Capitalism in the twentieth century has been marked by periods of persistent bad performance alternating with episodes of good performance. Much current economic research ignores this phenomenon; other work concentrates almost exclusively on developing technology as its cause. Cornwall and Cornwall draw upon Schumpeterian, institutional and Keynesian economics to investigate how far these swings in performance can be explained as integral to capitalist development. The authors consider the macroeconomic record of the developed capitalist economies over the past hundred years (including rates of growth, inflation and unemployment) as well as the interaction of economic variables with the changing structural features of the economy in the course of industrialization and transformation. This approach allows for changes both in the economic structure and in the economic variables to be generated within the system.

This innovative and original approach will be essential reading for macroeconomists and economic historians.

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Capitalist Development in the Twentieth Century

An Evolutionary-Keynesian Analysis

JOHN CORNWALL AND
WENDY CORNWALL
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Foreword

David Colander

True macroeconomists are hard to find these days. They seem to have dug themselves into the woodwork in response to the new classical, and their new Keynesian clone, population explosion. When you find a true Keynesian, you have found a treasure, and the Cornwalls are true, unre-pentant Keynesians.

I call their analysis ‘true New Keynesian’. (I can’t simply call it New Keynesian, because that term has been hijacked by a set of writing that often has little to do with either Keynes or macro, but is actually a combination of partial equilibrium analysis and new monetarism going under a Keynesian label.) It is Keynesian because it retains a framework within which aggregate demand can play a role in affecting the long-run performance of the economy. It is new because it incorporates new ideas that are relevant for the exposition. The Cornwalls have carefully followed the modern developments in macroeconomics, adapted those aspects of it they consider advances, and eliminated those aspects of it that they find fads.

In this well-structured book they present, in a wonderfully clear style, a framework that ‘explains’ the stylized facts of macroeconomic development of the industrial nations during the past hundred years. They consider these stylized facts in historical sequence, arguing that the facts trace out a pattern of alternating episodes of poor and superior macroeconomic performance. The framework they use is evolutionary; it is neither completely self-regulating nor knife-edge. The system adapts, but adapts slowly, to events and disturbances. Using their updated, evolutionary model, they explain the past and give us insight into the future.

The Cornwalls’ work is an example of the direction the macro profession would likely have gone had it not become lost in overly formal rational expectations models. It blends elements of three traditions: Schumpeterian, Svennilsonian, and Keynesian. The big change from the early Keynesian work is a switch from a focus only on the short run to a
focus on the intermediate run. In this intermediate run there are many possible directions the economy might take. Which it takes is not a priori determined.

This intermediate-run approach replaces the sterile concept of a unique long-run equilibrium with multiple equilibria. Agents are forward looking, but not so forward looking as to push our credulity over the limit. This intermediate-run approach directs us to think of the economy as a path-dependent process, where hysteresis rules. There’s no predetermined future. Which way the economy goes depends on how institutions and government policy deal with our problems.

The Cornwalls’ Keynesian macroeconomics admits to its deductive limitations. It recognizes the macroeconomy as a complex system from which one cannot build up from first principles to a complete understanding. Instead, one must build down, developing a contextual macroeconomic analysis through an understanding and appreciation of the economy’s institutions. It is an analysis in time. A name for it would be Charles Peirce’s term, abduction. Abduction is not deduction, not induction, but a sensible blend of the two. In abduction the role of theory is to create a reasonable story that 'explains' the facts. Using abduction one is careful not to claim a model is more than what it is – a reasonable story.

The Cornwalls’ overriding policy interest is in keeping unemployment as low as possible. That interest guides their analysis. They argue that a defining feature of the golden age was full employment. They contrast that golden age with the latest episode of neoliberalism where there has been much more unemployment. Drawing on their historical analysis they argue that, to achieve high employment, government, capital, and labour must create and sustain an institutional environment that makes social bargains possible and relieves the economy of constraints on aggregate demand. The golden age achieved this through an activist government. It worked because of a willingness by labour to abandon unrestricted collective bargaining and accept moderate wage demands in exchange for full employment, an expanded welfare state, and ‘fair’ treatment in the workplace.

The political forces that led society to create such golden age institutions have changed in the past thirty years, leading to a breakdown of those institutions and the establishment of a neoliberal regime. The defining characteristics of this modern neoliberal regime are a focus on price stability and an elimination of the institutions necessary for full employment. The Cornwalls argue that the neoliberal institutions place too strong a constraint on aggregate demand and are therefore inconsistent with the full employment goal. Whether institutions can change to become consistent with full employment is an open question. Based on history, the Cornwalls argue that some kind of big push – a precipitating event – is necessary for
the right kind of institutional change, and that this is unlikely in the near future.

I don’t agree with everything in this book but I agree with much of it, and I can highly recommend it to all. It is a sensible blend of institutional knowledge and analytic understanding. It is insightful and instructive, and it will give the reader an excellent sense of what the real issues in macro are.
To Dan, Ian and Isabel
w.c.

To the memory of my parents
J.C.
Preface

This book deals with economic development, and with macroeconomic performance in the context of capitalist development. In addition to explaining the macroeconomic record, for example rates of growth, inflation and unemployment, we explain the interaction of economic variables with the changing structural features of the economy in the course of capitalist industrialization and transformation. This requires a framework suited to analysing a more complex economic reality than mainstream economic theory can encompass. This complexity arises from two sources. First, we include institutions among the structural variables, and the impact of the distribution of economic and political power on these institutions. Second, we examine the interaction of economic performance with the structure of the economy to show how each causes changes in the other. This reaches beyond the ‘intellectual autarky’ of equilibrium analysis, in which structural variables influence the endogenous economic variables but are themselves subject only to unexplained change. Instead, our framework allows for changes both in the economic structure and in the performance variables to be generated within the system. In contrast to this evolutionary approach, mainstream theory focuses on equilibrium states and restricts itself to the less demanding task of establishing conditions for the existence and stability of the equilibrium.

To use our approach is to make what Nelson (1995, p. 85) refers to as ‘an intellectual bet that the price of added complexity is worth paying to buy the better ability to devise and work with a theory that rings right’. The bet is that an evolutionary approach will lead to an understanding of capitalist performance that is denied to those whose work is confined within the mainstream equilibrium framework. In the course of supporting our approach, we shall argue that mainstream macroeconomic theory has not been able to develop an adequate explanation of periods of malfunction, such as the past quarter-century of high unemployment, or even of episodes of superior performance such as capitalism’s ‘golden age’.
The ‘Evolutionary-Keynesian’ description of our approach that appears in the sub-title requires comment. The Keynesian component is chosen to suggest the critical role aggregate demand plays in our framework, echoing the message of the *General Theory*. We maintain there is no automatic tendency for the private sector of an affluent capitalist system to generate full employment levels of aggregate demand. Further, in our view Keynes underestimated the central role of aggregate demand in driving the economy, hence we will speak of an extension of the Keynesian model. The ‘evolutionary’ component of the subtitle is chosen to emphasize endogenous processes involving structural change in our explanation of macroeconomic development. For example, we will model development as a process in which performance generates change in technologies and institutions, which in turn alters performance. This changed performance subsequently induces further structural changes in an endogenous evolutionary process.

Institutions are an essential ingredient in our analysis. They are the laws, customs and norms that guide interactions among individuals in a society. We argue that it is impossible to explain the way an economy works, whether in the short or the long run, without including institutions as part of the economic structure. The mainstream view is that a mark of progress in any field of economics is the rigorous development of its micro foundations, whereas we emphasize institutions to make explicit the ‘macroeconomic foundations of microeconomics’, that is, the way the institutional framework places constraints on individual decision-making (Colander, 1996, 1999).

This study builds on and extends earlier work by the authors in three ways. First, rather than limit the analysis to the post-World War II period, we have set for ourselves the more ambitious goal of including a period covering approximately the twentieth century. Second, our earlier work was more informal and restrictive in its integration of structural features of the economy with the usual economic variables; it focused on the influence of institutions on macroeconomic performance (‘institutions matter’) and how performance affects institutions. In this study, we have attempted to construct a full-fledged framework for modelling the interaction of economic performance with economic structures, especially institutions and technology, in an evolutionary process that incorporates the causal linkages between historical episodes. Third, shifts in the distribution of economic and political power are given a key role in accounting for institutional change.

Because of the complexity of the subject matter, and because some of the topics covered will be unfamiliar to many economists, we have tried to keep the presentation of our ideas as non-technical as possible. In addition, and
in the hope that it will make the work accessible to economists whatever their special fields might be, we have provided background material for the less familiar topics.

We are indebted to the following for providing financial support during the course of writing this book: the Social Science and Humanities Research Council of Canada; the Office of the Dean of the School of Science and Dean Warwick Kimmins, and the Department of Economics, both at Dalhousie University; and the Internal Research Fund at Mount Saint Vincent University. We would like to thank Philip Arestis, Peter Burton, Sean Hargreaves Heap, Geoff Harcourt, Kurt Rothschild, Gouranga Rao, Peter Riach, Peter Skott and Tony Thirlwall for their comments and helpful criticisms. Most of all, we would like to express our gratitude to Mark Setterfield for his extremely thorough reading of the complete manuscript, his numerous helpful suggestions for improving the book, and his encouragement throughout its writing.

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