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"New Consensus," New Keynesianism, and the Economics of the "Third Way"

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1. INTRODUCTION

In this paper we seek first to set out the economic analysis which underpins the ideas of what has been termed the "third way." Notions of the "third way" were much discussed in the early days of the Blair government in the UK and the Schroeder government in Germany. The explicit mention of the "third way" has been much diminished, but we would argue the ideas continue to influence those governments (and more broadly other governments, and of the European Union). We argue that the ideas of the "third way" are closely related with "new Keynesian" economics. The paper then focuses on some particular aspects of new Keynesian economics and its emphasis on the role of monetary policy and the downgrading of fiscal policy. There has emerged a so-called "new consensus" on macroeconomic policy (specifically monetary policy), and we regard this as an outgrowth of new Keynesian economics. We review this "new consensus," and argue that the empirical evidence on the operation of monetary policy reveals that such a policy is rather impotent. Insofar as it does have an effect, it operates to influence the level of investment, which in turn affects future level and distribution of productive capacity. Thus, contrary to the prevailing view, monetary policy is not an effective way to control inflation, but can have effects on the real side of the economy. The lack of attention to fiscal policy and the over-emphasis on monetary policy leaves the European Union and its member countries without the means to tackle any serious recession or any upsurge of inflation. In section 2 we review the theoretical foundations of the "third way" before we provide a lengthy discussion of the new Keynesian Economics and the "new consensus." The macroeconomic policies of the "new consensus" are the focus of the section that follows, before we summarize and conclude in the final section.

2. THEORETICAL FOUNDATIONS OF THE "THIRD WAY"[1]

It is unlikely that economic policy pursued by any government is fully consistent either internally or with some theoretical paradigm. However, in view of the approach adopted by those governments that purport to follow the "third way," it can be thought of as embedded in the new Keynesian economics paradigm. We argue that the approach can be viewed as new Keynesian through its emphasis on the supply-side determined equilibrium level of unemployment (the "natural rate" or the non-accelerating inflation rate of unemployment, the NAIRU), its neglect of aggregate or effective demand, and of fiscal policy, the elevation of monetary policy, the concern over the "credibility" of economic policies (Brown, 2001, for example), and its adoption of the assumption of rational expectations,. The microeconomic notion of "market failure" can also be interpreted to support significant government intervention when "market failures" are viewed as widespread. "Market failure" is viewed as arising from the existence of externalities, the "public good" nature of some goods and monopoly, and the emphasis on

training and education by the new Labor government (and others) can be seen in this light of the government provision or encouragement of activities which would be under-provided by the market.

We postulate that the economics of the "third way" can be understood as based on the eight elements listed below which we would argue justify the description of a new Keynesian variety (see, also, Giddens, 2000; Hutton, 1998). The eight elements which we see as underlying the economics of the "third way" are as follows:

(i) The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilize the market economy. Markets, and particularly the financial markets, make well-informed judgments on the sustainability of economic policies, especially so in the current environment of open, globalized, capital and financial markets.

(ii) Monetary policy can be used to meet the objective of low rates of inflation (which are always desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates).[2] However, monetary policy should not be operated by politicians but by experts (whether banks, economists or others) in the form of an "independent" Central Bank.[3] Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long term loss (higher inflation). An "independent" Central Bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.[4] It is argued that a policy which lacks credibility because of time inconsistency is neither optimal nor feasible (Kydland and Prescott, 1977). The only credible policy is the one that leaves the authority no freedom to react to developments in the future, and that even if aggregate demand policies matter in the short run in this model, a policy of non-intervention is preferable. It is precisely because of the time-inconsistency and credibility problems that monetary policy should be assigned to a "credible" and independent Central Bank which should be given as its sole objective that of price stability.

(iii) The level of economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labor market. The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long-run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In this long-run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of interest. Monetary policy and thereby inflation policy is in the hands of central bankers. Control of the money supply is not an issue, essentially because of the instability of the demand for money that makes the impact of changes in the money supply a highly uncertain channel of influence.

(iv) The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the (long run) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU). Fiscal policy has a passive role to play in that the budget deficit position varies over the business cycle in the well-known manner. The budget (at least on current account) can and should be balanced over the course of the business cycle.

(v) The market system involves "market failure" in the neo-classical sense of the term. Markets do not reach an optimum outcome because of the presence of externalities, public and quasi-public goods (that is goods which are non-rivalrous in use and non-excludable), and monopoly situations. The policy conclusion is straightforward, namely that government seeks to correct externalities through appropriate taxation, subsidy and regulation, makes provision for "public goods" either itself or through paying the private sector to provide the goods, and competition policy can be used to reduce or restrain monopoly positions. This idea is, of course, not unique to the "third way," and has been a central element in conventional welfare economics.

(vi) Long-run growth in income per head depends on investment decisions rather than, as in traditional growth theory, on exogenous improvements in technology. Human capital is also seen as particularly important, and since the public sector is a heavy provider of education, and education adds to human capital, the public sector is again seen to play a significant role in growth. Endogenous growth theory also postulates that there are overall increasing returns to scale, but that includes some factors of production which are not privately owned. Knowledge and information, for example, add to productive potential but are not generally privately owned. These "public goods" (in the technical sense of being non-excludable and non-rivalrous) will generally be under-provided by the private sector, and the public sector has a role to play in providing them or encouraging their provision. In effect, endogenous growth theory again points to the role of the State in terms of the correction of market failure, and specifically in this context the provision or subsidy of "public goods," with research and development, education and training being the major examples.

(vii) Inequality is a further element of some significance. In the economics of "third way" there is concern over inequality of outcome rather than inequality of possibilities (see, also, Giddens, 1998). Inequality of outcome could be seen to be addressed through a progressive tax system and a redistributive social security system. Inequality of outcome can be addressed through education and training (initial endowments), through "employability" policies (for inclusion in the labor market and employment), and through seeking to change the rewards offered by the market. With the exception of the national minimum wage, it could be said that there has been little attempt to modify the rewards thrown up by the market. As Giddens (1998, p. 101) notes, a "winner takes all" element in parts of the labor market means large inequalities. But also Giddens (2000) perceives that "incentives are necessary to encourage those of talent to progress and that equality of opportunity typically creates higher rather than lower inequalities of outcome" (p. 86). It could be argued, though, that inequality of opportunity acts as a barrier for many to fulfil their potential. Those disadvantaged do not forego education because of a lack of incentives in terms of higher pay for the more educated but because of a range of barriers to their doing so. Greater opportunity would be expected to increase the supply of the well trained etc., and reduce the pay of the well trained relative to the pay of the untrained.

(viii) The final aspect refers to globalization. The rising ratio of international trade relative to GDP (at least again by way of comparison with the ratios of the "golden age" of capitalism in the 1950s and 1960s) and the increased role of foreign direct investment by transnational corporations is an accepted (and indeed welcomed) "fact of life" (see, also, Giddens, 1998, 2000). "Third way" perceives globalization as having virtually eliminated the possibilities of industrial policy (other than competition policy) and of macroeconomic policy. The mobility of industrial and financial capital is seen to preclude independent national economic policies in these regards. However, the nation state still has a role to play, though there are trends for moving government away from the nation state, sometimes in a downward decentralized direction (e.g. to regions within a country) and sometimes in an upward direction (e.g. to European Union). But the role of government is seen to shift towards creating a favorable environment for transnational investment whether in the form of low taxation on profits, subsidies to inward investment or to creating a highly skilled work force. The effects of globalization on policy perspectives is orchestrated in terms of a shift from industrial policy and Keynesian demand measures favored by "old" social democracy, but also from regulation to deregulation and market liberalization emphasized by neo-liberals. "The aim of macroeconomic policy is to keep inflation low, limit government borrowing, and use active supply-side measures to foster growth and high levels of employment" (Giddens, 2000, p. 73). Blair and Schroder (1999) argue in a similar fashion, "In a world of ever more rapid globalization and scientific changes we need to create the conditions in which existing businesses can prosper and adapt, and new businesses can be set up and grow" (p. 163). Hombach (2000) reinforces the point when he suggests that "It is not only the forces of globalization that demand the modernization of our institutions and political programmes, but, to no less an extent, changes in patterns of employment, in values and in demographic and social structures" (p. 31).

3. NEW KEYNESIAN ECONOMICS AND THE "NEW CONSENSUS"

The first four features of the "third way" given above relate to the approach to macroeconomic policy making. The role of fiscal policy is played down, and the role of monetary policy elevated, and the focus of monetary policy becomes the targeting of the rate of inflation. This approach to macroeconomic policy has not been confined to the

advocates of the "third way," and is very much reflected in the operations of the eurozone.

Many of the relevant features of this approach are reflected in what has become known as the "new consensus" in monetary economics and monetary policy (e.g. Meyer, 2001). This "new consensus" has been adopted by a broader range of economists than solely new Keynesians. But it is consistent with a new Keynesian approach, and fits well along side the first four of the features of the "third way" listed above.

The thrust of this "new consensus" can be summarized in terms of a simple model with three equations:

1) $Y^g_t = a_0 + a_1 Y^g_{t-1} + a_2 E(Y^g_{t+1}) - a_3 [R_t - E_t(p_{t+1})] + s_1$

2) $p_t = b_1 Y^g_t + b_2 p_{t-1} + b_3 E_t(p_{t+1}) + s_2$ (with $b_2 + b_3 = 1$)

3) $R_t = RR^* + E_t(p_{t+1}) + c_1 Y^g_{t-1} + c_2(p_{t-1} - p^T) + c_3 R_{t-1}$

where Y^g is the output gap, R is nominal rate of interest, p is inflation, and p^T is inflation target, RR* is the "equilibrium" real rate of interest (that is the rate of interest consistent with zero output gap which implies from equation 2 a constant rate of inflation), and s_i (with i = 1, 2) represents stochastic shocks. Although, as far as we are aware, no formal examination of the stability of this model has been conducted, the presumption is that it is stable with deviations of the economy from the equilibrium position arising from the impact of stochastic shocks (that is s_1 and s_2). It can be seen that economic fluctuations in the model come from stochastic shocks, rather than from, for example, endogenous forces such as movements in investment expenditure. Equation 1 is the aggregate demand equation; equation 2 is a Phillips curve; and 3 is a monetary policy operating rule which replaces the old LM-curve. There are three equations and three unknowns: output, interest rate and inflation. This model has a number of characteristics which are now discussed.

First, equation 1 resembles the traditional IS curve in that it is derived from the equality between output and demand. However, the private component of demand is derived from the intertemporal optimization of a utility function which leads to current consumer expenditure depending on expected future expenditure and the real rate of interest. But it can be noted that there is no explicit mention of government expenditure or of fiscal policy is this equation.

Second, there are both lagged adjustment and forward-looking elements; the model allows for sticky prices (the lagged price level in the Phillips-curve relationship) and full price flexibility in the long run. There is some price rigidity in the short run. In this way some of the important aspects of new Keynesian economics are introduced.

Third, the term $E_t(p_{t+1})$ in equation 2 purports to signal central bank credibility. A central bank that credibly signals its intention to achieve and maintain low inflation affects price expectations, which result in lower actual inflation. In this sense, the term $E_t(p_{t+1})$, then, indicates that it may be possible to reduce current inflation at a significantly lower cost in terms of output than otherwise.

Fourth, the monetary policy operating rule (often labeled "Taylor's rule") relates interest rate decisions to the inflation target (relative to actual inflation) and to the output gap. It implies that "policy" becomes a systematic adjustment to economic developments rather than an exogenous process. It contains no stochastic shock implying that monetary policy operates without random shocks. A significant element here is that this operating rule incorporates the stress on inflation targeting. The interest rate is raised when inflation is above the target and also when there is a positive output gap that (via equation 2) is seen to influence the rate of inflation. In some cases, but by no means in all cases this behavior is symmetric, as for example in the case of the Bank of England. In some other cases, as for example the practice of the European Central Bank (ECB), the behavior just alluded to is highly symmetrical. In the latter case what really matters is to lower inflation in one direction only, i.e. below 2 per cent in

the case of the ECB.

Fifth, it contains the neutrality of money property, that equilibrium values of real variables are independent of the money supply and that inflation is determined by monetary policy (that is the rate of interest). This is perhaps not surprising since there is no mention of the stock of money in the model. Some have suggested the addition of a fourth equation to the model in which the stock of money is related to nominal income and the rate of interest, and this equation would be designed as a demand for money equation. In that event, the stock of money would be viewed as determined by the demand for money. There would still be a neutrality of money view in so far as the demand for money is modeled as a demand for "real" money. The association between inflation and monetary policy is included by assertion in terms of the inclusion of a monetary policy rule which adjusts interest rates according to deviations of inflation from the target level. The inclusion of a fiscal policy rule rather than a monetary policy rule whereby the fiscal stance was adjusted in accordance with output and inflation would have an equivalent effect in the context of this model.

Sixth, the stock of money has no role in this model, and this is indicative of the more general proposition that the stock of money plays no role in monetary policy formulation. King (2002) has recognized that "as central banks became more and more focused on achieving price stability, less and less attention was paid to movements in money. Indeed, the decline of interest in money appeared to go hand in hand with success in maintaining low and stable inflation" (p. 162). The stock of money has become a residual, determined by the demand for money, but not feeding back to have any influence on the economy.

The three equations above which summarise the "new consensus" also embody relationships that summarizes the new Keynesian approach to macroeconomics, and also contain the essential elements of the theoretical macroeconomic framework of the "third way." It is also significant that neither contain those elements that could be reasonably labeled as "Keynesian."

4. THE "NEW CONSENSUS" AND CURRENT MACROECONOMIC POLICIES

The significance of "Taylor's rule" for the setting of the rate of interest is twofold. First, it treats the setting of interest rates as a domestic matter without reference to international considerations such as the exchange rate and interest rates elsewhere in the world. This is not just an attribute of using Taylor's rule in the context of the closed economy model used above, but is a more general feature of that rule. Second, the interest rate is adjusted in response to the output gap (and to the rate of inflation which in turn is modeled to depend on the output gap). A zero output gap is consistent with constant inflation, as can be seen from equation (2). Equation (3) then implies a nominal rate of interest which translates into a real rate equal to the "equilibrium" rate RR*, which is consistent with zero output gap and constant inflation. From equation (1), the value of RR* would need to be a_0/a_3. Provided that the Central Bank has an accurate estimate of RR* then it appears that the economy can be guided to an equilibrium of the form of a zero output gap and constant inflation (at an interest rate equal to the pre set target). In this case, equation (1) indicates that aggregate demand is at a level that is consistent with a zero output gap. In a private sector economy, this would imply that the real interest rate RR* brings equality between (*ex ante*) savings and investment. The equilibrium rate of interest corresponds to the Wicksellian "natural rate" of interest.

In effect, the model above portrays an economy in which the interest rate can be adjusted to secure equilibrium in terms of a zero output gap and a balance between aggregate demand and aggregate supply (alternatively between planned savings and planned investment). There are (at least) three factors that may prevent this from happening. First, mistakes may occur in the setting of interest rates. The Central Bank has imperfect information on the equilibrium real rate of interest RR* (assuming that such a rate does exist), and may aim for a real rate of interest which is not equal to a_0/a_3. It could also be noted that it has been implicitly assumed in equation (3) that there are no stochastic errors in decision making with accurate knowledge on the lagged output gap and inflation rate. Any shift in fiscal policy, in investors' confidence or in world trade conditions would be reflected in a change in a_0, leading thereby to a change in the equilibrium real rate of interest. This would, of course, exacerbate the problems of securing information on the equilibrium rate and exacerbate the chances of policy mistakes.

Second, the domestic interest rate may be incompatible with those which are being set internationally or have severe implications for the capital account. Insofar as interest rate parity holds, then the difference between the domestic interest rate and the foreign interest rate will be equal to the (expected) rate of change of the exchange rate. The relevant domestic interest rate (for international capital movements) may be a rate such as that on bonds but one assumed to be linked to the discount rate set by the Central Bank. Although the interest rate parity result appears often not to hold empirically it could still be expected that there is some relationship between domestic interest rates (relative to international rates) and movements in the exchange rate. As noted above, Taylor's rule neglects these exchange rate effects.

Third, the real rate of interest given by a_0/a_3 may be negative. This would be equivalent to saying that the savings and investment schedules do not intersect in the positive range of interest rates. The aggregate demand equation (equation (1) above clearly assumes that aggregate demand (and presumably investment) is interest rate sensitive (such that a_3 is greater than zero) and that there is a substantial autonomous component of demand (otherwise a_0 would be non-positive).

This "new consensus" focuses on the role of monetary policy (in the form of interest rates) rather than on fiscal policy (though shifts in a_0 in equation 1 could be used to represent the fiscal stance). It also focuses on the control of demand inflation, and not on cost inflation, as is evident from equation (2). As Gordon (1997) remarked (though not in the context of this "new consensus"), "in the long run inflation is always and everywhere an excess nominal GDP phenomenon. Supply shocks will come and go. What remains to sustain long-run inflation is steady growth of nominal GDP in excess of the growth of natural or potential real output" (p. 17). The significance of the "new consensus" is that it strongly suggests that inflation can be tamed through interest rate policy (using demand deflation) and that there is an equilibrium rate (or "natural rate") of interest which can balance aggregate demand and aggregate supply and which is feasible, and lead to a zero gap between actual and capacity output.

There are (at least) six ways which would upset the conclusion that interest rate policy can guide the economy to equilibrium with demand and supply in balance and inflation on target. The first is that the "equilibrium" rate of interest is either negative or positive but so low as to be unattainable.[5] In some respects this has overtones of the "liquidity trap," but the mechanisms are different. In the case of the "liquidity trap," it was presumed that the rate of interest on bonds was so low (and the price of bonds so high) that no-one would be willing to buy bonds in light of the possible capital losses in doing so. In the present case, a negative interest rate is ruled out on the basis that a zero rate of interest can also be obtained by holding cash. The emphasis here would be on the failure of the equality $I(r, Y_n) = S(r, Y_n)$ to have an economically meaningful solution, where Y_n is income level for which output gap is zero.

Second, and not unrelated to the previous point, interest rates may have very little effect on the levels of investment and savings and hence variations in the rate of interest would be ineffectual in reconciling savings and investment. The theoretical and empirical arguments on the ambiguity of the sign of the relationship between savings and the rate of interest are well known. The empirical literature on investment has often cast doubt on the impact of interest rates on investment and stressed the roles of profitability and capacity utilization. "In the investment literature, despite some recent rehabilitation of a role for neoclassical cost-of-capital effects … there remains considerable evidence for the view that cash flow, leverage, and other balance-sheet factors also have a major influence on spending [Fazzari, Hubbard, and Peterson (1988), Hoshi, Kashyap, and Scharfstein (1991), Whited (1992), Gross (1994), Gilchirst, and Himmelberg (1995), Hubbard, Kashyap, and Whited (1995)]" (Bernanke, Gertler, and Gilchrist, 1999, p. 1344). These authors further note in a footnote that "contemporary macroeconometric forecasting models, such as the MPS model used by the Federal Reserve, typically do incorporate factors such as borrowing constraints and cash-flow effects" (fn. 2, p. 1344).

Third, the linkage from the key discount rate set by the Central Bank and the interest rates which influence economic decisions may be rather loose and uncertain. For example, the long-term rate of interest may be viewed

as relevant for long-term investment decisions, and the response of the long-term rate of interest to changes in the key discount rate may be relatively slight and may vary over time. The banks could respond to a change in the discount rate by a combination of changes in the interest rate on loans and changes in the credit standards, which they set. Hence the impact of a change in the discount rate on interest-sensitive spending decisions depends on the decisions of banks and other financial institutions.

Fourth, the "equilibrium" rate of interest may be incompatible with foreign exchange balance. The clearest case of this would arise if the interest rate parity theorem held such that the interest rate differential between currencies is equal to the expected rate of change of the exchange rate between the currencies. A relatively high domestic interest rate would then be associated with a depreciating currency.

Fifth, the Central Bank cannot calculate and attain the "equilibrium rate" of interest through reasons of lack of information, a moving target or incompetence. It can be seen in the equations given above that the "equilibrium rate" depends on a_0/a_3 and these are parameters, which can and do vary over time. Shifts in the propensity to save, in the propensity to invest, in the demand for exports and in the fiscal stance could all be expected to lead to a shift in the equivalent of a_0/a_3. Information on the "equilibrium rate" is not exactly readily available, and indeed at best can only be estimated with some lag and over a period when it can be reasonably assumed the underlying parameters are stable.

Sixth, the Central Bank (or the government) may not wish to attain the "equilibrium rate" of interest as defined above. In other words, the Central Bank does not pursue a policy rule akin to Taylor's rule. The Central Bank may use its interest rate for objectives other than a target rate of inflation and/or zero output gap: these objectives could include rate of growth of stock of money or a target level of the exchange rate.

The effectiveness of monetary and fiscal policy can be approached along a number of routes, and we go down three here. The first can be discussed in terms of the model outlined above. There are shocks to the model (s_i, with $i = 1, 2$), and these lead to changes in output and inflation, and to which monetary policy in the form of interest rate changes is seen to respond. In those terms two questions are of interest. First, how effective is an interest rate change in offsetting the shocks? That is, what are the size of the coefficients a_3 and b_1. We cannot directly estimate these coefficients, but we can draw on simulations of macroeconometric models to judge the effects of a change in the rate of interest on output and inflation. In another paper (Arestis and Sawyer, 2002b) we argue, in effect, that these coefficients are in some sense relatively small. We suggest there that "the conclusions we draw from this brief survey of some empirical evidence are along the following lines. First, (at least within the context of the macroeconometric models) there are constraints to a permanent change in the rate of interest. We would see the effect of interest rate on the exchange rate (when interest rate parity is assumed) as being a significant element in this (in that an interest differential between the domestic interest rate and foreign interest rate leads to a continual change in the exchange rate). However, ... we remain skeptical of the empirical validity of that link. Second, and this is clear in the case of the euro area models, when interest rates have an effect on aggregate demand this comes through from substantial changes in the rate of investment .... This means that interest rate variations can have long lasting effects, in that the effects on investment will lead to changes in the size of the capital stock. Third, the effects of interest rate changes on the rate of inflation are rather modest .... A 1 percentage point change in interest rates is predicted to lead to a cumulative fall in the price level of 0.41 percent in one case and 0.76 percent in the other, after five years. The rate of inflation declines by a maximum of 0.21 percentage points" (p. 15). The effects of interest rate changes on output were also found to be rather small.

This perspective on monetary policy is a rather narrow one in the sense that it starts from the viewpoint that the economy is stable though subject to stochastic shocks. These shocks are presumably relatively small and are not serially correlated. In the event that shocks are relatively large and are highly serially correlated, it may be better to approach monetary and fiscal policy in terms of shifts in the parameters of the model. If, for example, there is a major shock which reduces demand and that reduction continues for a number of years, an analysis based on the downward shift of demand may be more insightful. This leads us to the second line of enquiry, namely how

effective would monetary policy be in combating a fall in autonomous demand.

The model of the "new consensus" portrays the macroeconomy as essentially stable. The disturbances to output and inflation come from stochastic shocks. Although it is not said explicitly, there is the suggestion that these shocks are relatively small and serially uncorrelated. There is little in the model to imply that major depressions or even significant recessions can occur. In contrast a Keynesian approach would countenance at least the possibility of major recessions, and point to the experiences of the past 30 years with three significant recessions (for example, in the UK in 1974/75, 1980/81 and 1990/92).

In the model above, output is viewed as fluctuating around its trend level as it is disturbed by the stochastic shocks. There is nothing said explicitly about the rate of unemployment, even though we can observe that within the eurozone in the past few years, output has been reported at or above the trend level but that has been associated with high levels of unemployment (e.g. over 12 percent in Spain, 10 percent in France and near 10 percent in Germany). There is the suggestion within the "new consensus" model that achieving the trend rate of output is desirable (or perhaps the best that can be done). The only instrument of economic policy in that model is used to seek to guide the economy to that trend level of output where it is believed inflation rate will be constant. But when the trend level of output corresponds to substantial rate of unemployment (as it does presently in many European countries), then there is nothing particularly desirable in the economy operating at or around the trend rate.

5. SUMMARY AND CONCLUSIONS

We have attempted to trace the ingredients of the economics of the "third way." We have argued that these are firmly and squarely embedded in new Keynesian Economics and the "new" consensus in macroeconomics. We then proceeded to examine closely the macroeconomic policies of this paradigm, essentially monetary policy. Fiscal policy has been downgraded to a passive instrument of economic policy, the job of which is essentially to balance the government budget. The effectiveness of monetary policy has been analyzed to conclude that it is not consistent with the policy implications of the "new consensus," in that it does not have the expected impact on output and inflation. Nor is it as effective as an instrument of economic policy in the way ascribed to it. We may, therefore, conclude that monetary policy is impotent to deal with major macroeconomic downturns, to remove significant levels of unemployment or to deal with upsurges of inflation (particularly if they emanate from the cost side of the economy).

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NOTES

1. This section draws heavily on Arestis and Sawyer (2001a, 2002a). See also the chapters in Arestis and Sawyer (2001b) which cover the experience of center-left governments in a dozen countries.
2. There is not actually a consensus on the relationship between inflation and growth. Ghosh and Phillips

(1998) find it "rather surprising ... that a consensus about the relationship between these two variables is yet to emerge" (p. 672). Using a large panel set that covers IMF countries over the period 1960-96, the same authors conclude that "there are two important nonlinearities in the inflation-growth relationship. At very low inflation rates (around 2-3 percent a year, or lower), inflation and and growth are positively correlated. Otherwise, inflation and growth are negatively correlated, but the relationship is convex, so that the decline in growth associated with an increase from 10 percent to 20 percent inflation is much *larger* than that associated with moving from 40 percent to 50 percent inflation" (p. 674). The point at which, however, the nonlinearity changes from positive to negative is thought to deserve a great deal more research.

3. There is also the idea that those operating monetary policy should be more "conservative" (that is place greater weight on low inflation and less weight on the level of unemployment) than the politicians (Rogoff, 1985).

4. See Forder (2000) for an extensive discussion and critique of the notion of credibility.

5. This discussion is in terms of the Central Bank rate. It is assumed that the rate of interest on loans is above the Central Bank rate, and that it is the rate of interest on loans, which is relevant for investment decisions. Given the risks for banks involved in extending loans it can be assumed that there is a minimum level below which banks would not go in terms of the loan rate.