PART ONE

INTRODUCTION AND OVERVIEW

ONE

Understanding the Great Recession

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> I must say that I, back in 2007, would not have believed that the world would turn out to be as fundamentalist-Keynesian as it has turned out to be. I would have said that there are full-employment equilibrium-restoring forces in the labor market which we will see operating in a year or two to push the employment-to-population ratio back up. I would have said that the long-run funding dilemmas of the social insurance states would greatly restrict the amount of expansionary fiscal policy that could be run before crowding-out became a real issue.
>
> I would have been wrong.
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> Brad DeLong blog, *Grasping Reality with Both Hands*
> (from "More Results from the British Austerity Experiment,"
> http://delong.typepad.com/sdj/2011/04/, April 27, 2011)

In December of 2007, the U.S. economy entered a recession. As economic statistics in the first part of 2008 confirmed an emerging downturn, the policy establishment acknowledged the weakness, but seemed to expect nothing more than a mild recession followed by a quick recovery. For example:

> The U.S. economy will tip into a mild recession in 2008 as the result of mutually reinforcing cycles in the housing and financial markets, before starting a modest recovery in 2009 as balance sheet problems in financial institutions are slowly resolved. (IMF World Economic Outlook, April, 2008).
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> Our estimates are that we are slightly growing at the moment [April, 2008], but we think that there's a chance that for the first half [of 2008] as a whole, there might be a slight contraction.… Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. (Ben Bernanke, Testimony to the Joint Economic Committee, April 10, 2008)

We now know that these forecasts badly missed the mark. Job losses and financial instability accelerated through the summer of 2008. After the dramatic events in the wake of the collapse of Lehman Brothers (September 15, 2008) the U.S. economy went into a free fall that eerily tracked the first months of the Great Depression. Job losses in the United States and abroad were the worst in generations and in contrast to early predictions that recovery would come soon, the best that can be said about the U.S. economy as we approach *five years* from the official beginning of the recession is that collapse has been replaced by stagnation.

The dramatic crisis and extended stagnation seem to have caught most economists by surprise. Prior to the onset of the Great Recession in 2007, thinking had converged to the idea that since the mid-1980s, the United States (and other developed countries) had been experiencing a "Great Moderation" – a marked reduction in the volatility of the aggregate economy as compared with the 1970s and early 1980s (see, for example, Galí and Gambetti, 2009). Researchers posited a number of explanations for this favorable performance. Particularly prominent was the view that enlightened monetary policy pursued according to well-defined rules can effectively contain instability and quickly turn negative-growth hiccups back to a favorable long-run path of high employment and rising living standards.

In contrast, a group of macroeconomists, largely outside of the academic mainstream, repeatedly warned during the Great Moderation years that gradual, but very strong, forces were leading the U.S. economy toward a deep recession and persistent stagnation. These economists drew on an alternative perspective, rooted in Keynesian theory, that emphasizes the central roles played by aggregate demand, uncertainty about the future, and finance in determining the path of the aggregate economy through time. From this vantage point, the Great Moderation was not a permanent structural change that could be expected to deliver robust and low-variance growth indefinitely. Rather, the relatively good performance of the U.S. economy in the decades following the deep recession of the early 1980s arose from unique historical circumstances, most prominently a high rate of demand growth financed by unprecedented borrowing in the household sector.

The expansion of borrowing and lending was not just accommodated but, in some cases, actively encouraged by institutional changes in the financial sector. The experience of financial stability in the post–World War II era, assisted in large part by the extensive regulation imposed on the financial sector following the Great Depression, increased the confidence of financiers and their customers. Ironically, this relative financial stability that emerged in a policy-constrained environment validated the increased confidence in markets and induced the subsequent institutional changes designed to "free up" the way they work. As the system was deregulated, the degree of sophistication of financial models, credit rating systems, and trading platforms grew, and the demand stimulus from more aggressive financial practices helped reinforce optimistic perspectives about risk and returns. The economy grew, then, by gradually undermining the institutional supports responsible for generating financial stability and aggressively funding demand growth with debt. In other words, growth resulted from the steady increase of financial fragility.

This fragility remained largely contained during the superficially successful era of the Great Moderation, but since 2007 it has become dramatically manifest, with disastrous macroeconomic consequences. Moreover, now that the consumption-led and household-debt-financed engine of aggregate demand growth has ground to a halt, there is no automatic mechanism to generate the demand necessary for recovery. Insufficient demand of this nature can create a persistent problem, one not just confined to the "short run" of mainstream "New Keynesian" models. The return to economic conditions that even approximate full employment will be a difficult and protracted process. If policy is to mitigate this sluggishness, it will require much more significant intervention to create demand growth than has been pursued in the United States over recent decades. Furthermore, conventional "stimulus" policy, both monetary and fiscal, may not be sufficient to improve economic performance so that it once again appears normal by the standards set during the Great Moderation. A true recovery may be possible only with deep structural change, particularly in the distribution of income, which induces healthy demand growth without unsustainable borrowing.

This volume collects the thinking of a group of Keynesian macroeconomists whose understanding of the Great Recession (as previously summarized) is distinct from that of most academic economists, policy makers, and journalists.[1] A number of authors represented in this volume "saw it coming" and published early warnings that not only predicted a crisis of historic magnitude but also explained in broad terms how it would unfold.[2]

[1] As the quotation from Brad DeLong at the start of this introductory chapter suggests, a number of other economists have since come around to the more fundamentally Keynesian way of thinking that informs the contributions to this volume.

[2] The title of Palley (2002), "Economic contradictions coming home to roost? Does the US economy face a long-term aggregate demand generation problem?" says it all. Setterfield

These perspectives also implied that recovery would be sluggish (at best), both because the challenge of sustaining robust aggregate demand growth is more difficult than often appreciated and because the usual policy actions that many mainstream economists trusted during the Great Moderation period would turn out to be woefully inadequate once the household debt engine of demand growth ran out of gas.

This introductory chapter surveys the landscape of the Great Recession as it has unfolded to date, and summarizes the economic thinking that lies behind the contributions in the following chapters. A fundamental objective of this project is to explore the implications of the perspective developed here for the way forward, as the U.S. economy struggles to restore growth and fully employ its resources. Each chapter addresses this issue. In addition, the concluding chapter draws the various threads from individual authors together to discuss the challenges facing the economy over the coming years. The final chapter also addresses what the body of work presented here teaches us about what policy can – and cannot – do to enhance the prospects for recovery.

1. The Great Recession: A Brief History

The Great Recession created the most severe disruption in U.S. economic activity since the 1930s. Figure 1.1 shows the profile of employment for all U.S. recessions since 1974–75, itself a watershed event that ended the post–World War II period of relatively good macroeconomic performance. The figure indexes employment to 100 at the beginning of each recession and tracks the number of jobs through their decline and recovery until employment again reaches its pre-recession level.[3] The decline in employment at the trough of the Great Recession was roughly three times more severe than the average decline in the four other comparison events. The persistence of

(2006, p.59) warns that the U.S. "incomes policy based on fear" during the Great Moderation may be undermining the demand-generating capacity of the U.S. economy. In an op-ed in the *St. Louis Post Dispatch* (October 3, 2007, page B9) Cynamon and Fazzari warn that "the current financial instability in the mortgage markets is merely the initial rumbling of a much bigger economic storm on the horizon." Wray (2007, p.44) fears the emergence of "a huge demand gap that is unlikely to be fully restored by exploding budget deficits or by exports." Also see Godley and Izurieta (2002).

3 The 1980–83 period is treated as a single event in this figure even though it includes two separate recessions according to National Bureau of Economic Research (NBER) dating. Employment briefly rose modestly above its pre-recession level in 1981 only to decline significantly a few months later. None of the following interpretations change if this event is treated as two separate recessions.

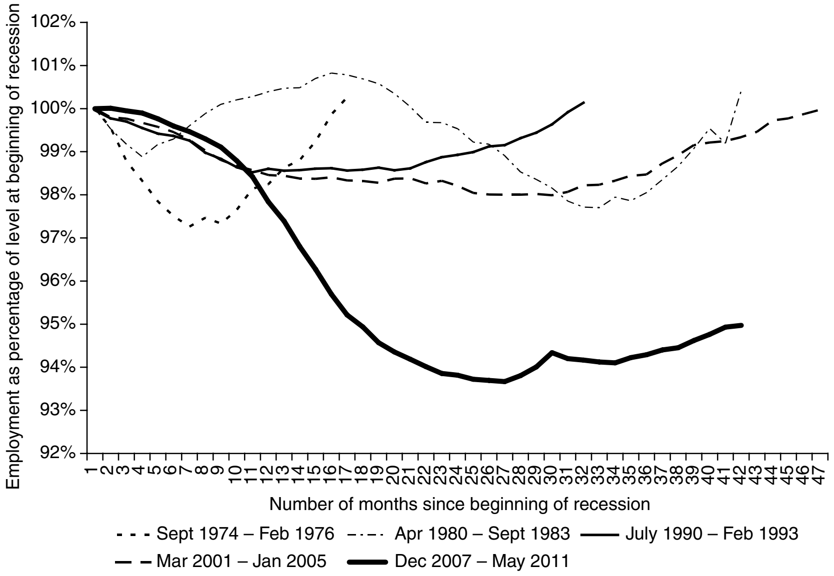

Figure 1.1. Employment profile of recent U.S. recessions.
Source: Total non-farm employees from U.S. Bureau of Labor Statistics' establishment survey. Initial employment indexed to 100 for each recession.

the job losses is also remarkable. Although modest job growth began after twenty-five months of decline, this growth only managed to recover about a quarter of the job losses in the subsequent year and a half. If this rate of growth continues, it will take about eight years from the beginning of the recession for employment to recover to its pre-recession level – a period approximately double that of the worst previous recession since the 1930s. Something fundamentally different is going on compared to more than sixty years of previous history.

The disruptions beginning in 2007 also caused the first serious drop in U.S. consumption since the early 1980s. After two decades of almost continuous increases, the ratio of consumption to disposable income tumbled about four percentage points in 2008 alone. Although this statistic fell by similar amounts during the severe 1974 and 1980 recessions, consumption bounced back quickly as robust recoveries took hold. From 2009 through mid-2011, however, the consumption-income ratio has remained about four percentage points below its 2007 levels.

Residential construction has been an unmitigated disaster. It rose substantially from 2002 to 2006 as a share of GDP, but despite common descriptions of excessive home building as a massive misallocation of resources during these years, the "boom" period was largely in line with historical fluctuations. What was unparalleled in recent history, however, was the decline in home construction beginning in 2006. By 2011, residential investment was much less than half of the value it attained at the 2005 peak, and about half of the fairly stable value for the decade prior to the pre-crisis boom.[4] A look at historical residential construction statistics shows that every U.S. recovery since (at least) 1975–76 has been driven in large part by a housing boom. In the bleak conditions for housing evident almost five years since the onset of the Great Recession, there is no prospect for anything like a return to normal, much less a boom. These declines in consumer spending and home building represent massive declines in aggregate demand, and from the Keynesian perspective, they are the proximate cause of the Great Recession.

Of course, the obvious candidate for the trigger that forced both consumption and residential construction to plummet was overextended mortgage debt and the dramatic financial crisis this debt created. Not since the early 1930s has the U.S. economy gotten close to the kind of financial collapse that followed the failure of Lehmann Brothers investment bank in the fall of 2008. The crisis largely shut down the extension of consumer credit, choking off what had become the fuel for demand expansion during the previous two decades.

Policy actions have also been dramatic during the past few years. The Federal Reserve and the U.S. Treasury pursued a wide variety of refinancing – that is, "bailout" – policies, starting in the late summer of 2007, even before the official recession began. The Fed's balance sheet expanded dramatically as it bought mortgage-backed securities and, later, long-term Treasury bonds for trillions of dollars. Fiscal stimulus took a variety of forms. The nearly $800 billion American Reinvestment and Recovery Act passed early in the Obama administration was the most prominent among "stimulus" measures. However, automatic stabilizers (rising entitlement spending and falling tax revenues) were quantitatively more important. The federal deficit rose to about 10 percent of GDP in 2010, about double the previous post–World War II record set in the early Reagan years.

Prior to the Great Recession, virtually no analyst of U.S. policy would have predicted such aggressive policy responses. Yet, the sluggish recovery and continued deep uncertainty about the economy's future several years

4 Residential construction averaged a remarkably stable 5.2% of GDP from 1993 through 2002. In 2005, it peaked at almost 6.2% of GDP, similar to its peak in the mid-1980s (earlier peaks were even higher). As of 2011, construction was about 2.5% of GDP.

after the events that triggered the Great Recession suggest, if anything, that the policy responses were too timid.

2. Mainstream Macroeconomics and the Great Recession

The essential feature of the perspective that connects the contributions to this volume is that the interplay of three central features of capitalism – aggregate demand, uncertainty, and finance – explains much of the boom of the Great Moderation period and the bust that culminated in the Great Recession.[5] Increased confidence and "animal spirits" fed into an unprecedented increase in household indebtedness that fueled the expansion of aggregate demand, until financial fragility finally cracked (initially in the subprime mortgage market), rupturing confidence and dousing animal spirits. This set up a sudden and precipitous decline in aggregate demand, as credit contraction, wealth destruction, and decreasing aggregate expenditures interacted in a vicious spiral that was only arrested by massive policy interventions.

However, this account is quite at odds with the perspective of most mainstream macroeconomics, especially as practiced prior to the dramatic events of the fall of 2008. Much mainstream theory was, and remains, committed to an avowedly supply-side view of the economy, according to which variations in aggregate demand have no direct role to play in determining "real" macroeconomic outcomes (such as unemployment), even in the short run. From this point of view, the essential cause of the Great Recession was a supply-side shock – a sudden increase in labor market frictions, or a shock to labor supply or financial intermediation, for example – causing dislocations in the economy that are most likely temporary.[6] Even if these shocks represent more persistent structural problems, the solution to them has nothing to do with replacing the aggregate demand growth that was lost with the end of the housing-debt-financed consumption boom.[7]

5 Some parts of sections 2 and 3 are extensively revised from Cynamon and Fazzari (2010).

6 For example, according to Feldstein (2010), we can look forward to a period of *faster* growth over the next ten years, as a sharp rebound from the Great Recession itself puts the United States back on the trend set by an uninterrupted natural rate of growth.

7 For example, in mid-2010, the president of the Federal Reserve Bank of Minneapolis, Narayana Kocherlakota proposed that much of the unemployment problem is the result of mismatched skills and geographic preferences: workers are not in the places or industries where the jobs are. If this is the case, it follows that "[m]ost of the existing unemployment represents mismatch that is not readily amenable to monetary policy" (speech at Northern Michigan University, August 17, 2010).

Yet it is hard to escape the seemingly central role of finance in bringing about the Great Recession (despite the proclivity of some supply-side accounts of recent events to do just this by focusing instead on, for example, the workings of the labor market – see Ohanian, 2010). And although some supply-siders do see a role for finance in causing the Great Recession (a shock to the technology of financial intermediation, for example), their models do not, in our view, provide the best foundation for such an account.[8] As Edmund Phelps (2010, p. 2, emphasis in original) has recently remarked:

> [Supply-siders are] not in a position to argue that the excessive vulnerability of banks (and counterparties) to loans gone sour and resulting stoppage of loans to businesses, which has been recurrent in the past two centuries, can be viewed as just an unusually large value in some disturbance term in this school's models. After all, the precepts of this school imply that episodes of excessive leverage and credit stoppages *do not occur*: Markets are perfectly efficient to a decent approximation.… The school that laid the ground for the belief in "the magic of the market" cannot pretend that its models succeed in encompassing gross mispricing of risk and pathological values put on familiar assets.

Despite the search for an exclusively supply-side explanation for the Great Recession among some academics, the events of the past four years have created a remarkable shift toward Keynesian thinking among many mainstream economic analysts, including journalists and policy makers.[9] Consider first how we understand the sources of the Great Recession. As noted earlier, the role of finance is virtually inescapable, and so it is not surprising to find that almost all explanations begin with problems in the U.S. mortgage market and emphasize a channel that goes from credit to demand. The bursting of the housing bubble created a clear and direct "demand shock." Residential construction collapsed and the American consumer juggernaut crashed for the first time in more than two decades. A broad swath of the economics

[8] This likely explains why many supply-siders were quite sanguine about the prospects for the U.S. economy, even as it entered the teeth of the financial crisis in fall 2008. For example, in the aftermath of the failure of Lehman Brothers in the fall of 2008, University of Chicago Professor Casey Mulligan opined that "[e]conomic research has repeatedly demonstrated that financial-sector gyrations like these are hardly connected to non-financial sector performance … So, if you are not employed by the financial industry (94 percent of you are not), don't worry. The current unemployment rate of 6.1 percent is not alarming, and we should reconsider whether it is worth it to spend $700 billion to bring it down to 5.9 percent" (Mulligan, 2008).

[9] As will become clear, this remains true despite current obsessions in the political sphere with "excessive" public deficits and debt and the "need" for austerity measures. We return to discussion of these themes later in this chapter.

profession and virtually all forecasters recognize the need for renewed spending, private or public, as critical for any kind of meaningful recovery. For example, Christina Romer, who had a front-row seat to the crisis in her role as chair of President Obama's Council of Economic Advisors, stated in an April 12, 2011 speech at Washington University in St. Louis, "I believe that when scholars finish analyzing both the U.S. and international evidence, the bottom line will be that fiscal stimulus is, and was in this past recession, a key tool to fight cyclical unemployment."

Macroeconomic policy has also been explicitly Keynesian, perhaps more than at any time for at least a quarter century. In the aftermath of the fall 2008 crash, fiscal stimulus packages emerged around the world with the explicit objective of boosting spending. This is a major change. Since the Reagan-Thatcher years, fiscal responses to recessions have been justified with supply-side arguments, even if it turned out that the most important effect of the resulting tax cuts was to stimulate demand rather than supply. However, discussions of recent stimulus measures in the immediate response to the most severe period of the recession largely jettisoned supply-side rationales and focused on the importance of creating spending, and doing so quickly.

Recent events have also transformed monetary policy, both its execution and how it is perceived by mainstream economists. The Bernanke Fed has cut short-term interest rates to zero for an extended period and pursued aggressive lender-of-last-resort interventions. Whereas there are clear grounds to criticize the way policy makers implemented the Troubled Asset Relief Program (TARP), the Term Asset-Backed Securities Loan Facility (TALF), bailouts of Fannie Mae, Freddie Mac, and AIG, and other such initiatives (particularly the distributional consequences of propping up massive institutions and their outrageously compensated management), the basic logic that motivates the systemic ambitions of these remarkable actions comes from Keynesian theory, broadly conceived to include Hyman Minsky's perspective on financial instability.

In addition, mainstream macroeconomic thinking may be shifting in another important but less obvious way. As economists digest the dramatic events of recent years, the relevance of the so-called new consensus approach to macroeconomics seems to be fading. These models adopt the microfoundations methods of new classical research, but price stickiness leads to short-run monetary non-neutrality. They admit short-run Keynesian features, but also posit competent monetary engineers, their tool belts equipped with Taylor rules and inflation targets, who keep the real effects of demand shocks well in check. One corollary of this thinking is