



**The Central Core of
Heterodox Macroeconomics**

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Abstract

The purpose of this paper is to seek to answer the question as to whether there is a common core set of propositions for macroeconomic analysis on which there would be broad agreement amongst heterodox economists. It postulates eight key features of heterodox macroeconomics, and draws out some implications of those features.

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1. Introduction

This paper is founded on the view that there is a common core to which heterodox macroeconomists would generally subscribe, and it seeks to sketch that core and to briefly consider some of the implications particularly in the policy direction. I have avoided the term post Keynesian as a number of the propositions advanced below either do not make an appearance in Keynes's writings or run counter to his analysis (and it enables me to side step the issue of what is post Keynesian, though leaving the question of what are the boundaries of heterodox macroeconomics). A term involving Kaldor, Kalecki and Robinson could be a more appropriate one given the influence of those authors in the development of heterodox macroeconomics.

The paper outlines in the next section what are considered to be the eight key features of a heterodox macroeconomic analysis. The following section draws out three sets of implications from those features. Whilst we would argue that the eight features listed are the central ones, the three sets of implications are intended to be illustrative rather than exhaustive.

2. The key features of heterodox macroeconomics

Heterodox macroeconomics is macroeconomics in the sense described by Pasinetti when he wrote that it is 'not "macro-economic" in the sense of representing a first simplified rough step towards a more detailed and disaggregated analysis. It is macro-economic because it could not be otherwise. Only problems have been discussed which are of a macro-economic nature; an accurate investigation of them has nothing to do with disaggregation. They would remain the same – i.e. they would still arise at a macro-economic level – even if we were to break down the model into a disaggregated analysis' (Pasinetti, 1974). But I would argue that the heterodox approach has always been involved microeconomics in the obvious sense that the behaviours of households, social classes and firms are analysed and modelled. It involves the analysis of monetary capitalist economies in which the future is inherently uncertain (in the sense of Keynes). We argue that there are eight key features in the heterodox approach.

2.1 Aggregate demand

The notion that the level of aggregate demand is key to the determination of the level of economic activity in the short run is shared by a many macroeconomic approaches (including new Keynesian and new consensus in macroeconomics) but not all (the new classical macroeconomics being the obvious example). A crucial element in a heterodox approach is that the level of demand is important for the level economic activity in the long-run (however

that is defined) as well as the short-run, and would thereby deny the approach of the neo-classical synthesis portraying the long-run as characterised by supply side equilibrium (at full employment). A further important aspect is that there are no market forces which could be relied on to propel the level of aggregate demand towards any supply-side equilibrium (or towards any other desired level of economic activity). There is a denial of the operation of relative prices to clear markets or of the real balance effect (in an endogenous money world) as the instrument of adjustment. As Hein and Stockhammer (2007) analyse how private aggregate demand changes in the face of unemployment may depend on the reactions of wages and prices, the change in the distribution of income and the impact which that has on the level of demand. There are numerous ways in which the level of demand impacts on supply and the evolution of supply potential, and this is outlined in section 2.4.

2.2 Role of investment

There has long been agreement in heterodox analysis on the key and dual roles played by investment as a relative volatile component of aggregate demand and the driving force in the savings-investment relationship and as a creative of productive potential. There is, we suggest, broad agreement also on the factors influencing investment, notably profitability as a source of finance and as a spur to capital accumulation, the level and change in capacity utilisation through some form of accelerator mechanism. Investment in effect fuses together the demand and supply side in that it is a component of demand but adds to productive potential. The particular significant aspect of the heterodox approach is that investment responds to on-going events including those impacted by the level of demand (most obviously capacity utilisation) rather than being the way in which the capital stock adjusts to the pre-determined growth path of the economy. ‘The long-run trend is but a slowly changing component of a chain of short-period situations; it has no independent entity’ (Kalecki, 1968, p.263). Further, ‘technical progress is infused into the economic system through the creation of new equipment, which depends on current (gross) investment expenditure’ (Kaldor and Mirrlees, 1962, p.174)

Investment is, of course, undertaken by firms, and hence the amount of investment undertaken depends on the objectives of the firms, their organisation structure and goals as well as the market structure and the competitive framework within which they operate. A significant development in the past two decades or so has been that of financialization (e.g. Epstein, 2005) and the changing relationship between industry and finance. In macroeconomic terms a key aspect of that has been the impact on rate of investment and

capital accumulation (there are, of course, many other important aspects). The prevailing technological paradigm and the opportunities for investment are also relevant.

2.3 *Income distribution*

It is a basic proposition from Kaldor (1955) and Kalecki that the propensity to save out of wages is small (or zero) and out of profits substantial. Kaldor (1955) clearly indicates the relevance of that proposition for the distribution of income between wages and profits, though his analysis is based on an assumption of full employment. The Kaleckian approach views the distribution of income as set by the degree of monopoly, leading to the view that the volume of profits is determined by the spending decisions of capitalists ; the well-known aphorism that ‘workers spend what they earn, capitalists earn what they spend’ summarises this view.¹

The view that the propensity to spend out of wages was much larger than that out of profits led to a stagnationist view, namely that low demand and hence stagnation could result from wage share being relative low thereby depressing consumption demand. The incorporation of the idea that investment depends on profitability and capacity utilisation by Bhaduri and Marglin (1990) along with the differential propensities led to the distinction which they drew between a stagnationist regime and an exhilarationist regime, now more usually referred to wage-led or profit-led regimes. The significance of this approach is that it brings income distribution into a central role in the determination of aggregate demand and the level of economic activity. It also serves as a reminder that shifts in behaviour or in structure – in this case in the differential in propensity to consume and the influence of profitability on investment – can have marked effects on approach to policy. The particular important element of this approach is the view that in a wage-led regime application of the orthodox medicine for unemployment – that is restraint of real wages – becomes counterproductive. The establishment of whether an economy is in a wage-led or profit-led regime then becomes a matter of some importance. Stockhammer and Onaran, for example, conclude on the basis of their empirical work for USA, UK and France that ‘wage reductions are ineffective in combating unemployment, whereas demand matters’ (Stockhammer and Onaran, 2004, p.443). Naastepad and Storm (2006, p. 211) conclude that ‘(1) demand is wage led in France, Germany, Italy, the Netherlands, Spain, and the United Kingdom, and (2) the decline in

¹ Ascribed by Joan Robinson to Kalecki, but not actually to be found in his writings (see Robinson 1966, p. 341).

world trade growth is the dominant cause of sluggish growth in all economies, including profit-led Japan and the United States.’

2.4 *Interdependence of demand and supply and path dependency*

The independence of demand and supply has been a (perhaps the ?) central proposition in mainstream economics, whether at the microeconomic level where the demand and supply curves only interact through the price mechanism with a separation of the factors influencing demand and those influencing supply or at the macroeconomic level. The AD-AS analysis rather replicates the microeconomic demand and supply analysis. The separation of the real and monetary sides of the economy, reflected in the classical dichotomy and the use of the term ‘natural’ ‘to try to separate the real forces from monetary forces’ (Friedman, 1968, following Wicksell). The way in which the growth process has been modelled as converging on the ‘natural rate of growth’ is a further illustration.

The interdependence of demand and supply is closely related with path dependency. The term path dependency is used to emphasise two features. First, the path of the economy is not pre-determined as in neo-classical growth theory (including endogenous growth theory) but is rather built up step by step (reflecting the quote from Kalecki given above). There is much more of an evolutionary aspect. Second, it is used rather than the term hysteresis which tends to suggest a movement from one equilibrium to another, albeit that the equilibrium towards which there is movement is influenced by the path taken.

The mechanisms by which there is path dependency and by which the path of demand opens up the supply future are various but three are generally to the fore. The first one has already been discussed in the context of investment, where it is clear that current demand influences investment which thereby adds to the capital stock. This general idea can readily be extended to a range of investment including that in education and health provision. The second is the way in which people are drawn into or pushed out of the effective labour supply through demand. Participation rates vary, ages of enter into and exit from labour force change and there is regional and international migration. Clearly not all of such changes can be ascribed to pressures of demand as demographics, changes in social attitudes etc are involved. But we would argue the evolution of the labour force cannot be understood without reference to demand. The third comes from the operation of a Verdoorn law type effect and ‘learning by doing’ (and a variety of other forms of learning, e.g. ‘learning by exporting’). The rate of productivity change is then linked with the level of activity in the economy, which itself is determined by the level of demand.

Bhaduri (2006) provides an example of a growth model which fuses together the demand and supply sides. His model is one in which 'both investment and savings decisions exert their influences on the long-run equilibrium growth of output.... While this result is a natural outcome of introducing aggregate demand in the analysis by separating investment from savings decisions, it is the endogeneity of labour productivity growth with increasing returns that provides the main impetus to the growth process on the supply side. A novel aspect of this model is to view the growth in both the real wage rate and in labour productivity as being driven simultaneously by the forces of intra-class competition among capitalist firms over market shares, as well as by inter-class conflict over income shares' (p. 80). Dutt (2006) is a further example with 'a simple model with endogenous technological change in which aggregate demand and aggregate supply both have a role to play and in which long-run growth can be affected by aggregate demand' (p. 331).

2.5 *Money and credit*

The role of money created through the credit system and now labelled endogenous money has been a central element in heterodox macroeconomics for the past quarter of a century, though ideas on endogenous money and the development of the circuitist approach go much further back. Moore (1988) was a major contribution which marked out the way for post Keynesian analysis, and ensured an emphasis was given to the money creation processes². Kalecki (as argued in Sawyer, 2001), Kaldor (1970), Robinson (1956) and others had incorporated an essentially endogenous money approach. Keynesian analysis (in the form of IS-LM) had, of course, proceeded with exogenous money and all that entailed, and it was perhaps only the onslaught of monetarism which required more serious attention be given to the nature and role of money (Kaldor, 1970). Endogenous money becomes a central element for a number of rather diverse reasons. First, the adjustment process which relies on some idea of real balance effect is no longer viable since endogenous money does not constitute net worth; the orthodoxy (in the form of the new consensus in macroeconomics, NCM : see Arestis and Sawyer, 2007) has now adopted some aspects of endogenous money but rely on the wisdom of the Central Bank in the setting of interest rates (at the 'natural rate of interest'). The adjustment process becomes a matter of administrative decision rather than market mechanism. Second, the manner in which loans are provided by the bank system becomes a central question. It is not only that banks hold key to expansion since any refusal on their part of provide loans would limit any expansion. The way in which the inevitable credit rationing

² See Arestis and Sawyer (2006c) for a wide range of essays on heterodox approaches to money and finance.

occurs in terms of who are 'awarded' loans and who are not reflects a wide range of discrimination (gender, ethnicity etc.). The type of sectors (e.g. large vs. small business, high tech vs. low tech) favoured which influence the evolution of the economy in a path dependent world. The terms and conditions on which loans are supplied can also interact with the analysis of financial liberalisation. Instead of the 'loanable funds' approach of McKinnon (1973) and Shaw (1973) in which banks act as intermediaries between savings and investment, the banks provide credit 'off their own bat'.

Third, monetary policy becomes more closely identified with interest rate policy, though interest rate policy has always been the key element in monetary policy even in the hey day of monetarism. But the heterodox analysis suggests that interest rate movements have relatively small effects and points to the need for a broader concept of monetary policy (see Arestis and Sawyer, 2006a).

The focus on endogenous money and credit is highly relevant in many respects, and we highlight two here. First, the behaviour of banks and related credit institutions become important for the economy. Their willingness or otherwise to provide loans and the terms on which they are provided impact on the level and structure of demand. Further, the financial sector is prone to act in ways which generate bubbles and crises : 'instability is determined by mechanisms within the system, not outside it; our economy is not unstable because it is shocked by oil, wars or monetary surprises, but because of its nature' (Minsky 1986, p. 172). Second, any notion of the non-neutrality of money disappears. It is difficult to even envisage what a non-monetary economy would look like in order to judge the neutrality or otherwise of money. But since money comes into existence via the credit process, the ways in which credit is created impacts on investment, and thereby the productive potential of the economy.

2.6 Supply-side of the economy

The supply-side of the economy is viewed as being imperfectly competitive. Enterprises make interrelated decisions on price, output supply and employment offers in light of the demand conditions which they face and their own productive capacity. The determination of wages is represented by a wage curve (based on efficiency wage considerations or on collective bargaining). From the interaction of these price and wage determinations a form of supply-side equilibrium can be derived, which can be seen as forming an inflation barrier. This could be seen as akin to a non-accelerating inflation rate of unemployment (NAIRU). But this inflation barrier differs from the NAIRU in (at least) two major respects. First, it is presented in a manner which seeks to emphasise that the interaction of prices and wages do not take place in what may be described as 'the labour market', and hence the supply-side

equilibrium is not set by the features of the labour market. Instead the emphasis is placed on the role of productive capacity. Second, there is no presumption that the CILO acts as a strong (or even weak) attractor for the actual level of economic activity. There are no market forces which lead the level of aggregate demand to adjust to the CILO.

2.7 Inflation

Inflation is a non-monetary phenomenon in the sense that changes in the stock of money do not determine the rate of inflation in any causal sense, but rather the rate of change of the stock of money (endogenously) adjusts to the pace of inflation. There are a range of factors which impact on the rate of inflation including a struggle over income shares, the level of and rate of changes of the level of aggregate demand and cost-push factors coming notably from the foreign sector (change in import prices and the exchange rate).

A heterodox approach (which we have elsewhere labelled a structuralist approach, Arestis and Sawyer, 2005) concentrates on three key elements in the inflationary process. One set of inflationary pressures comes from the level of demand relative to the size of productive capacity. There is no presumption that there is adequate capacity in an economy to support the full employment of labour, and hence enterprises may be operating at or even above normal capacity with substantial levels of unemployment.

A second and related set of inflationary pressures comes from the inherent conflict over the distribution of income. The ability of the economy to reconcile the conflict depends, *inter alia*, on the productive capacity of the economy. The determination of an inflation barrier (as indeed in the literature on the NAIRU and on the ‘natural rate of unemployment’) involves the notion that wages and prices rise together with the difference in the rate of increase of wages and that of prices being equal to the rate of labour productivity growth. In other words, the distribution of income between wages and profits would remain constant. This serves as a reminder that there are basic conflicts over the distribution of income. If all groups and classes in society were in effect content with the existing distribution of income, then it could be expected that there would not be a problem of inflation: at a minimum it would mean that the rate of inflation was constant. An increase in the rate of inflation can be viewed as arising from some combination of intention of some groups to increase their share of income and enhanced opportunity to do so. A higher level of demand for labour may, for example, be seen as enhanced opportunity for workers to increase their share. But a related higher level of demand for output would allow firms to increase their profits. The ‘conflict theory’ of inflation can be seen as based on this insight.

Third, the level of economic activity depends on the level of aggregate demand, and there is no presumption that the level of demand will generate full employment of labour and/or full capacity utilisation. Investment has a crucial dual role to play through its impact on aggregate demand and through its enhancing impact on capital stock. Further, there is no automatic mechanism, which takes the level of aggregate demand to any supply side equilibrium. Mechanisms such as adjustment of real wages to clear the labour market, or the operation of the real balance effect, are explicitly rejected.

2.8 *Open economy considerations*

The open economy means that the domestic economy is buffeted by events in the rest of the world. There is no reason to think that the domestic economy can be insulated from the rest of the world through smooth adjustments in the exchange rate : hence inflation in the rest of the world impacts on domestic inflation in that it cannot be assumed that some form of purchasing power parity holds under which the nominal exchange rate would move to offset any inflation differential.

It would be generally agreed that there has been considerable volatility of exchange rates (both nominal and real) under the floating exchange rate regime, and that capital related flows, rather than trade related flows, across the exchanges are the dominant factor influencing movements in the exchange rate. It has not been possible to understand the movements in the exchange rate, perhaps other than to say that uncovered interest rate parity does not apply. Whilst the real exchange rate has some mean reverting properties, these do not prevent movements of the order of +/- 25 to 30 per cent in the real exchange rate (and also in the nominal exchange rate given the similarities of inflationary experience across industrialised countries).

Orthodox economics makes much of 'inter temporal budget constraints' and the limitations which they place on the behaviour of individuals and of government. Yet the most significant of those type of constraints, namely that on the country as a whole, has played little role³. In heterodox economics by contrast a variant of such constraints has played a considerable role, notably in the form of balance of payments constrained growth as developed by Thirlwall. The argument is straightforward : as a country cannot borrow more and more on its capital account, this places a constraint on its current account and trade position. Imports and exports

³ It is well-known that a deficit (of whatever kind) of d relative to income will lead to a debt ratio which would stabilise at $b = d/(g - r)$; this requires $g > r$, which may hold for governments (who can borrow at the risk free rate of interest and in effect pay the post-tax rate of interest) but is unlikely to hold in general for individuals or for countries.

of goods and services have to grow at much the same rate, and putting continuous real devaluation to one side, this leads to growth of domestic income = (income elasticity of demand for exports) times growth of world income/income elasticity of demand for imports.

3. Some implications

3.1 Demand management policies

In the heterodox approach, securing a high level of aggregate demand and of economic activity retains a high priority for the usual reasons (including the lowering of unemployment) but also for the longer term effects. There is clearly no presumption that the level of demand will be consistent with a high level of economic activity (nor that there is sufficient productive capacity to employ the available labour). Nor is there any clear market mechanism which would secure the required level of demand. The heterodox approach would tend to view fiscal policy as a much more potent means of securing the high level of demand than monetary policy (Arestis and Sawyer, 2003). The arguments which have been advanced against the use of fiscal policy are based on the assumption that there is no issue over the lack of aggregate demand (Arestis and Sawyer, 2006b) : for example crowding out arguments assume there is something to be crowded out.

3.2 The nature of inflation barriers and policy implications

A key aspect of the prevailing orthodoxy can be summarised in the terms ‘natural rate of unemployment’ (NRU) and ‘non-accelerating inflation rate of unemployment’ (NAIRU)⁴. The significance of those terms is that the emphasis is placed on the labour market (if such exists) as the arena in which the level of unemployment is effectively determined. It is a supply-side concept with the (often implicit) assumption that the level of economic activity will gravitate to that level of unemployment. Further, there is the suggestion that a relatively high level of unemployment is a consequence of poorly functioning, over-regulated, inflexible labour markets.

The heterodox approach has often been viewed in terms that money wages may be settled in the labour market (whether through collective bargaining or not) but real wages are effectively set in the product market through the pricing decisions of firms. This type of view is evident in Keynes (1936) and Kalecki’s analysis of the degree of monopoly which not only is seen to set the distribution of income but also the level of real wages. Whilst accepting that

⁴ The terms are often used synonymously though we would associate the ‘natural rate of unemployment’ with the market-clearing position of a competitive labour market, and hence akin to full employment, and the ‘non-accelerating rate of unemployment’ with imperfectly competitive markets (e.g. Layard, Nickell and Jackman, 1991).

the setting of wages must necessarily be in money terms, and that pricing decisions of firms are significant for real wages, we bring in the effects of workers' aspirations and bargaining power into the determination of any inflation barrier. There is a conflict over the distribution of income, and the inflation barrier represents the position where there is some 'reconciliation' of that conflict.

In market economies, there is often a mismatch between available productive capacity and the labour force and its geographical distribution. Specifically, the zero output gap (where output equals trend output) and the full employment of labour cannot be used interchangeably. Higher levels of employment require more productive capacity. The aligning of productive capacity with the size and distribution of the work force is a major task, which is rarely accomplished. There are generally supply-side (as well as demand-side) constraints on the achievement of full employment of labour. But the nature of those constraints comes from the lack of productive capacity rather than any notion of them arising from inflexible or rigid labour markets. Industrial and regional policies are required to ensure that any inflation barrier is compatible with the full employment of labour. Public expenditure, particularly investment, can also be structured to ease supply constraints. It then follows that policies which may be described as industrial and regional policies are required to address these issues of lack of productive capacity.

3.3 The non-neutrality of money and finance

'Money matters' is a rather bizarre way of summarising monetarism in the sense that while money supply was viewed as a causal factor in inflation, it had no effect on the level of or composition of output and employment. The neutrality of money and the classical dichotomy were central to monetarism and related approaches. In a similar vein the Wicksellian based new consensus in macroeconomics retains a sense of neutrality in that it is based around a 'natural rate of interest' which "is neutral in respect to commodity prices, and tend neither to raise nor to lower them. This is necessarily the same as the rate of interest which would be determined by supply and demand if no use were made of money and all lending were effected in the form of real capital goods. It comes to much the same thing to describe it as the current value of the natural rate of interest on capital" (Wicksell, 1965, p. 102).

It is difficult (impossible) to envisage how a sophisticated market economy would operate without money or finance, and hence the 'benchmark' of a real economy against which the neutrality of money and finance would be assessed is not available. It is clearly possible to write down macroeconomic models without explicit mention of money or finance, as is done in many Kaleckian models. But there is an implicit (and sometimes explicit) view of the

banking system to the effect that loans will be forthcoming to enable investment to be financed and that if loans were not provided then the investment could not occur.

4. Conclusions

The belief which lies behind this paper is that there is a set of propositions which are broadly shared by heterodox macroeconomists. We have sought to sketch out those propositions and to illustrate their significance, and to look at some of the implications of this heterodox approach.

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