AFTER THE GREAT RECESSION

The severity of the Great Recession and the subsequent stagnation caught many economists by surprise, but a group of Keynesian scholars warned for some years that strong forces were leading the United States toward a deep, persistent downturn. This book collects essays about these events from prominent macroeconomists who developed a perspective that predicted the broad outline and many specific aspects of the crisis. From this point of view, the recovery of employment and revival of strong growth requires more than short-term monetary easing and temporary fiscal stimulus. Economists and policy makers need to explore how the process of demand formation failed after 2007, and where demand will come from going forward. Successive chapters address the sources and dynamics of demand, the distribution and growth of wages, the structure of finance, and the challenges from globalization, and provide recommendations for policies to achieve a more efficient and equitable society.

Barry Z. Cynamon is a Research Associate at the Weidenbaum Center on the Economy, Government, and Public Policy at Washington University of St. Louis. His early research on the U.S. consumer age of the past quarter century linked rising household spending and debt to group interactions and cultural norms. This work was published in 2008, just as the "risk of collapse" it identified played out to become known as the Great Recession. He has also published research on both monetary and fiscal policy. He holds an MBA from the University of Chicago.

Steven M. Fazzari is Professor of Economics and Associate Director of the Weidenbaum Center on the Economy, Government, and Public Policy at Washington University in St. Louis. He received a PhD in economics from Stanford University in 1982. The author of more than forty peer-reviewed journal articles and book chapters, Professor Fazzari's research explores two main areas: the financial determinants of investment and R&D spending by U.S. firms and the foundations of Keynesian macroeconomics. His teaching awards include the 2002 Missouri Governor's award for excellence in university teaching, the 2007 Emerson Award for teaching excellence, and Washington University's distinguished faculty award, also in 2007.

Mark Setterfield is Professor of Economics at Trinity College, Hartford (CT); Associate Member of the Cambridge Centre for Economic and Public Policy at Cambridge University (U.K.); and Senior Research Associate at the International Economic Policy Institute, Laurentian University (Canada). He is the author of *Rapid Growth and Relative Decline: Modelling Macroeconomic Dynamics with Hysteresis*, and the editor (or co-editor) of six volumes of essays, and he has published on macroeconomic dynamics and Keynesian macroeconomics in journals including the *Cambridge Journal of Economics, European Economic Review, Journal of Post Keynesian Economics*, and *The Manchester School*.

After the Great Recession

The Struggle for Economic Recovery and Growth

Edited by

BARRY Z. CYNAMON
Washington University in St. Louis

STEVEN M. FAZZARI
Washington University in St. Louis

MARK SETTERFIELD
Trinity College, CT

Foreword by **Robert Kuttner**

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

Shaftesbury Road, Cambridge CB2 8EA, United Kingdom

One Liberty Plaza, 20th Floor, New York, NY 10006, USA

477 Williamstown Road, Port Melbourne, VIC 3207, Australia

314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre, New Delhi – 110025, India

103 Penang Road, #05–06/07, Visioncrest Commercial, Singapore 238467

Cambridge University Press is part of Cambridge University Press & Assessment,
a department of the University of Cambridge.

We share the University's mission to contribute to society through the pursuit of
education, learning and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781107015890

First published 2013

A catalogue record for this publication is available from the British Library

Library of Congress Cataloging-in-Publication data
After the great recession : the struggle for economic recovery and growth /
[edited by] Barry Z. Cynamon, Steven M. Fazzari, Mark Setterfield.
pages cm
Includes bibliographical references and index.
ISBN 978-1-107-01589-0
1. United States – Economic policy – 2009– 2. Recessions – United States – History –
21st century. 3. Global Financial Crisis, 2008–2009. 4. Unemployment –
Effect of inflation on – United States – History – 21st century. 5. Keynesian
economics. I. Cynamon, Barry Z., 1984– editor of compilation. II. Fazzari,
Steven M., editor of compilation. III. Setterfield, Mark, 1967– editor of compilation.
HC106.84.A37 2012
330.973–dc23 2012012602

ISBN 978-1-107-01589-0 Hardback

Contents

Figures

Cambridge University Press & Assessment
978-1-107-01589-0 — After the Great Recession
Edited by Barry Z. Cynamon, Steven Fazzari, Mark Setterfield, Foreword by Robert Kuttner
Frontmatter
More Information

Tables

Contributors

Dean Baker, Center for Economic and Policy Research, Washington, DC

Robert A. Blecker, Department of Economics, American University, Washington, DC

James Crotty, Department of Economics, University of Massachusetts, Amherst, MA

Barry Z. Cynamon, Weidenbaum Center, Washington University, St. Louis, MO

Gerald Epstein, Department of Economics, University of Massachusetts, Amherst, MA

Steven M. Fazzari, Department of Economics, Washington University, St. Louis, MO

Jan Kregel, Jerome Levy Economics Institute, Bard College, Annandale-on-Hudson, NY

Thomas I. Palley, Economics for Democratic and Open Societies, Washington, DC

Mark Setterfield, Department of Economics, Trinity College, Hartford, CT

Pavlina R. Tcherneva, Department of Economics, Bard College, Annandale-on-Hudson, NY

L. Randall Wray, Department of Economics, University of Missouri, Kansas City, MO

Foreword

Robert Kuttner

Seldom has there been more of a disjuncture between economic reality and the national conversation about the cause and cure of our predicament. Most serious economists would agree with the core propositions put forth by the contributors to this volume. The economy is stuck in a prolonged period of deflation that is characteristic of the aftermath of a severe financial collapse. The collapse, in turn, was caused by a combination of destructive financial "innovation" and regulatory corruption. The largest banking institutions, having escaped the salutary constraints of the New Deal era, failed at their role of assessing risk and allocating credit. Instead, they behaved like hedge funds, operating at extremely high leverage ratios, creating and trading opaque securities that added nothing to economic efficiency, and hugely profiting at the expense of the real economy. All of this intensified systemic risk and inflated a series of asset bubbles. When the bubbles popped, an immense unwinding occurred, leaving the economy in a prolonged slump. The period we are in is popularly termed "The Great Recession," but it has more of the characteristics of a depression.

The divergence between productivity and wages, which began in 1973, is a big part of this story. As real wages stagnated for most working families, the economy faced a shortfall of aggregate demand. But this weakening of purchasing power coincided with a period of asset inflation created by the same financial abuses that finally resulted in the collapse of 2008. The Federal Reserve contributed by combining low real interest rates with weak regulation, inviting speculative abuses. It did so in order to bail out banks from the consequences of earlier speculative excesses. As housing prices inflated, hard-pressed workers and consumers got into the habit of borrowing against their homes. They also increased their credit card debt. Bankers were only too happy to oblige them. This also coincided with a period when student loan debt grew from almost nothing to a trillion dollars by 2012. For the three middle quintiles of the income distribution, household debt relative to household income increased from 67 percent in 1983 to 157 percent in 2007.[1] Like all bubbles, this could be sustained only as long as asset prices kept inflating.

The asset bubble and reliance on debt as a substitute for income were already well advanced when the boom in subprime mortgages after 2000 caused housing prices to inflate even more steeply. By 2007, the savings rate turned negative and aggregate demand was sustained only by asset inflation and borrowing. When it all came crashing down in 2008, these dynamics went into reverse.

Now, nearly five years later, with the federal deficit still close to 10 percent of GDP, many analysts wonder why the economy is not yet in a durable recovery. The reason, as this book so cogently explains, is that we are still in a 1930s-style debt deflation. The massive overhang of the housing collapse still drags down the recovery. Banks continue to derive the preponderance of their profits from creating and speculating in highly leveraged securities rather than pursuing the more useful, prosaic, and less remunerative business of making commercial and household loans. Wages continue to diverge from productivity growth and unemployment remains high. Consumers are prudently paying back debt. It all adds up to a classic liquidity trap, in which the economy remains stuck in an equilibrium well below its full employment potential.

In this circumstance, monetary policy by itself is powerless to ignite a recovery because banks are too traumatized to lend, consumers and businesses are too risk-averse to borrow, and aggregate demand is too weak. Even zero interest rates and unprecedented emergency bond purchases by the Federal Reserve have been sufficient only to prevent a total collapse but not to stimulate a sustainable recovery. The dynamics are very reminiscent of the middle and late 1930s, in which GDP growth turned positive but depression conditions continued.

Any competent economic historian will report that in such circumstances it takes both fiscal stimulus and the use of taxation on the well-to-do to finance public investment to compensate for the shortfall in private demand and investment. History's great example is of course World War II. The New Deal deficits of 4 percent to 6 percent of GDP were not sufficient to restore full employment. There was a lot of familiar-sounding nonsense explaining

[1] Edward N. Wolff, Recent Trends in Household Wealth in the United States, Levy Institute, March 2012, http://www.levyinstitute.org/pubs/wp_589.pdf.

persistent unemployment in terms of automation and what today would be called the "skills-mismatch" hypothesis.

But when war came, and government began running deficits in excess of 20 percent of GDP, unemployment melted away, a whole generation of workers got trained, a generation of industry got recapitalized, and the economy grew at the record rate of 12 percent per year for four years. The economy suddenly produced at its potential. And then, when the war ended, the economy accommodated some 12 million returning GIs as people cashed in their war bonds and the stimulus of war gave way to the stimulus of postwar recovery. In the boom that followed, wages increased slightly faster than productivity. The economy grew faster than the national debt, and the debt ratio of more than 120 percent of GDP came steadily down. There was no Bowles-Simpson commission in 1945 targeting the debt-to-GDP ratio in 1955 as a bizarre recovery strategy of confidence-building. Tight regulation of banking permitted financing of the large war debt at very low interest costs without fueling speculation.

There is almost no dispute among economists that the massive fiscal stimulus of the war, coupled with very high taxes on the affluent, produced the public spending to cure the Depression. Indeed, conservative analysts have pointed to the war in order to disparage the partial success of the New Deal.[2] But in today's very similar circumstances, the conventional wisdom is that we must somehow deflate our way to recovery. Most Democrats as well as Republicans, and prominent media commentators, are obsessed with the idea that the deficit, rather than the depressed economy, is the most urgent problem, and that recovery will somehow be stimulated by cutting public spending. There is no plausible economic theory that explains how this will occur. The extremely low interest rates on long-term bonds are evidence that there is neither "crowding out" nor investor fears of inflation. The modest financial reforms of the 2010 Dodd-Frank Act are being undermined by a rearguard lobbying action, and the same business model that caused the collapse is all too intact. There is far too little effort to alleviate the crushing overhang of the housing collapse, which functions as one more drag on recovery.

The conventional wisdom promoting an austerity cure is the result of one more imbalance in the political economy – the disproportionate political influence of finance that stems from its outsized economic influence. If we pursue this deflationary course, we will be condemned to at least a decade

[2] Amity Schlaes, *The Forgotten Man: A New History of the New Deal*. New York: Harper-Collins, 2008.

of a severely depressed economy. The debt-to-GDP ratio is a moving target. If we try to reduce it by rejecting expansionary policies and prematurely cutting deficits, we may eventually get to a balanced budget but a much reduced level of economic output. Or as growth and revenues both slow, we may find that debt reduction is a mirage.

Instead, the economy needs a restoration of wage income. It needs re-regulation of the financial sector so that finance can once again serve the real economy. And it needs World War II–scale public investment (without the war, thank you). But one scarcely finds this analysis in mainstream political discourse. That vacuum makes this very thoughtful volume all the more essential.

Robert Kuttner is the coeditor of *The American Prospect*, senior Fellow at Demos, and author of ten books, most recently *Debtors' Prison: The Politics of Austerity versus Possibility* (2013).

Preface

The project culminating in this book began with a conversation between Steven M. Fazzari and Thomas I. Palley about how the events of the Great Recession in 2008 and 2009 validated the economic analysis put forward by a group of Keynesian macroeconomists before the recession, in some cases well before. A group of these economists were then invited to a workshop in the summer of 2009 to discuss the remarkable economic events of the previous several years. The meeting was held at Washington University in St. Louis and organized by the Weidenbaum Center on the Economy, Government, and Public Policy. Following this interesting discussion, the Weidenbaum Center commissioned the papers that became the chapters of this book, early drafts of which were discussed in detail at a second St. Louis workshop in the summer of 2010.

The editors are grateful to the Weidenbaum Center for generous financial support throughout this project. Center Director Steven Smith offered helpful guidance as we developed the book manuscript. Center staff members Gloria Lucy, Chris Moseley, and Melinda Warren provided their typical competent and friendly help with arrangements for both of the St. Louis meetings and other administrative tasks as the book came together. Scott Parris and Kristin Purdy from the economics and finance group at Cambridge University Press provided quick responses to many queries during production of the book. The comments of three anonymous reviewers chosen by the Press significantly improved the manuscript. We thank Noah MacMillan for creative cover art. Finally, we are most grateful to the authors of the following chapters for their original and important insights, as well as the efforts they made to link their perspectives so that this book provides a coherent whole greater than the sum of its parts.

Barry Z. Cynamon, Steven M. Fazzari, and Mark Setterfield
St. Louis, Missouri
May 2012