Australian School of Business Research Paper No. 2013 ECON 36

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G.C. Harcourt
P. Kriesler
J.W. Nevile

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by G.C. Harcourt, P. Kriesler and J.W. Nevile

UNSW

Abstract

There is a myth underlying neoclassical economic analysis of a 'Western' economy, which is that in anything but the relatively short run, defined as the length of a business cycle, the economy reaches an equilibrium position determined entirely by supply side factors and unaffected by measures taken to increase aggregate demand during a slump This myth is not based on any factual analysis, it is simply assumed. It threatens the wellbeing of the world economy because it allows those who hold it to deny there is any need to change the deregulated state of the international financial sector, that caused the global crisis which started in 2007 and the effects of which have persisted ever since. The fundamental myth has a number of corollaries, which are worth calling associated myths. One of the most important is that the composition of spending to increase aggregate demand during a slump is irrelevant, so that it does not matter if the spending is directed towards consumer goods or to increasing physical and human capital. Another is that monetary policy has a more desirable impact on the economy than does fiscal policy. The paper focusses on neo-classical growth theory; comparative static implications are not considered. Finally, the policy implications are discussed.

JEL Codes, E6, E32, 04

Keywords: Financial crisis, Macroeconomic policy, deregulation, neo-classical growth theory

1. Introduction

This paper begins by documenting and discussing two propositions. The first is that neoclassical economic analysis of a 'Western' economy assumes that in the longer run the economy reaches an equilibrium position which is not only determined entirely by supply side factors but is unaffected by measures taken to increase aggregate demand during a slump or to restrict demand during a boom. The process of transition, via the medium term, is never explained, and remains problematic as Solow has often pointed out, eg. In Solow 2000. This myth is not based on any factual analysis, it is simply assumed. This is an important feature of the vertical long-run Phillips curve, where any deviation of capacity, real GDP or unemployment from their normal levels leads to *changes* in the inflation rate. This means that the potential or normal level of capacity is unaffected by what happens in the economy at the macro level. Unlike the Post Keynesian story, normal capacity is not influenced by aggregate demand or the path of actual capacity. In other words, “The main policy implication of this principle is that inflation-targeting strategies, namely aggregate demand fine-tuning through interest-rate management with a view to hitting inflation targets, do not affect unemployment, output or any other real variable in the long run.” (Fontana and Palcio-Vera 2007 p. 270) Moreover, in the academic world neoclassical macroeconomics often obscures the substance of the argument with an excessively mathematical exposition. Velupillai (2013) discusses this and sets out a better approach.

The new consensus advocates a policy rule, describing a central bank reaction function, where central banks change interest rates on the basis of deviations of inflation from its target level, or of output from its normal level. Long-run normal or potential capacity is invariant to changes in macroeconomic policy and aggregate demand, being determined by supply side factors at the micro level. This is documented in the next section together with a discussion of why this particular view of the world has become so widespread.

The second proposition is that this view of the world allowed the finance sector, both within countries and internationally, to obtain undue influence and behave in a way that caused the crisis that started in 2007 with effects that are still bedevilling most western economies.[1] This is documented in section 3 of the paper.

In the light of the material in these two sections the paper then considers the best policies to adopt both with special reference to Australia and more generally. Of course, as far as the international finance sector is concerned, Australia can only argue in international forums for the appropriate changes to be made. When the focus is on Australia the there are two aspects of the problem. One is technical and concerned with which policy measures will be most effective. The other is attitudinal. To borrow a phrase from Keynes: “The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.” (Keynes 1936 p. 322). The consequences of ignoring the recommendations of this section will also be set out. These are not just for the unemployed but for the nature of our society as a whole.

2. Neoclassical growth theory assumes full employment

Solow’s seminal 1956 article explicitly assumed full employment and generally discusses what happens in the long period when “the real wage adjusts so that all available labour is employed” (p.68).

Similarly, Swan (1956) explicitly assumes that:

> Effective demand is so regulated (via the rate of interest or otherwise) that all savings are profitably invested, productive capacity is fully utilized, and the level of employment can never be increased merely by raising the level of spending. (p. 335)

[1] To some extent this was also true of the previous one in the 1990s.

Solow (2000) is more forthright. Neoclassical growth theory, he says, supposes

> "the available supply of labour always to be fully employed and the existing stock of productive capital goods always to be fully utilized ... This assumption of full utilization could better be made explicit by introducing a government that makes (useless) expenditure and levies (lump-sum) taxes in order to preserve full utilization but this is rarely done......Full employment/utilization is usually just assumed." (p 350).

Solow sometimes suggests that measures to influence aggregate demand in the short run do not affect the longer run picture given in the neoclassical growth model. After discussing such short-run measures he comments, "the appropriate vehicle for analysing the trend motion is some sort of growth model, preferably mine" (1997, p. 230) Despite this typical light-hearted comment, in the same article he laments the lack of any real coupling between the short-run picture and the long-run picture. Moreover, in the 2000 article Solow follows this up with a more damaging criticism of neoclassical growth theory as usually understood:

> "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" (ibid).

As Solow discusses later in the 2000 article, this is true of investment in human capital as well as investment in physical capital. However, Solow's position is not that of most of his colleagues, who do not believe that fluctuations can influence the path of potential output.

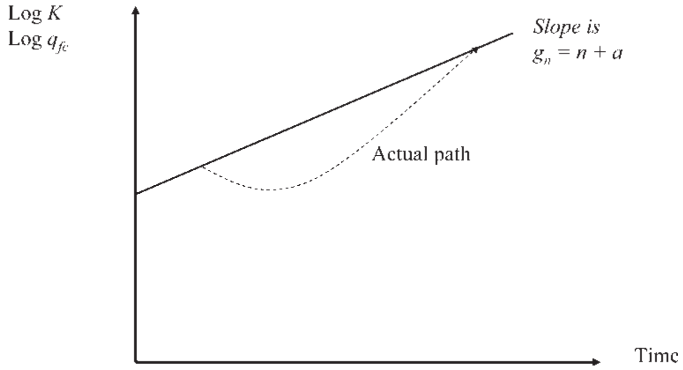

Figure 1. The standard neoclassical assertion: demand shocks have no long-run effects on the rate of unemployment and capacity output

In fact, in many neoclassical models, short run problems will have no effect on either the growth rates of employment, capacity or output, nor on their actual levels. This is depicted in Figure 1 which traces the relevant transition path. It shows that, a negative demand shock, will have no long-run effect on the absolute value of capacity output or on the stock of capital. Although unemployment will rise in the short run, so that there will be some transitional wastage of unutilized labour resources, the economy eventually revert to its unique NAIRU. This will be achieved through rates of growth that will exceed the natural rate during the latter periods of the transition. This is the standard neoclassical position, as it can be found in, for example, Filardo (1998, p. 35).

An alternate position, which Solow advocated in both his 1956 and 2000 papers and Swan (1956) pointed out, is that negative shocks, while having no effect on the long-run growth rates of capacity or of output and employment, will have a permanent impact on their levels[2].

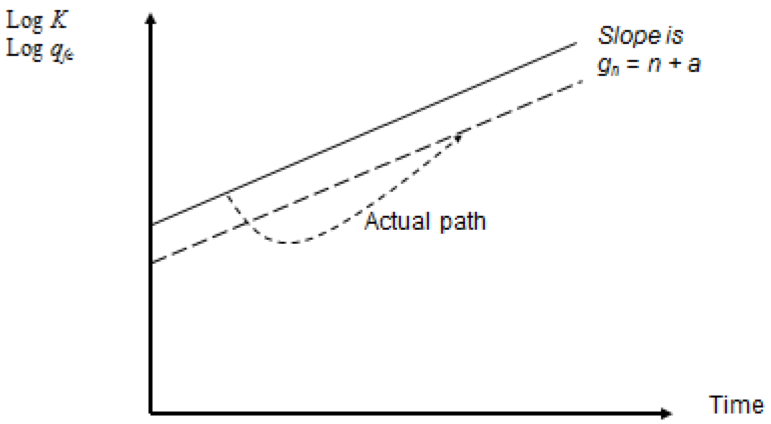

Figure 2 Demand has an effect on the absolute value of capacity, but no effect on the long-run growth rate of capacity

Why has this neoclassical picture of the world with its complete separation of the short run and the long run become so dominant? To understand the answer to this it is helpful to outline another neoclassical myth, that there is a value free part of economics commonly called positive economics. The naivety of this myth is remarkable. Even purely deductive reasoning depends on the value that this is a worthwhile thing to do. But positive economics is not just a matter of deductive reasoning. More often than not it appeals to empirical studies, or at least an implied assumption that real world situations do not differ enough from what is assumed in the analysis to affect the conclusions. This is a matter of judgement and this judgement is heavily influenced by the values of the person making the judgement[3].

Many neoclassical economists are also neoliberals, or what in Australia are often called economic rationalists, who place a high value on political and personal liberty and are suspicious of government intervention and regulation, which they see as reducing personal liberty and generally hindering the functioning of the market. It is perhaps not surprising that such economists generally make the professional judgement that market failure is rare, that is, if left to itself, it is unusual for the market not to produce an efficient outcome. Given the values that they hold, the costs of unnecessary government intervention are high. From this viewpoint it is responsible to be very cautious in claiming that market failure exists.

Other economists are more concerned about the costs of not intervening when to do so will be beneficial to the economy. If there is market failure, the people who suffer are usually the

[2] This is discussed in great length in Kriesler and Lavoie (2007)

[3] "And Lucas argues that the world operates for most of the time near enough to a steady-state rate of growth as to use the latter as a short cut in his explanations. "The balanced growth path will be a good approximation to any actual path "most of the time" … exactly the reason why the balanced path is interesting to us", Lucas (1988, 11)" Harcourt 2010 p. 50

economically weak, who may well experience very real poverty. This is particularly true of the labour market where a major symptom of failure is involuntary unemployment, particularly where it has persisted for long periods of time resulting in significant long term unemployment. Economists who put a high value on economic security for all, on preventing anybody falling below a certain level of income, are far more likely to make the professional judgement that market failure is an important problem in an unregulated capitalist economy than are those with a neoliberal social philosophy.

For those who know statistical jargon, it is all a matter of type 1 and type 2 error. Those who believe that positive economics is value free, forget that there is no objective way of deciding whether it is a type 1 or a type 2 error that is more important. It is a matter both of the consequences of each type of error and one's value judgements about the relative undesirability of each set of consequences. It is entirely proper for neoliberals to allow value judgements about freedom to influence their policy prescriptions. It is improper, and more importantly incorrect, for them to claim, even implicitly, that these policy prescriptions flow simply from the laws or theories of economics.

This does not explain why the neoliberal view of the world became so dominant. This is more a question for political scientists, sociologists and social psychologists to answer than economists but let us quickly mention four possibilities. One is what could be called physics envy or the desire to gain for economics the prestige attached to the natural sciences among the public at large. The second is a new generation of young economists wanting to work in a new field, show their elders a thing or two and being attracted by theoretical developments such as rational expectations and efficient markets. The third, and in our view the least important among economists, is the brilliant selling job done by Milton and Rose Friedman. . Finally, there is the argument of Dumenil and Levy (2004) which links the growth of neoliberalism to the rise of the power of the financial sector both nationally and globally[4]

Certainly, the rise of this view was clearly foreshadowed in Kalecki's famous 1943 paper.

3. Neoclassical Myths and the Global Financial Crisis

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, and it will be helpful to quickly review what was different from this in 2007-08. Global financial crisis 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 these investments. 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, see also Harcourt 2001).

While there were other contributing factors, in 2007-2008 there were 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

[4] This was brought to our attention by an anonymous referee.

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 (Kriesler and Nevile, 2009). Indeed, Keynes' own explanation of what occurs in a financial crisis could have been written as a description of the events of 2007/08.

> "It is the nature of organized investment markets, under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yield of capital-assets, that, when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force" (1936, pp 315-6)

Neoclassical myths were crucially involved in this because they supported self-serving arguments by participants in the international finance sector that deregulation of financial markets would produce the best of all possible worlds[5]. A recent paper by Caballero (2010) makes a devastating attack on the conventional macro/finance economics to support the argument that deregulation will enable the market to put national and international economies on a sound footing. The opposite is true. The almost complete deregulation of the international financial system in the western world must be reversed. Arguments in support of this can be made at various levels ranging from informed judgements about current institutions and practices to complex theories about how a capitalist economy works and its implications for the international financial system followed by an evaluation of the evidence supporting such theories.

The first of these approaches approach is not a-theoretical. Ultimately it must rest upon a model of capitalism such as those discussed in the second approach. However, the simpler model of the first approach will suffice, based only on noting both the low level of regulation in the international financial sector, and the intense pursuit of profits (some would say excessive greed) in that sector and then considering the likely effects of this combination. The conclusion is that emphasis on free markets at any cost, which became the mantra of highly paid participants in the finance sector, was both self-serving and bad economics.

In 2000, a Special Session of the United Nations (UN) reviewed and appraised the implementation of the commitments and program adopted by the World Summit for Social Development. As part of the preparation for the meeting, 30 experts from around the world were invited to speak at a UN seminar on how the values underlying social development and those of the market economy fit together. One of the authors of this paper (JWN), attended and predicted that the lack of regulation in the global financial system, together with the belief that the market itself was better able than any intervention by government to cure problems as they arose, was a recipe for a severe crisis in the whole world economy. The seminar as a whole agreed with this prediction and in fact went further arguing, as noted later

[5] Voltaire's panglossian satire is frighteningly appropriate.

in this paper, that reversal of the deregulation of the financial system was necessary for the health of society and not just of that of the economy.

The second approach is beyond the scope of this paper. Taylor (2010) is recommended to those who would like to read such an analysis. However Taylor's own conclusion provides a fitting end to this part of the analysis.

> "Along the lines argued by the French sociologist Pierre Bourdieu, finance theory, with its key assumption of fully efficient, completely deregulated markets, dominated the discourse about financial practices. It supported a 'compilictous silence' that allowed bankers to engage in destabilizing transactions without any criticism being raised. Small wonder there was a crash" (pp. 334-335)

A distinctly American aspect of the role of myths in generating the crisis is the result of the market fundamentalist belief in the efficiency and dynamism of unregulated markets that holds all government intervention hinder economic progress. The increased indebtedness of households, which was one of the features of the current crisis distinguishing it from previous ones, was the direct result of adherence to these neoclassical myths. In this case it was the myth of the market's ability to generate full employment and efficient outcome. This lead to a laissez faire attitude and deregulation of markets, particularly labour and financial markets in the United Sates, reinforced by the commitment to fight inflation even at the expense of employment. The net effect of the "market fundamentals" myth led to stagnant wages and incomes, and to increased inequality: "between 1979 and 2006, the income share of the bottom 40 per cent of US households decreased significantly, while the income share of the top 20 per cent increase dramatically." (Palley 2012 p. 37) Real wages did not increase in the period from the 1970s, so that they were unable to keep up with productivity growth, as Table 1 shows:

Period	Productivity Growth	Hourly Wage growth	Productivity-wage gap
1967-73	2.5%	2.9%	-0.4
1973-79	1.2	-0.1	1.3
1979-89	1.4	0.4	1.0
1989-200	1.9	0.9	1.0
2000-2006	2.6	-0.1	2.7

(Source Palley 2012 p. 37)

Table 1 Wage growth lagged behind productivity growth

Since wages provide the main source for consumer demand, the impact of this was aggregate demand growing much slower than output. The unregulated financial system then played the role of maintaining demand by increasing household debt, to overcome the stagnation tendencies of the neoliberal model. So, in the short run, the combination of these events postponed the crash, but ensured that it was on a much larger scale when it inevitably occurred. A detailed account of the squeeze on real wages and its implications is given in Stockhammer (2011)[6]

4. Policy Implications for the Economy

We argue that at the heart of the correct response to high unemployment, is expenditure on improvements in physical and human capital, with an emphasis on green friendly projects and that this should be financed by borrowing and usually by "borrowing" from the Central Bank (often referred to as "printing money"). This will increase the future 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. With a focus on the medium term, we emphasize that improvements in physical and human capital should continue at all stages of the cycle in economic activity in a counter cyclical manner and, more controversially, that this should be still financed by "borrowing" from the Central Bank. In times of economic activity above the full employment level temporary increases in taxation rates could be necessary to free resources for public sector investment, since this type of public expenditure should be maintained, though not increased during booms. Throughout the whole upswing incomes policies may be necessary. Nevertheless, in the medium term and longer appropriate public sector investment will be self-financing.

The policy package we suggest assumes that there will be infrastructure projects with specifications drawn up and planning permission granted so that they are ready to be brought forward if needed. Even so major infrastructure projects probably will take time to be fully operational. However, when unemployment is severe they are important. They can be targeted at some particular groups of workers, in particular workers in the construction industry whose jobs are usually among those most at risk except in the mildest of recessions. When a slump occurs and major projects are not yet fully operational, small construction projects can be increased. Moreover, expenditure does not have to be on physical infrastructure, only on things that will increase future productivity in the economy or some part of it. For example, much of the administrative work in organising a project to ensure all children are immunised against measles, scarlet fever and whooping cough could be done by providing federal funds to employ people who lose clerical jobs – in practice probably mainly jobs at the less skilled level. If, in a recession, private sector schools and state schools have to reduce or freeze teacher numbers, teachers could be employed in federally funded positions. More and better quality education will add to the productivity of employed workers in the future as well as reducing the numbers of unemployed. Anything that will increase the productivity of the economy and raise living standards will also increase taxation revenues as long as there is no downward change in tax rates.

Previously we had not commented on the remuneration to be paid to those workers drawn into the government sector, often for relatively short periods of time. Following a lead given

[6] Again we are indebted to the referee for drawing this to our attention.

by Philip Harvey[7] we advocate that they be paid the going rate for the job that they are doing including the appropriate wage and associated conditions for casual workers if they are employed on that basis.

A few years ago the Australian Treasury put forward an argument which implies that the type of fiscal policy we envisage is not sustainable in the longer run. The argument can be countered at two levels. The fundamental counter to it is that, as set out above, the expenditure we advocate is self-financing and therefore by definition sustainable. However, even if we ignore this and examine the Treasury's arguments on their own terms these arguments are not sustainable even as a worst case scenario.

The Treasury argued 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[8]. The policy of achieving a budget surplus over the cycle is certainly a sufficient condition to avoid constraints of using budget deficits to counter slumps, but it is not a necessary condition as the Treasury strongly implies by calling it a key element in a sustainable fiscal strategy. A much less draconian policy than this would achieve the same end. Given that over the cycle the Australian economy is growing in real terms and even more in nominal terms, achieving slightly less than a balanced budget over the cycle would maintain a constant ratio of debt to GDP after allowing for cyclical effects. Moreover, in the case of Australia the ratio of debt to GDP is so low that some rises in the ratio could continue for years before the debt to GDP ratio became a problem – see Domar 1944. Table 6 in IMF (2010) lists the Gross Debt to GDP ratios for 2009 in the larger advanced economies. Australia has the lowest at 15.9%. The next lowest is for Sweden at 49.9%. No other country has a ratio below 50%. The Treasury appears to have accepted arguments relevant to counties with very high debt to GDP ratio especially those in the Euro zone where monetary policy and related matters are determined by the European Central Bank. As Sen has pointed out this has led to "the massive destabilisation of human lives in frantic efforts to stabilise the financial markets." (2011, p2). However, as argued above the underlying truth is that, for countries with a central bank, borrowing is only necessary to fund government deficits when output and employment are at levels great enough to cause significant bottlenecks and shortages of labour and capital more generally.

Also and importantly, to ensure that any long-run stagnationist tendencies are minimalized, there needs to be an incomes policy which prevents the growth in wages being below the growth in productivity. Productivity gains, when they are not accompanied by equivalent increases in wages, will lead to problems with demand, unless investment can fill the gap. At the same time, the incomes policy would be important in the case of the economy reaching high enough levels of employment of cause inflationary problems.

If the policies that we recommend are not followed, the result will be a higher level of unemployment, especially long-term unemployment. If, when the economy starts to grow rapidly, the government puts priority on restoring a surplus and reducing the public debt, many of the long-term unemployed will miss out on gaining a job. Labour market programs fit people for jobs, but they do not create jobs for people. In general the long term

[7] See e.g. Harvey (2006), especially footnote 6.

[8] Harcourt 2013 argues that, implicit in this view is the idea of a static (no growth) economy.

unemployed are the last that employers consider when hiring new staff. Often correctly, employers believe that they need to relearn skills and even basic habits required to be a productive employee. The best chance that the long-term unemployed have of getting a job is when rapid growth is restored and every effort should be made to help them achieve this, rather than cutting expenditure to restore a budget surplus. (See Junankar 2011)

As well as helping to ensure that the rising tide of employment does lift all boats and reduce the numbers of long-term unemployed, labour market programs can increase the supply of effective workers and help reduce any inflationary pressure in a boom though of course incomes policy must still play the major role in this respect.

In his final chapter Taylor (2010) makes a strong case that the causes of the crisis of 2007-2009 were financial. He then goes on to say that while more regulation including imposing high capital requirements on large institutions would be desirable, the fundamental policy challenge is to build a firewall to shield the rest of us from the excesses of the finance sector. He makes suggestions about various measures that could play a part. These include a Tobin tax, and a FAT tax on banks' financial activities. He also suggests measures to reduce inequality such as progressive income and capital gains taxes, strengthening unions[9]. His final comment on the possibility of success is

> "all these and similar policies will not be applied unless the world and national economies go through a double movement, towards a more egalitarian and anti-liberal socio-political regime." (p 356).

Perhaps not surprisingly Palley (2012) reaches a very similar conclusion as does Harcourt (2012).

Sen argues that the priority given to the desires of financial markets threatens European democracy.

> "There are profound issues to be faced about how Europe's democratic governance could be undermined by the hugely heightened role of financial institutions and rating agencies, which now lord it freely over parts of Europe's political terrain. ……….
>
> Rearranging the euro zone has to begin with immediately restraining the unopposed power of rating agencies to issue unilateral commands. These agencies are hard to discipline despite their abysmal record, but a well-reflected voice of governments can make a big difference to financial confidence while solutions are worked out, especially if the international financial institutions are supportive.
>
> Stopping the marginalisation of the democratic tradition of Europe has an urgency that is hard to exaggerate. European democracy is important for Europe - and for the world" (Sen 2011 pp. 1-2)

[9] See also Harcourt (2010a) and Kriesler, Nevile and Harcourt (2013)

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