Keynesian Macroeconomics for the 21st Century Part 2: Intrinsic Keynesian Dynamics—Sowing the Seeds of Crisis

YSI – INET Lectures
Edinburgh, Scotland—October, 2017

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Intrinsic Keynesian Model

- Demand most often the limiting factor on production and employment
  - Supply necessary, but not sufficient
  - Very different from mainstream theoretical lens: demand "beyond the short run"
  - Rough assessment of recent US history
- Interrogate "demand generation process"
  - Fundamentally dynamic

Three Generic Models of Demand-Led Growth

- Kaleckian growth model
  - Autonomous investment function
  - Growth driven by capital accumulation: Net I / K
  - Equilibrium growth from adjustment of capacity utilization
  - Income distribution affects both consumption and investment
- Supermultiplier models
  - Path of (autonomous demand) * (dynamic multiplier)
  - Investment follows demand, firms choose utilization
- Historical analysis
  - Demand dynamics depend on specific historical circumstances
- Use perspectives to explore recent important events

What Caused the Great Recession?

- Explore demand generation process
- Central role of finance and financialization
  - Debt boom, housing bubble, securitization, subprime …
- Bursting of bubble triggers crisis
- Hyman Minsky’s theory of financial instability
  - Primarily employs the historical framework
  - My angle: adds distributional / Kaleckian factors
- Reflection: “real world” and shift from business investment to household finance
  - Locus of financial instability
  - What’s really big?

Minsky Thumbnail: Stability is Destabilizing

- Start with tranquil, stable financial structure
  - Profit opportunities nudge toward more aggressive finance
  - More finance => more spending
  - Higher spending raises incomes and cash flows (Keynes)
  - <u>Validation</u> of more aggressive behavior
- Validation encourages even more aggressive finance => rising financial <u>fragility</u>
  - Hedge, speculative, Ponzi spectrum
- Continues until fragility triggers crisis ("Minsky Moment")
  - Stress test metaphor
- Research objective: explore dynamics of validation and rising financial fragility in historical context

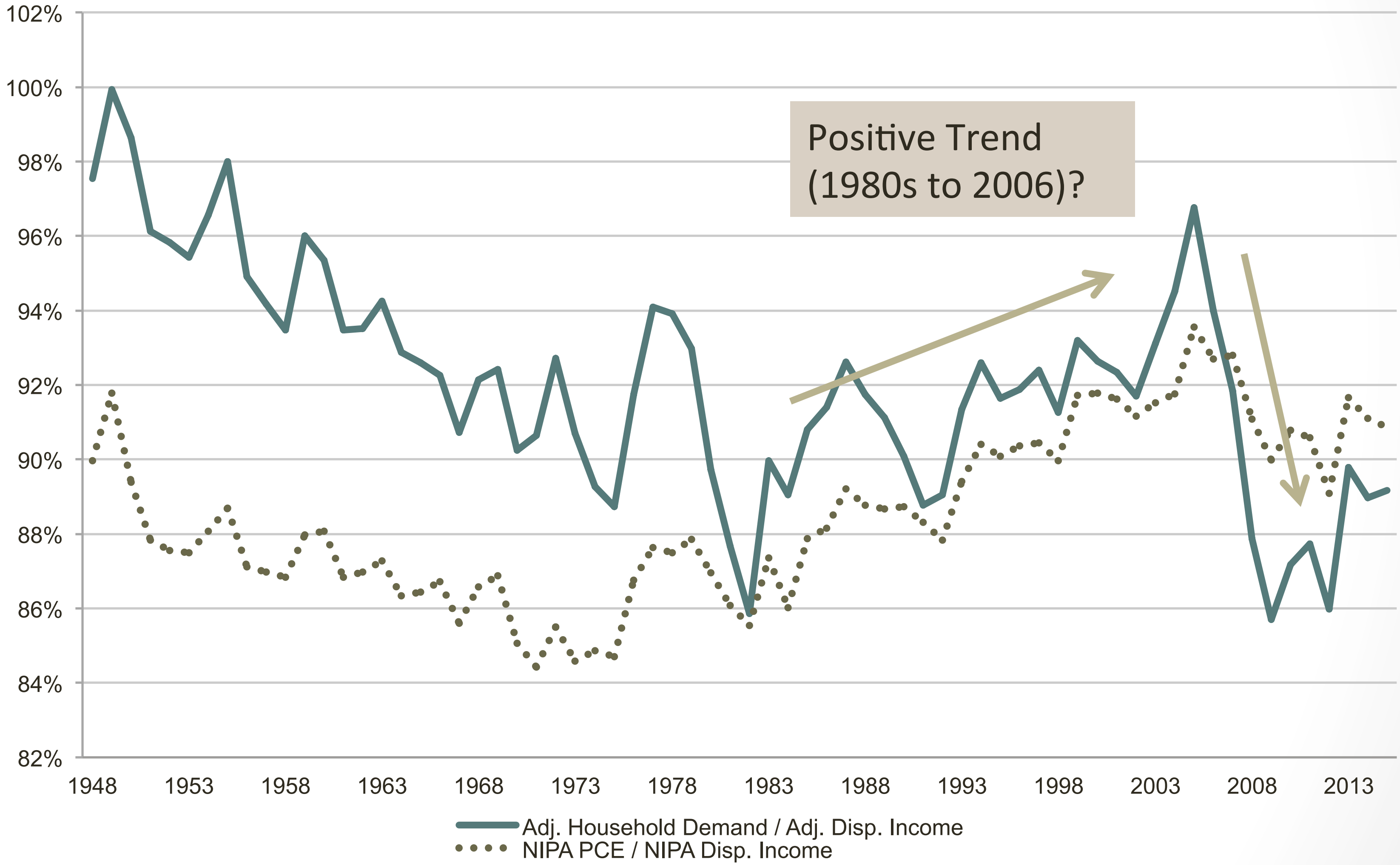
Some Notes on Measurement

- Key question: demand from the household sector?
- Cynamon-Fazzari, *Review of Income and Wealth (2017)*
  - Get rid of implicit owner-occupied components for housing
  - Replace with residential construction
  - Medical care: who pays?
- Consistent framework for measuring demand
- Practical integration of consumption and residential construction

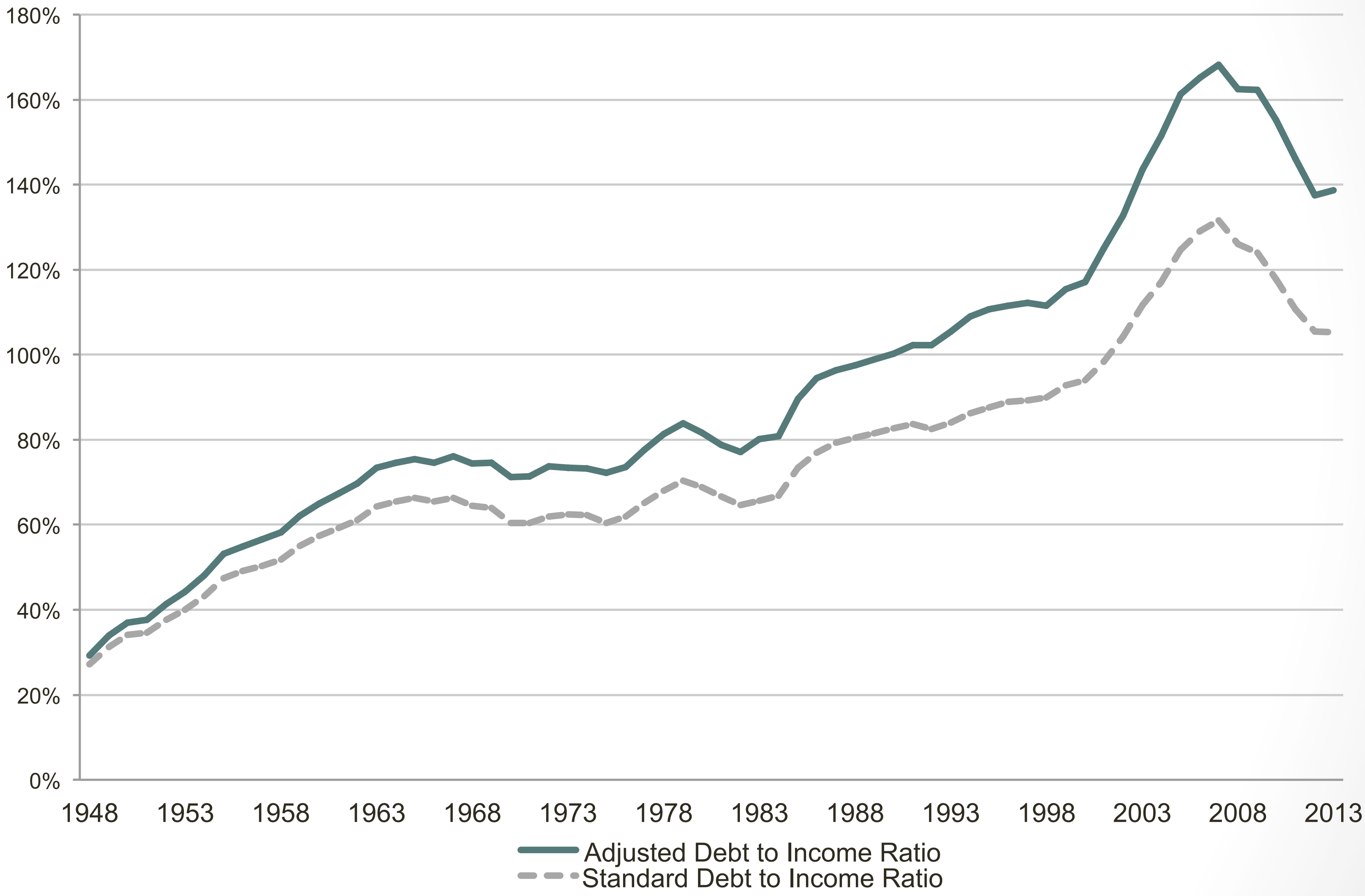
The Consumer Age

- Strong trend of U.S. household demand: mid 1980s to 2007
  - Stable, rising consumer spending
  - Perhaps the primary cause of the so-called "Great Moderation"
  - <u>Validation</u>; central feature of several decades of dynamic demand generation
- But associated with dramatic rise in debt to income: <u>fragility</u>
- Collapse of the Great Recession

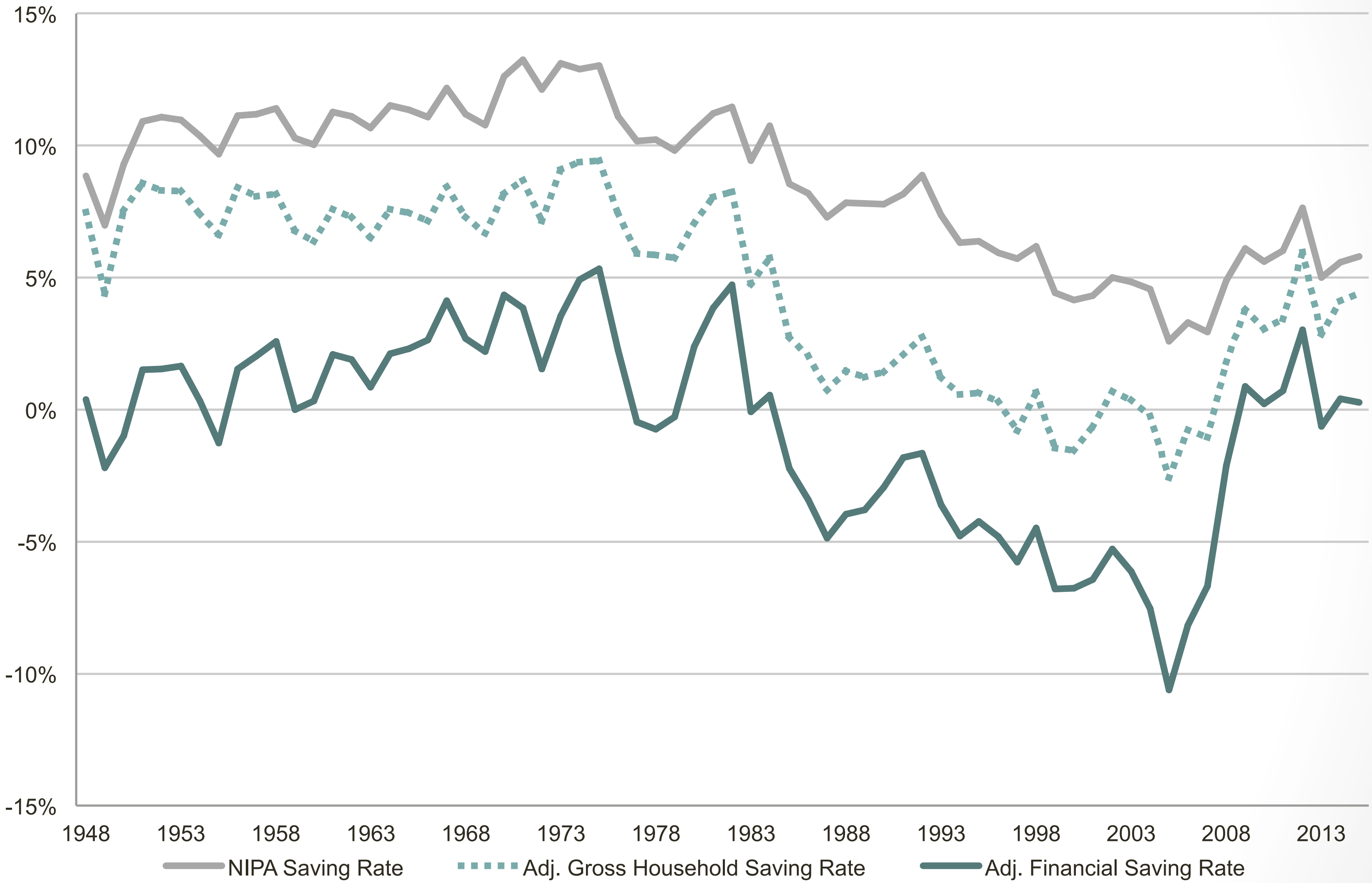
Household Demand to Adjusted Disposable Income vs. NIPA PCE to NIPA Disposable Income



Financial Fragility—Household Debt to Income
(Adjusted and Standard Measures)



Household Saving Rate: Further Signs of Fragility (**)



Keynesian Validation

- Finance stimulates demand
- Strong demand drives incomes
  - Great Moderation and "mild recessions"
  - Partial result of consumption-debt engine
- Consumption and housing: big quantitative effects
  - PCE + Residential Construction (68% to 74% of GDP since 1990)
  - Compare with business investment (11% to 14% of GDP since 1990)
- Asset prices (mostly houses)
  - Wealth effects on spending
  - Collateral and borrowing
  - Expectations and confidence
- Keeps demand generation dynamics going

Financial Fragility

- Success => more aggressive lending & borrowing
  - Shift toward short-term financing
  - Teaser rates; expectation of refinance (speculative)
  - Borrowing to pay interest (Ponzi)
  - Lax underwriting, riskier loans
- Irrational?
  - Refinancing into low-rate markets worked for two decades
  - Validate convention in uncertain world
- Stress test metaphor again
  - When test item doesn't break, provides validation
  - But addition of stress leads to more fragility

In Their Own Words …

Boykin Curry, managing director of Eagle Capital: "For 20 years, the DNA of nearly every financial institution had morphed dangerously. <u>Each time someone at the table pressed for more leverage and more risk,</u> <u>the next few years proved them 'right.'</u> These people were emboldened, they were promoted and they gained control of ever more capital. Meanwhile, anyone in power who hesitated, who argued for caution, was proved 'wrong.' The cautious types were increasingly intimidated, passed over for promotion. They lost their hold on capital. This happened every day in almost every financial institution over and over, until we ended up with a very specific kind of person running things."

- Quoted in Farid Sakaria column "There is a Silver Lining," <u>Newsweek</u>, October 12, 2008, emphasis added

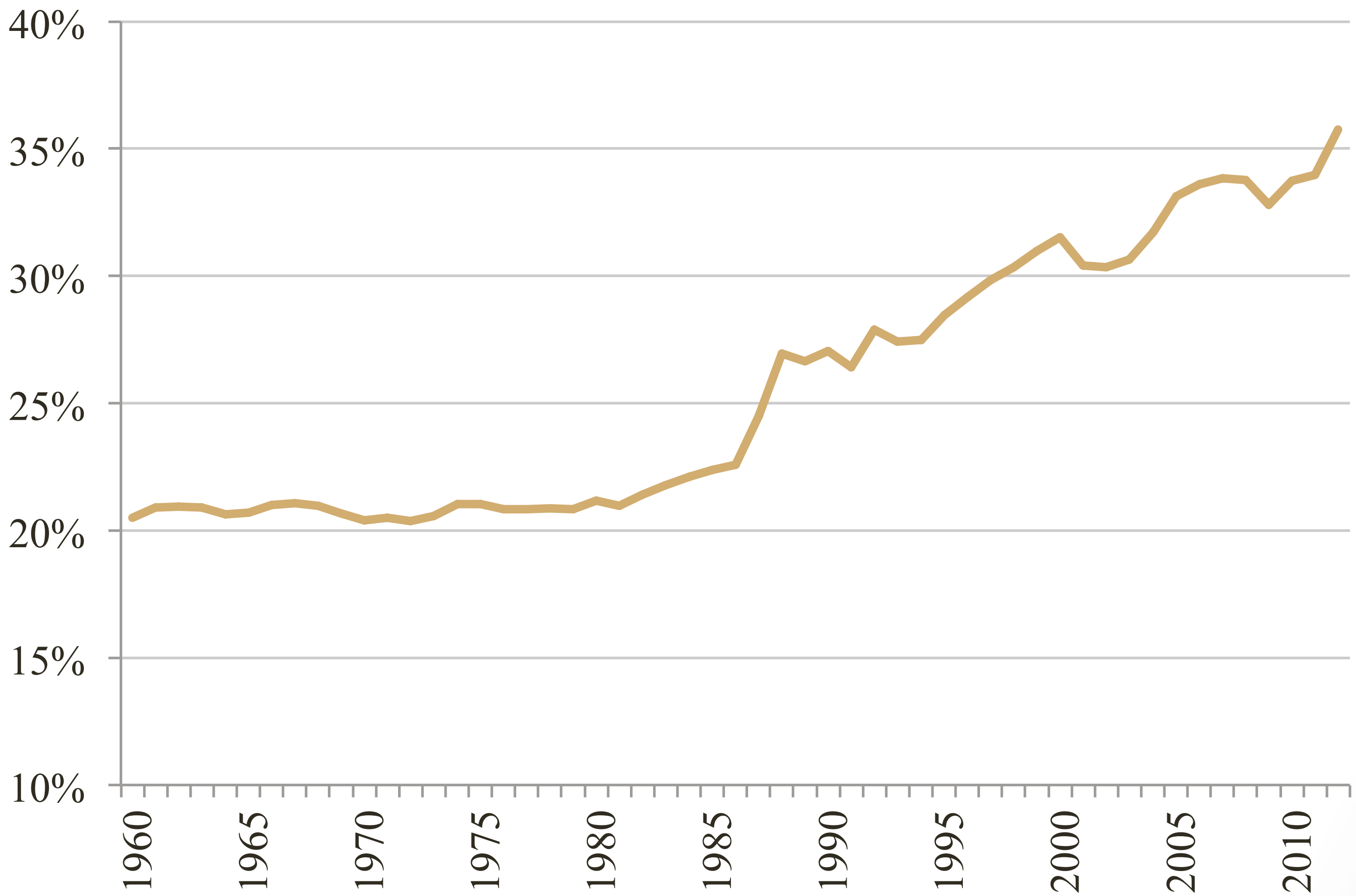
Financial System Softens Budget Constraints (**)

Minsky (1992): When we go to the theater we enter into a conspiracy with the players to suspend disbelief. The financial developments of the 1980s can be viewed as theater: promoters and portfolio managers suspended disbelief with respect to where the cash would come from that would [validate] the projects being financed. Bankers, the designated skeptic in the financial structure, placed their critical faculties on hold.

- Replay in the "consumer age"
  - Strong incentives for people to maintain, even increase, consumption in face of unfavorable financial circumstances
  - Consumption norms (Cynamon and Fazzari, 2008 & 2013)
  - Financial system "suspended" its role as budget constraint enforcers
  - Result of specific historical process, but part of systematic pattern
- Perspective on irresponsible behavior

Role of Inequality

(Share of top 5% --World Top Incomes Data with Capital Gains)

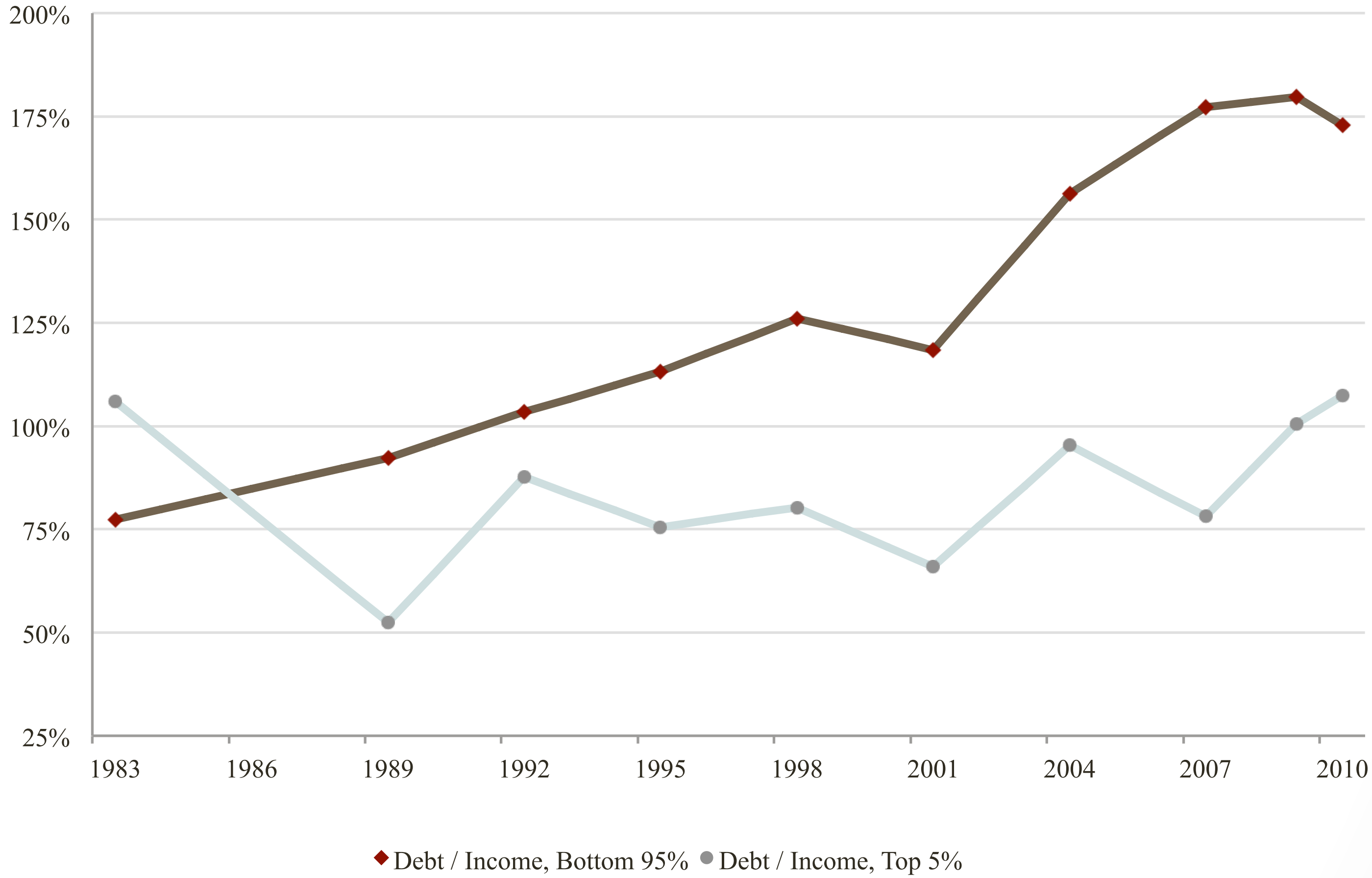


Paradox: Strong Consumer Spending with Rising Inequality

- Look beyond aggregates …
  - What was happening to spending and debt across income classes?
  - Cynamon & Fazzari (Cambridge Journal of Economics, 2015)
- Survey of consumer finance for debt
- Data challenges for spending and saving
  - Mark Zandi (plus a lot of work) for spending rates

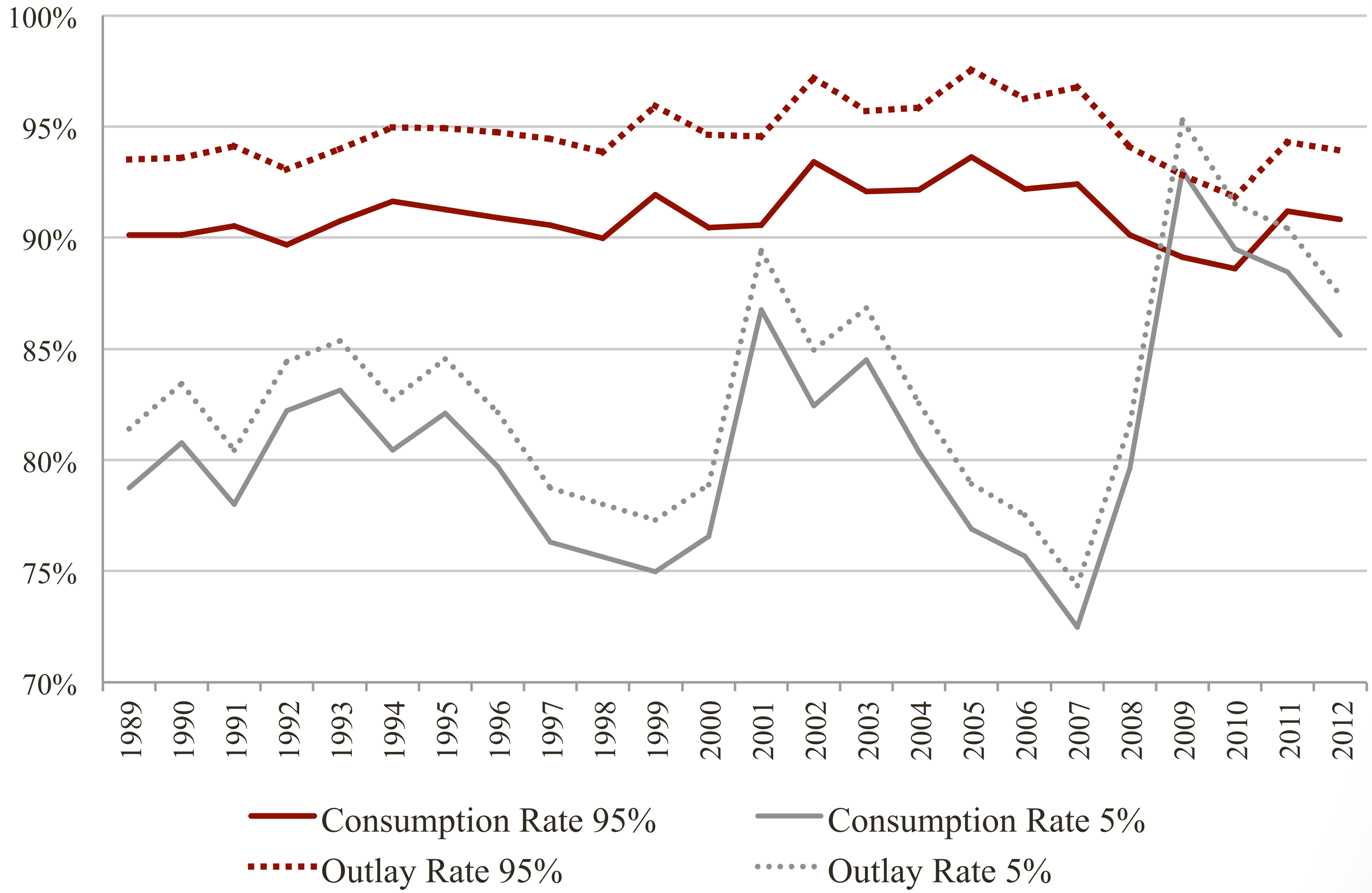
Who Was Borrowing? (SCF)

Household Debt / Disposable Income



Disaggregated Demand and Outlay Rates

(Credit Crunch vs. Consumption Smoothing)



Collapse of Demand Generation Process

- Crisis triggers
  - In Minsky: historically specific and difficult to predict
  - Fear of inflation and rising rates compromise refinance game
  - Perception of rising fragility and "greater fool" problem
  - Home prices flatten (collateral) before collapse
- Loss of debt-financed demand generation from middle class
- Deep recession—Keynes
- Stagnant recovery ("secular stagnation")
- Questions and discussion …