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AFTER THE BUST

The Outlook for Macroeconomics and Macroeconomic Policy

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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. 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 new U.S. administration face three challenges:

(1) *Stop the bleeding*—which means freeing markets from the liquidation trap (Palley 2008a). This requires putting a floor under the financial crisis by stopping further wholesale asset price deflation and restoring credit flows.

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(2) *Jump-start the economy*—which means getting the economy and employment growing again. This requires sustained 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). 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, it is a predictable outcome of the economic paradigm that has driven growth since the neoliberal era was inaugurated, in the early 1980s, by Prime Minister Thatcher and President Reagan (Godley 2000, 2001, 2005; Palley 1998, 2001, 2005, 2006a, 2006b). 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. The average compensation of nonsupervisory workers and U.S. median family income have stagnated since the late 1970s, even as productivity has continued to rise. This disconnect in turn explains widening income inequality, as income has been shifting to the top of the distribution.

The neoliberal economic policy paradigm can be described in terms of a box, as illustrated in Figure 1. (The box analogy is attributable to Ron Blackwell, chief economist for the AFL-CIO.) 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 strength of the neoliberal policy box derives from a new relationship between corporations and financial markets. This new relationship has been termed "financialization" (Epstein 2001, Palley 2008b). Figure 2 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 (Palley 2008b). 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. The case for small government is based on Milton Friedman's (2002) arguments for a minimalist, or "night watchman," state. The retreat from full employment has been driven by New Classical macroeconomics, which substituted

Figure 1 **The "Neoliberal" Policy Box**

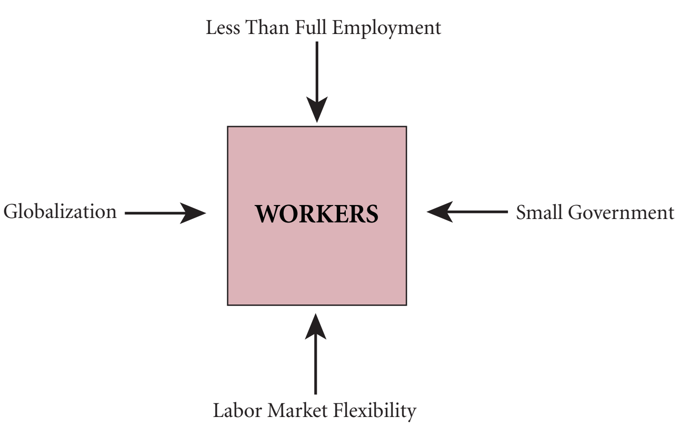
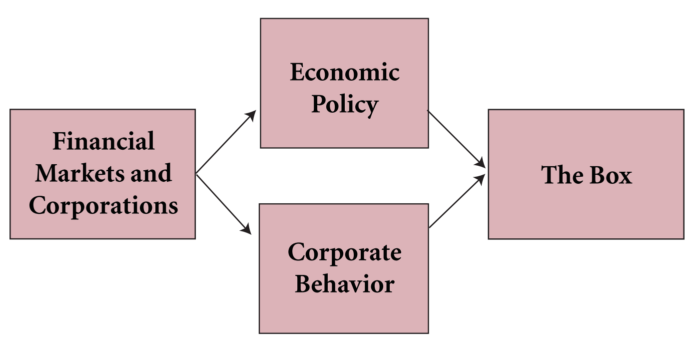


Figure 2 **Dynamics of Financialization**



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.

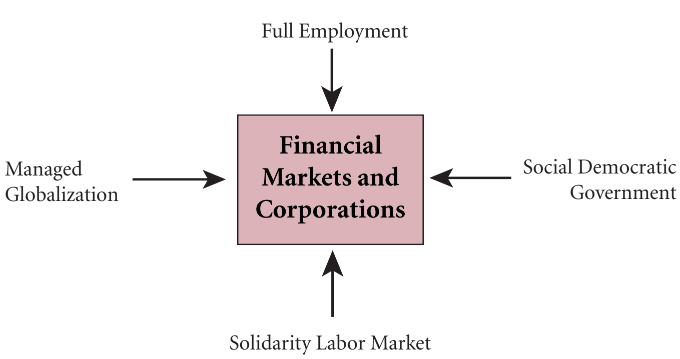
The push for so-called "flexible" labor markets has been driven by the neoclassical construction of markets based on marginal productivity theory, which has fueled an attack on unions, the minimum wage, and employment protections, all of which are characterized as labor market "distortions." Increased 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.

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); 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, which has been used to justify exotic financial innovations in the name of risk spreading and portfolio diversification; and q theory (Tobin and Brainard 1968), which supports the claim that financial markets do a good job of directing investment and the accumulation of real capital.

An Alternative, Progressive Box

The neoliberal policy box is suggestive of an alternative, "progressive Keynesian" box that would align the interests of corporations and financial markets with that of the public, as shown in Figure 3. This requires redesigning and repacking the box as follows:

Figure 3 **Repacking the Box**



(1) Globalization, with labor and environmental standards that promote upward harmonization instead of a race to the bottom, strengthened international economic governance arrangements (e.g., managed exchange rates), and capital controls.

(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. This failure provides an opportunity for Post Keynesian economics, because it was the Post Keynesians who predicted the outcomes that have come to pass.

According to the mainstream's "Great Moderation" hypothesis, the economy has become more stable and the business cycle has been tamed. Yet, the current financial crisis has shown the Great Moderation to have been a period of artificial calm that was driven by (1) a retreat from full employment that reduced the income distribution conflicts which surround full employment, and (2) reliance on the temporary but unsustainable stimulus of borrowing to fuel growth (Palley 2008c).

Nothing epitomizes the mainstream's failure more than former Federal Reserve 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. The Fed, the International Monetary Fund (IMF), and leading economists on both sides of the Atlantic have all provided clear evidence of the lack of understanding (e.g., Bernanke 2007, IMF 2007).

Where there was mainstream criticism regarding the U.S. trade deficit, it was strikingly wrong. Thus, some economists predicted a run on the dollar, while others 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. 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.

Events have conclusively shown that the theoretical analysis by mainstream economists is essentially flawed: they failed to connect the dots linking the weak U.S. expansion, the U.S. trade deficit, and the U.S. housing bubble; and they 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.

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

A second obstacle to change is the intellectual dominance of neoliberal economics and a generation of miseducation, which 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 whose assumptions lace both professional and public discourse, and generate the conventional neoliberal prescriptions regarding labor market flexibility; balanced budgets; the desirability of unimpeded international financial flows and free trade à la the World Trade Organization; monetary policy guided by the natural rate of unemployment; and supply-side economics, which emphasizes tax cuts.

C. The Sociology of Economics

A third obstruction to change is the sociology of the economics profession, which operates to exclude 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. That in turn justifies purging dissidents from orthodox economics departments and ignoring the few that remain in heterodox departments, thereby diminishing their capacity to challenge the neoliberal paradigm, and thwarting the possibility of ground-level change (Palley 1997).

D. Cuckoo Economics

Lastly, there is the obstacle of "cuckoo" economics, which claims 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 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. 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, not Keynes.

The latest example of cuckoo economics is "hip" orthodoxy and behavioral economics (Hayes 2007). 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). Neoliberal economics has an astounding capacity to reinvent itself without real change, 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.

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