of his life, Keynes argued that the pendulum had swung too far in the opposite direction with too much attention on the short-run, at the expense of any on longer-run considerations (Harcourt, 2010, p.237), Geoff’s paper criticises the conventional notions of how markets work as an equilibrating process. Instead, markets initiate cumulative processes which push economies and sectors within them further and further from any equilibrium, with the path taken determining their destination. This is reinforced by the Keynesian/Kaleckian emphasis on the role of investment in determining

saving, so that policy aimed at increasing national saving must also simultaneously increase investment. In addition, Harcourt is sceptical about the ability of monetary policy to influence the economy. Within this framework, policy should be aimed at “minimiz[ing] the amplitude of fluctuations, and keep[ing] average levels of employment as near as possible to full employment.” (p. 244)

2. The integrated nature of cyclical fluctuations and longer-run movements in economic activity

From the beginning Keynesians have accepted the integrated nature of cyclical fluctuations and longer-run movements in economic activity. In 1936 Harrod published *The Trade Cycle: An Essay*. In this book, as in his later writings, Harrod held that “the trade cycle we know is conditioned by its occurrence in a dynamic (growing) economy“ (Harrod, 1948, p.12)². The growth equations which became identified as the core of Harrodian dynamics were developed as part of trade cycle analysis. The influence also went the other way. Harrod’s fundamental growth theorems were very general. Any complete analysis required consideration of the cycle: “the value of warranted rate depends on the phase of the trade cycle and the level of activity” (Harrod, 1939, p.30). Thus, Harrod makes a strong case that responses to cyclical fluctuations and trend can not be divided into two separate spheres but must be considered as a joint response to intertwined parts of the economy. This is emphasised by other major post-Keynesians, particularly Kalecki and Goodwin, who argued “that the trend and cycle are indissolubly mixed.” (Harcourt 2006 p. 146)

If this insight is ignored, in general effective macroeconomic policy will at worst occur by chance and at best because of intuition. The biggest opportunities to improve economic conditions in the longer-run as well as in the short-run are likely to occur during recessions, but if these opportunities are not grasped the decline in investment during recessions will adversely affect supply in the future reducing living standards. This is confirmed by the limited empirical evidence available. The OECD sums up this evidence with the words:

“[t]he limited empirical literature examining the long-run implications of recessions suggest that they result in permanent output losses, and that losses from recessions associated with financial crises are even larger. For example, Kim *et al.* (2005) consider the output response to recessions in Australia, Canada, the United Kingdom, and the United States, and estimate that permanent losses to output range from 1 ¼ to 5 ¼ percent. Recent OECD research also finds evidence of persistent output losses from financial crises. Furceri and Mourougane (2009) estimate that financial crises

² Harrod considered that his later writings on dynamic economics expressed his ideas in a “more precise form”, but continued to reaffirm the central parts of his original theory of the trade cycle. See e.g. Harrod, 1951, pp. 261-263.

permanently lower potential output by 1 ½ to 2 ½ percent on average, and by up to 4% for severe crises” (OECD 2009, p. 234).

We argue that fiscal policy should be the major type of policy used to combat recessions (Nevile and Kriesler, 2002). This gives the opportunity to tailor expenditure so that actions taken to increase aggregate demand in the short-run have beneficial effects on levels of economic activity from then on. It draws on an insight expressed very succinctly by Joan Robinson in the words ‘the very process of moving has an effect on the destination of the movement’ (1953, p.590). In particular a bright future is possible because if government expenditure is used to increase physical infrastructure and to improve the quality of education at all levels, this will increase the productivity of the economy and raise living standards. Hence, it will increase the capacity to pay taxes and reduce the public debt in the future, in other words, it will contribute to positive “intergenerational transfers”, if that is thought desirable³. The detailed arguments to support this are included in Section 4 on fiscal policy.

Section 3 The Unemployment/Inflation relation

Over the last few decades there has been a substantial shift worldwide in economic policy partly due to the increased importance of the financial sector. In particular, fighting inflation (inflation-targetting) and keeping it at low levels has become the predominant aim of most governments, with any emphasis on low unemployment now taking a subsidiary role. This is illustrated by the statement of the then Governor of the Reserve Bank of Australia, Bernie Fraser who, just before retiring, noted that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than employment. He was quite explicit about the reason for this:

“Most financial market participants rate low inflation ahead of the Reserve Bank’s other objectives. This reflects a number of factors but the financial harm that is done to the holders of bonds when inflation and interest rates rise is the main one.” (Sydney Morning Herald 16/8/96)

While the theoretical basis of this change in emphasis of policy originally came from monetarism, it has since been taken up by most conventional economists. Underlying this is the view that, in the long-run, markets will guarantee full employment and that only short-run impediments may prevent the economy achieving full employment of all resources, including labour. Related to this, is the long-run neutrality of money, so that any attempt to use policy to increase employment in the long-run will either crowd out private sector expenditure or, by increasing the money supply, be inflationary. This is illustrated with a vertical long-run

³ In Australia at least, almost the opposite argument is frequently made namely that the policy actions we advocate will make our children bear the cost of policies that benefit the recent generation. The truth is exactly the opposite. If we finance with current taxes, things which will bring benefits for many years to come we are being generous to our children who will reap benefits they have not paid for.

Phillips curve which is important in understanding the basis of the long-run view. The opposite position is held by most political economists and Post-Keynesians, who believe that there is no such automatic adjustment mechanism in either the short or the long-run (Harcourt 2010 pp. 240-241), and that money, far from being neutral, can have important effects on an economy.

When one turns to the short-run, conventional wisdom that monetary policy is the best way to increase aggregate demand is also dubious. The main economic variables which are supposedly influenced by changes in interest rates are the level of private sector savings and private sector investment. With respect to consumption, the overall impact on quantity depends on the direction and relative size of the income effect. This means that the question of the likely effect is an empirical one. Empirical evidence suggests that there is no significant relation between interest rates and saving, although changes in interest rates may, via its influence on portfolio decisions, influence the assets in which people save⁴. Similar ambiguities lie in the relation between interest rates and investment. Investment activity is undertaken when it is profitable to do so. No matter how low interest rates are, investment will not respond in a recession when business does not expect to be able to sell the output of the investment project.

In Australia, and many other countries, Governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer-run growth in output and employment. While there is little doubt that this is true for very high rates of inflation, there is substantial evidence that this is not the case when the rate of inflation is below, say, 10 per cent. The argument for the importance of fighting inflation as the over-riding goal of macroeconomic policy is strongly supported by the current dominant neoclassical school. However, Professor Robert Barro, a well respected member of this school, in a study of the experience of more than a hundred countries over thirty years, found that there was evidence of “causation from higher long-term inflation to reduced growth and investment” but immediately commented that “it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation” (Barro 1996, p.168). The general tenor of Barro’s article suggests that he had inflation rates above 20 per cent a year in mind when he used the term high, although anyone less sympathetic to the argument that inflation has adverse effects on growth might maintain that his empirical work shows that “high” should be taken to mean more than 50 per cent a year. Barro’s general result has been supported by numerous other studies (Kriesler and Nevile, 2009).

Others have argued that, unless we give the priority to policy aimed at fighting inflation this will run the risk of making inflation harder to contain in the future, whereas pre-emptive interest rate rises add credibility to policy which lessens the risk of future increases in inflation. Whether this is correct depends on the role of expectations in the inflationary

⁴ . See, for example, Edely and Britten-Jones (1990) and Honohan (1999) especially p. 98.

process. However, there are serious problems with the usual arguments establishing a link, and, in particular, there has not been any serious analysis of the expectations transmission mechanism, so that the link between inflationary expectations and actual inflation rates may be very weak. (Nevile and Kriesler 2008). Even if we accept that the argument is correct, it is completely symmetrical with respect to unemployment. Pre-emptive increases in policy to expand employment equally lessen the risk of an increase in unemployment. In the Australian case, this is illustrated by the experience of the 25 years following the Second World War. No one doubted the commitment of successive governments to maintain full employment. Both monetary and fiscal policy reacted quickly to the first signs of any looming decline in the rate of economic growth and minimised departures from full employment growth. The most spectacular example was the 1952 recession precipitated by the virtual halving of the price of wool that occurred as a result of the cessation of hostilities in the Korean war. The value of wool exports fell by about a half while that of all other exports increased slightly. Real gross national product declined by over 10 per cent in 1951/52, but both aggressive monetary and fiscal policy halted the fall after that one year. Unemployment rose in 1952/53 but by a relatively small amount and the rise did not last long (Kriesler and Nevile, 2009).

In any case, there is serious doubt about the association of higher employment levels with inflation, at least at levels of capacity utilisation below full capacity of the labour force or of the capital stock. Most contemporary arguments about the dangers of inflation associated with low levels of unemployment do so on the basis of the neoclassical model with its emphasis on the NAIRU. The essence of this model is that the self-correcting activities of the market will generate a tendency towards full employment. At full employment (defined here as the NAIRU), any attempt to reduce employment must, by definition, increase demand beyond capacity limits and therefore will be inflationary. However, heterodox economists deny these long-run full employment tendencies of the market, and, as a result have questioned the basis of the supposed trade-off, and have argued that reasonably low levels of unemployment are possible with little if any inflationary implications - see for example Kriesler and Lavoie (2007). In this case, inflation only becomes a potential cost of reducing unemployment at very low levels of unemployment, and other policies, such as incomes policies, may further alleviate the problem.

These results have been replicated in more conventional economic research by the Federal Reserve of New York (Peach et al, 2011) Their results support the idea of a “threshold Phillips Curve”, where the Phillips curve “relationship is relevant only when conditions in the economy are either extremely slack or extremely tight.” (p. 6) They do not, however, suggest theoretical explanations for this relationship. Nevertheless, it provides additional support for the idea that, over large ranges of output, associated with the normal operations of the economy, there is no relationship between unemployment levels and inflation. In other words, policies to reduce unemployment, especially when it is at high levels, will not be associated with increases in inflation until the unemployment rate is quite low. (See also Hall 2011)

This section has examined the relationship between inflation and unemployment that has led to the conventional policy wisdom being “to fight inflation first”, and has rejected it on two

separate grounds. First, the evidence suggests that an annual inflation rate inflation less than 20% (and possibly less than 50%) is unlikely to influence economic growth or investment. Second, there is little evidence, either theoretical or empirical, that policies aimed at reducing unemployment and stimulating economic growth will have an inflationary impact, unless they are enacted in times where the levels of economic activity and employment are near full capacity, which, in any case, is an inappropriate setting in which to implement stimulatory policy.

Section 4. Fiscal Policy

The appropriate policy response to the current economic conditions in countries like the UK and the USA fall into two categories. The first are broad principles and the second more detailed measures, whose importance may vary from economy to economy The broad principles are:

- Fiscal policy stimulus is still essential and must play the major part. It should include substantial public investment in both physical capital and human capital, which will have long-term benefits for the economy (including green investments);
- Helping those in employment to retain jobs e.g. through multiskilling;
- Aiding those who become unemployed to keep in contact with the labour market e.g. by improving their job search skills which is desirable for both economic and social reasons.

Overall, the key is to increase animal spirits by policy measures that are having some visible success.

Economic conditions in different countries vary in detail and may require additional different specific measures, but measures that will often be needed include:

- incentives for the private sector to invest in the immediate future, especially in Countries where expectations are particularly depressed;
- Incentives to bring forward consumption in the household sector e.g. through temporary reductions in consumption taxes;
- Giving those already unemployed for some time the skills and characteristics needed if they are to be able as well as willing to obtain jobs as they become available.

Expenditure on improvements in physical capital and improvements in education at all levels are at the heart of the correct response to present high levels of unemployment. This should be “financed” by “borrowing” from the central bank⁵. This will increase the future

⁵ It only need be financed by formal loans if it is thought desirable to support the level of government securities.

productivity of workers employed as a result by maintaining or even increasing their skills. It will also reduce the numbers of unemployed. Both these things will increase the productivity of the economy and raise living standards. The consequent increase in GDP will raise taxation revenue even if rates remain unchanged, and hence the ability to reduce the public debt if that is thought desirable (Kriesler and Nevile, 2009). Moreover, when a longer term perspective is taken, a high priority should be given to quality education and training at all levels for the disadvantaged, as this will help reduce long-term unemployment and hence significantly increase the productivity of the work force (Heckman and Kreuger, 2003).

This issue is also important in terms of the health of our society since long-term unemployment creates many societal ills. Unemployment not only imposes costs on society as a whole but these costs also increase as the length of the spell of unemployment grows (Junankar and Kapuscinski 1992, Saunders and Taylor 2000). They start with the loss of output that those seeking work would have produced as workers and the loss of potential productivity, or human capital, that occurs as the skills of the jobless waste away or become redundant. The costs also include more marriage breakups, increased health costs and increased criminal activity. It is the children of the unemployed who are the group in which unemployment is most likely to lead to criminal activity (Weatherburn 2002). As far as minimising the costs of crime is concerned, it is important to reduce both frequent and long-term unemployment among young poorly educated workers, especially where the unemployment is concentrated geographically. In general the health and cohesion of society are most damaged where inherited unemployment creates an ongoing underclass.

Infrastructure projects can be targeted at specific groups of workers, especially those in particular geographical locations and perhaps workers in the construction industry in countries where these are most depressed. As Harcourt (2010) argues, the infrastructure spending should be “determined by medium- to long- term needs” (p. 244) Where there is a shortage of major construction projects small construction projects that do not require lengthy period for detailed planning and governmental approval can be increased. Moreover, expenditure does not have to be on physical infrastructure or even human capital only on things that will increase employment in a productive way. For example, much of the administrative work in organising a local government project to ensure all children are immunised against measles, scarlet fever and whooping cough could be done by providing central government funds to employ people who lose clerical jobs – in practice probably mainly jobs at the less skilled level.

One objection to our fiscal policy proposals, the inflation issue has already been discussed in Section 3 above. Apart from this, our policy package emphasizing government expenditure to expand physical and human capital is in flat contradiction to the neoclassical theory which is dominant in the UK, the US and Australia among other countries. The argument that fiscal policy cannot affect long-run output and employment has been put at two levels. There is analysis that specifically relates to fiscal policy and argues that the stimulus it provides will, in the longer-run, crowd out an equivalent amount of private sector economic activity. In addition there is the more general belief that the longer-run growth path of an economy is determined by supply side factors. Hence, fiscal policy, like any other policy instrument

designed to influence aggregate demand, has no effect on real variables in the longer-run. As Solow put it: “the appropriate vehicle for analysing the trend motion is some sort of growth model, preferably mine” (1997, p. 230). But taking the particular before the more general the discussion of crowding out will come next.***

Crowding-out theory maintains that an increase in the deficit will cause a fall in private investment expenditure of (almost) the same size as the rise in the deficit⁶. If the government borrows to finance the deficit this will force up interest rates reducing private investment. While in the short-run multiplier effects may be such that economic activity increases, more money will be demanded by the public to carry out this increased economic activity. The increased demand for money will force up interest rates until the increase in gross domestic product is reversed.

When it was first formulated this theory assumed an exogenous constant rate of growth in the stock of money. Even before the deregulation of financial markets targeting the rate of growth of the monetary stock of money was remarkably unsuccessful. Today it is generally accepted that the supply of money is endogenous. In effect those supporting crowding out in today’s world of deregulated financial markets are arguing that, whenever government expenditure increases, the central bank actively tightens monetary policy to the extent necessary to reduce private investment by an amount equal to all, or most of, the increase in public expenditure. However, one qualification of this argument could be made. It is short-term interest rates that are the monetary policy instrument. Long-term interest rates are more relevant to investment decisions in the private sector. Perhaps large budget deficits typically increase the spread between short-term and long-term interest rates because they increase expectations of inflation, so even if short-term interest rates were held constant long-term rates could rise crowding out private investment. It is unlikely that inflation is a significant problem in OECD countries today and even before the current recession there is little empirical evidence to support this hypothesis. For example, for the 13 years after the Australian exchange rate was floated there was virtually no correlation between budget deficits and the spread between short and longer term interest rates (Nevile, 1999). Empirical evidence gained in other studies also failed to find evidence to support crowding out. For example, Heilbroner and Bernstein (1989) carried out a cross-sectional analysis of the G7 countries and found no evidence that increases in the public debt were correlated with rises in interest rates.

Despite what is widely believed, Solow’s growth model does not imply short-run policy can have no effect on the longer-run growth rate of output, only that it does so through actions that increase productivity. It does assume full employment of both capital and labour, but not of the level of output. Solow sums this up with the words ‘Full employment/utilization is usually just assumed’ (2000, p 350). Neoclassical economists generally take the quote from Solow to mean that the market will deliver the best outcome for output and employment over

⁶ Nevile (2000) gives a more extended discussion of the material in this and the following paragraph.

the whole cycle in economic activity and aggregate demand policy should not concern itself with such things but Solow himself rejects this assertion, stating that:

‘the neoclassical model allows in one important effect for the interaction between fluctuations and growth: fluctuations will surely perturb the rate of investment and that will necessarily affect the path of potential output’ (*op. cit.*).

The argument does not distinguish between public investment and that carried out in the private sector and, as Solow makes clear later in his article, it is true of investment in human capital as well as investment in physical capital. In Solow’s understanding, there is nothing in the neoclassical growth model that would make the policies we advocate undesirable.

One other argument frequently levied against the fiscal policy measures we advocate is that they will result in an unsustainable rise in the public debt. The correct answer to this is that the increases in government expenditure we propose will be self-funding. However, in a number of countries, both policy makers and media commentators accept the rule that the government budget deficit should be balanced over the cycle⁷. Until this acceptance can be changed by a public education campaign, the key question is who holds the public debt.

If a country’s public debt is largely held by its own citizens, the liability (to taxpayers) is balanced by the assets of those citizens who hold the debt. This is usually the case in advanced economies (Reinhart and Rogoff, 2011) Nevertheless, the consequences for income distribution of a continually growing public debt may be important. In theory these could be overcome through taxation and other fiscal measures for redistribution, but if the interest bill is large, this may not be feasible for political reasons. Even so, the rule that the budget should be balanced, not over a year but over the business cycle, is too strict as it ignores the effects of inflation and economic growth. If nominal gross domestic product is growing there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of public debt to gross domestic product.

Section 5 Monetary Policy

[L]et me paraphrase a wise saying from ... the late Sir Dennis Robertson: “People tell me that the bank rate is a beautiful and delicate instrument but I think it is coarse and blunt”. (Harcourt, 2010 p. 241)

As this indicates, it is generally accepted that monetary policy is a blunt and uncertain instrument. Partly as a result of financial and exchange rate deregulation, the transmission channels have become increasingly unreliable, first in terms of the lag between when the central bank implements changes in interest rates and when these have an impact on the economy, and, secondly, in terms of the size of that impact. Not only is monetary policy associated with ‘long and variable lags’, but there is significant uncertainty as to the size of its impact.

⁷ In Australia, where the Federal public debt is almost non-existent, this is not enough to satisfy the Australian Treasury. It argues in 2010 Budget paper no.1 Statement 3 that achieving a budget surplus on average over the cycle in economic activity is a key element of a sustainable medium-term strategy because it will ensure that there are no constraints, due to heavy loads of debt, on running budget deficits in a slump.

The most important and most direct effect impact of changes in interest rates on real economic activity is through the interest elastic components of aggregate demand. Here certain types of expenditure, particularly private sector investment and consumption, are held to be directly influenced by the rate of interest. As a result, tight monetary policy associated with increases in interest rates immediately lead to reductions in these components of demand. This, via a multiplier process, leads to further reductions in aggregate demand, output and employment, reducing (demand-pull) inflationary pressure. However, the lack of any deterministic relation between interest rates and the main components of domestic private expenditure has been discussed in Section 3 above, and suggests that this channel is of dubious efficacy. In addition, it should be noted that the impact of interest rates on demand will depend strongly on the debt structure of the economy. The recent substantial increase in private household indebtedness in many western countries means that consumer demand will be more responsive to interest rate changes than has historically been the case, due to the income effects. As a result, increases in interest rates will directly impact on household's real income due to their impact on mortgage repayments, which will, in turn influence household consumption.

Changes in interest rates also have an indirect impact on real activity through their influence on the exchange rates. Since mobile international capital is seeking the highest expected return, it will act positively to increases in the interest rate differential between countries. Other things being equal, tight monetary policy, by increasing that differential, will lead to appreciation of the currency. By reducing the domestic price of imports and raising the overseas price of exports, this will reduce both cost and demand inflationary pressures, as well as output and employment.

The indirect impact of interest rates through exchange rates is also not as tight as it is sometimes argued. By influencing the interest rate differential between the home country and the rest of the world, changes in domestic interest rates will influence international capital flows subject to two important provisos. The first condition is that the change in domestic interest rate does change international interest rate relativities, which is not always the case, for example, where the central bank changes interest rates purely as a reaction to changes in international rates. The second is that market expectations, particularly with respect to future exchange rate movements, will be of equal importance in influencing such flows.

Although changes in the exchange rate will directly influence domestic inflation rates through their impact on the domestic cost of imported goods and perhaps exports, their impact on output and employment will depend on the price elasticities of exports and imports. In the case of a relatively small open economy like Australia, which exports mainly raw materials and imports, mainly intermediate goods neither exports nor imports are likely to be price elastic, so that the Marshall/Lerner conditions may not be satisfied (see, for example, Kriesler and Halevi, 1995). This means that the main impact of interest rate changes through the exchange rate will be on the price level rather than on output or employment.

Despite the general acceptance of the limitations of monetary policy as a useful policy for short-run cyclical purposes, it is often advocated for this purpose. In particular, the use of

monetary policy for inflation targeting, as advocated particularly by the New Consensus, is based on a belief in its short-run efficacy, within a framework where money and monetary policy can not have any real impact in the long-run. In addition, underlying the framework is a belief in the long-run neutrality of policy, as a result of the efficacy of markets which will ensure full employment. This is characterised by the vertical long-run Phillips curve, which demonstrates the idea that, in the long-run, the economy will always be at its “natural rate” of output with the corresponding rate of employment. In this framework, the only function of macroeconomic policy in general, and monetary policy in particular, is to alleviate any short-run deviations of the economy from its long-run position. There can be no feedback from short-run phenomena to the long-run position, which is, therefore path independent. (Kriesler and Lavoie 2007).

Post-Keynesian and other heterodox economists clearly reject most aspects of this view. As indicated in the discussion of Harcourt 2010 at the beginning of this paper, these economists reject the notion of the self-regulating properties of markets, particularly with respect to employment. Flexible money wages, as both Keynes and Kalecki demonstrated, are not sufficient to guarantee full employment. There is no mechanism, in either the short or long-run, which will push the economy to its ‘natural rate’ of employment or output – if indeed such rates exist. Rather, it is the task of economic policy, including monetary policy, to achieve these conditions. Further, we have argued that inflation targeting is an inappropriate policy goal, with full employment being a much more desirable one. To facilitate this, monetary policy cannot be used as a short-run lever to fine tune the economy, since, for the reasons discussed, it is not suitable for that task. Where monetary policy will have its most important impact is in the medium and long-term through monetary conditions relating to the availability of credit.

In rejecting inflation targeting, and highlighting the limited nature of monetary policy for short-term stabilization considerations, the question naturally arises as to what is the appropriate setting for monetary policy? Clearly the aim of monetary policy should shift away from short-term stabilization policy, and particularly from any attempt to target inflation. Instead, it should be set so as to achieve higher growth and employment, with its distributive impacts also being of importance. Rochon and Setterfield (2007) consider a number of possible interest rate rules, ranging from setting either the nominal or the real interest rate close to zero – the long-term effect of which would approach Keynes’s notion of euthanasia of the rentier – to setting a “fair” rate of interest which would not influence income distribution “between interest and non-interest income groups.” (p. 25).

However, a more appropriate interest rate strategy which achieves many of these goals is that specified by Harcourt and by Smithin:

“There is a lot to be said, within given constraints, of setting relatively low interest rates and keeping them there, using other measures to tackle short-term fluctuations and long-term needs.” (Harcourt 2010 p. 245)

“There seems therefore to be no valid reason why the real interest rate should not simply be set as low as can practicably be achieved, provided that it is not allowed to become negative.” (See also Smithin 1994 p. 64)

As was discussed above, when we look at the history of financial crisis and of asset bubbles, it is clear that, as Minsky in particular argued, the scope of monetary policy needs to extend beyond just the setting of interest rates. Minsky showed that, in addition to cycles in real activity, there are financial cycles, where the underlying financial structure of the economy evolves through stages in a cyclical pattern. This cycle culminates in financial fragility and the dominance of Ponzi debt structures which influence real output and employment, predicating an economic collapse. In other words, the scope of monetary policy needs to be broadened so as to offer additional instruments in order to provide controls over banks’ capital assets. (Minsky 1986). A number of Post-Keynesians have extended this to recommend monetary policy be used to control a larger range of assets. (Palley 2003, 2004)

Section 6 Conclusion

This paper has taken up those themes in Harcourt 2010, which describe the features of a Post-Keynesian macroeconomic policy, and applied them to the current circumstances of those Western countries which are not bound by the rules and regulations of the Euro-zone. Also, to clear the ground, we set out the most important differences between what we advocate and the conventional wisdom held by those who determine macroeconomic policy in most Western countries.

Our policy package emphasizing government expenditure to expand physical and human capital is in flat contradiction to the neoclassical theory which is dominant in the UK, the US and Australia among other countries. The belief that the longer-run growth path of an economy is determined by supply-side factors, so that short run policies to increase aggregate demand, have no effect on the longer-run position of an economy is found to have no foundations except ideology. Its supposedly theoretical underpinning in neoclassical growth theory has been rejected by Solow himself. It was never accepted by Swan. Similarly, Friedman’s version of the nature of the unemployment-inflation tradeoff and its corollary, the so-called natural rate of unemployment, are not supported by either theoretical or empirical analysis. Instead, we argue that the position of an economy in the longer-run is path-dependent. Hence, policies to increase aggregate demand in a recession can lead to a bright future. Fiscal policy must be the major policy tool used in recessions. It should be biased towards increasing physical and human capital which will improve the productivity of an economy, raising living standards and hence taxable capacity, thus enabling future public debt to be reduced if this is desirable.

Monetary policy should be used to achieve long-run goals. Interest rate settings can be used as part of income distribution policy preferably in a manner that distributes income away from rich rentiers. In addition the scope of monetary policy needs to be broadened and the trend to deregulation reversed with additional controls over banks’ capital assets in order to

prevent a recurrence of the events that played a large part in precipitating the current recession.

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