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AFTER THE BUST

The Outlook for Macroeconomics and Macroeconomic Policy

THOMAS I. PALLEY

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Preface

"Change" was the buzzword of the U.S. presidential campaign, in response to a political agenda precipitated by financial turmoil and a global economic crisis. According to Research Associate Thomas I. Palley, the neoliberal economic policy paradigm underlying the current agenda must itself change if there is to be a successful policy response to the crisis. He observes that the financial downturn has exposed the faulty economics of the existing policy paradigm, thus presenting the opportunity for real change, but that there are profound political, intellectual, and sociological obstacles to such change.

The ideology of the economics profession—mainstream economic theory—remains unreformed, says Palley, and he warns of a return to failed policies if a deep crisis is averted. Since Post Keynesians accurately predicted that the U.S. economy would implode from within, there is an opportunity for Post Keynesian economics to replace neoliberalism with a more successful approach.

Palley outlines the policy challenges, noting that there is significant disagreement among economic paradigms about how to ensure full employment and shared prosperity. A salient feature of the neoliberal economy, which is supported by mainstream economic theory (e.g., free trade, deregulation, and the notion of a natural rate of unemployment), is the disconnect between wages and productivity growth that explains widening income inequality. Workers are boxed in on all sides by globalization, labor market flexibility, concern with inflation rather than with full employment, and a belief in "small government" that has eroded economic rights and government services. Financialization, the economic foundation of neoliberalism, serves the interests of financial markets and top management. Thus, reversing the neoliberal paradigm requires a policy agenda that addresses financialization and ensures financial markets and corporations are more closely aligned with the greater public interest.

Palley outlines several major obstacles to changing both economics and economic policy. Social democratic political parties are divided in terms of the merits of the neoliberal economic paradigm. Other obstacles include the dominance of neoliberal economics within the academic community and among policymakers, which is supported by a misplaced belief that neoclassical economics is a scientific fact. This belief is used by the academic establishment to block alternative points of view.

New Keynesian economics is a form of real-business-cycle theory in the tradition of Arthur C. Pigou rather than John Maynard Keynes, says Palley. Though mainstream economists are willing to recommend Keynesian policies in times of economic crisis, they are unwilling to change the core analytical assumptions driving modern neoclassical macroeconomics (an example of so-called "cuckoo" economics). The only satisfactory escape from this intellectual and political stew is the creation of a new, progressive Keynesian consensus. That will require placing economics at the center of the political stage.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
January 2009

After the Bust

Introduction: Crisis, Economists, and Change

The current moment of financial crisis and the prospect of deep recession offer a historic window of opportunity for change in economics and in economic policy. The combination of crisis and accumulated popular resentments following two decades of wage restraint, widening income inequality, and increased economic insecurity makes for a political atmosphere conducive to change.

In the 1930s and '40s, the Great Depression and World War II provided the launchpad for the Keynesian revolution in economics. In the 1970s, monetarists and New Classical economists used the economic crisis created by the OPEC oil shocks to launch a counterrevolution (Johnson 1971).

Milton Friedman, the intellectual godfather of American neoliberal economics, understood the role of crisis in fostering change:

> *There is enormous inertia—a tyranny of the status quo—in private and especially governmental arrangements. Only a crisis—actual or perceived—produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around.*
>
> (Friedman 2002, pp. xiii–xiv)

He went on to describe the role of economists as follows:

> *. . . to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes politically inevitable.*
>
> (Friedman 2002, p. xiv)

The good news is, current conditions may have created a crisis moment in which policy and thinking can change. The bad news is, deep recession

means there will likely be enormous economic suffering, and the economics profession will be profoundly resistant to change.

The Postbust Policy Challenge

European governments and the U.S. president face three challenges:

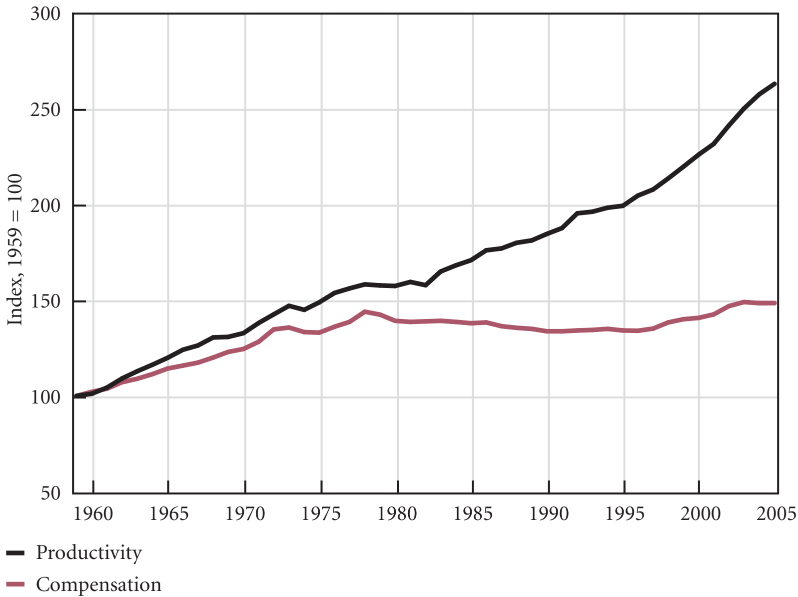
(1) *Stop the bleeding*—which means stopping the liquidation trap (Palley 2008a) that currently grips markets. This requires putting a floor under the financial crisis by stopping further wholesale asset price deflation and restoring credit flows.
(2) *Jump-start the economy*—which means getting the economy and employment growing again. This requires further monetary easing and massive fiscal expansion.
(3) *Ensure that future growth is characterized by full employment and shared prosperity*—which means having wages grow with productivity and reducing current high-income inequality to levels that prevailed 30 years ago, before the neoliberal economic policy experiment.

Among policymakers, there is significant agreement on challenges (1) and (2), but significant disagreement on challenge (3).

Regarding the first two challenges, any differences are largely a matter of degree—such as, What is the best way to thaw credit markets and stabilize asset prices? How far should interest rates be lowered and how fast? How much should taxes be cut, and whose taxes should be cut? How much should government spending be increased and what form should it take?[1] These are important differences, but as President Nixon famously observed in 1971, "We are all Keynesians now." The truth of that statement is being confirmed by current policy developments, though Nixon should more accurately have said, "In a recession, we are all Keynesians."

However, there is significant disagreement regarding the challenge of ensuring economic growth with shared prosperity. For most mainstream economists, the crisis is being represented as a perfect storm, the result of a rare probability event. From a post-Keynesian perspective (Godley 2000, 2001, 2005; Palley 1998, 2001, 2005, 2006a, 2006b), it is a predictable outcome of the economic paradigm that has driven growth since the neoliberal era was

Figure 1 **Index of Productivity and Hourly Compensation of Production and Nonsupervisory Workers, 1959–2005**



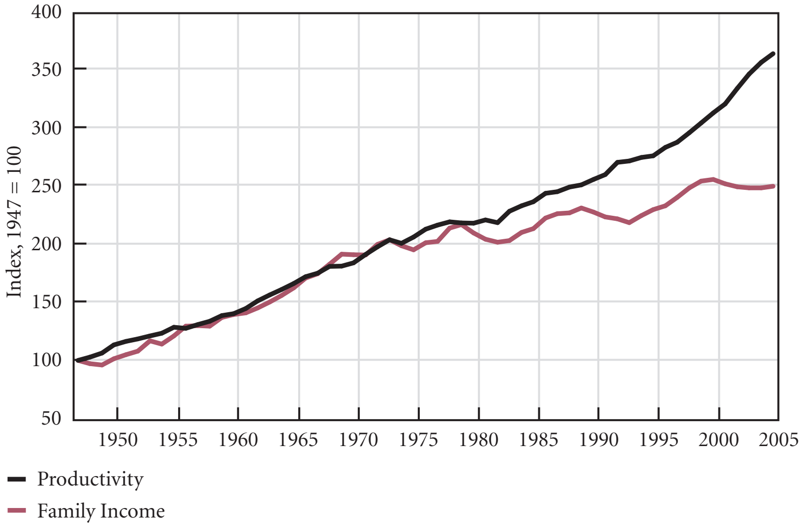
Source: Mishel, Bernstein, and Allegretto 2006, Table 1.3

inaugurated, in the early 1980s, by Prime Minister Thatcher and President Reagan. That paradigm is now exhausted. It was never able to generate growth with shared prosperity; now it is unable even to generate growth with inequality.

The Neoliberal Paradigm and Mainstream Economics

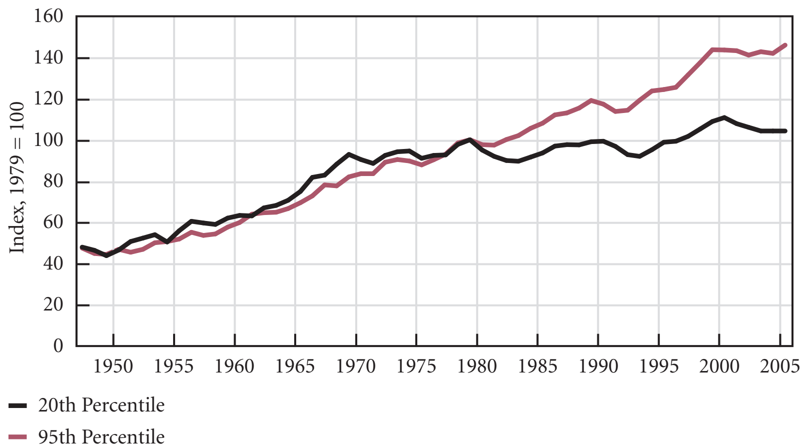
The single most salient feature of the neoliberal economy is the disconnect between wages and productivity growth, as exemplified by the U.S. experience. Figure 1 shows an index of U.S. productivity and average compensation (which includes all benefits) of nonsupervisory workers, who represent 80 percent of the workforce. Until the late 1970s, the two series grew together; since then, they have grown apart, with compensation stagnating even as productivity has continued to rise. Figure 2 tells the same story for the relation between U.S. median family income and productivity.

Figure 2 **Median Family Income and Productivity, 1947–2005**



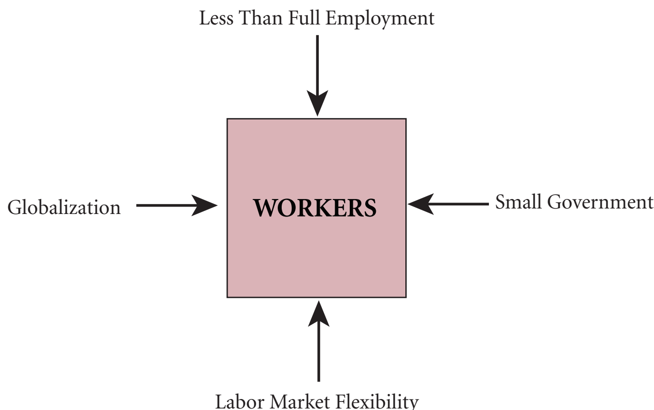
Source: Mishel, Bernstein, and Allegretto 2006, Table 1.3

Figure 3 **Index of Low Family Income and High Family Income, 1947–2005**



Source: Mishel, Bernstein, and Allegretto 2006

Figure 4 **The "Neoliberal" Policy Box**



This disconnect in turn explains widening income inequality. With wages stagnating at the bottom of the distribution but productivity still rising, income has been shifting to the top of the distribution. This pattern is captured in Figure 3, which shows income growth at the 20th and 95th percentiles of the U.S. income distribution. The two income series grew in tandem until the late 1970s but separated after 1980, when inequality also started rising.

The neoliberal economic policy paradigm can be described in terms of a box, as illustrated in Figure 4.[2] Workers are "boxed in" on all sides by a policy matrix consisting of globalization, labor market flexibility, a focus on inflation rather than full employment, and the erosion of popular economic rights (as exemplified by the 1996 welfare reform act) in the name of "small government." Similarly, there has been an erosion of government's administrative capacity and its ability to provide services, with many government functions being outsourced to corporations. This has created a "predator state" (Galbraith 2008) in which corporations enrich themselves on the back of government contracts while the workers who provide these privately produced–publicly funded services are placed in a more hostile work environment. The result is the *appearance* of Big Government. The reality is a government whose capacity has been significantly cannibalized.

The strength of the neoliberal policy box derives from a new relationship between the "side supports" of corporations and financial markets, as

Figure 5 Lifting the Lid and Unpacking the Box

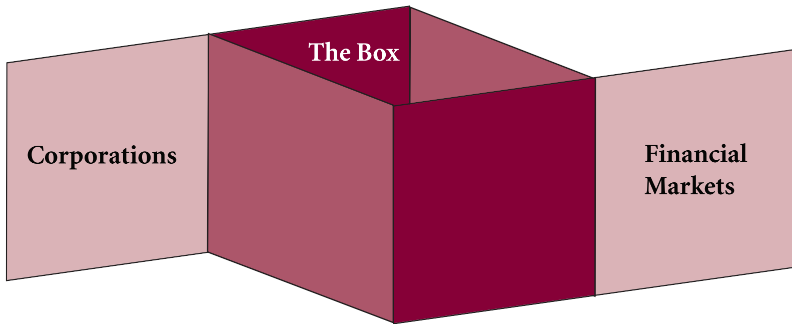


Figure 6 Dynamics of Financialization

illustrated in Figure 5. This new relationship has been termed "financialization" (Epstein 2001, Palley 2008b), and the box would collapse without it.

Figure 6 shows the economic workings of financialization. The basic logic is that financial markets have captured control of corporations, which now serve market interests along with the interests of top management. That combination drives corporate behavior and economic policy, creating an economic matrix that puts wages under continuous pressure and raises income inequality. Viewed from this perspective, financialization is the economic foundation of neoliberalism. Reversing the neoliberal paradigm therefore requires a policy agenda that addresses both financial markets and corporations, with the aim of bringing their behavior in line with the greater public interest.

The structure of the policy box has been supported by mainstream economic theory, which has provided justification for these outcomes. Neoliberal globalization has been justified by appeal to the theory of free trade based

upon comparative advantage, and to neoclassical arguments for deregulating financial markets and allowing uncontrolled international capital flows.

The case for small government is based on Friedman's (2002) arguments for a minimalist, or night watchman, state. Moreover, the Chicago School of Economics recommends that even market failures be ignored, since government intervention to fix them can give rise to even more costly failures.

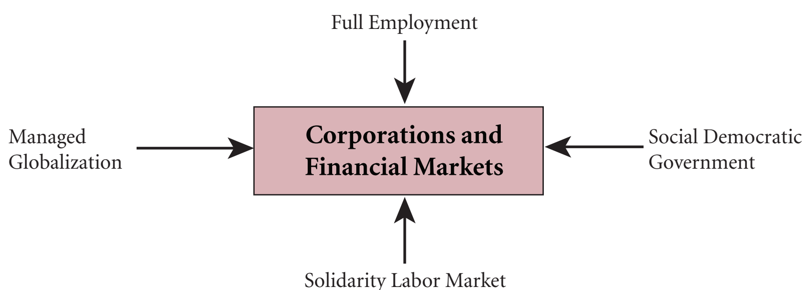
The retreat from full employment has been driven by New Classical macroeconomics, which substituted the notion of a natural rate of unemployment and a vertical Phillips curve for the negatively sloped long-run Phillips curve (Friedman 1968). In the process, concern with inflation has replaced concern about employment. The theoretical justification is that policy can have no permanent impact on employment, and that the market by itself gravitates quickly to full employment.

The push for so-called "flexible" labor markets has been driven by the neoclassical construction of labor markets based on marginal productivity theory (e.g., that competitive markets ensure labor is paid fairly for its contribution to production). That theory has fueled an attack on unions, the minimum wage, and employment protections, all of which are characterized as labor market "distortions."

Increased corporate power has been justified by the shareholder-value model of corporations, which claims that wealth and income are maximized if firms maximize shareholder value without regard to other interests. To the extent that there is a principal-agent problem with managers not maximizing shareholder value, this is to be solved by aligning managers' interests with shareholder interests via bonus payments and stock options.

Lastly, expansion of financial markets has been promoted by appeal to the theory of efficient markets (Fama 1970), claims that speculation is stabilizing (Friedman 1953), and the notion of a market for corporate control that ensures firms are disciplined by shareholders (Jensen and Meckling 1976). Kenneth Arrow and Gerard Debreu's (1954) contingent-claims approach to financial markets has been used to justify exotic financial innovations in the name of risk spreading and portfolio diversification, while q theory (Tobin and Brainard 1968) has been used to support the claim that financial markets do a good job of directing investment and the accumulation of real capital.

Figure 7 **Repacking the Box**



An Alternative, Progressive Box

The neoliberal policy box is suggestive of an alternative, "progressive Keynesian" box that would supplant workers with corporations and financial markets, as shown in Figure 7. This requires redesigning and repacking the box as follows:

(1) Globalization, with labor and environmental standards that promote upward harmonization instead of a race to the bottom. Additionally, international economic governance arrangements are to be strengthened, especially regarding exchange rates, so as to prevent a repeat of the recent huge global imbalances. Capital controls must also be a legitimate part of the policy tool kit.

(2) A balanced approach to government that ensures government efficiently provides public goods, health insurance, social insurance, education, and needed infrastructure.

(3) Restoration of full employment as a policy priority.

(4) The promotion of labor markets that encourage creation of high-quality jobs that pay fair wages, which grow with productivity.

(5) A corporate agenda that restricts managerial power by enhancing shareholder control, places limits on managerial pay, limits unproductive corporate financial engineering, and represents other stakeholders.

(6) Financial market reform that consolidates and strengthens regulation, limits speculation, increases transparency, and provides central banks with tools (such as asset-based reserve requirements) to address asset price bubbles.

An Opportunity for Post Keynesian Economics

Mainstream macroeconomics completely failed to understand the fragility and unsustainability of the current macroeconomic regime. The extent of this failure cannot be overstated and it provides an opportunity for Post Keynesian economics. That is because Post Keynesians (Godley 2000, 2001, 2005; Palley 1998, 2001, 2005, 2006a, 2006b) predicted the outcomes that have come to pass.

The economics profession has talked widely of "the Great Moderation." According to that hypothesis, the economy has become more stable and the business cycle tamed through a combination of improvements in monetary policy driven by improved economic theory, and innovations in financial markets and business management that have spread risk, stabilized credit flows, and reduced inventory fluctuations. Federal Reserve Chairman Ben Bernanke is himself a strong proponent of the Great Moderation thesis: "My view is that improvements in monetary policy, though certainly not the only factor, have probably been the most important source of the Great Moderation" (Bernanke 2004, p. 2).

Yet, the current financial crisis has shown the Great Moderation to have been a period of artificial calm. Moreover, the crisis also lends credence to an alternative Post Keynesian interpretation (Palley 2008c) that the Great Moderation was driven by a retreat from full employment that reduced the income distribution conflicts that surround full employment, and by reliance on the temporary but unsustainable stimulus of borrowing to fuel growth.

Nothing epitomizes the mainstream's failure more than former Fed Chairman Alan Greenspan's admission to Congress, on October 23, 2008, that his economic ideology was flawed and that the self-interest of lending institutions had failed to protect shareholders. Greenspan's approach to financial regulation and the conduct of monetary policy was widely endorsed by the economics profession. Thus, when he retired from the Federal Reserve, in 2006, he was feted by the profession, with the liberal New Keynesian economists Alan Blinder and Ricardo Reis declaring that Greenspan "has a legitimate claim to being the greatest central banker who ever lived" (Blinder and Reis 2005).

The Federal Reserve, the International Monetary Fund (IMF), and leading economists on both sides of the Atlantic all provide clear evidence

of the lack of understanding. In March 2007, current Fed Chairman Bernanke testified before the Joint Economic Committee of Congress that "the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained" (Bernanke 2007). And throughout 2007 and into 2008, district Federal Reserve Bank Presidents Jeffrey Lacker (Richmond), Charles Plosser (Philadelphia), and Thomas Hoenig (Kansas City) all consistently played up the danger of inflation rather than financial crisis and slump.

The IMF has laid claims to being the global economy's early warning system. Yet in July 2007, just as the crisis was about to erupt, the IMF (2007) revised its global growth forecast upward, emphasizing that inflation risks had edged up and central banks would likely need to further tighten monetary policy. Even more than the IMF, the European Central Bank seems to have misunderstood the financial crisis, which explains its resistance to lowering interest rates in 2007 and much of 2008. The same also holds for the Bank of England.

Harvard professor and former IMF Chief Economist Ken Rogoff (2008b) also focused on inflation, writing as late as July 2008 that the global economy was a "runaway train" requiring tighter monetary and fiscal policy. Moreover, Rogoff (2008c) misunderstood the significance of the collapse of Lehman Brothers, celebrating it with an article titled "No More Creampuffs" that argued Lehman's failure would put an end to moral hazard and restore healthy business incentives.

British economist Willem Buiter (2008) also failed to see the system's instability, virulently criticizing the Federal Reserve for its decision in January 2008 to cut the federal funds rate by 75 basis points, from 4.25 to 3.50 percent. Likewise, the politically liberal Paul Krugman (2008) failed to appreciate the extent of speculation in oil and commodity markets, rationalizing the surge in oil and commodity prices in 2008 as the result of market fundamentals rather than speculation.

With regard to the global economy, proponents of the so-called "Revised Bretton Woods" (RBW) hypothesis (Dooley, Folkerts-Landau, and Garber 2003) claimed the huge global financial imbalances associated with the U.S. trade deficit were stable and sustainable. Another argument for sustainability came from Harvard professor and former Inter-American Development Bank Chief Economist Ricardo Hausman (2005), who, with

his colleague Federico Sturzenegger, claimed the U.S. trade deficit was a nonissue because of "dark matter" investments that yielded huge excess returns to U.S. overseas investments.

Where there was mainstream criticism regarding the U.S. trade deficit, it was strikingly wrong. Thus, some economists (Eichengreen 2004; Obstfeld and Rogoff 2007; Rogoff 2007, 2008a; Bergsten 2005) predicted a run on the dollar, while others (Goldstein and Lardy 2005) predicted China's inflation would force a rebalancing.

None of this has come to pass. Instead, the U.S. economy has imploded from within as predicted by Post Keynesians, sending shock waves around the world. Far from collapsing, the dollar has actually strengthened during the crisis, as the extent of global economic dependence on the U.S. consumer as buyer of last resort has become clear.

Mainstream economists have been intellectually honest and guided by their theoretical models. The problem is, events have conclusively shown their theoretical analysis to be fundamentally flawed. Both in its theory and empirical analysis, mainstream macroeconomics failed to connect the dots linking the weak U.S. expansion, the U.S. trade deficit, and the U.S. housing bubble. It also failed to connect long-term developments in the U.S. economy concerning expanding debt, wage stagnation, and worsening income distribution.

This contrasts with Post Keynesian economics, which got it right and provides clear justification for the type of fiscal and monetary policies being implemented. For Post Keynesians, the challenge is to win recognition for this record, as the mainstream profession will try to airbrush the past and rewrite history by burying its own failures and ignoring the success of its critics.

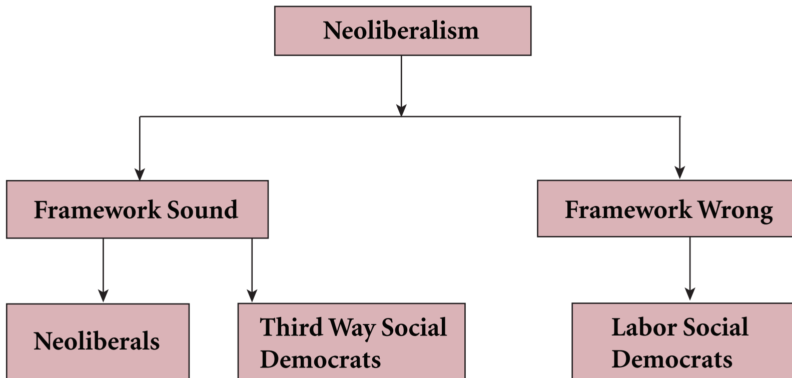
Obstacles to Change

Though the current moment provides an opportunity for change in both economics and economic policy, there are a number of major obstacles to overcome.

A. Politics and the Split among Social Democrats

A first obstacle concerns politics, and the fact that social democratic political parties—including the Democratic Party in the United States, the

Figure 8 **The Political Dilemma of Neoliberalism**



Labour Party in the United Kingdom, and the Social Democratic Party in Germany—are split regarding the neoliberal economic paradigm.

Figure 8 illustrates this split. At the most fundamental level there is a divide between those who see the neoliberal economic paradigm as sound (e.g., neoliberals and Third Way social democrats) and those who see it as intrinsically flawed (labor social democrats). The political problem is that these opposing views split social democrats, making it harder to dislodge the paradigm. Neoliberals continue to promote the paradigm, and their response to the crisis has been to try and shift blame onto government, arguing that the crisis is another example of government failure. For instance, U.S. conservatives (see, for example, Schiff 2008) are falsely blaming the government-sponsored mortgage giants Fannie Mae and Freddie Mac for causing the crisis. The Community Reinvestment Act (1977), which aims to promote homeownership among disadvantaged communities, has also been falsely blamed.[3]

Third Way social democrats also remain committed to the neoliberal model. The key difference separating them from neoliberals is that they support stronger financial regulatory reform as well as "helping hand" programs to assist those adversely affected by the market. In the United States, the Third Way "New Democrat" explanation of the Bush Administration's economic failure is that it abandoned budget discipline and pursued inegalitarian tax and social policies. That is a critique of policy rather than a critique of the paradigm.

This Third Way acceptance of the neoliberal economic paradigm creates a division with labor social democrats who support progressive Keynesianism. That division in turn creates a major political conundrum. On the one hand, if labor social democrats split from Third Way social democrats, they risk bringing about a full-blown neoliberal triumph. On the other hand, if they maintain their fractious union, the risk is a gradual entrenchment of neoliberalism. The only satisfactory solution is the creation of a new, progressive Keynesian consensus that places economics front and center on the political stage.

B. Intellectual Opinion

The importance of economics points to a second obstacle to change: the intellectual dominance of neoliberal economics in academic and public policy discourse. Though the current crisis has created an opportunity to unseat neoliberalism and bring the "Age of Milton Friedman" to an end, events are running ahead of the climate of opinion, which remains dominated by neoliberalism. The political environment may have become more favorable, but a generation of miseducation impedes change. That miseducation affects policymakers, economic advisers, think tanks, and the media alike.

The dominant analytical framework among economists is the neoclassical, dynamic, general equilibrium, real-business-cycle model, which is adjusted to include price rigidities by so-called "New Keynesians." The assumptions of this model—competitive market clearing, the "loanable funds" theory of interest rates, and the neoclassical theory of labor markets—lace both professional and public discourse. These assumptions generate the conventional neoliberal prescriptions regarding labor market flexibility; balanced budgets; the desirability of unimpeded international financial flows and free trade; monetary policy guided by the natural rate of unemployment; and supply-side economics, which emphasizes tax cuts.

The implication is that, as long as economic thinking remains dominated by the neoclassical, dynamic, general equilibrium, real-business-cycle framework, mainstream economics will continue to be a major obstacle to change.

C. The Sociology of Economics

The importance of intellectual understandings in turn spotlights a third obstruction to change: the sociology of the economics profession, which

operates to exclude and ignore alternative points of view. This practice is justified by appealing to a myth that claims neoclassical economics is a scientifically proven truth, while opposing views are scientifically wrong.

The neoclassical "science" myth plays a critical function, which explains the repeated claim that neoclassical economics *is* science. This function supports the sociological practice that has mainstream economists labeling dissidents as wrong. That in turn justifies purging dissidents from orthodox economics departments and ignoring them in heterodox departments, thereby stripping dissidents of intellectual standing and diminishing their capacity to challenge the neoliberal paradigm.

The deeper sociological problem is that academic economics is a club in which new members are elected by existing members. Today, club members only elect those who subscribe to the current dominant paradigm, as this behavior is justified by the science myth. This poses an intractable sociological obstruction to alternative points of view and the possibility of fundamental change (Palley 1997).

D. Cuckoo Economics

Lastly, there is the obstacle of "cuckoo" economics. The cuckoo bird surreptitiously places its eggs in the nests of other birds, which then raise its young. In many regards, neoliberal economics does the same to Keynesian economics. This serves to create confusion, blur distinctions, and promote the claim that Keynesian ideas are already fully incorporated in mainstream economic thought and have nothing further to contribute.

The practice of cuckoo economics is evident in the tendency of mainstream economists to recommend Keynesian policies in times of economic crisis. Thus, many economists support expansionary discretionary fiscal policy and robust interest rate reductions in such situations, even though their theoretical models are hard pressed to justify such actions.

New Keynesianism is the ultimate example of cuckoo economics. It is impossible to read John Maynard Keynes's *General Theory* (1936) and believe that his theory of unemployment rests on the combination of imperfect competition and price adjustment "menu" costs. However, that is the New Keynesians' claim, and their adoption of the "Keynesian" label serves to confuse debate and dismiss authentic Keynesian claims about the exclusion of Keynesianism (see, for instance, DeLong 2007). The reality is that

New Keynesian economics is a form of real-business-cycle theory. It should really be called "New Pigovian economics," as it is firmly in the tradition of Arthur C. Pigou rather than Keynes.

The latest example of cuckoo economics is "hip" orthodoxy and behavioral economics (Hayes 2007). Thus, some mainstream economists are now embracing ideas from social psychology that critics of the mainstream have long talked about. These ideas include concerns with relative standing (Veblen 1899, Duesenberry 1949), fairness, and less-than-perfect rationality. The trick behind the new behavioral paradigm is that it draws on arguments made by critics of the mainstream but adopts only those ideas that leave unchanged the core analytical assumptions driving modern neoclassical macroeconomics (Palley 2007).

This capacity to selectively incorporate ideas reflects the amoeba-like character of neoliberal economics, which, though dented by recent events, has an astounding capacity to reinvent itself without real change. The implication is that neoliberal economics has not been staked through the heart, and it therefore promises to rise again, like a zombie, when times stabilize.

Conclusion: The Outlook for Macroeconomics and Macroeconomic Policy

The depth of the current economic crisis means there will almost certainly be a policy turn in a Keynesian, or even a Post Keynesian, direction. However, there are profound political, intellectual, and sociological obstacles blocking any fundamental change to macroeconomics. In particular, the economics profession and its ideology remain unreformed. There is little indication of shifts in core understandings concerning labor markets, globalization, and the theory of the natural rate of unemployment. The only place where there is evidence of substantive intellectual change is in attitudes toward financial regulation (though even here, "market transparency" recommendations dominate "quantitative requirements"). These obstacles will mute the policy response to the crisis, and, if a deep economic downturn is averted, will tend to encourage a return to the existing policy paradigm, which has failed disastrously.

Notes

1. With regard to jump-starting the economy, one major disagreement concerns the treatment of debt. Progressive Keynesians prefer policies and legislation that facilitate canceling household debts, whereas neoliberals strongly oppose this action and seek government bailouts of financial institutions without obligating those institutions to cancel outstanding debts.
2. The box analogy is attributable to Ron Blackwell, chief economist for the AFL-CIO.
3. See Ritholtz (2008a, 2008b) for a rejection of the claim that the housing crisis was caused by the Community Reinvestment Act and a failure to regulate the government-sponsored mortgage lenders Fannie Mae and Freddie Mac.

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