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**Article — Published Version**

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Intereconomics

*Suggested Citation:* Heise, Arne (2006) : Market constellations and macroeconomic policymaking: Institutional impacts on economic performance, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 41, Iss. 5, pp. 272-281, <https://doi.org/10.1007/s10272-006-0195-2>

This Version is available at:

<https://hdl.handle.net/10419/41887>

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Arne Heise\*

# Market Constellations and Macroeconomic Policymaking: Institutional Impacts on Economic Performance

*The following article presents a broad outline of a market participation theory of economic policy and attempts to determine how macroeconomic demand management can be used to influence market constellations. On that basis it then inquires into how far macroeconomic governance can be used to explain the different growth and employment performances of selected EU countries.*

Ever since the end of the “golden age”, unemployment has been the most serious and socially least acceptable vice of highly developed capitalist economies. Moreover, ever since that time economists have been asked and expected to provide solutions to cure that vice – a very legitimate demand particularly since a discipline is addressed that often claims to have unveiled the laws of economic interaction as much as natural science has discovered natural laws. In mainstream (Walrasian) economics,<sup>1</sup> the story is rather simple: unemployment must be rooted in the malfunctioning of the labour market. Either the actors directly involved – employers and their organisations or employees and their unions – or the actor providing the legal and institutional framework – i.e. the government or state actor regulating labour markets or providing a social cushion that influences the decisions of the actors that are directly involved – must in some way or the other be blamed for not allowing market forces to do their job. And the bulk of theory providing ever more rationale for disrupting the allocative process of labour markets has become unintelligible: efficiency wage theories, monopolistic union theories, public choice theories and, last but not least, NAIRU theories of different origins fill bookshelves to overflowing.

Common to all such approaches is a microeconomic perspective which is supposed to provide an answer to the question why it may be rational for economic agents not to allow market forces to clear the labour market at the equilibrium real wage level. This kind of research stance can be understood as a reaction to standard Keynesian reasoning of the Hicks-Hansen type, which apparently relied completely on ad hoc rigidities (price and wage stickiness) and seemed

to be irreconcilable with the stagflation period of the late 1970s and which, furthermore, was too hydraulic not to be puzzled as to why governments found it so difficult to restore full employment. In Germany, for instance, the Keynesian “Growth and Stability Act” of 1967 was recognised as helping to overcome the 1966/67 business cycle downturn, but seemed incapable of dealing with the following recessions of the mid-1970s and early 1980s. Under these circumstances, the Keynesian focus on explaining unemployment as a systematic product of uncoordinated market behaviour – not as a temporary failure of markets to behave appropriately – has been almost completely lost: *unemployment as an equilibrium phenomenon*. New Keynesian and post-Keynesian authors from different backgrounds have emphasised the importance of effective demand (constraints) in determining the overall volume of employment (and, hence, unemployment) independent of labour market failures.<sup>2</sup>

It is this New Keynesian or post-Keynesian basis<sup>3</sup> on which the following analysis is built. Firstly, a market

<sup>1</sup> For a reference as to what is meant by “mainstream economics” see e.g. S. Keen: *Debunking Economics, The naked emperor of the social sciences*, London/ New York 2001, here p. 10. Carlin and Soskice refer to the “neoclassical benchmark model”: cf. W. Carlin, D. Soskice: *Macroeconomics. Imperfections, Institutions and Policies*, Oxford 2006, pp. 574 ff.

<sup>2</sup> Income distribution and fundamental uncertainty resulting in liquidity preference considerations play prominent roles in different post-Keynesian approaches; for a quick overview of post-Keynesian theories of unemployment cf. J. E. King: *Labour and unemployment*, in: R. P. F. Holt, S. Pressman (eds.): *A New Guide to Post Keynesian Economics*, London and New York 2001, pp. 65–78. New Keynesian models – sometimes called new neoclassical synthesis (cf. e.g. M. Goodfriend, R. G. King: *The New Neoclassical Synthesis and the Role of Monetary Policy*; in: *NBER Macroeconomics Annual*, Vol. 12, 1997, pp. 231–283; W. Carlin, D. Soskice, op. cit., pp. 81ff.) – are structurally more Walrasian, but produce “Keynesian results” by focussing on institutions and imperfections.

<sup>3</sup> Some important features are: (1) macroeconomic modelling; (2) importance of fundamental uncertainty as opposed to stochastic risks; (3) importance of money as the institution linking present decisions and an uncertain future; (4) a hierarchy of markets running from the financial markets to commodity and labour markets; cf. also M. Lavoie: *Foundations of Post-Keynesian Economic Analysis*, Aldershot 1992.

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participation theory of economic policy will be outlined in very broad strokes and a cooperative approach to macroeconomic policymaking portrayed. This will be needed to determine in what way macroeconomic demand management can be used to manipulate “market constellations” in a systematic, though not hydraulic, way. In a further step, we shall inquire as to how far macroeconomic governance can be used to explain the different growth and employment performances of selected EU countries, or to put it differently: are there differences in the abilities of nations to create favourable “market constellations”?

### The Creation of Favourable “Market Constellations”

Once the idea of a general equilibrium as the natural long-term position of any economy is replaced by the notion of multiple equilibria, unemployment becomes a systematic characteristic of decentralised market economies as opposed to merely being a “market failure”. Therefore, economic policy towards establishing full employment is not solely a functional device of “market repair” but must be established by a political will (normative target) and can only be pursued by way of participating in the market process. Therefore, the political actor(s) is not a subject external to the market participants (objects) but a market participant (object) himself who is constrained by market forces just like any other market participant.<sup>4</sup> Governmental (and other corporatist actors’) interventions will have measurable impacts on quantities and prices, but as any other market participant, the political (or corporatist) actor has finally to accept the market outcome, i.e. cannot *ex ante* discriminate between warranted quantity and unwarranted price effects.<sup>5</sup> However, there are means to reduce the magnitude of this contingency (or lack of sharpness in policy control) by way of introducing (codified) rules and regulations or setting up or stimulating institutions that reduce the available number of options for market participants and, therefore, decrease the uncertainty about future actions. Obviously, there is a trade-off between transaction costs (due to the need to adapt to changing market situations) and uncertainty costs – which leaves the optimal mix of “laissez-faire” and “regulation” open to experience.

<sup>4</sup> The idea of a “market participation theory of economic policy” as opposed to the traditional “market failure theory of economic policy” has been most forcefully put forward by the German post-Keynesian economist Hajo Riese. Cf. H. Riese: *Wider den Dezisionismus der Theorie der Wirtschaftspolitik*, in: W. Vogt (ed.): *Politische Ökonomie heute*, Regensburg 1988, pp. 91-115; H. Riese: *Zur Reformulierung der Theorie der Makropolitik*, in: A. Heise (ed.): *Renaissance der Makroökonomik*, Marburg 1998, pp. 25-39.

<sup>5</sup> As is the case with employment policies. In the case of disinflation policies, the price effects are warranted and the quantity effects are unwarranted, yet again it is impossible to plan them in advance.

Yet, uncertainty-reducing institutions and regulations are much easier to justify in a New Keynesian or post-Keynesian framework than in the neoclassical theory of “market failure”<sup>6</sup> and can help in creating a “market constellation” which is favourable to growth and employment.

Some of these uncertainty-reducing institutions – with particular respect to our purpose – are collective bargaining systems, the institutional settings of central banks and institutional structures to coordinate different independent but interdependent political actors in order to establish an optimal policy mix. Collective bargaining systems provide the necessary “nominal anchor” in modern non-precious metal (fiat money) currency systems; the central bank design is important for securing the scarcity of paper money. Both institutional set-ups reduce the otherwise precarious volatility of (nominal) wages and prices: it has become common sense that there is a strong correlation between the degree of independence of central banks and the inflation performance of an economy on the one hand, and a likewise strong correlation between inflation performance and inflation volatility. There is less agreement about the influence of collective bargaining systems on wage settlements and inflation developments. A very influential study by Calmfors and Driffil<sup>7</sup> proposes a “hump-shaped” link while other evidence<sup>8</sup> argues in favour of a negative correlation: the more decentralised the collective bargaining system, the higher wage settlements and inflation rates will be.<sup>9</sup> Be that as it may, there is no doubt that collective bargaining institutions and the central banking design may impinge in a systematic way on the degree of uncertainty about inflation developments and the valuation of assets.

Only recently, the mutual causality (*Wechselwirkung* in a Kantian sense<sup>10</sup>) of collective bargaining systems and central banking designs has been studied in depth and some “conventional wisdom” about the

<sup>6</sup> J. A. Kregel: *Markets and institutions as features of a capitalist production system*; in: *Journal of Post Keynesian Economics*, Vol. 3, No. 1, 1980, pp. 32-48; G. Hodgson: *Post-Keynesianism and Institutionalism: The Missing Link*; in: J. Pheby (ed.): *New Directions in Post-Keynesian Economics*, Aldershot 1989, pp. 94-123; W. Carlin, D. Soskice, op. cit.

<sup>7</sup> L. Calmfors, J. Driffil: *Bargaining structure, corporatism and macroeconomic performance*, in: *Economic Policy*, No.1, 1988, pp. 14-61.

<sup>8</sup> D. Soskice: *Wage Determination: The Changing Role of Institutions in Advanced Industrialized Countries*; in: *Oxford Review of Economic Policy*, Vol. 6, No. 4, 1990, pp. 36-47.

<sup>9</sup> This relation becomes plausible if we assume strong trade unions at company level (“local pushfulness”) in at least bigger companies and a signalling function of the wage settlements of “key companies” (i.e. bigger, more visible companies).

<sup>10</sup> J. Hicks: *Causality in Economics*, Oxford 1979.

(long-term) neutrality of monetary policy and the “free lunch” assumption of central bank independence has been shaken.<sup>11</sup> Moreover, it has been asked whether it is sensible to delegate half of demand management to an autonomous body such as the central bank<sup>12</sup> – indicating a possible coordination problem between fiscal and monetary policies.<sup>13</sup> Both lines of discussion can be joined by realising that all the actors involved – the political actor, the central bank and the social partners – pursue individual utility maximisation under the constraint of the Phillips curve trade-off,<sup>14</sup> but may (and most certainly will) have different preferences with respect to inflation and unemployment. In a moment, we shall see how this can end up in a policy game which not only leaves the actors involved dissatisfied but also produces a sub-optimal result in terms of overall welfare. Therefore, institutions that produce incentives for the actors involved – i.e. the political actor responsible for fiscal policy, the central bank responsible for monetary policy and the social partners responsible for wage policy – to cooperate may be able to create market constellations – i.e. a macro-economic environment – favourable to growth and employment.

**The Nordhaus Model**

As a three actors game is too complex to be exposed, it will be split into two separate games in which the central bank is the connecting piece. This seems appropriate as it is the central bank’s monetary policy which is the mutual focus of both wage policy and fiscal policy alike, but there is no direct interaction between the latter two. Let us start with the interaction

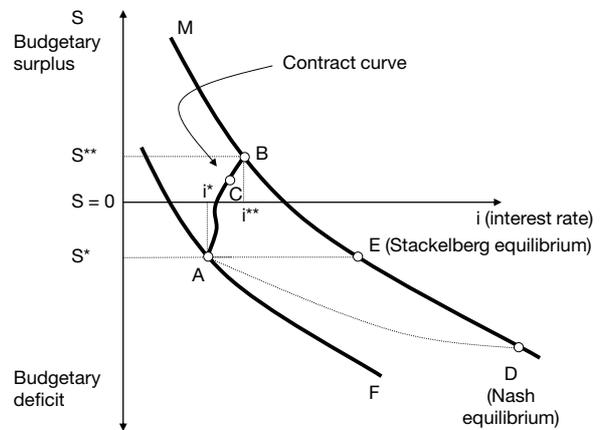
<sup>11</sup> Cf. e.g. R. J. Franzese, P. Hall: The Institutional Interaction of Wage Bargaining and Monetary Policy; in: T. Iversen, J. Pontusson, D. Soskice (eds.): Unions, Employers, and Central Banks, Cambridge 2000, pp. 173-204; A. Cukierman, F. Lippi: Central bank independence, centralization of wage bargaining, inflation and unemployment: Theory and some evidence; in: European Economic Review, Vol. 43, 1999, pp. 1395-1434. The “free lunch” assumption has been particularly discussed by V. Grilli, D. Masciandaro, G. Tabellini: Political and Monetary Institutions and Public Finance Policies in the Industrial Countries; in: Economic Policy, Vol. 13, 1991, pp. 341-392; M. Gärtner: Central Bank Independence and the Sacrifice Ratio: The Dark Side of the Force; in: Swiss Journal of Economics and Statistics, Vol. 133, 1997, pp. 513-538; A. Posen: Central Bank Independence and Disinflationary Credibility: A Missing Link?, in: Oxford Economic Papers, Vol. 50, 1998, pp. 335-359; D. Soskice, T. Iversen: The Non-Neutrality of Monetary Policy with Large Price Setters; in: Quarterly Journal of Economics, Vol. 115, 2000, pp. 265-284.

<sup>12</sup> N. Rankin: Is Delegating Half of Demand Management Sensible?, in: International Review of Applied Economics, Vol. 13, No. 3, 1998, pp. 415-422; S. Power, N. Rowe: Independent Central Banks: Coordination Problems and Budget Deficits; in: Economic Issues, Vol. 3, Part 1, 1998, pp. 69-75.

<sup>13</sup> W. D. Nordhaus: Policy Games: Coordination and Independence in Monetary and Fiscal Policies; in: Brookings Papers on Economic Activity, No. 2, 1994, pp. 139-216.

<sup>14</sup> In the case of the social partners, it is the original Phillips curve (linking nominal wages increases to unemployment) which is important.

**Figure 1**  
**Monetary and Fiscal Policy Game**



of monetary and fiscal policy as portrayed in the Nordhaus model.<sup>15</sup> We assume that:

- the utility functions of both actors include the variables “unemployment” and “inflation”;
- both actors show different preferences with respect to unemployment and inflation (the central bank is more averse to inflation than the political actor);
- there is a (short and long-term) Phillips curve trade-off between unemployment and inflation;
- both actors target a (different) volume of aggregate demand in order to achieve the preferred combination of unemployment and inflation;
- the political actor additionally puts emphasis on the budgetary balance as it provides the means to offer public goods to the electorate (necessary to secure re-election).

In Figure 1, the M and F curves portray the level of aggregate demand which the central bank (M) and the political actor (F) target respectively. They can do so by choosing a policy mix of monetary and fiscal policy, here approximated by the instrument variables *i* (real interest rate) and *S* (budgetary balance): the same aggregate demand can be achieved through a more expansionary monetary policy and tighter fiscal policy (i.e. lower *i* and higher, or more positive, *S*) or, alternatively, through a more restrictive monetary policy in combination with a more expansionary fiscal policy (i.e. higher *i* and lower, or more negative, *S*).

The difference between the M and F curves reflects the autonomous relevance that fiscal policy (budgetary balance *S*) has for the political actor. Points A and B represent the “optimal” combinations of fiscal and

<sup>15</sup> Cf. W. D. Nordhaus, op. cit.

monetary policy as preferred by the central bank and the political actor:<sup>16</sup> as the central bank is more averse to inflation than the political actor, it favours point B at tighter monetary policy and the political actor favours point A at more expansionary monetary policy and higher budget deficits (as an expression of the desire to have more room to manoeuvre). Obviously, points A and B cannot both be realised at the same time: either there is some kind of coordination between fiscal and monetary policy and some point C on the contract curve will eventually be reached<sup>17</sup> or, in the case of conflict (or non-cooperation), we will end up at point D – which is a non-cooperative Nash equilibrium – or at point E, which is a Stackelberg equilibrium. Whether the cooperative point C will be preferred as compared to the non-cooperative points D and E depends on the preference structure of both actors: the more averse to inflation the central bank and the more averse to unemployment the political actor, the less likely it will be that the cooperative point C will be preferred.<sup>18</sup> Or to put it differently, if both actors do not care only for one of the two policy goals of “low inflation” and “high employment”, a cooperative effort will be able to establish a policy mix which both actors prefer to the non-cooperative solutions of the Stackelberg or Nash equilibria.<sup>19</sup> However, such a preferred policy mix will only be achieved if the famous cooperation trap of the “prisoner’s dilemma” can be overcome.

### Role of the Social Partners

Here we are not concerned with the (institutional) incentives necessary to increase the likelihood of cooperation<sup>20</sup> but shall pose the question whether the underlying conflict can be mitigated by bringing the social partners into the picture. Indeed, this would be the case if the social partners were able to prevent inflationary developments (to which the central bank is more averse than the political actor) from accompanying increasing employment (which the political actor favours more than the central bank) – i.e. if they were able to suppress the Phillips curve logic. As the Phillips curve is based on the “original Phillips curve” linking

inversely nominal wage increases to falling unemployment, the social partners may well have a stake in the game. From a large number of studies<sup>21</sup> we know that the potential to control the Phillips curve logic depends on the ability of the social partners to create external effects (i.e. nominal wage claims in excess of the distributional margin given by labour productivity growth and the tolerated inflation rate) and the willingness to internalise such external effects: decentralised collective bargaining systems (acting at company level) are said neither to expose a willingness to internalise external effects nor to have the ability to create such external effects (Calmfors-Driffill case). Centralised collective bargaining systems,<sup>22</sup> in which the social partners (and, most importantly, the trade unions) act as “encompassing organisations”, do have the ability to create external effects but will also be willing to internalise them. They will do so once they have realised that any nominal wage increase will (*ceteris paribus*) be completely passed on to prices and leave real wages unaltered. Intermediate collective bargaining systems (acting at regional or sectoral level), however, have the ability to create external effects, yet they are not willing to internalise them as the effect of the nominal wage increases on the overall price level will be a restricted one (for the restricted scope – regional or sectoral – of their bargaining power) and, hence, enable them to alter their (sectoral or regional) real wage rate.<sup>23</sup> This may also be the case with respect to decentralised collective bargaining systems if we allow for the signalling effects of key companies and “local pushfulness”, i.e. strong and myopic trade unions at company level (Soskice case).

Figure 2 depicts the different settings:  $w_b^*$  is the real wage rate which trade unions (as the crucial side of

<sup>16</sup> For a derivation of the points A, B, C, and D based on preferences, cf. W. D. Nordhaus, *ibid.*

<sup>17</sup> Where exactly on the contract curve such a cooperative point C will come to lie depends on the bargaining position of both actors. This position is determined by the preference structure of the actors.

<sup>18</sup> A. Heise: *New Politics. Integrative Wirtschaftspolitik für das 21. Jahrhundert*, Münster 2001.

<sup>19</sup> The willingness to cooperate can, therefore, be interpreted as a litmus test of whether they really pursue not only a single target policy. Autonomous central banks (and the Bundesbank in particular) have often been accused of pursuing only price stability and neglecting employment and growth completely.

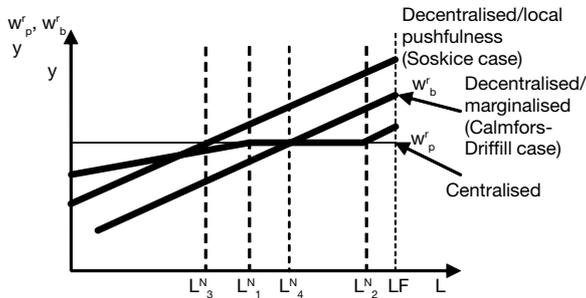
<sup>20</sup> Cf. A. Heise: *New Politics ...*, op. cit.

<sup>21</sup> Cf. e.g. R. J. Franzese: *Macroeconomic Policies of Developed Democracies*, Cambridge 2002; R. J. Franzese, P. Hall, op. cit.; P. Hall: *Central bank Independence and Coordinated Wage-Bargaining: their Interaction in Germany and Europe*; in: *German Politics and Society*, 1994, pp. 1-23; E. Hein: *Monetary policy and wage bargaining in the EMU: restrictive ECB policies, high unemployment, nominal wage restraint and inflation above the target*; in: *Banca Nazionale del Lavoro Quarterly Review*, Vol. 55, 2002, pp. 299-337; OECD: *Economic Performance and the structure of Collective Bargaining*; in: *Employment Outlook 1997*, Paris 1997, pp. 63-92; F. Traxler, B. Kittel: *Bargaining System and Performance: A Comparison of 18 OECD Countries*; in: *Comparative Political Studies*, Vol. 33, 2000, pp. 1154-1190.

<sup>22</sup> Centralisation means that the collusion of heterogeneous interests into credible commitments is possible; i.e. decentralised but highly cooperative trade unions and employers’ organisations may be *de jure* decentralised but act *de facto* as a centralised collective bargaining system in the above sense.

<sup>23</sup> D. Soskice: *Macroeconomic Analysis and the Political Economy of Unemployment*; in: T. Iversen, J. Pontusson, D. Soskice (eds.): *Unions, Employers, and Central Banks*, Cambridge 2000, pp. 38-76, here p. 47, spells out the necessary, yet realistic assumptions: (1) industrial trade unions indeed only care about employment and wages of the labour force in their own sector, (2) they bargain independently.

**Figure 2**  
**Monetary and Wage Policy Game with Independent Central Bank**



the social partners in this argument) are targeting<sup>24</sup> with respect to the level of employment. LF is the labour force which is, for the sake of simplicity, taken as given.  $w'_p$  is the real wage rate which the employers are willing to accept (which is given by labour productivity growth and a mark-up accounting for imperfect competition on commodity markets). In the case of a centralised bargaining system, for a considerable margin trade unions are willing and able to suppress the “Phillips curve logic” – from a level of employment  $L^N_1$  onwards, they will not ask for higher (targeted) real wages but increase the utility of the labour force (as their political aim) by increasing employment. Above employment level  $L^N_2$ , which can be interpreted as the point at which the number of unemployed equals the number of vacancies, real wages will start to increase either through higher collective claims or by way of wage drift. Below employment level  $L^N_1$ , pressure on trade unions will force them to accept lower (targeted) real wage increases than employers would be willing to pay at full employment levels.<sup>25</sup>

Whether a fiscal and monetary policy mix will be able to establish employment level  $L^N_1$  or  $L^N_2$  depends on implicit or explicit coordination mechanisms.

- If an institution – a concerted action or macro-dialogue – empowers the actors involved to commit themselves credibly to pre-established policy rules, the central bank may be willing and forced to allow for a level of aggregate demand which reflects the preferences of the political actor and the social partners –  $L^N_2$  in this case. This may be called “*ex ante*” coordination.

<sup>24</sup> “Targeting real wages” means that trade unions bargain nominal wages under the expectation of price inflation. The assumption is that their expectations are met, i.e. no revision of plans is necessary.

<sup>25</sup> The exact position of  $L^N_1$  depends on the strength of the collective bargaining institutions to suppress the Phillips curve logic in both ways, i.e. to balance externalisation and internalisation.

- If the central bank pursues a monetary policy of “testing the waters”<sup>26</sup> and the political actor and the social partners can bring themselves not to exploit the central bank’s pragmatism,  $L^N_2$  may also be reached – this may be termed the “Fed strategy” for it has allegedly been the policy stance of the US Federal Reserve Board during the 1990s.<sup>27</sup> Almost the same scenario would be imaginable if the political actor were to take the more active (fiscal) policy stance, and the central bank were not to react in a restrictive manner but allow for aggregate demand to increase (i.e. any point on the contract curve in Figure 1).<sup>28</sup> Both cases may be called “*ex post*” or implicit coordination. However, they seem to be very fragile and rather coincidental forms of cooperation.<sup>29</sup> as the incentives for the actors involved not to defect (i.e. not to exploit) are not very strong – that at least is what game theory teaches us.

- If cooperation cannot be established, the central bank will enforce its level of aggregate demand (at Nash or Stackelberg equilibrium) preventing employment from rising above  $L^N_1$  – this may be termed “monopolistic coordination”<sup>30</sup> or the “Bundesbank strategy” for it has allegedly been the policy stance of the German Bundesbank ever since it pursued an independent monetary policy.<sup>31</sup>
- If the central bank were to accommodate any wage and fiscal policy stance,<sup>32</sup> again  $L^N_2$  would be within

<sup>26</sup> A monetary policy stance of “testing the waters” implies a policy of direct inflation targeting with symmetric reaction functions (cf. e.g. P. L. Siklos: Central Bank Behavior, the Institutional Framework, and Policy Regimes: Inflation versus Noninflation Targeting Countries; in: Comparative Economic Policy, Vol. 22, No. 2, 2004, pp. 331-343). “Testing the waters” means that central banks risk expanding monetary policy as long as no inflation potential arises.

<sup>27</sup> U. Bibow: Making EMU work: some lessons from the 1990s; in: International Review of Applied Economics, Vol. 15, 2001, pp. 233-259; E. Hein: Geldpolitik und Lohnverhandlungssysteme in der EWU, in: A. Heise (ed.): Neues Geld – alte Geldpolitik? Die EZB im makroökonomischen Interaktionsraum, Marburg 2002, pp. 199-228.

<sup>28</sup> S. Collignon: The European Republic. Reflections on the Political Economy of a Future Constitution, London 2003.

<sup>29</sup> G. A. Horn: Zur Koordinierung von Geld- und Lohnpolitik. Eine empirische Analyse für die USA und Deutschland; in: W. Filc, C. Köhler (eds.): Macroeconomic Causes of Unemployment: Diagnosis and Policy Recommendations, Berlin 1999, pp. 419-440; U. Fritzsche et al.: Macroeconomic regime and economic development: the case of the USA; in: E. Hein et al. (eds.): Macroeconomic policy coordination in Europe and the role of the trade unions, Brussels 2005, pp. 69-110.

<sup>30</sup> H.-P. Spahn: Zum Policy-Mix in der Europäischen Währungsunion; in: E. Hein, A. Heise, A. Truger (eds.): Finanzpolitik in der Kontroverse, Marburg 2004, pp. 275-304.

<sup>31</sup> E. Hein: Geldpolitik und Lohnverhandlungssysteme in der EWU, op. cit.

<sup>32</sup> In this case, the central bank either shows a low degree of independence or is led by a “populist central banker” (as compared to the “conservative central banker” of price stability orientation).

**Table 1**  
**Unemployment and Inflation in Various Market Constellations**

		Monetary and Fiscal Policy Mix			
		Accommodating	Non-Accommodating – monopolistic coordination (Bundesbank strategy)	Non-Accommodating – <i>ex post</i> coordination (Fed strategy and/or active fiscal policy)	Non-Accommodating – <i>ex ante</i> coordination (Cooperative)
	Co-ordinated	UNR: low ( $L_2^N$ ) INF: medium	UNR: medium ( $L_1^N$ ) INF: low	UNR: low ( $L_2^N$ ) INF: low	UNR: low ( $L_2^N$ ) INF: low
Wage Policy	Non-Co-ordinated	UNR: medium ( $L_4^N$ ) INF: high	UNR: high ( $L_3^N$ ) INF: low – deflationary	UNR: high (SOSKICE) ( $L_3^N$ ) Medium - low (Calmfors-Driffill) ( $L_4^N - L_2^N$ ) INF: low – deflationary	--

reach, yet at a comparably high inflation rate (the exact amount of which depends on the inflation aversion of the social partners).<sup>33</sup>

As is summarised in Table 1, the market constellations look quite different if we focus on decentralised, non-coordinated (company or industry level) collective bargaining systems.

- If the central bank accommodates whichever wage claims and fiscal policy stances arise, the inflation rate will certainly be very high and possibly accelerating. As high inflation rates are typically associated with high inflation volatility, liquidity preference considerations of wealth owners will curtail investment spending, economic growth and employment – hence, employment will be below  $L_2^N$ , but probably above the level which a non-accommodating central bank under “Bundesbank strategy” would enforce;<sup>34</sup> for instance at level  $L_4^N$ .
- An (explicitly) cooperative constellation including a non-accommodating central bank and non-coordinated social partners is hard to imagine as the number of actors (particularly on the side of the social partners) is too numerous for a strategic and credible commitment.
- In the case of a non-accommodating central bank, the result will be high unemployment ( $L_3^N$ ) in combi-

nation with low inflation whatever the central bank strategy is. This is at least true as long as we assume an intermediate bargaining level (industry or region) or “local pushfulness” at company level (i.e. the Soskice case).

- Only under the condition of “marginalised”, decentralised social partners (i.e. the Calmfors-Driffill case) and a “Fed strategy”, may employment rise to levels between  $L_4^N$  and  $L_2^N$  – the exact position of the  $w_b^r$  curve (in Figure 2) depends on the extent of “marginalisation”.<sup>35</sup> Nevertheless, this is likely to be an unstable constellation once disinflationary developments turn into a deflationary process due to the lack of a nominal anchor.<sup>36</sup>

Table 1 captures possible outcomes for employment and inflation under different market constellations which depend on collective bargaining systems, central banking designs and explicit or implicit mechanisms of coordination between the key macroeconomic policy fields. Assuming that the individual members of a society receive positive utility from low inflation and high employment (or, rather, low unemployment), it becomes clear that a non-accommodative monetary policy, either under the “Fed strategy” or in cooperative orientation, coupled with a centralised collective bargaining system, provides the best and preferred market constellations. However, these results merely show that macropolitics matter as much as the insti-

<sup>33</sup> V. Guzzo, A. Velasco: The case for a populist Central Banker; in: European Economic Review, Vol. 43, 1999, pp. 1317-1344; R. J. Franzese, P. Hall, op. cit.

<sup>34</sup> It must be admitted that this is a very risky statement – above all based on empirical observations (cf. R. J. Franzese, P. Hall, op. cit. here p. 195). Whether an accommodating central bank is able to provide market constellations that are more favourable to growth and employment than the market constellations provided by a non-accommodating central bank under the “Bundesbank strategy” may well depend on the extent of “local pushfulness” of decentralised social partners and the degree of uncertainty about whether this scenario may turn into accelerating inflation.

<sup>35</sup> “Marginalisation” would be complete – and thus, the  $w_b^r$  curve would cut the  $w_p^r$  curve at point  $L_2^N$  – if the actors on the labour market were pure “price takers”.

<sup>36</sup> It needs to be remembered that there may be an equilibrium real wage rate at  $w_b^r = w_p^r$  but definitely no equilibrium nominal wage rate. Yet, the ghost of deflation can possibly be banned if demand management can be used efficiently to control employment levels and/or if downward barriers to nominal wage drops – such as effective minimum wages – are introduced.

tutional setting makes a difference.<sup>37</sup> But it should not be forgotten that these results are “normative” in the sense that they solely mark out the ability of the political actors to govern. In no way do they positively prove to what extent actual governments and corporate actors use their room for manoeuvre. In the following, we shall explore empirically the extent to which differences in macroeconomic performance can be explained by different macropolitical governance.

**Macroeconomic Governance and Economic Performance**

As the focus of our investigation will be on monetary, fiscal and wage policy under particular external conditions, and as we have established that the institutional embeddedness of macroeconomic governance is crucial for the understanding of the room for manoeuvre and the creation of market constellations, a multi-country cross-comparison does not seem an appropriate method to capture the differences in performance, as the implicit non-linearity of instrumental relations will be better recorded by a narrative approach.<sup>38</sup> Moreover, it seems more appropriate to focus on a few countries only rather than on country clusters (“models” or “regimes”) as has become common in modern social science<sup>39</sup> since different macroeconomic market constellations may well cut across different “models”. The selection of such countries follows the comparativistic research designs<sup>40</sup> “most

<sup>37</sup> U. Fritzsche et al.: *Wirtschaftliche Regime westlicher Industrielandern. Unterschiede, Wachstumsperspektiven und wirtschaftspolitische Optionen in ausgewählten Ländern*, Abschlussbericht eines Forschungsprojektes der Hans Böckler Stiftung, Berlin 2005, also name the “external economic scenario” as a cornerstone of a particular market constellation. Although exchange-rate developments may clearly impinge on the growth and employment performance of a country (as we shall see later) and may also cause monetary and wage policy reactions, I have so far not explicitly included the “external economic scenario” into my investigation for one reason: for the longest time in the period under investigation, the exchange rates among EMS countries had no instrument status as they were fixed among each other. However, real exchange rates, being influenced by the wage policy of the social partners, may well be a strategic variable particularly in small, open economies in fixed currency systems.

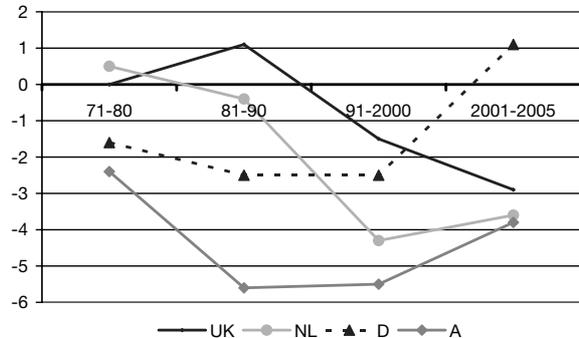
<sup>38</sup> For an introduction to the “narrative approach” in comparative economics cf. J. A. Miron: *Empirical methodology in macroeconomics. Explaining the success of Friedman and Schwartz’s ‘A monetary history of the United States 1867 – 1960’*; in: *Journal of Monetary Economics*, Vol. 34, 1994, pp. 17-25; D. N. McCloskey: *If Your’re so Smart: The Narrative of Economic Expertise*, Chicago 1990; D. N. McCloskey: *Knowledge and Persuasion in Economics*, Cambridge 1994. As compared to highly sophisticated econometric analysis, which may be an important tool in “data-mining”, the narrative approach is better able to study complex interactions in detail, to identify critical junctures and non-linearities (as may be expected in our case).

<sup>39</sup> Cf. e.g. G. Esping-Andersen: *Three Worlds of Welfare Capitalism*, Princeton 1990; B. Amable: *The Diversity of Modern Capitalism*, Oxford 2003.

<sup>40</sup> For the methodology of comparison as “quasi experiment” cf. e.g. M. Dogan, D. Pelassy: *How to Compare Nations*, Chatham 1984; P. R. Gregory, R. C. Stuart: *Comparative Economic Systems*, Boston 1999; A. Przeworski, H. Teune: *The Logic of Comparative Social Inquiry*, New York 1970.

**Figure 3**  
**Comparative Unemployment Development in Four EU Member States**

(Difference between unemployment rates and EU-15 average)



Sources: European Economy, Statistical Annex, autumn 2005; own calculations.

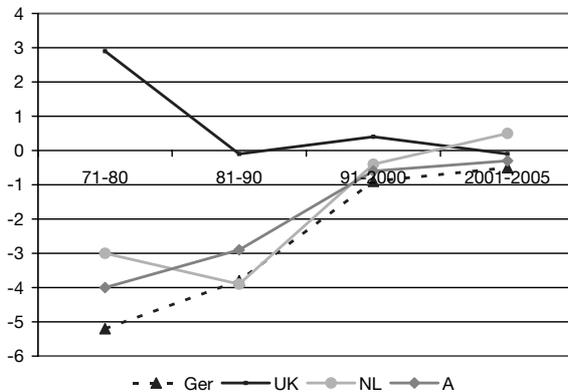
similar with different outcome” and “most different with similar outcome”. As can be seen from Figure 3, Germany, the Netherlands and Austria show rather different labour market outcomes in terms of the level and development of unemployment, yet they are ordinarily clustered as “coordinated market economies”<sup>41</sup> showing very similar labour market (allocational system) and welfare state institutions (distributional system). While Austria experienced an above-average employment trend over the whole period under investigation (with only a slight divergence since the beginning of the last decade), Germany’s trend was much closer to the EU-15 average for the first three decades and has sharply moved below average (i.e. showing higher unemployment) since the beginning of the last decade. The Netherlands, moreover, produces a very average result during the first two decades under investigation only to move sharply above average during the 1990s and to keep that position ever since.<sup>42</sup> And the United Kingdom reveals a quite similar outcome to the Netherlands despite considerable differences in labour

<sup>41</sup> The distinction “coordinated market economies” and “liberal market economies” is borrowed from P. A. Hall, D. Soskice (eds.): *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage*, Oxford 2001. Quite similar distinctions are called “corporatist model” versus “liberal model” or “Rhenish model” versus “Anglo-American model” (cf. D. Soskice: *Divergent production regimes: coordinated and uncoordinated market economies in the 1980s and 1990s*, in: H. Kitschelt et al. (eds.): *Continuity and Change in Contemporary Capitalism*, Cambridge 1999, pp. 101-134; M. Albert: *Capitalism versus Capitalism*, New York 2001) or “Keynesian welfare national state” versus “Schumpeterian competitiveness state” (cf. B. Jessop: *The Future of the Capitalist State*, Cambridge 2002).

<sup>42</sup> Apparently, the EMU countries Germany, the Netherlands and Austria have all done worse (to differing degrees) than the non-EMU country UK – one is tempted to establish a link to the budgetary policy rule of “zero deficits” enshrined in the European Stability and Growth Pact. As experience is still too short, this cannot be tested here but clearly shows that the institutional settings marking a relevant market constellation must be expanded in future research to budgetary policy designs (such as the “golden rule” versus “zero-deficit rules”).

**Figure 4**  
**Comparative Inflation Development in**  
**Four EU Member States**

(Difference between inflation rates and EU-15 average)



Note: Inflation as measured by final consumption deflator

Sources: European Economy, Statistical Annex, autumn 2005; own calculations.

market and welfare state institutions which commonly group it with the “liberal market economies”.

With respect to inflation (cf. Figure 4), the three continental EU members (as “coordinated market economies”) show a very similar development: during the 1970s and 1980s, price stability was clearly higher than the EU average – yet the Netherlands improved its record during the 1980s after having fixed the Dutch guilder to the deutschmark and the legendary “Wassenaar accord” in 1982. During the 1990s and the first half of the following decade, a marked trend towards price stability convergence can be detected – partly a worldwide phenomenon of growing importance attached to price stability, partly a European phenomenon on the “Maastricht road” to European Monetary Union. The UK (as a “liberal market economy”) differs with respect to the early decades under investigation but has joined the “price-stability gang” since the 1990s.

In the following, two questions will be posed.

- Are the comparative unemployment and inflation developments (compared to the EU-15 average) explicable in terms of different market constellations created by distinguishable macropolitical governance?
- Do these results positivistically match the normatively derived hypothesis summarised in Table 1?

It must be remembered that a possible mismatch does not necessarily reject the underlying theoretical frame but may indicate that political and corporatist

actors may refuse to use their room for manoeuvre. In any case, a mismatch would demand further investigation.

Let us start by putting the selected countries into the frame of probable market constellations provided by Table 1. Before we can do so, we have to qualify the monetary policy stance of each country as to whether it must be judged to be “non-accommodative” or “accommodative”, and if it is non-accommodative, whether it follows the asymmetric “Bundesbank strategy” or the symmetric “Fed or cooperative strategy”. Additionally, we shall have to qualify the collective bargaining systems with respect to their degree of corporatism<sup>43</sup> and “marginalisation”.<sup>44</sup> Numerous studies<sup>45</sup> have provided different indices to measure monetary policy orientations. Although the focus of each study differs with respect to the legal, institutional or functional independence of central banks, they all claim to measure the “conservativeness” of central bankers concerning the priority given to price stability against alternative targets (e.g. employment and growth). Or to put it differently, the more conservative a central bank, the more non-accommodative its policy orientation. However, there is a major problem with all these indices: they do not take into account that legally, institutionally or functionally dependent central banks may, nevertheless, pursue a non-accommodative policy by pegging the exchange-rate of their currency irrevocably to some other currency.<sup>46</sup> However, this is very important in the case of our country sample, where the Netherlands and Austria completely pegged their currencies to the deutschmark, leaving no room whatsoever for discretion. The Austrian Oesterreichische Nationalbank (OENB) handed monetary policy over to the Deutsche Bundesbank in 1976, the Dutch central bank – De Nederlandsche Bank (NLB) – followed in 1984, implying that their respective monetary policy stance can henceforth only be judged as “non-accommodative/Bundesbank strategy”. Even prior to 1976, the OENB was seen as fairly independent (non-accommodative) while prior to 1984 the NLB was definitely more accommodative than the Bundesbank

<sup>43</sup> “Corporatism” or, synonymously, “coordination”, means the *de facto* ability to behave as “encompassing organisation” as compared to the *de jure* degree of centralisation of a bargaining system.

<sup>44</sup> Cf. footnote 39.

<sup>45</sup> Cf. e.g. A. Alesina, L. H. Summers: Bank Independence and Macroeconomic Performance: Some Comparative Evidence; in: Journal of Money, Credit, and Banking, Vol. 25, No. 2, 1993, pp. 151-162; V. Grilli, D. Masciandaro, G. Tabellini, op. cit.; A. Cukierman: Central Bank Strategy, Credibility and Independence, Cambridge 1992; T. Iversen: Contested Economic Institutions, Cambridge 1999.

<sup>46</sup> Cf. e.g. John B. Goodman: Monetary Sovereignty: The Politics of Central Banking in Western Europe, Ithaca 1992.

(resulting in a continuous fall of the Dutch gilder relative to the deutschmark). After pegging their currencies to the deutschmark, the “macroeconomic policy game” changed in the Netherlands and Austria: neither fiscal nor wage policy had to take monetary policy actions into account when fixing their policy stance. While wage policy in both countries was embedded in an institutional framework<sup>47</sup> in order to secure (international) competition-led wage settlements, fiscal policy was free to target employment or alternative goals (e.g. fiscal consolidation). The British Bank of England (BoE) was only granted (instrumental) independence in 1998 by the New Labour government under Tony Blair. Until then, it was a subordinated part of the Treasury, which was commonly translated into a (very) accommodative monetary policy stance. However, monetary restriction as part of the monetarist macroeconomics favoured by Margret Thatcher’s governments since 1979 can hardly be described as “accommodative”. Yet, as monetary and fiscal policies were still combined in the hand of a unitary actor (the Treasury), no non-cooperative strategic policy game was to be feared and a strategic policy-targeting (breaking inflation expectations in the 1980s, stabilising aggregate demand and employment in the 1990s<sup>48</sup>) was still possible.

It seems easier to place the selected countries in the “coordinated-non-coordinated” range of collective bargaining systems. Although many studies<sup>49</sup> claim Germany and the Netherlands legally to have intermediately centralised bargaining systems (with a dominant industry bargaining level), the high coverage rate (80-90%) and cooperative organisational structures within the employers’ and employees’ organisations allow us to group them alongside Austria as “coordinated collective bargaining systems”, while the UK must be regarded as “uncoordinated” (with dominant company bargaining level). Moreover, there are signs that the “local pushfulness potential” of company-level actors has suffered during the reforms of the Thatcher

administration<sup>50</sup> and we have come a long way down from the “Soskice case” towards the “Calmfors-Driffill case”.

Taking into account that the figures in Table 2 show averages over periods of different length and start from different levels,<sup>51</sup> there seems to be no obvious mismatch between the hypothetical levels of inflation and unemployment in different market constellations and the empirical picture of the selected countries: the continental economies of Germany, Austria and the Netherlands combining a non-accommodative Bundesbank strategy with highly coordinated collective bargaining systems have done considerably better in both inflation and employment performance<sup>52</sup> than the UK and its non-coordinated bargaining system in the realm of monetarist non-accommodative monetary orientation since the 1980s. Yet, the UK has seemingly gained from its move to a more Fed-like central bank design since the early 1990s and changes in wage-setting behaviour in line with the Calmfors-Driffill case.<sup>53</sup> However, presupposing the developments portrayed in Figures 3 and 4, it remains to be clarified why the Netherlands did not do better, particularly with respect to unemployment, during the period until 1984, and why Germany has been doing so badly in recent times<sup>54</sup> – both of which are not quite explained by the predetermined market constellations.

### Conclusion

This paper has only made a start to explaining and assessing economic policymaking in the analytical framework of market participation and the creation of market constellations. It has been argued that a set of institutional, cultural and political factors form peculiar

<sup>47</sup> In the Netherlands, the tripartite “Socio-Economic Council” and the bipartite “Stichting van de Arbeid” must be mentioned, in Austria it is the tripartite “Economic and Social Council”. At this point, we will simply ignore the specific institutional designs and incentive systems.

<sup>48</sup> For the sequencing of economic policy during the Thatcherite monetarist reforms cf. e.g. P. Minford: *Mrs. Thatcher’s Economic Reform Programme – Past, Present and Future*; in: R. Skidelsky (ed.): *Thatcherism*, London 1988; N. M. Healey (ed.): *Britain’s Economic Miracle – Myth or Reality?*, London/ New York 1993.

<sup>49</sup> P. Schmitter: *Interest Intermediation and Regime Governability in Contemporary Western Europe and North America*; in: S. Berger (ed.): *Organizing Interests in Western Europe: Pluralism, Corporatism and the Transformation of Politics*, Cambridge 1981, pp. 287-327; L. Calmfors, J. Driffill, op. cit.; D. Cameron: *Social Democracy, Corporatism, Labor Quiescence, and the Representation of Economic Interest in Advanced Capitalist Society*; in: J. H. Goldthorpe (ed.): *Order and Conflict in Contemporary Capitalism*, Oxford 1984, pp. 143-178.

<sup>50</sup> A. Heise: *Grenzen der Deregulierung*, Berlin 1999. A. Glyn, S. Wood: *New Labour’s Economic Policy*, in: A. Glyn (ed.): *Social Democracy in neoliberal Times*, Oxford 2001, pp. 200-222.

<sup>51</sup> The UK, for instance, displays an unemployment rate of 3.8% on average during the period 1970 – 1979 and 7.0% on average during the period 1990 – 2004. The former is assessed as “medium” while the latter is assessed as “medium to low” – which seems odd. Yet 3.8% during the first period was, after the “golden age” of the 1960s, just about European average, while 7.0% is, after the stagflation period of the 1970s and stagnation of the 1980s, well below the European average and, particularly, masks a rapidly falling trend.

<sup>52</sup> Both dimensions are often combined to form the “misery index”.

<sup>53</sup> R. Barrell, M. Weale: *Designing and Choosing Macroeconomic Frameworks: The Position of the UK after 4 years of the Euro*, National Institute of Economic and Social Research Discussion Paper No. 212, London 2003.

<sup>54</sup> A politico-economic interpretation is given in A. Heise: *The Political Economy of Meritocracy. A Post-Kaleckian, Post-Olsonian approach to Unemployment and Income Inequality in modern varieties of capitalism*, Working Papers on Economic Governance No. 16, Department of Economics and Politics at Hamburg University, 2005; and A. Heise: *German Social Democratic Economic Politics in the Light of Agenda Theory*; in: *Intervention – Journal of Economics*, Vol. 2, No. 2, 2005, pp. 131-151.

## MACROECONOMIC GOVERNANCE

**Table 2**  
**Unemployment and Inflation in Different Market Constellations – Hypothesis and Reality**

		Monetary and Fiscal Policy Mix				
		Accommodating	Non-Accommodating – monopolistic coordination (Bundesbank strategy)	Non-Accommodating – <i>ex post</i> coordination (Fed strategy and/or active fiscal policy)	Non-Accommodating – <i>ex ante</i> coordination	
		<b>Prediction:</b> <b>UNR: low</b> <b>INF: medium</b>	<b>Prediction:</b> <b>UNR: medium</b> <b>INF: low</b>	<b>Prediction:</b> <b>UNR: low</b> <b>INF: low</b>	<b>Prediction:</b> <b>UNR: low</b> <b>INF: low</b>	
Co-ordinated	Country: <i>Netherlands</i> <i>(until 1984)</i>	NL UNR:6.0 INF: 6.5	Country: <i>Germany</i>	Ger UNR:5.1 INF: 3.2	Country: <i>Austria</i> <i>(since 1976)</i>	<b>A</b> <b>UNR: 3.3</b> <b>INF: 3.2</b>
					<i>Netherlands</i> <i>(since 1984)</i>	<b>NL</b> <b>UNR: 5.5</b> <b>INF: 1.8</b>
Wage Policy	Prediction: UNR: medium INF: high		Prediction: UNR: high INF: low – deflationary	Prediction: UNR: high (SOSKICE) Medium - low (Calmfors-Driffill) INF: low – deflationary		
	Country: <b><i>United Kingdom</i></b> <b><i>(until 1979)</i></b>	<b>UK</b> <b>UNR:3.8</b> <b>INF:14.0</b>	Country: <b><i>United Kingdom</i></b> <b><i>(during 1980s)</i></b>	<b>UK</b> <b>UNR:9.6</b> <b>INF:6.3</b>	Country: <b><i>United Kingdom</i></b> <b><i>(since 1990s)</i></b>	<b>UK</b> <b>UNR: 7.0</b> <b>INF:3.0</b>

Notes: ***Italic-bold*** = country example (*hypothesis*); **bold** = empirical average; UNR = standardised unemployment rates; INF = GDP-deflator; figures show averages since 1970 (or as otherwise stated).

Sources: European Economy, various issues; own calculations.

market constellations if they show some persistence. These market constellations may, on the one hand, explain the exact position of an economy where the theoretical foundation – e.g. a post-Keynesian model – is merely able to describe multiple equilibrium positions. On the other hand, market constellations may also be shaped by institution-building and may, thus, reduce the magnitude of contingency in policy control without propagating the idea of hydraulic policy control, i.e. formability (*Gestaltbarkeit*) without Cartesian creatability (*Machbarkeit*).

Of course, there are still many more questions to pose and answer. Can the general impression given in Table 2 be confirmed once a more detailed empirical investigation follows? If a non-accommodative monetary policy orientation mixed with a coordinated collective bargaining system establishes a market constellation most favourable to general welfare, which institutional setting may guarantee that a cooperative

or Fed strategy systematically prevails as opposed to coincidental outcomes depending on personal attitudes (of central bankers)?<sup>55</sup> Are more uncoordinated collective bargaining systems really prone to instability (the UK experience over the past decade seems to suggest a less sceptical outlook).<sup>56</sup> Or are there institutional incentives not yet detected? Can different budgetary policy designs (i.e. “zero-deficits rules” versus “golden rules”) be identified and integrated into the market constellation framework? If market constellations only provide the room for manoeuvre, which institutional incentives can be given to ensure that any room for manoeuvre will be used?

Research into market constellations and macroeconomic policymaking is work in progress. However, eventually it may fill the wide gap between nomocratic policy denial on Hayekian premises and teleocratic policy euphoria on (standard) Keynesian premises which has led the theory of economic policy into disarray for the past three decades.

<sup>55</sup> There is a long tradition on attributing considerable importance to such personal factors; cf. e.g. B. M. Friedman: Should there be an Independent Monetary Authority?; in: L. B. Yeager (ed.): In Search of a Monetary Constitution, Cambridge Mass. 1962; G. Toniolo (ed.): Central Banks' Independence in Historical Perspective; Berlin/ New York 1988.

<sup>56</sup> Cf. e.g. A. Glyn: The British Economy: A Growth and Employment Miracle?; in: Intervention – Journal of Economics, Vol. 2, No. 2, 2005, pp. 40-45.