After the Bust: The Outlook for Macroeconomics & Macroeconomic Policy

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Abstract

The current economic crisis offers an historic opportunity for change. The depth of the crisis means there will likely be a policy turn in a Keynesian and even Post Keynesian direction. However, there are profound political, intellectual and sociological obstacles blocking change in underlying economic thinking. In particular, the economics profession and its ideology remain unreformed, with little indication of change regarding 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 attitudes toward financial regulation. These obstacles will mute the policy response to the crisis, and if a deep crisis is averted will tend to encourage a return of the existing policies that have failed so disastrously.

Keywords: Crisis, macroeconomic policy, mainstream economics.

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I 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 economic policy. The combination of crisis plus accumulated popular resentments at two decades of wage restraint, widening income inequality, and increased economic insecurity make for a political atmosphere conducive for change.

In the 1970s monetarists and new classicals used the economic crisis created by the OPEC oil shocks to launch a counter-revolution against Keynesian economics (Johnson, 1971). Before that, the Great Depression and World War II provided the launch pad for the Keynesian revolution in economics.

Milton Friedman, the intellectual godfather of American neo-liberal economics, understood the role of crisis, writing:

“There is enormous inertia – a tyranny of the status quo – in private and especially government arrangements. Only a crisis – actual or perceived – produces real change. When that crisis occurs the actions that are taken depend on the ideas that are lying around (Friedman, 2002, p.xiii-xiv).

He went on further to describe the role of economists as:

“to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes possible (Friedman, 2002, p.xiv).”

The good news is current conditions may have created a crisis moment when policy and thinking can change. The bad news is there will likely be enormous economic suffering and the economics profession will be profoundly resistant to change.
II The Post-bust policy challenge

European governments and the next president of US face three challenges. Those challenges are:

(1) *Stop the bleeding* – which means stopping the liquidation trap (Palley, 2008a) that currently grips markets. That requires putting a floor under the financial crisis by stopping further wholesale asset price deflation and restoring credit flows.

(2) *Jump-start the economy* – which means getting the economy and employment growing again. That will require further monetary easing and massive fiscal expansion on a scale not yet considered.

(3) *Ensure that future growth is characterized by full employment & shared prosperity* – which means having wages grow with productivity and reducing current high income inequality back to levels that prevailed thirty years ago before the neo-liberal economic policy experiment.

Among policymakers there is significant agreement on challenges (1) and (2), but there is significant disagreement on challenge (3).

Regarding the first two challenges, where differences exist they are largely matters of degree such as what is the best way to thaw credit markets and stabilize asset prices. How far should interest rates be lowered and how fast? How much should taxes be cut, and whose taxes should be cut? And how much should government spending be increased and what forms should increased spending take?\(^1\)

These are important differences, but as Richard Nixon famously observed in 1971

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\(^1\) With regard to jump starting the economy, one major disagreement concerns treatment of debt. Progressive Keynesians would like policies and legislation that facilitate cancellation of household debts, whereas neo-liberals are strongly opposed to this and seek government bailouts of financial institutions without obligations for financial institutions to cancel debts they are owed.
“We are all Keynesians now.” The truth of that statement is being confirmed by current policy developments - though Nixon should more accurately have said “In recessions, we are all Keynesians now.”

However, there are enormous differences regarding the challenge of ensuring growth with shared prosperity. 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 in the neo-liberal era inaugurated by Margaret Thatcher and Ronald Reagan (Godley, 2000, 2001, 2005; Palley, 1998, 2001, 2005, 2006a & b). That paradigm is now exhausted. It was never able to generate growth with shared prosperity, now it is unable to even generate growth with inequality.

III The neo-liberal paradigm and mainstream economics

The single most salient feature of the neo-liberal economy is the disconnection between wages and productivity growth, as exemplified by the US experience. Figure 1 shows an index of U.S. productivity and average compensation (which includes all benefits) of non-supervisory workers who represent eighty percent of the workforce. From 1947 until late 1970s the two series grew together, but thereafter they have grown apart with compensation stagnating even as productivity continued growing. Figure 2 tells the same story for the relation between U.S. median family income and productivity.

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2 Figures 1, 2 and 3 are provided by the Economic Policy Institute, Washington, DC.
This disconnect in turn explains widening income inequality. With wages stagnating at bottom but productivity still rising, income has been shifting to the top. This
pattern is captured in Figure 3, which shows income growth at the 20th and 90th deciles of the U.S. wage distribution. The two series grew together until the late 1970s, but they separated after 1980 when inequality also started rising.

![Figure 3. Index of Low-family income & high-family income, 1947-2005](image)

The neo-liberal economic policy paradigm can be described in terms of box as illustrated in Figure 4.3 Workers are boxed in on all sides by a policy matrix consisting of globalization, labor market flexibility, replacement of concern with full employment by concern with inflation, and an attack on government.

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3 The idea of a box is attributable to Ron Blackwell of the AFL-CIO.
The attack on government is often couched in terms of the case for “small government” but in practice it has taken the form of erosion of popular economic rights, exemplified by the 1996 reform of U.S. welfare rights. Additionally, there has been an erosion of government’s administrative capacity and 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 workers who provide these privately produced – publicly funded services are placed in a more hostile work environment. The result is the appearance of big government, but the reality is a government whose capacity has been significantly cannibalized.

Figure 4 shows the neo-liberal policy box. The strength of the box derives from a new relationship between corporations and financial markets that is illustrated in Figure 5. This new relationship pattern has been termed “financialization” (Epstein, 2001; Palley, 2008b), and the box would collapse absent these side supports.
Figure 5. Lifting the Lid & Unpacking the Box

Figure 6 shows the economic workings of financialization. The basic logic (Palley, 2008b) is that financial markets have captured control of corporations, which now serve financial market interests along with the interests of top management. That combination drives corporate behavior and economic policy, producing an economic matrix that puts wages under continuous pressure and raises income inequality. Viewed from this perspective, financialization is the economic foundation of neo-liberalism. Reversing the neo-liberal paradigm therefore requires a policy agenda addressing financial markets and corporations. That agenda must aim to re-align the behaviors of both financial markets and corporations so that they incorporate a greater public interest.

The six sides of the box have been supported by mainstream economic theory that
has provided justification for these outcomes. Neo-liberal globalization has been justified by appeal to the theory of free trade based upon comparative advantage, and by appeal to neo-classical arguments for deregulating financial markets and allowing uncontrolled international capital flows.

The case for small government is based on Friedman’s (1962) arguments for a minimalist or “night watchman” state. Moreover, Chicago school economics recommends that even market failures be ignored because government intervention to fix them can give rise to even more costly government failure.

The retreat from full employment has been driven by new classical macroeconomics that substituted the notion of a natural rate of unemployment and a vertical Phillips curve for the negatively sloped long run Phillips curve (Friedman, 1968). That switch replaced concern with employment with concern about inflation. The theoretical justification is that policy can have no permanent impact on employment and the market gravitates quickly by itself to full employment.

The push for so-called “flexible” labor markets has been driven by the neo-classical construction of labor markets based on marginal product theory. That theory has fuelled an attack on unions, minimum wages, 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 wealth and income is maximized if corporations maximize shareholder value without regard to other interests.

To the extent that there is a principal – agent problem with managers not maximizing shareholder value, this is to be solved by aligning managers’ interests with
shareholder interests via bonus payments and stock options.

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), and the idea of a market for corporate control that ensures corporations are disciplined by shareholders (Jensen & Meckling, 1976). Arrow-Debreu (1954) contingent claims theory has been used to justify exotic financial innovation in the name of risk spreading and portfolio diversification, while q-theory (Tobin and Brainard, 1968) has been used to justify the claim that financial markets do a good job directing investment and the accumulation of real capital.

**IV An alternative progressive box**

The neo-liberal box is suggestive of an alternative “progressive Keynesian” box that would take workers out and put corporations and financial markets inside, as shown in Figure 7.

**Figure 7. Repacking the Box**

This requires repacking the six sides of the box as follows:

(1) Globalization with labor and environmental standards that promote upward
harmonization instead of a race to the bottom. Additionally, international economic governance arrangements are to be strengthened, especially as regards exchange rates so as to prevent a repeat of recent huge global imbalances. Capital controls must also be a legitimate part of the policy tool kit.

(2) A balanced approach to government that ensures government efficiently provides public goods (including law and order), 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 provides representation for 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.

V An opportunity for Post Keynesian economics

Mainstream macroeconomics completely failed to understand the fragility and unsustainability of the current macroeconomic regime. The extent of this failure cannot be overstated and it provides an opportunity for Post Keynesian economics. That is because Post Keynesians (Godley, 2000, 2001, 2005; Palley, 1998, 2001, 2005, 2006a & b) predicted the outcomes that have come to pass.

The mainstream’s failure is epitomized by former Federal Reserve Chairman Alan
Greenspan’s admission to Congress (October 23, 2008) that his economic ideology was flawed and that the self-interest of lending institutions failed to protect shareholders. Greenspan’s approach to financial regulation and the conduct of monetary policy was widely endorsed. Thus, when Greenspan retired from the Federal Reserve he was feted by the profession and the liberal new Keynesian economist Alan Blinder declared that “he (Greenspan) has a legitimate claim to being the greatest central banker who ever lived (Blinder and Reis, 2005).”

The Federal Reserve, the IMF, and leading economists on both sides of the Atlantic all provide clear evidence of the lack of understanding. In March 2007 current Federal Reserve Chairman Ben Bernanke testified before the Joint Economic Committee of Congress that “the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained (Bernanke, 2007).” And throughout 2007 and into 2008 district Federal Reserve Bank Presidents Lacker (Richmond), Plosser (Philadelphia) and Hoenig (Kansas City) all consistently played up the danger of inflation rather than financial crisis and slump.

The IMF has laid claims to being the global economy’s early warning system. Yet in July 2007 just as the crisis was about to erupt, the IMF (2007) revised upward its global growth forecast, emphasizing that inflation risks had edged up and central banks would likely need to further tighten monetary policy. Even more than the IMF, the European Central Bank seems to have misunderstood the financial crisis, which explains its resistance to lowering interest rates in 2007 and much of 2008. The same also holds for the Bank of England.

Harvard professor and former IMF Chief Economist Ken Rogoff (2008a) also
focused on inflation writing as late as July 2008 about inflation being “The World’s Runaway Train” requiring tighter monetary and fiscal policy. Moreover, Rogoff (2008b) misunderstood the significance of the collapse of Lehman Brothers, celebrating it with an article titled “No More Creampuffs” that argued Lehman’s failure would put an end to moral hazard and restore healthy business incentives.

British economist Willem Buiter (2008) also failed to see the system’s instability, virulently criticizing the Federal Reserve for its decision in January 2008 to cut the Federal Funds rate by 75 basis points from 4.25 percent to 3.50 percent. Likewise, the politically liberal Paul Krugman (2008) failed to appreciate the extent of speculation in oil and commodity markets, rationalizing the surge in oil and commodity prices in 2008 as the result of market fundamentals rather than speculation.

With regard to the global economy, proponents of the so-called “Revised Bretton Woods (RBW)” hypothesis (Dooley et al., 2003) claimed the huge global financial imbalances associated with the U.S. trade deficit were stable and sustainable. Another argument for sustainability came from Harvard professor and former Inter-American Development Bank Chief Economist Ricardo Hausman (2005), who claimed the U.S. trade deficit was a non-issue because of “dark matter” investments that yielded huge excess returns to U.S. overseas investments.

Where there was mainstream criticism regarding the U.S. trade deficit, it has been strikingly wrong. Thus, some (Eichengreen, 2004; Obstfeld and Rogoff, 2007; Rogoff, 2007 & 2008c; Bergsten, 2005) predicted a run on the dollar, while others (Goldstein and Lardy, 2005) 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 (Palley, 2006b), sending shock waves into the global economy. 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.

Mainstream economists have been intellectually honest and guided by their theoretical models. The problem is events have conclusively shown their theoretical analysis to be fundamentally flawed. Both in its theory and empirical analysis, mainstream macroeconomics failed to connect the dots linking the weak U.S. expansion, the U.S. trade deficit, and the U.S. housing bubble. It also failed to connect long-term developments in the U.S. economy concerning expanding debt, wage stagnation, and worsening of 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. For Post Keynesians the challenge is to win recognition for this record, as the mainstream profession will try to airbrush the past and re-write history by burying its own failures and ignoring the success of its critics.

VI Obstacles to change

Though the current moment provides an opportunity for change in both economics and economic policy, there are several major obstacles to overcome.

(VI.a) Politics and the split among social democrats

A first obstacle concerns politics and the fact that social democratic political parties are split regarding the neo-liberal economic paradigm. This political split holds for the Democratic Party in the U.S., the Labor Party in the U.K., and the Social
Democratic Party in Germany.

Figure 8 illustrates the split. At the most fundamental level there is a divide between those who see the neo-liberal economic paradigm as sound and those who see it as fundamentally flawed. Both neo-liberals and Third Way social democrats see neo-liberalism as fundamentally sound, while labor social democrats see it as fundamentally flawed. The political problem is that this splits social democrats, making it harder to dislodge the paradigm.

Figure 8. The Political Dilemma of Neo-liberalism

Neo-liberals continue to promote the paradigm, and their response to the crisis has been to try and shift blame on to government, arguing the crisis is another example of government failure. For instance, conservatives (see for example Schiff, 2008) in the U.S. are falsely blaming the government sponsored mortgage giants, Fannie Mae and Freddie Mac, for causing the crisis. The 1977 Community Re-investment Act, which aims to promote home ownership among disadvantaged communities, has also been falsely blamed.4

Third Way social democrats also remain committed to the neo-liberal model. The
key difference from neo-liberals is that Third Way social democrats support stronger financial regulatory reform, and they also see a need for “helping hand” programs to help those injured by the market’s invisible hand. In the U.S., the Third Way “New Democrat” explanation of the Bush administration’s economic failure is that it abandoned budget discipline and pursued inegalitarian tax and social policy. That is a critique of policy rather than critique of paradigm.

This Third Way acceptance of the neo-liberal economic paradigm creates a division with labor social democrats who want to replace neo-liberalism. That division in turn creates a major political conundrum. On one hand, if labor social democrats split from Third Way social democrats they risk a full-blown neo-liberal triumph. On the other hand if they stick in fractious union with Third Way social democrats, the risk is a gradual entrenchment of neo-liberalism. The only satisfactory solution is the creation of a new progressive Keynesian consensus, and that calls for placing economic theory and vision at the center of the political stage.

**(VI.b) Intellectual opinion**

The importance of economics points to a second obstacle to change, which is that neo-liberal economics remains intellectually dominant in academic and public policy discourse. Though events have created an opportunity to end the Age of Milton Friedman and replace neo-liberalism, events are running ahead of the “climate of opinion” which remains dominated by neo-liberalism. The political environment may have become more favorable to change, but a generation of mis-education impedes change. That mis-education affects policymakers, economic advisers, think-tanks, and the media.

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4 See Ritholtz (2008a & b) for a rejection of the claim that the housing crisis was caused by the Community Reinvestment Act and the government sponsored mortgage lenders, Fannie Mae and Freddie Mac.
Among economists the dominant analytical framework is the neo-classical dynamic general equilibrium real business cycle model, adjusted to include price rigidities by so-called “New Keynesians”. The assumptions of this model - competitive market clearing, the loanable funds theory of interest rates, and the neo-classical theory of labor markets - lace both professional and public discourse. These assumptions generate the conventional neo-liberal prescriptions regarding labor market flexibility, balanced budgets, desirability of unimpeded international financial flows and free trade, monetary policy guided by the natural rate of unemployment, and supply-side economics that emphasizes tax cuts.

The implication is as long as economic thinking remains dominated by the neo-classical dynamic general equilibrium the real business cycle framework, mainstream economics will constitute a major obstacle to change.

(IV.c) The sociology of economics

The importance of intellectual understandings – what Friedman termed “the climate of opinion” – in turn spotlights a third obstruction to change, which is the sociology of the economics profession. This sociology operates to exclude and ignore alternative points of view. That practice is justified by appeal to a science myth that claims neo-classical economics is scientifically proven truth, while other points of view are scientifically wrong.

The neo-classical science myth plays a critical function, which explains the repeated claims that neo-classical economics is science. This function is to support sociological practice that has mainstream economists labeling dissidents as wrong. That in turn justifies cleansing dissidents from economics departments and ignoring dissidents
in heterodox departments. This in turn strips dissidents of intellectual standing, thereby diminishing their capacity to challenge the neo-liberal paradigm.

The deeper sociological problem is that academic economics is a club in which existing members elect new members. Today, club members only elect those who subscribe to the current dominant paradigm, with this behavior being justified appeal to the science myth. That poses an intractable sociological obstruction to changing economics and opening to alternative points of view (Palley, 1997).

**(IV.d) Cuckoo economics**

Lastly, there is the obstacle of “cuckoo” economics. The cuckoo bird takes over the nests of other birds by surreptitiously placing its young in their nests and having others raise them. In many regards, neo-liberal economics does the same to Keynesian economics. This serves to create confusion, blur distinctions, and promote the claim that Keynesian ideas are already incorporated and have nothing to contribute.

The practice of cuckoo economics is evident in the tendency of mainstream economists to recommend Keynesian policies in times of economic crisis. Thus, in crises many economists support expansionary discretionary fiscal policy and robust interest rate reductions even though their theoretical models are hard-pressed to justify such actions.

New Keynesian economics is the ultimate example of cuckoo economics. It is impossible to read Keynes’ (1936) *General Theory* and believe his theory of unemployment rested on the combination of imperfect competition and price adjustment “menu” costs. However, that is the New Keynesian claim, and their adoption of the Keynesian label serves to confuse debate and dismiss authentic Keynesian claims about the exclusion of Keynesianism (for instance see De Long, 2007). The reality is new
Keynesian economics is a form of real business cycle theory. It should really be called “new Pigovian economics” as it is firmly rooted in the tradition of Pigou rather than Keynes.

The latest example of cuckoo economics is “hip” orthodoxy and behavioral economics (Haynes, 2007). Thus, some mainstream economists are now embracing ideas from social psychology that critics of the mainstream have long talked about. These ideas include concerns with relative standing (Veblen, 1899; Duesenberry, 1949), fairness, and less than perfect rationality. The trick behind the new behavioral paradigm is that it draws on arguments made by critics of the mainstream, but it only takes those ideas that leave unchanged the core analytical assumptions that drive modern neo-classical macroeconomics (Palley, 2007).

This capacity to selectively incorporate reflects an amoeba like property of neo-liberal economics. Though neo-liberal economics has been dented by recent events, it has an astounding capacity to reinvent itself without real change. The implication is that the zombie that is neo-liberal economics has not been staked through the heart, and it therefore promises to rise again when times stabilize.

V Conclusion: the outlook for macroeconomics and policy

The current economic crisis offers an historic opportunity for change. The depth of the crisis means there will almost certainly be a policy turn in a Keynesian and even Post Keynesian direction. However, there are profound political, intellectual and sociological obstacles blocking change to macroeconomics.

In particular, the economics profession and its ideology remain unreformed, with little indication of change regarding 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 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 crisis is averted will tend to encourage a return of the existing policies that have failed so disastrously.

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