

PART SIX

THE WAY FORWARD

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THIRTEEN

Demand, Finance, and Uncertainty Beyond the Great Recession

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This book consists of a series of chapters written by different authors, with each chapter exploring a different aspect of the causes and consequences of the financial crisis and Great Recession. However, the various perspectives flow from a single, shared vision of how the economy works. This vision emphasizes the pervasive importance of aggregate demand, uncertainty, and finance as the central factors that determine the path of the U.S. economy and employment of its resources. Of course, technology and resource availability are necessary for production, but these supply-side factors usually do not constrain economic activity at the margin, and in the aftermath of the Great Recession, there is no evidence whatsoever that supply constraints are likely to bind in the U.S. economy for years to come. The shared perspective that informs the contributions to this book involves elements of Keynesian thinking that are largely outside the mainstream of macroeconomics. These are, however, essential for understanding the origins of recent events, analyzing the implications of the crisis for economic performance in coming years, and developing policies that have the potential to improve outcomes. Not surprisingly then, and despite the seeming diversity of topics covered in the preceding chapters, a coherent narrative emerges from these chapters regarding the course of events we have witnessed over the last few years, the longer-term developments that preceded them, and their likely future consequences.

In this concluding chapter, we first outline key elements of the shared vision that informs this volume. We then reflect on the various policies proposed in the preceding chapters – recommendations designed to address the failings that gave rise to the crisis, and to put the economy back on a track of shared prosperity, financial stability, and sustainable growth.

1. The Great Recession: What Went Wrong – Where Do We Stand?

The view developed in this volume identifies both real and financial causes for the Great Recession, including the real income stagnation suffered by households across most of the income distribution on one hand, and deregulation and institutional change in the financial sector on the other. The interplay of these factors led to massive debt accumulation, particularly by U.S. households seeking to supplement stagnant incomes in their pursuit of increasing consumption aspirations. Household borrowing was spurred on by a financial sector rendered ever freer of inter- and postwar financial regulations. These regulations came to be seen as unnecessary fetters on an inherently self-regulating “free market,” an idealized notion in which financiers and policy makers placed increasing trust and confidence. Ultimately, the self-reinforcing developments in the real and financial sectors proved deadly. They led to the steady accumulation of financial fragility, even as we ostensibly experienced a “Great Moderation” celebrated by mainstream thinking as a permanent reduction in macroeconomic volatility. This is because the pattern of debt-accumulation we witnessed did *not* involve adjustment toward an optimal path for household consumption, facilitated by the removal of regulatory “imperfections” that constituted “sand in the gears” of otherwise perfect financial markets. Instead, it constituted an unsustainable trajectory, but one that was for decades reinforced by steadily increasing confidence in consumption and financial norms that evolved to guide behavior in an environment characterized by uncertainty about the future. As the trajectory progressed, it seemed all the more plausible and reasonable to households and financiers alike, even as it became increasingly precarious.

What all this implied, in the language of the financial instability hypothesis developed by Hyman Minsky, was that by the late 2000s, the growth regime in the U.S. economy was thoroughly dependent not just on the “ordinary workings of the goods and labor markets” (necessary to generate the income flows required to service outstanding debt), but also what came to be perceived as the “ordinary workings of financial markets” – more specifically, their proclivity to roll over existing debt, and keep expanding new credit (Pollin, 1997). These “ordinary workings” were required because of both the increasing dependence of the growth regime on debt accumulation, and the increasingly risky nature of the financial postures adopted by borrowers and lenders. The U.S. economy was, as a consequence, increasingly vulnerable to any bad news in the short run that would give pause for thought to the households and/or financial institutions participating in the

run-up of indebtedness that undergirded the seemingly impressive macroeconomic performance of the economy. Furthermore, the system came to depend on falling (or at least not rising) interest rates that allowed heavily indebted households and financial units to refinance their fragile positions. In the end – and perhaps not surprisingly given the mixture of real and financial forces that gave rise to the preceding boom – the “trigger” for the Great Recession arose from an untimely (and interrelated) confluence of real and financial events:

- Rising short-term interest rates that the Fed (perhaps naively) assumed were necessary to preempt inflation. It seems clear, however, that the Fed did not realize how precarious financial conditions had become. Higher short rates had devastating consequences on the riskiest segments of the housing market that relied on adjustable-rate mortgages.¹
- The end of the housing bubble. Housing prices stopped rising, in part because of the rise in short rates and the spillover to the cost and availability of risky, adjustable-rate mortgages. With stagnant home prices, the collateral engine for massive equity extraction that had fueled an ever-increasing consumption-income ratio shifted abruptly into reverse. In addition, the end of the housing bubble suddenly and drastically revised the refinancing options for households vulnerable to default in the event that their introductory “teaser” mortgage repayment terms should expire.
- A historic collapse in new housing construction.
- The subsequent failure of many subprime mortgages, and the consequent writing down or writing off of many mortgage-backed securities. Those securities, issued in abundance as highly rated financial instruments, were suddenly deemed “toxic.”

What followed was a sharp lesson in the fundamental Keynesian maxim that money and finance matter for the aggregate demand-generating process and hence for macroeconomic performance. Minsky’s “ordinary workings” failed. As wealth was destroyed and, in particular, as credit froze in the initial stages of the financial crisis, so aggregate demand fell – both as the direct result of wealth destruction and the credit freeze, and indirectly,

¹ In the middle 2000s, there was much discussion of what Alan Greenspan labeled a “conundrum”: the remarkably modest rise in mortgage rates after the Fed began raising the overnight federal funds rate in mid-2004. It is true that thirty-year conventional mortgage rates rose very little between 2004 and 2006. The one-year adjustable rate, however, rose almost 250 basis points from its trough in early 2004 to its peak in mid-2006.

as wealth destruction and the credit freeze suddenly diminished confidence and animal spirits. Even solvent and liquid households and firms began cancelling expenditure plans. The decline in aggregate demand and consequent rising unemployment only worsened conditions in the housing market, making the whole process dangerously self-reinforcing. And so the Great Recession began, with a frighteningly severe economic decline in late 2008 and early 2009.

At this point, raw fear (if not a well-informed understanding of what was happening among policy makers) ignited the most significant Keynesian policy actions that the world has, perhaps, ever seen. Whatever the faults in its design – and there were arguably many – the monetary and fiscal stimulus response to the events of 2008–09 actually engineered something of a “soft landing.” Ultimately, we were spared the experience of a second Great Depression and instead experienced “only” the trauma of the Great Recession. There is no doubt that the primary objective of these policies was to stabilize aggregate demand, in large part by shoring up finance and by containing the panic created in the most severe outbreak of economic uncertainty since the early 1930s.

Policy put a floor under the downward trajectory of a structurally flawed growth and financial regime and thus saved us from the worst-case scenario in the short term. However, it now falls to public policy to “pick up the pieces” and to reconstruct the U.S. economy so that it is once again capable of generating widespread and sustainable prosperity going forward. At the time of writing, policy has already faltered in the pursuit of this agenda. The national debate in the United States has been “hijacked” by “austerity buzzards” (to use Epstein’s phrase from Chapter 9), whose focus on public deficits and debt conceals their true desire for smaller government at any and all costs. Governments in Europe, meanwhile – many shackled by the institutional constraints that accompany membership of the euro zone – have already gone further along the path to repeating the errors of the late 1930s, when fiscal retrenchment motivated by a perceived need for “sound finance” repeatedly threatened recovery from the Great Depression (until the massive build-up of public spending that accompanied World War II finally eliminated the problem of chronic demand-deficiency).

No one said the path to redemption would be easy. So what have we learned from the experience of the last few years – and more particularly, from the reflections on this experience contained in this volume – that would inform an appropriate policy agenda from this point onward?

2. Where Do We Go from Here?

The first point that deserves to be emphasized is that the “government as the problem” versus “government as the solution” dichotomy that seems to polarize much public debate is false, misleading, and unhelpful. The simple fact is that government is quite capable of playing both roles – that of hindrance and help. Hence, many of the chapters in this book identify sources of error in public policy in the run-up to the financial crisis and Great Recession, even as they advocate policy responses designed to redress the economic circumstances in which we now find ourselves. Clearly, then, informed public policy needs to formulate and promote policies that will aid recovery while remaining wary of and seeking to eliminate those that will obstruct it. This disarmingly simple rule is far more useful in today’s economic and financial climate than any broad, ideologically motivated rule expressing either “zero tolerance” for government (beyond certain minimal functions associated with law enforcement and defense), or proclaiming government as the universal solution for problems that emanate only from unruly “free markets.” As Nobel Laureate Peter Diamond recently opined, “To the public, the Washington debate is often about more versus less – in both spending and regulation. There is too little public awareness of the real consequences of some of these decisions. In reality, we need more spending on some programs and less spending on others, and we need more good regulations and fewer bad ones” (Diamond, 2011). Diamond’s ethos provides a useful starting point, but beyond this general rule, what, specifically, is to be done?

Financial Reform and Monetary Policy

Each of the chapters in this book recognizes the central role played by financial instability in creating the conditions that led to the Great Recession, and in several chapters financial instability is the central theme. It therefore seems clear that rethinking financial regulation is a necessary and appropriate part of any response to what has transpired. As Kregel, Chapter 4, and Wray, Chapter 3, point out, however, we cannot simply put the financial system back into the old Glass-Steagall box. The Depression-era regulatory structure was in large part responsible for the relatively tranquil financial environment of the postwar decades, but it has become anachronistic. Just because the old rules were anachronistic, however, does not mean that all rules must be abandoned (as was commonly argued in the deregulatory

march that led to the Great Recession). The first major financial reform package emerging from the financial wreckage of 2008 and 2009, widely known as the Dodd-Frank reforms, have some useful elements, as pointed out by Epstein in Chapter 9. However, Epstein and many of the other authors of this volume (particularly Wray and Kregel, Chapters 3 and 4) find the approach taken so far both too weak and, in certain fundamental respects, misguided.

The economy needs finance to better serve the public purpose, which requires effective structures to serve both of the “two masters” identified by Kregel: a stable payments system and effective channelling of finance to foster the economy’s capital development. Wray argues that this means returning banks to their traditional role of “underwriting,” that is, assessing risk and project quality as a means of determining the directions that capital development will follow. As Kregel points out, this role was largely lost in the decades prior to the Great Recession as banking shifted from an “originate and hold” model, in which the bank assessed risks that it would then hold on its balance sheet, to an “originate and distribute” model, in which the objective was to maximize the number of loans that could be made and then sold off in secondary markets. Wray asks why banks deserve the public-private partnership implied by institutions such as deposit insurance and discount-window lending if they do not act in the social interest? In Chapter 9, Epstein suggests further direct public intervention in finance, moving in the direction of what he has aptly named “finance without financiers.” Crotty, in Chapter 5, meanwhile, highlights the importance of making financial sector remuneration schemes properly compatible with a greater pursuit of social purpose by the financial sector. This is an essential ingredient if the systemic ambitions of Kregel, Wray, and Epstein are not to be “sabotaged from within” by inappropriate managerial behavior that is actively incentivized by the structure of corporate compensation.

Although financial reform is undoubtedly important, both to restart necessary demand growth and to foster capital development, it certainly isn’t the be-all and end-all. In particular, financial reform – indeed, *any* policy – that has as its objective simply “getting the private sector borrowing and spending again” isn’t what we need. The objective is not to create another unsustainable, debt-fueled growth episode that serves only to leave us wondering when the next crisis will occur (and lamenting its destructiveness when it does).

This perspective diverges somewhat from the mainstream preoccupation with restoring what came to be thought of as “normal” credit market

activity prior to the Great Recession. In particular, the Fed seems focused on getting the banks to lend again. Various policy makers seem frustrated by the massive and unprecedented (at least since the 1930s) accumulation of excess reserves in the banking system, which has a parallel in the oft-cited accumulation of cash on corporate balance sheets. Commentators ask a question that seems to follow, at least superficially, from a Keynesian view of the world: why don't they lend and invest, which would then stimulate demand? The answer developed in this volume is that the old way of generating demand through excessive household borrowing is broken. As Wray provocatively asks in Chapter 3: why "should government policy try to get banks to make loans they do not want to make! After all, if banks are our underwriters, and if their assessment is that there are no good loans to be made, then we should trust their judgment. In that case, lending is not the way to stimulate aggregate demand to get the economy to move toward fuller employment."

These observations lead to another important common perspective that emerges from this book: monetary policy as practiced for much of the past two decades has been singularly ineffective in its ability to cure stagnation in the aftermath of the Great Recession. This stands in contrast to the widely held view, perhaps associated most prominently with Ben Bernanke, that monetary policy can effectively restore full employment when demand falters, even if policy rates push up against the "zero bound." These ideas emerged in large part as mainstream economists criticized the Japanese monetary authorities for not responding more aggressively to their "lost decade" problem. However, it now seems clear that such policies as raising inflation expectations so that real interest rates decline even with a constant zero nominal rate are much easier to model and talk about than to implement in a persistently stagnant economy. Moreover, it seems clear in retrospect that when monetary policy did restore demand after macroeconomic hiccups in the decades prior to the Great Recession, it did so, in Palley's words from Chapter 2, "by lowering interest rates and opening the spigot of credit" to facilitate a path of private-sector debt accumulation that was anything but sustainable. It is for these reasons that many of the chapters in this volume propose outside-the-box thinking about monetary policy and financial reform. In addition, we obviously cannot rely *exclusively* on monetary policy to emerge from stagnation. Indeed, Epstein argues that perhaps the most important role for monetary policy going forward is to keep interest rates low as a means to support expansionary fiscal policy, a topic to which we now turn.

The Challenges of Fiscal Policy

In 2011, American politics was consumed with hyperbolic debates surrounding what should have been a routine legislative process to raise the country's legal debt limit. The major parties take different positions in most respects, but almost all of the participants in the fiscal policy debate seem to agree that a primary goal of U.S. economic policy should be to eliminate deficits and even to pay down the national debt. The perspectives presented in this book argue strongly that these goals are fundamentally misguided.

The common vision presented in this volume supports a basic critique of the demand generation process of the two decades leading up to the Great Recession: rising household debt in an environment of increasing income inequality precipitated the collapse. This engine of demand growth will not rev up again, at least for an extended period, which explains the persistent stagnation of the U.S. economy that conventional macroeconomics has failed to anticipate.² Aggressive fiscal stimulus is an alternative source of demand that can at least partially offset the spending lost as the household sector retrenches to repair its collective balance sheet. In sharp contrast to the political rhetoric in Washington, large deficits in times like these *are* fiscally responsible. The goal of fiscal policy is not to achieve some artificial and arbitrary target for deficits or debt. Instead, fiscal policy should be functional, that is, designed to serve a particular economic function. In Tcherneva's words from Chapter 12, "a bold and imaginative approach is required, which weds fiscal policy to the goal of full employment."

A first step that may appear bold in the current environment, with austerity buzzards circling everywhere, is to assess what evidence tells us about the size of deficits and debt and the effects they have on actual macroeconomic activity. Most of the authors who contributed to this volume are of an age to remember the widespread criticism of Reagan's supposed fiscal irresponsibility in the 1980s. At that time, the politics of deficit bashing favored the Democrats, but the arguments were similar in direction (if not intensity) to recent Tea Party rumblings: a profligate government living beyond its means would saddle future generations with unsustainable debt service, high interest rates, and low productivity as deficits "crowded out" capital

² Here is a telling quote from economics reporter David Leonhardt more than two years after the supposed recovery from the Great Recession began. "The past week brought more bad news . . . causing economists to downgrade their estimates for economic growth yet again. It's a familiar routine by now. Forecasters in Washington and on Wall Street keep saying the recovery's problems are temporary – and then they redefine temporary" (from "We're Spent," *New York Times*, July 16, 2011).

investment. A full generation has passed since those fears were rampant; what has happened? Interest rates are down, federal debt service is a smaller fraction of GDP, and productivity has risen. On the surface of things, the debt legacy of the Reagan years hasn't hamstrung the current generation. More systematically, Baker in Chapter 10 concludes that smaller government deficits (or larger government surpluses) have not done much, if anything, to improve U.S. economic performance over the past two decades. In Chapter 11, Cynamon and Fazzari take a careful look at the concerns about the burden on future taxpayers arising from current U.S. indebtedness and argue that we could enact massive fiscal stimulus over the next few years, with minimal cost. The sense that federal finances require immediate tightening because "we're broke" (as Republicans like to say) has no basis in fact. What is truly "irresponsible" is the hyperbolic rhetoric of austerity buzzards that scares the citizenry into believing that a catastrophe in public finance is imminent.

Because of the deeply compromised private demand-generation process in the aftermath of the Great Recession, the U.S. economy is likely to need large federal deficits well into the future. A rising federal government debt-to-GDP ratio is likely to result, at least for awhile. Perhaps this outcome, in isolation, is unfortunate (it is certainly viewed that way in political discussion). However, as either higher government spending or lower taxes that stimulate private spending employ otherwise idle resources, the perspectives developed in this volume imply that social benefits will far exceed what are likely minimal costs. The analysis in Chapter 11 implies that debt service would be easily manageable for the United States with a debt-to-GDP ratio of 100 percent or more, nearly double the value of privately held debt to GDP in 2011. Such an increase would support a huge contribution to demand generation, either public or private, in coming years. At a higher debt ratio, the "sustainable" size of the deficit is higher than almost any conventional discussion suggests. A simple example proves the point. Suppose the economy has a nominal long-term growth rate of 5 percent (3 percent from real output and 2 percent from inflation). If the debt-GDP ratio were 100 percent, a federal deficit equal to 5 percent of GDP, much higher than historical values in all but the worst recessions, would leave the debt-GDP ratio unchanged (see Galbraith, 2011, for further discussion).³

³ Government debt critics often point to the long-term future liabilities of entitlement programs, particularly Medicare, for an aging population as the reason that we need current fiscal austerity. We agree that society will have to come to terms with the future resource cost necessary to provide adequate health care. However, destroying jobs today does nothing to make this task easier. Indeed, effective demand stimulus today will lead to a stronger

Although the need for fiscal stimulus emerges rather obviously from the Keynesian perspective on the Great Recession and its aftermath, the most desirable form that such policy should take is less clear. The most obvious class of policies that receives the strongest support from the political left in the United States imagines large public works. Public expenditure projects, in addition to stimulating aggregate demand, can also influence *what* is demanded. That is, expenditures could target infrastructure to get benefits on the supply side as well as generating demand, as discussed in Chapter 10 by Baker. In addition to enhancing the traditional public capital stock, public expenditure can be designed to meet broader social goals, perhaps most obviously to transform the U.S. economy into a more energy-efficient, “greener” economy. The gaping hole in demand, unprecedented since the Great Depression, implies that there are plenty of resources for large projects that could capture the imagination of the country. Indeed, we believe it is important to help both politicians and voters to recognize that the unused resources provide a social opportunity. We need to focus on what can be accomplished, with the twin objectives of mobilizing idle resources *and* transforming important parts of society. This message will serve the interests of society dramatically better than obsessing about public debt or deficit ratios, the costs of which are greatly exaggerated.

We do not presume, however, that useful fiscal policy in these times should take the form of higher government spending only. As argued by Cynamon and Fazzari in Chapter 11, the demand gap is so large that even an aggressive and imaginative program of expanded public projects may not be enough to push us [toward](#) full employment. The United States has a long tradition of manipulating taxes to meet fiscal goals. As a rough rule of thumb, if the economy still suffers from substantial demand slack even when government spending is, in a sense, optimized given existing political alignments, this is *prima facie* evidence that tax revenues are too high. One way to think about the relative role of tax cuts versus spending increases as appropriate demand stimulus is to recognize that any fiscal action has two dimensions. First, there is the effect on aggregate demand and how that demand relates to the goal of employing idle resources. Second, there is an allocation dimension: any actual fiscal stimulus policy affects the specific way in which unemployed resources will be used. Government spending programs use the political process to determine the second dimension, whereas tax cuts cede the specific allocation process to private decision-making.

future economy that would be better able to handle the challenge of providing health care for the entire population.

Of course, if there are costs to government debt, even if those costs have been exaggerated in recent mainstream analysis, one objective of any fiscal stimulus program is to maximize “bang for the buck.” In the case of higher government spending, the initial demand impact is dollar-for-dollar by definition and maximizing impact implies choosing the best projects to enhance social value. In the case of tax cuts, however, their effectiveness as stimulus depends fundamentally on whether or not they will raise spending. This simple principle therefore implies that effective tax cuts should flow to groups that will turn them into aggregate demand. The most obvious implication is that tax cuts should accrue to lower- and middle-income/wealth groups.⁴ Furthermore, although distributive justice is not the focus of this book, we would be remiss to not acknowledge the obvious synergy between fiscal policies that most effectively stimulate demand and those that create a more just society.

We also echo Tcherneva’s call in Chapter 12 for public policy that does more than just target short-run aggregate demand. Even when the official unemployment rate was low by historical standards, as it was prior to the Great Recession, the U.S. economy suffered substantial problems with long-term joblessness among certain subsets of the population. Those afflicted by this problem are mostly invisible in standard unemployment statistics. Direct job-creation programs have promise in addressing this issue, and we believe they are also an important complement to more conventional stimulus programs that raise aggregate demand in the face of a recession. This point is underlined by the recent tendency of U.S. recoveries to look “jobless,” as has been evident again in the aftermath of the Great Recession.

Returning to a theme we presented in Chapter 1, we argue that it is essential to see the policy response to the Great Recession and its aftermath as a problem that the United States (and other countries) must confront for a number of years to come. This isn’t the kind of recession we have become familiar with in the postwar period. That is, the Great Recession isn’t a merely temporary disruption. It is evident that the stagnation will be protracted. In

⁴ Political considerations may lead to the conclusion that there is little gained from completely excluding the wealthy. Suppose a tax cut is allocated as a fixed amount per person or per family. The “bang-for-the-buck” argument suggests that the tax cut not be applied to the wealthy. Recognizing that a few percentage points of additional public debt has minimal cost, however, it may be politically expedient to simply give everyone the same amount of tax relief. Problems arise, however, when the wealthy, who spend proportionately less of each additional dollar of income, receive massively *greater* tax cuts than the middle class, or when lower-income people receive little or nothing, as was the unfortunate case with many tax cut programs in recent decades.

that context, the policy response should be both more significant and longer in duration. On the one hand, that makes the challenge more daunting and raises the stakes when we contemplate the consequences of failure. On the other hand, the need to support demand generation over a longer period means that we can and should think more imaginatively. All indications are that the economy will have sufficient unused resources to undertake large, long-term infrastructure projects. Permanent tax changes to boost consumption spending, especially among lower- and middle-income households who have seen their standards of living stagnate in recent decades (see Chapters 2 and 7 by Palley and Setterfield), have the potential to be much more effective than the tax cut policies of recent years, which have been either temporary or largely skewed toward high earners. One somewhat paradoxical aspect of a big crisis is the opportunity, indeed the need, to think big about solutions.

Wages, Productivity, and Global Engagement

Although fiscal policy can and should play a central role in demand generation, larger government alone is not likely to fully replace the pre-Great Recession consumption and housing boom as a source of adequate demand growth indefinitely. Indeed, it is not clear that more government activity on the level we need to once again approach full employment is socially desirable, even if it were politically feasible. This is not to say that there are not significant needs that the government must address. Rather, this perspective recognizes that the demand problem is huge. As such, part of the policy challenge in the aftermath of the Great Recession is to reconstitute the *private* aggregate demand-generating process on a more sustainable basis. As Stiglitz (2011) recently remarked, “[prior to the Great Recession] output growth in the United States was not economically sustainable. With so much of the U.S. national income going to so few, growth could continue only through consumption financed by a mounting pile of debt.” Central to the mission of reconstituting the aggregate demand-generating process, then, are policies and institutional changes that reduce the dependence of U.S. households on debt accumulation as a source of rising consumption expenditures and increase the extent to which rising consumption can be funded by income growth.

Picking up on the theme emphasized by Setterfield in Chapter 7, this suggests that, looking forward, a major ambition of public policy should be to revive the income share of working and middle-class households, and to realign wage and productivity growth. Achievement of this ambition would

create steady growth in household consumption expenditures that is funded by steady, across-the-board real income growth, and that is therefore financially sustainable indefinitely. On the domestic front, rethinking the changes in labor law that have weakened the bargaining power of workers over the past thirty years could help reach this goal. Reform of laws that have made unionization by workers harder and union busting by firms much easier would at least begin to address the institutional changes in the labor market that have created the disconnect between real wage and productivity growth. Workers have a vested interest in increasing (and then maintaining) the wage share of income. Alleviating existing legal constraints on the exercise of this self-interest would therefore facilitate some reconstruction of the aggregate demand-generating process *within* the private sector *by* the private sector.

However, domestic initiatives alone will likely not suffice on this front. As noted in Chapter 2 by Palley and Chapter 8 by Blecker, the unsustainable, debt-fueled U.S. growth regime that policy must now seek to replace has a distinctly *global* dimension. In the first place – as argued by Blecker – the fabled global trade imbalances that have garnered such attention over the past decade and more are essentially a symptom of an *international* growth regime that emerged as numerous countries responded in different ways to the same phenomenon plaguing their domestic economies: wage stagnation and the concomitant inability of households to fund sufficient consumption expenditure from their real income. Ultimately, then, the reliance of the U.S. economy on household debt accumulation not only provided a temporary salve for its own latent demand deficiency, it also had spillover effects elsewhere. Specifically, it facilitated the reliance on external demand to top off inadequate domestic demand in countries such as Germany and China, as U.S. households became “consumers of the last resort” for the world economy.

Global phenomena have not merely *reflected* but have also *contributed* to the structural flaws in the aggregate demand-generating process that have come to plague the United States and other economies. As emphasized by Palley in Chapter 2, trade agreements (coupled with the steady reduction in shipping costs since the 1960s) have created an anything-but-level global playing field on which footloose corporations can credibly threaten to relocate between national political jurisdictions unless their demands for wage and tax concessions are met. This has contributed – both directly through the resulting pressure on wages, and indirectly through its distortion of the tax system – to wage stagnation. Putting the pieces together, this analysis suggests that fixing the private aggregate demand-generating process

requires concerted international action that would see multiple nations attend to the income stagnation afflicting their working and middle-class households. It would also involve commitment to common labor standards to prevent otherwise desirable cross-border trade in goods and services from degenerating into a “race to the bottom” that eviscerates both wage growth and working conditions.

If it is not already obvious, implementing these sort of policy initiatives constitutes an enormous task. It is well to remember, then, that as intimated at the end of the previous subsection, some progress can be made through more modest means. Specifically, fiscal policy can act as a surrogate for labor market and broader institutional reforms by addressing the distribution of after-tax income, and thereby seeking to offset and correct imbalances created by the distribution of pre-tax income. This task is made easier if, as suggested by Crotty in Chapter 5, many of the biggest incomes at the top of the income distribution are composed largely of rents – in which case they can be taxed without impairing productive effort. The revenues raised in this fashion can then be used to either boost the “social wage” (through expenditures on the direct public provision of goods that enhance the consumption of lower- and middle-income households – parks, public transportation, etc.), or through transfer programs designed to enhance the low and stagnant real incomes of the same households.

Finally, it is important to remember that however achieved, restoring robust real income growth to working- and middle-class families will reduce their debt-dependence and enhance their ability to service the debts they *do* carry – developments that are obviously conducive to financial stability. The sorts of policy proposals discussed in this subsection, then, address more than just the problem of fixing structural flaws in the private aggregate demand-generating process. It follows that monetary and financial policy need not bear sole responsibility for the job of restoring the financial sector of the U.S. economy to good health: revitalizing real income growth across the entire income distribution also has an important role to play. This observation only serves to add to the appealingly “bottom up” character of the recovery proposals in this section. Policy targets incomes, and hence purchasing power, from the bottom of the income distribution up through the middle class. The result is more robust and sustainable aggregate demand conditions and better household debt-servicing capabilities. In what might be referred to as a “trickle up” process, strong income growth below the top quintile benefits the rest of the economy, including corporate and financial sector balance sheets, as well as profits and other capital income.

3. Toward a Better Future

The Great Recession and subsequent stagnation has created profound social adversity, some of it represented in statistical measures, and some incalculable. Tens of millions of U.S. citizens have been forced to confront unemployment or significant underemployment directly. Tens of millions more must deal with the stress of unemployment, either because they fear threats to their own jobs or because the incomes of other members of their household have been directly affected. Of course, unemployment is a waste of resources. Society has obvious needs for more production, and idle workers are both willing and able to meet more of those needs. Yet for reasons discussed extensively in the pages of this volume, the economic systems of the most developed countries of the early twenty-first century cannot coordinate their activities to bridge the gap between resources and needs. Outfitted with their statistical measures and quantitative proclivities, this failure is the single most prominent feature of the Great Recession in the minds of most economists, and we certainly agree that the material waste caused by the Great Recession is of first-order importance.

However, material waste may not be the greatest problem that has arisen since late 2007. Unemployment does not just waste resources, it also rips at the identity of those it afflicts and tears apart the fabric of their social life. In the United States, our jobs define to a large extent who we are as individuals. We all know that the question “what is it that you do” refers to our occupations. Consider also how young children are acculturated to an identity largely defined by work by the question asked of them from a very young age: “what do you want to be?” The expected answer is never along the lines of “I want to be a healthy, well-adjusted human being who has meaningful relations with those around me and contributes to the social good.” Instead we expect “fireman,” “doctor,” “teacher,” and so forth. In addition, what has come to be known as the American Dream suggests that you can be whatever you want to be if you play by the rules of the idealized economic game – that is, if you take your education seriously, work hard, live within your means, and behave responsibly. Of course, the idea that with good behavior and dedication a person can obtain literally *any* professional outcome is exaggerated. Nonetheless, such ideas permeate deeply into our culture. A natural reaction for people thrown out of work, therefore, is to feel at least partially responsible for their plight and to begin to question their worth. The fact that they are just one of millions of people suffering the same fate probably does not offer much comfort. The objective reality may be that it is the system that has failed unemployed workers and

their families but, it is hard to not reflect blame and the associated loss of self-esteem on oneself.

Furthermore, even if people can protect their psychological identity from the ravages of unemployment, there is no firewall for the household budget. The United States has notoriously stingy safety nets, especially when it comes to health insurance. Of course unemployment compromises living standards, but it also adversely affects physical health and family relations.

What is particularly tragic is that there is no physical reason why people must bear these costs. Workers after the Great Recession are neither less motivated nor less skilled than they were in 2006 or 2007. Indeed, labor productivity has *risen* remarkably in recent years. We have not suddenly forgotten how to apply modern technology to produce high living standards. Our capital has not been destroyed by natural disaster. It is our economic system that has failed to coordinate our ability to produce with our ability to purchase. The unstable dynamics of finance and uncertainty leading up to the Great Recession have finally ground the debt-fueled, consumption-led growth engine to a halt, shutting down the aggregate demand-generating process that the United States and world economies came to rely on during the late twentieth century. In the United States, the core problem, as analyzed extensively in this volume, is that a system that distributes its income so unequally cannot generate growing aggregate demand without unsustainable household debt growth and financial excess. We can complain about individually “irresponsible” behavior in taking on too much debt. We can rail against the captains of finance for their greed that led to financial bubbles. The fact is, however, we had come to rely on excessive household borrowing and financial bubbles to maintain the demand growth we needed to even get close to full employment over the past two decades. We can rely on that approach no longer.

The contributions to this book argue that we need a new model to sustain demand growth in coming years. That model requires a greater public role in guiding finance to socially useful activities. It also needs mechanisms to generate more government demand to fill the gap created by the end of the debt-financed consumption boom. This perspective stands in strong contrast to the political ideology that has gripped much of the developed world recently, as it clings to the neoliberal “small government” ideas of the past several decades and promotes government fiscal “austerity” as virtuous. Perhaps most important, the new model must find a way to share more equally the fruits of what could be a highly productive economy. Of course, more balanced distribution will improve social justice. However, faster income growth across the social spectrum is also necessary, we argue,

to initiate a new kind of aggregate demand-generating process, one that moves the economy toward – and then maintains – full employment of our resources. It is not just jobs that are at stake. Strong demand growth is also necessary to support the financing and innovation that are necessary for sustained increases in our standards of living.

These problems highlight the fundamental interdependence of individuals in modern society. Economic models that treat the country as a whole as if it were Robinson Crusoe on his own island will neither explain the Great Recession nor offer much help to guide us out of its stagnant aftermath. The Keynesian perspective that underlies this book fundamentally recognizes social interdependence: one person's income is another's spending; we cannot earn income on our own unless others spend. However, interdependence requires coordination. To a remarkable degree, market forces unguided by a centralized authority coordinate social activity. Nevertheless, the inability to fully utilize the economy's productive resources reflects a failure of the market. It seems clear that individual incentives alone are inadequate to assure the social coordination necessary to reach and maintain full employment. As the perspectives developed in this book point out, the solution involves expanding the government's role in coordination. That role may involve the creation of spending and incomes when the private sector will not. It may involve guiding the private sector away from destructive financial behaviors that arise from the unfettered pursuit of private interest in complex and uncertain modern markets. It may involve establishing institutions that raise the prospects for lower- and middle-class income growth in an increasingly globalized world that has concentrated a disproportionate share of the rewards from rising productivity at the top of the income distribution. These actions might appear to threaten private interests, but the reality of social interdependence is that good private outcomes cannot be secured by private action alone. The failure to recognize this point in the ideologies that guided economic policy in recent decades is, in a broad sense, responsible for the crisis we now confront.

The Great Recession marks the end of an era in which neoliberal policies that suppressed or completely ignored the inherent social interdependence illuminated by Keynesian macroeconomics could be plausibly argued to deliver prosperity, stability, and social justice. The results of recent years have been tragic. The immediate prospects for significant improvement are also unfavorable, as it seems that the economic policy establishment has yet to come to terms with the challenges of demand generation without some kind of financial bubble that leads to exploding debt. It is important to remember, however, that although robust and sustainable recovery is not

assured, it is not impossible to achieve: it won't come about automatically, but the right policy interventions *can* help resolve the current crisis. We hope that these difficult times give way to a new approach to macroeconomics that is reflected in both theory and policy – an approach that, in the decades to come, allows modern economies to realize their immense potential and to share that potential with all of their citizens.

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