PART I

ORIGINS OF THE GREAT RECESSION

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Goodbye Financial Crash, Hello Stagnation

This book is about the financial crash of 2008 and the Great Recession that followed. It also predicts the Great Recession will be followed by a Great Stagnation during which the unemployment rate will remain high, wages will stagnate, and a general sense of economic disquiet will prevail.

This is not a tight numeric forecast, but rather a prediction about directional tendency based on current economic policies in the United States and other countries. There will undoubtedly be months when the news is good and months when it is bad, but the general tendency will be one of stagnation and failure to recover shared prosperity. Growth will continue, but it will be growth with unnecessary high unemployment. Moreover, growth will be slower than what could be achieved in a full-employment economy.

Though difficult to predict, the stock market may even do well. First, stagnation will result in low interest rates and that tends to be good for stock values. Second, high unemployment will pressure wages in favor of profits. Third, many companies may be able to make profits from their operations in emerging market economies where the consumer credit cycle looks like it may rev up. But, regardless of how the stock market performs, a strong stock market should not be confused with shared prosperity. Stock ownership is enormously concentrated among the wealthy, and ordinary working families depend on wage and salary income.

In effect, the Great Recession has created a wounded economy in which large segments of society risk permanent exclusion from prosperity. Even though policy makers succeeded in preventing the financial crisis from spiraling into a second Great Depression, they

have failed to fix the underlying structural failings that led to the crisis. That is why the economy is wounded and why the prognosis is one of stagnation.

This gloomy economic outlook reflects the fact that the private sector and global economy is beset by economic weakness and contradiction created by thirty years of market fundamentalist policy. Much of the global economy is now debt-saturated and short of demand. In this environment, stagnation is the default condition and the existing policy mix of expansionary monetary and fiscal policy will be insufficient to jump-start sustainable growth with shared prosperity.

It does not have to be this way. A flawed economic paradigm created the current condition and as long as it prevails, the prospect is for stagnation. If the paradigm can be replaced, then prosperity can be restored. The great lesson of the twentieth century is that shared prosperity is made and not found. The right economic structure based on the right policies produces shared prosperity, as happened in the generation after World War II. A wrong economic structure based on wrong economic policies produces exclusion and stagnation, as happened in the 1930s and is happening again.

Core Thesis

The core thesis of the book is that the roots of the financial crisis of 2008 and the Great Recession can be traced to a faulty U.S. macroeconomic paradigm that has its roots in neoliberalism, which has been the dominant intellectual paradigm. One flaw in the paradigm was the growth model adopted after 1980 that relied on debt and asset price inflation to drive demand in place of wage growth linked to productivity growth. A second flaw was the model of engagement with the global economy that created a triple economic hemorrhage of spending on imports, manufacturing job losses, and off-shoring of investment.

The combination of stagnant wages and the triple hemorrhage from flawed globalization gradually cannibalized the U.S. economy's income and demand-generating process that had been created after World War II on the back of the New Deal. However, this cannibalization was obscured by financial developments that plugged the growing demand gap.

Financial deregulation and financial excess are central parts of the story, but they are not the ultimate cause of the crisis. Financial developments contributed significantly to the housing bubble and the subsequent crash. However, they served a critical function in the new model, their role being to fuel demand growth by making ever larger amounts of credit easily available. Increasing financial excess was needed to offset the increasing negative effects of the model of growth and global economic engagement that undermined the demand-generating process on which the U.S. economy depended.

This process might have gone on for quite a while longer. However, between 2001 and 2007, the flawed model of global economic engagement accelerated the cannibalization process – which is where China becomes such an integral part of the story. This created the need for a huge bubble that only housing could provide, and when it burst, it pulled down the entire economy because of the housing bubble's massive dependence on debt.

Finance plays a critical role within this explanation of the financial crisis and the Great Recession, but it is not the prime cause. Persistent financial expansion kept the process going far longer than it would otherwise. Absent this expansion, the economy would have tumbled into stagnation long ago because of its contradictions. However, the price of keeping the economy going in this fashion was a deeper crash. Rather than coming to a slow grinding halt, extended financial excess meant when the contradictions finally asserted themselves, the economy exploded in financial pyrotechnics. It also means more prolonged stagnation because of the burden of accumulated debt.

The old post–World War II growth model based on rising middle-class incomes was dismantled by the market fundamentalist revolution of the late 1970s and early 1980s. The financial crisis of 2008 signaled the implosion of the market fundamentalist model. That has created the opening for a new paradigm that the book labels "structural Keynesianism."

Economic Policy and the Metaphor of Pump Priming

The underlying economic policy problem can be thought of in terms of the metaphor of a well in which the flow of water represents economic activity. Expansionary monetary and fiscal policy "prime the pump"

by stimulating demand. That creates spending and jobs, triggering a multiplier effect in the economy.

The problem with pump-priming policy is it only works if there is water in the well, and the well is now dry. That implies existing policy will not succeed.

If the well is dry, we need to drill a new well. That means building a new economy based on a new economic paradigm. The challenge is to rebuild the income and demand-generating process, which have been corroded by thirty years of market fundamentalism. Only this can generate the self-sustaining private-sector growth needed to eliminate mass unemployment and restore shared prosperity.

History, Politics, and Where to Begin

One of the great challenges writing a book on the economic crisis is choosing where to begin the story. The financial crisis and the Great Recession are part of history, and history is a continuum. For many economists, the focus is the housing price bubble that burst in 2006, and the housing price bubble clearly played a major role in the crisis. However, this book argues that the origins of the crisis are to be found long before the housing price bubble. Moreover, the bubble was a logical outcome when viewed in the context of a longer historical narrative about the U.S. economy.

Most accounts of the crisis take a relatively short horizon. That makes telling the story easier. First, a shorter period means a simpler story with fewer factors to take into account. Second, events are more recent and therefore fresher in readers' memories. Third, there may also be political motives in attributing the crisis to recent events. In particular, Democrats would like to pin the blame on the Bush administration of 2001–2009.

In this author's view, the Bush administration was not the cause. It certainly played along by embracing the policies that caused the crisis. However, the ultimate cause lies in the failure of the market fundamentalist paradigm that was adopted in the late 1970s and early 1980s.

The important implication is that political support in the United States for the paradigm has been bipartisan. That also holds in Europe where "new" social democrats have moved closer to their conservative counterparts. In the United States, there certainly have been different

shades of support, and a significant segment of the Democratic Party always opposed the market fundamentalist paradigm. However, the politically dominant New Democrat wing of the Democratic Party has always supported it and still does.

There are several lessons from these brief political observations. First, the economy is not a "natural" phenomenon. Instead, it is made and shaped by economic policy.

Second, the policy adopted reflects the economic views of the winners, and those views in turn reflect the economic interests of the winners. That also holds for academic economics. Universities and economics departments are part of society and they therefore reflect society's dominant view that is shaped by society's winners. Except for economists, this is something most social scientists recognize and acknowledge.

Third, changing economic policy involves putting new ideas in place via politics. This is a two-step agenda: winning the war of ideas and winning the political battle. One without the other does not produce change. That is the historical tragedy of the Obama administration.

Fourth, the fact that neoliberal economics has captured both sides of the political aisle (Republican and New Democrat) makes it extremely difficult to dislodge. This difficulty operates at two levels. First, the two parties masquerade as if engaged in a titanic economic policy struggle when in reality both have supported a common paradigm. That masquerade is confusing to the public and crowds out political space for a true alternative. Second, the United States has an entrenched two-party political system with limited room for political competition via new entry. That is because of the "first past the post," winner-take-all electoral system. Putting the two difficulties together creates a real bind. Even if the public were to see through the political masquerade, it would have nowhere to go.

This political system is very durable, but it is not indestructible. The problem is it will only give way under extreme events that impose significant economic suffering and hardship. Moreover, if it does give way, there are no guarantees about the subsequent outcome. Thus, the forces of reaction, who argue for a doubling-down of the market fundamentalist policies that have already failed us so badly, could win. Those forces may also be accompanied by other political forces of intolerance and hate.

In this regard, the experiences of the 1930s in Europe and the United States hold important lessons about the political dangers that could accompany the Great Stagnation. Although fascism only prevailed in Europe, there were powerful similar forces in the United States in the form of the German American Bund, the Liberty League, the America First movement, and the Klu Klux Klan. Popular history provides a comforting narrative about the overwhelming triumph of FDR's politics and economics of the New Deal. The historical record is far more complex and ominous.

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The Tragedy of Bad Ideas

In his famous essay on the Bengal famine of 1943, Nobel Prize–winning economist Amartya Sen (1982) argues famines occur because of political inequalities built into the mechanism for distributing food. The great Ukraine famine of 1932–33 in Stalin's Soviet Union also had political roots, as did the late 1950s Great Leap Forward famine in Mao's communist China. The greatest tragedies are human-made and are rooted in bad ideas.

The same holds for the financial crash of 2008, the Great Recession, and the looming Great Stagnation, which are the product of flawed economic ideas, implemented through economic policy, in the service of particular economic and political interests. Keynes (1936) was aware of this power of ideas as he struggled to win acceptance of the ideas in his *General Theory*: "(T)he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist" (p. 383). The tragedy of bad economic ideas is that once they grab hold of society's imagination, it becomes nearly impossible to persuade people to abandon them. Instead, the ideas must be lived through and disproved by experience. This may now have happened to neoliberalism, with the crisis creating an opportunity to implement a new set of economic ideas.

Ironically, this power of ideas and the role of crisis in creating opportunity for change was fully understood by the great neoliberal economist, Milton Friedman (1962, 2002):

"There is enormous inertia – a tyranny of the status quo – in private and especially government arrangements. Only a crisis – actual or perceived – produces

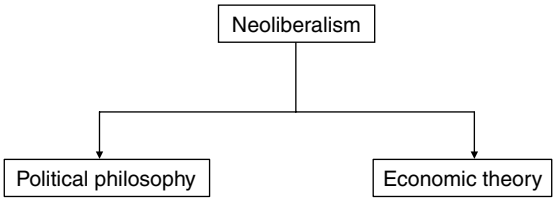

Figure 2.1. The structure of neoliberalism.

real change. When that crisis occurs the actions that are taken depend on the ideas that are lying around" (pp. xiii–xiv).

He went on further 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 possible" (p. xiv).

Friedman exploited the social and economic dislocations of the 1970s to push his policy agenda. Even though he was a purveyor of faulty ideas, he was a brilliant polemicist and intellectual strategist. The intellectual revolution he fathered is still with us, but the financial crash of 2008 and the Great Recession have finally created an opportunity for a sensible counterrevolution.

The Origins and Logic of Neoliberalism

The flawed idea that has dominated economic policy making for the past thirty years, to the exclusion of almost all else, is neoliberalism. As illustrated in Figure 2.1, neoliberalism is a way of thinking about society that embodies both a political philosophy and an economic theory. The reference to "liberalism" reflects an intellectual lineage that connects with nineteenth-century economic liberalism associated with Manchester, England. The Manchester system was predicated on laissez-faire economics and was closely associated with the free-trade movement of that era.

Modern neoliberalism comes in European and American versions that have subtle but important differences. The European strain is principally associated with the work of Austrian economists Friedrich von Hayek and Ludwig von Mises, who impressed deeply British Prime Minister Margaret Thatcher. It sees the economy as historical