Keynesian Macroeconomics for the 21st Century
Part 3: Demand Dynamics, Inequality and Secular Stagnation

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Understanding Recent Experience

- Aftermath of the Great Recession: slow recovery
  - Brief empirical case for "secular stagnation"
- Inadequacy of supply-side stories
- Strong case for sluggish demand growth
  - Household demand dynamics
  - Role of inequality
  - Government
- Reverse Say's Law: demand leads supply
- A few thoughts on policy

Recent Stagnation

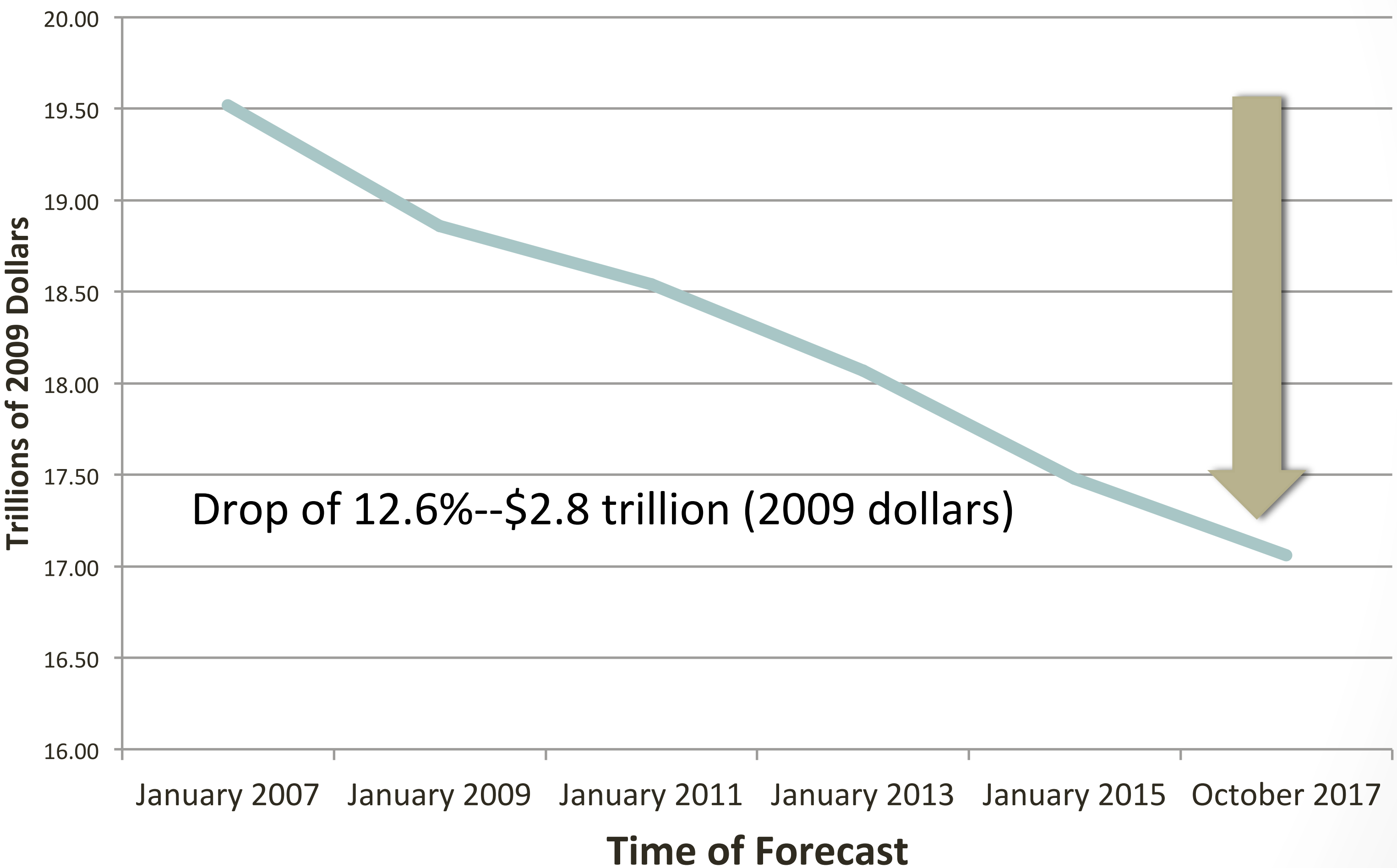
(Peak-to-peak growth of real GDP per capita)

Peak Dates	Total Growth (per capita)	Growth per Year (per capita)
1973:4 to 1979:3	11.9%	1.8%
1979:3 to 1990:2	25.0%	2.1%
1990:2 to 2000:2	24.2%	2.2%
2000:4 to 2007:4	10.9%	1.4%
2007:4 to 2017:2*	**5.6%**	**0.6%**

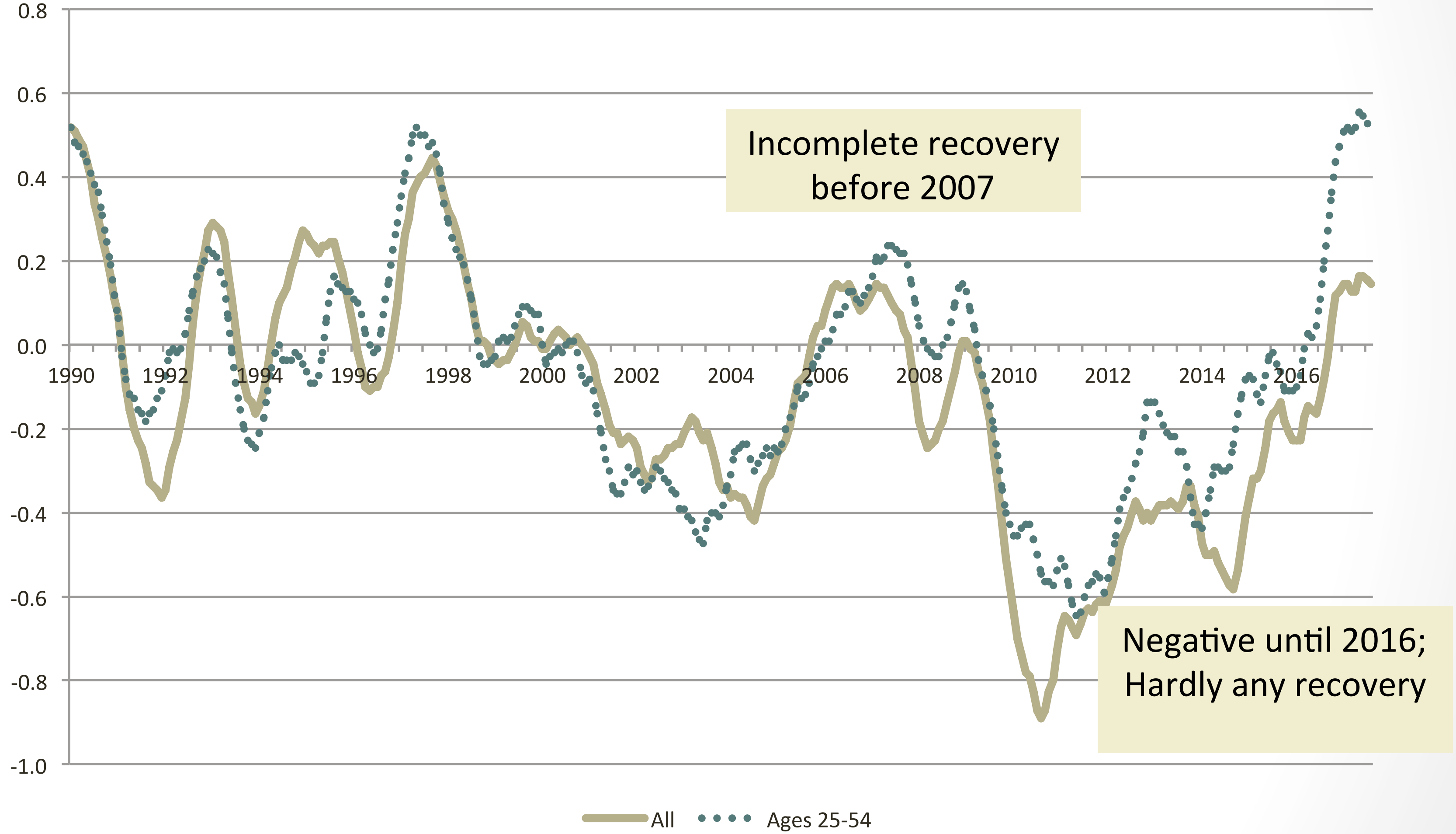
*Final cycle is incomplete

An Excessively Optimistic Forecast

(Evolution of CBO Real Potential Output for 2017:Q2)



Growth of Labor Force Participation
(Percentage points, smoothed year over year)

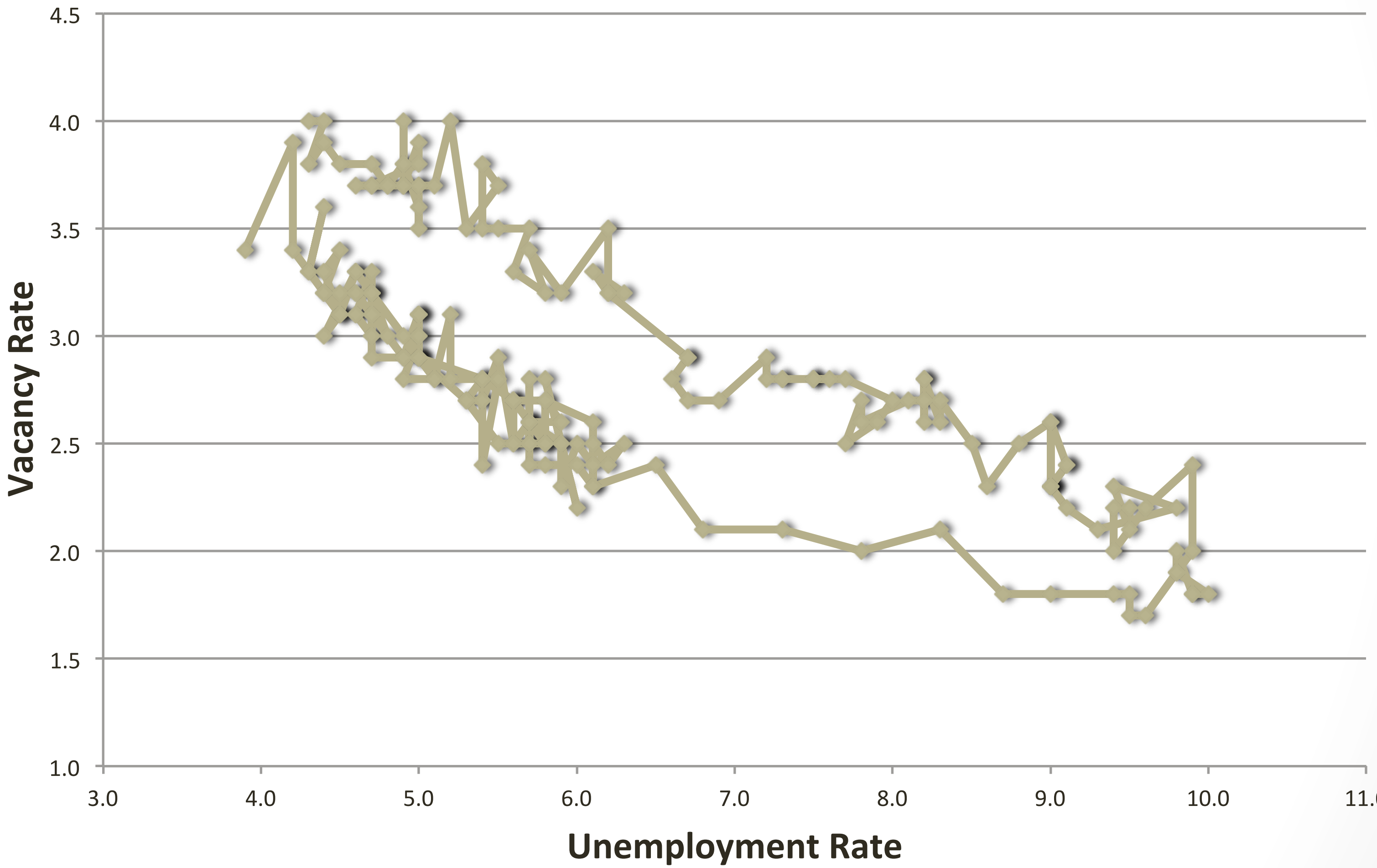


Stagnation through the Mainstream Lens

- Persistent: 10 years since peak; 8 years since trough
- We are “beyond the short run”
  - Conventional view: Keynesian effects should have been corrected
  - Some qualification for zero lower bound on short rates
  - But Fed is raising rates now
- Therefore, it must be the supply side
  - Bad policy: it’s all Obama’s fault
  - Bad luck: structural supply-side shocks and mediocre “new normal”
- Let’s look …

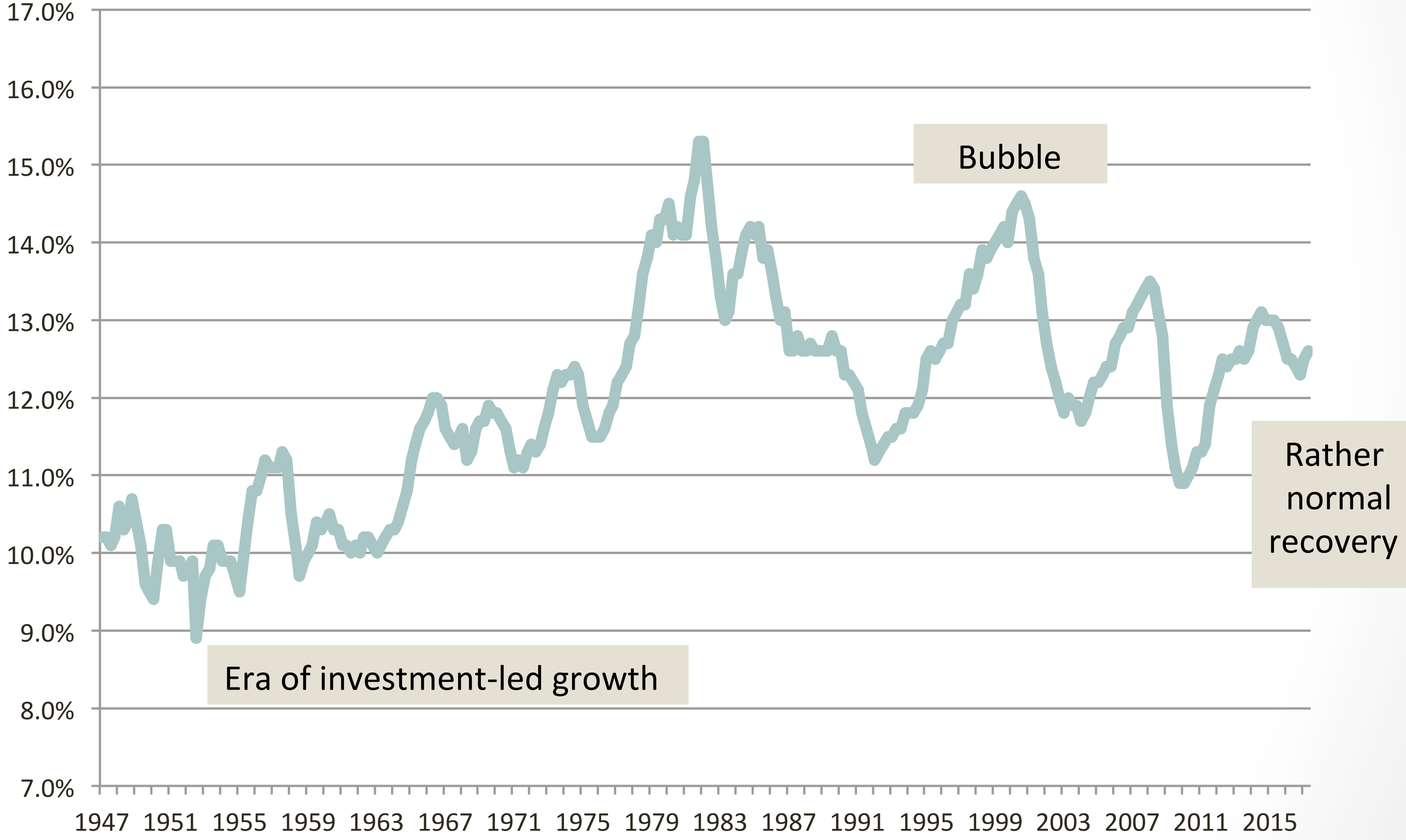
Labor Market Mismatch?

(The Beveridge Curve)

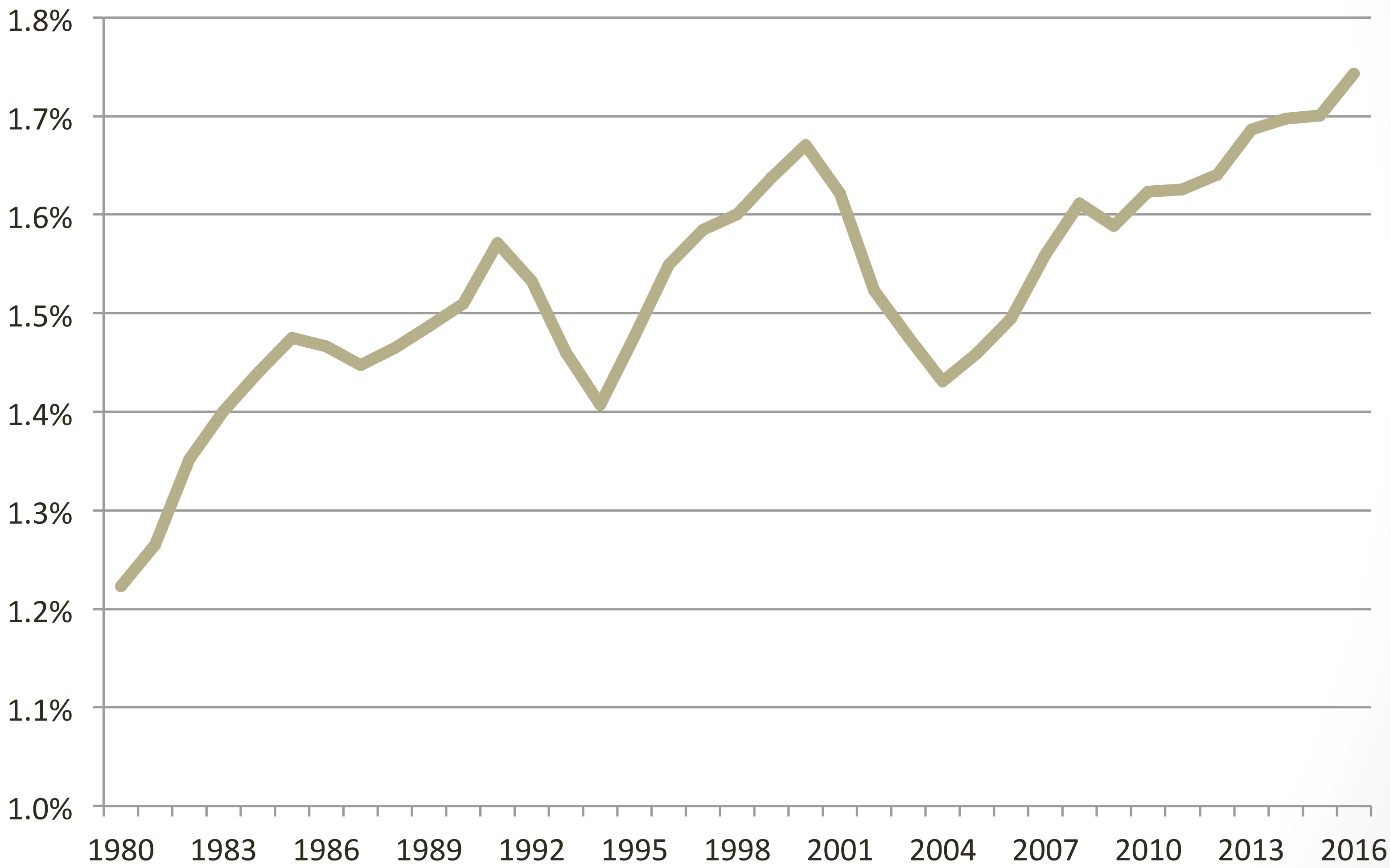


Lousy Business Capital Investment?

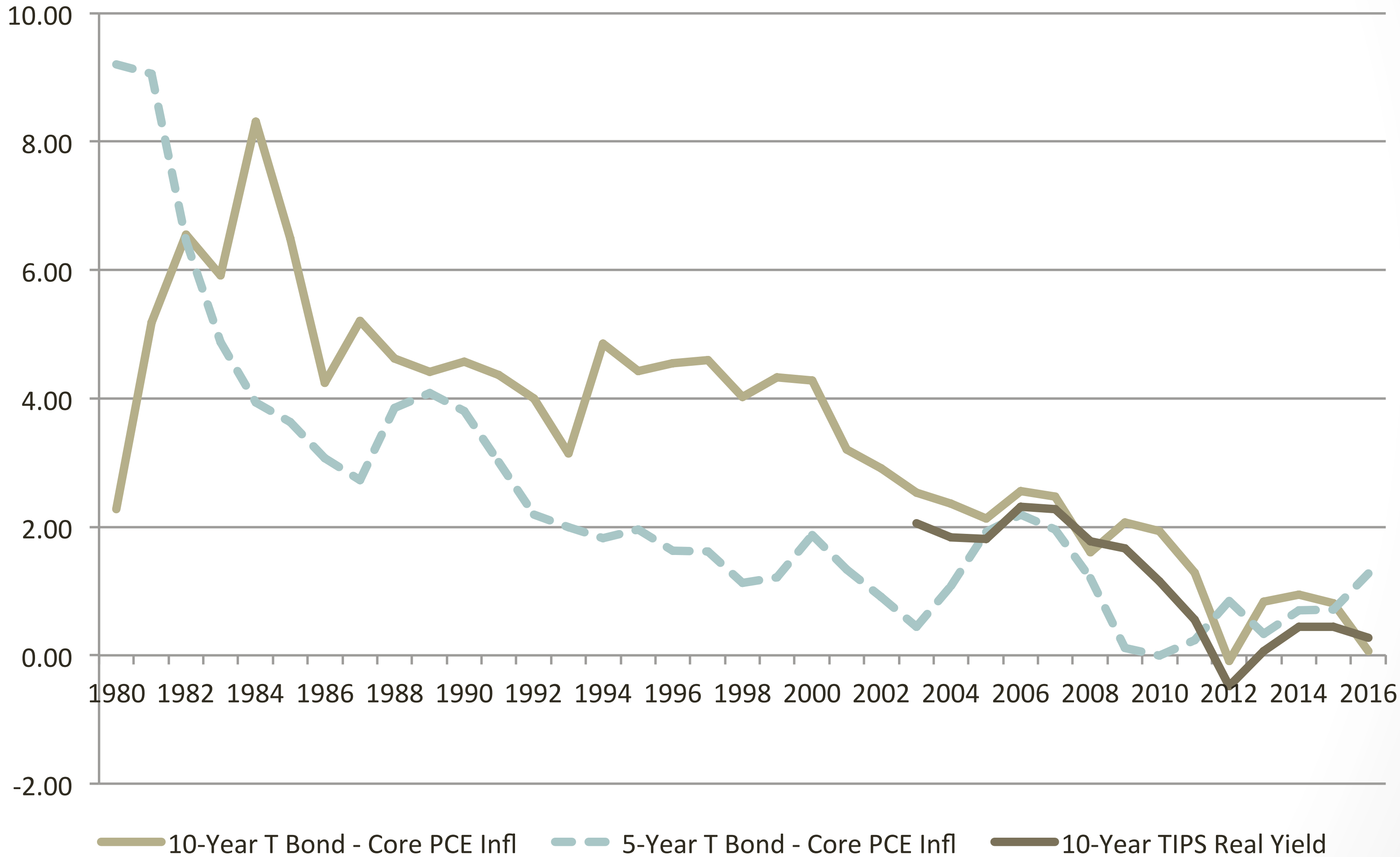
(Nominal nonresidential Fixed Investment / Nominal GDP)



Weak Innovative Activity?
(Private R&D to GDP)



Supply or Demand? (Real) Interest Rates will Tell

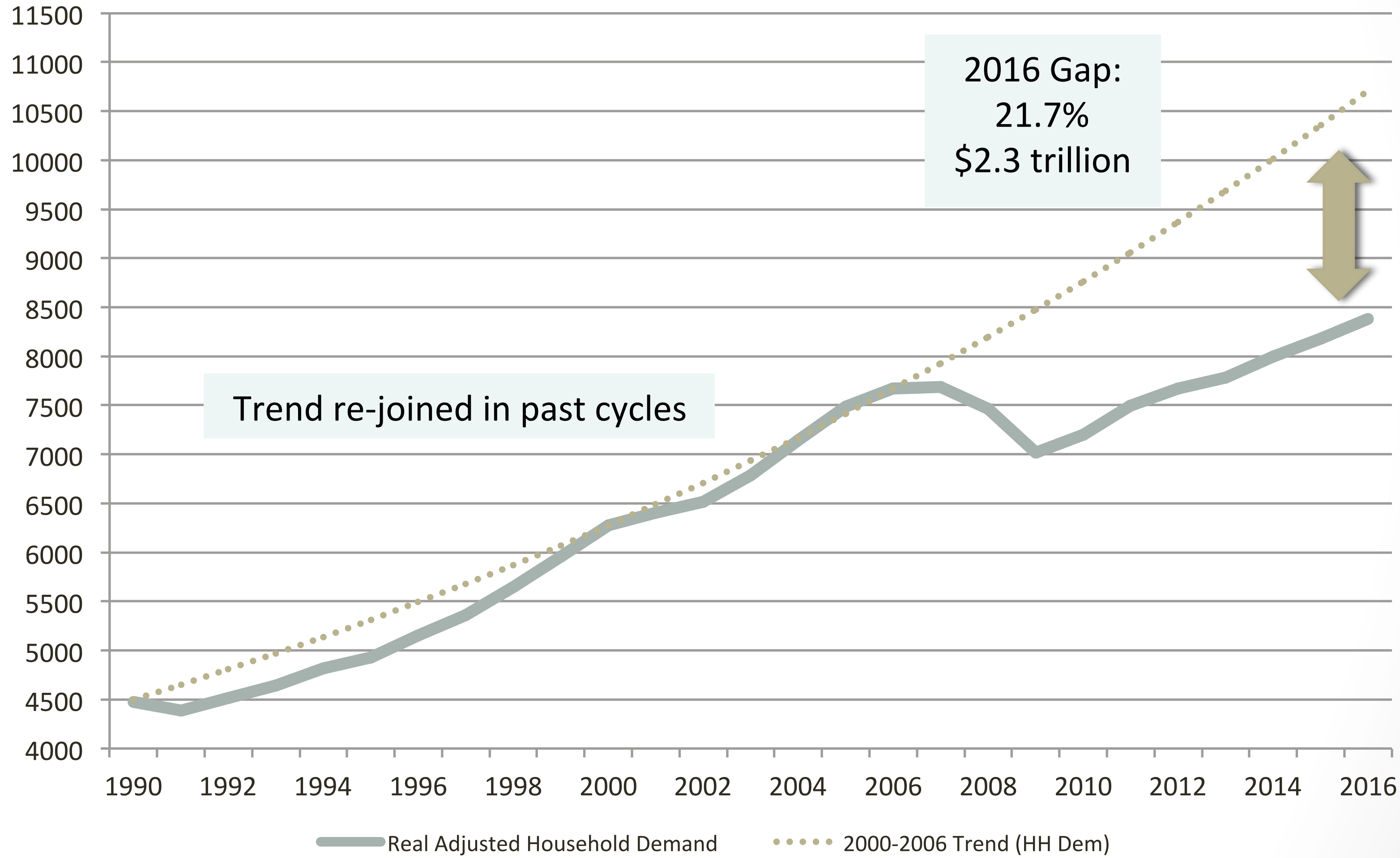


The Demand-Side Theoretical Lens

- No automatic or policy mechanism to restore AD to Y* "beyond the short run"
- Demand growth dynamics are proximate determinate of economic activity
- To understand stagnation, look at the demand generation process

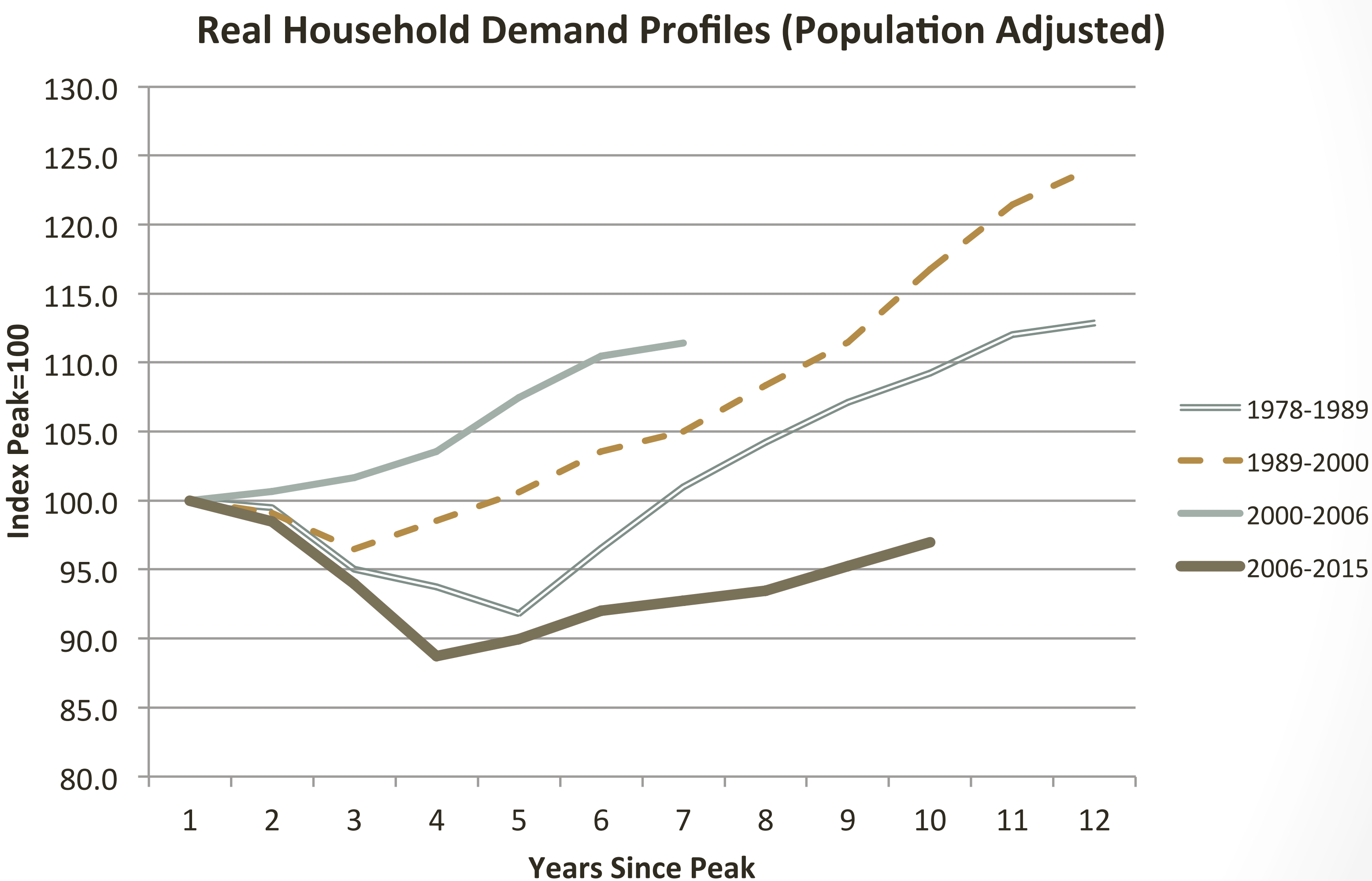
Household Demand: OMG!

(Adjusted household demand based on Cynamon & Fazzari, 2017)



Weak Household Spending and the Stagnant Recovery

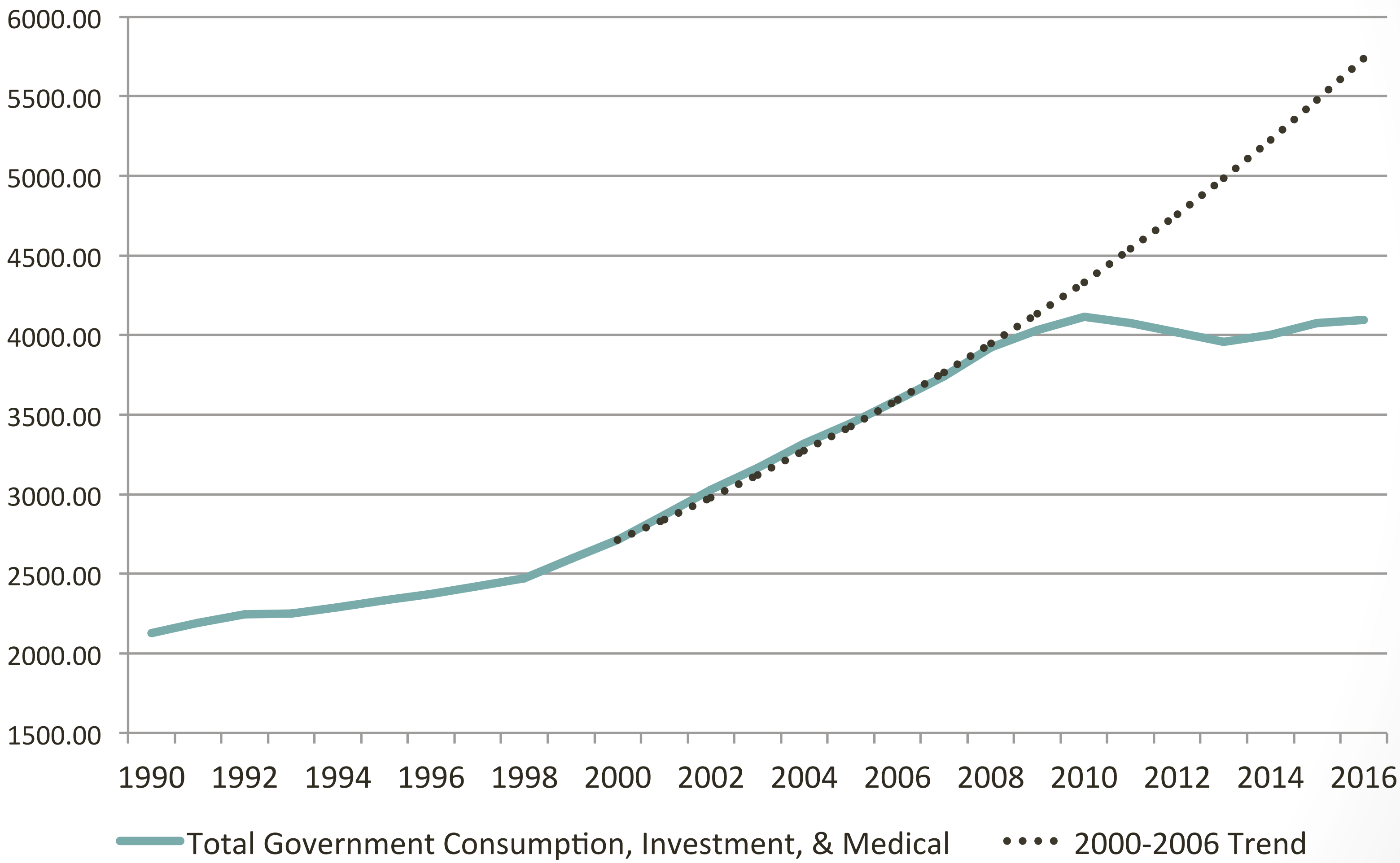
(Based on Cynamon-Fazzari Review of Income & Wealth, 2017)



Historic Shift of Demand Generation

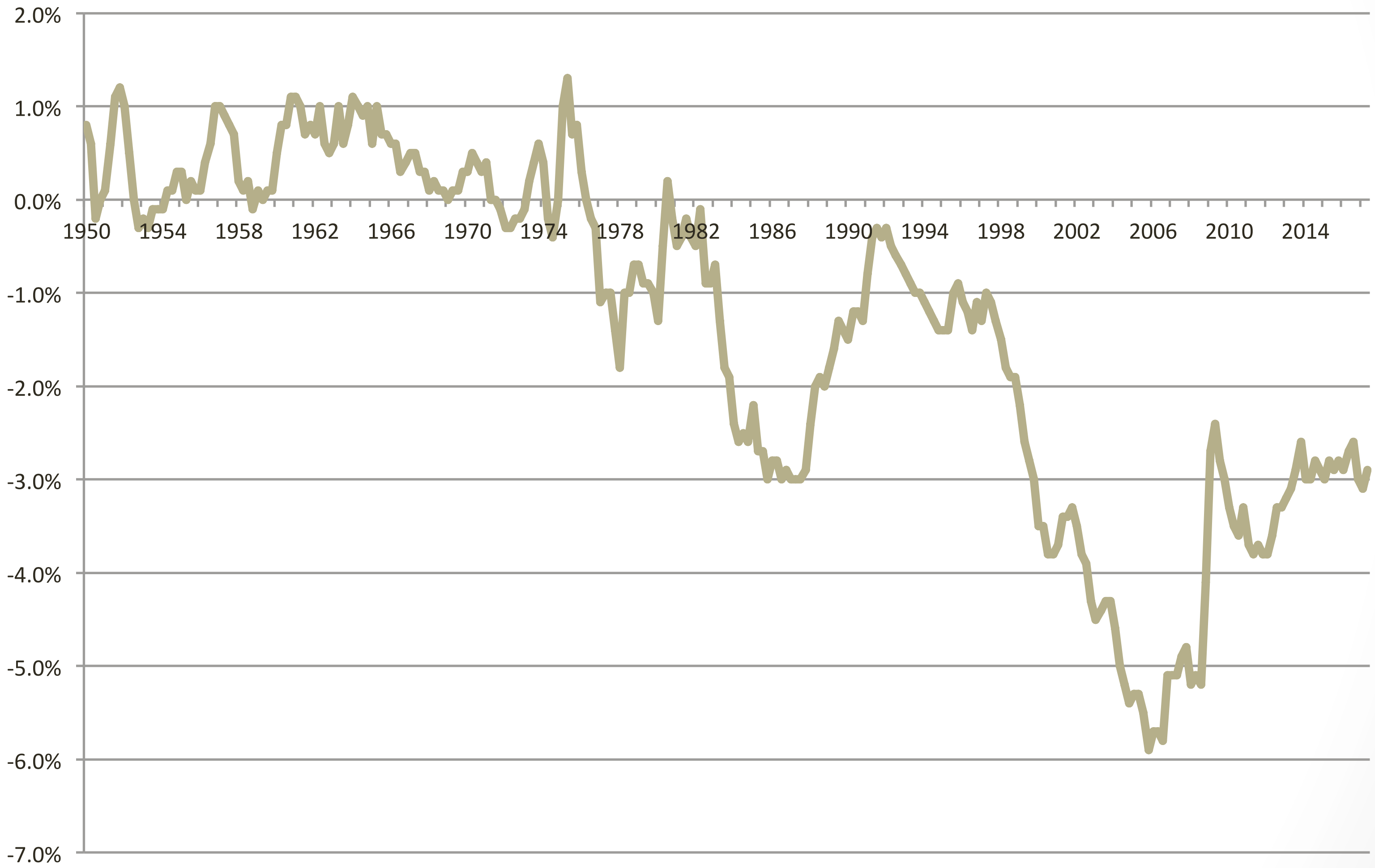
- Past trend not “structural, “ but what economy needed
- Pre-crisis demand growth required unsustainable household finance
- But now the “consumer age” financial dynamics have changed
- Severe and persistent demand stagnation
- Consistent with interest rate data and generalized correlation of weakness across sectors

Government Did Not Replace Households



It Could Have Been Worse …

Net Exports / GDP



Nuanced Role for Inequality

- Rising inequality as explanation for stagnant demand
  - Rich spend or “recycle” a smaller share of income than others
- Timing problem
- Borrow-and-spend era <u>postpones</u> demand drag
- Aided and abetted by the financial system!
  - <u>Not</u> inequality vs. financial expansion
  - Inequality <u>and</u> financial expansion
  - Again, dynamics of demand generation
- Great Recession forces middle-class demand down
  - More in line with stagnant incomes
  - But we <u>needed that demand</u>

Inequality in a Keynesian Growth Model

- Autonomous demand and the "supermultiplier:"

$$M = \frac{1}{1 - \lambda_H \alpha_H (1 - \tau_H) - (1 - \lambda_H) \alpha_L (1 - \tau_L)}$$

- Income distribution between "H" and "L" groups (λ), spending propensities (α), and tax rates (τ)
- Two problems
  - (1) Loss of autonomous consumption and government spending
  - (2) Lower supermultiplier due to rising inequality
  - #1 abrupt; #2 slow
- Simple calibration (Cynamon & Fazzari, EJEEP, 2015)
  - Multiplier alone can explain at least 10 percent

Demand Leads Supply

- Current US situation
  - No huge output gap despite stagnation
  - Mainstream: unfortunate new normal
  - Alternative: weak demand lowers supply
- Channels
  - Investment and technological dissemination
  - Pressure for labor-saving innovation (Dutt: "necessity is the mother of invention")
  - Endogenous labor supply: participation and immigration
- Reverse Say's Law

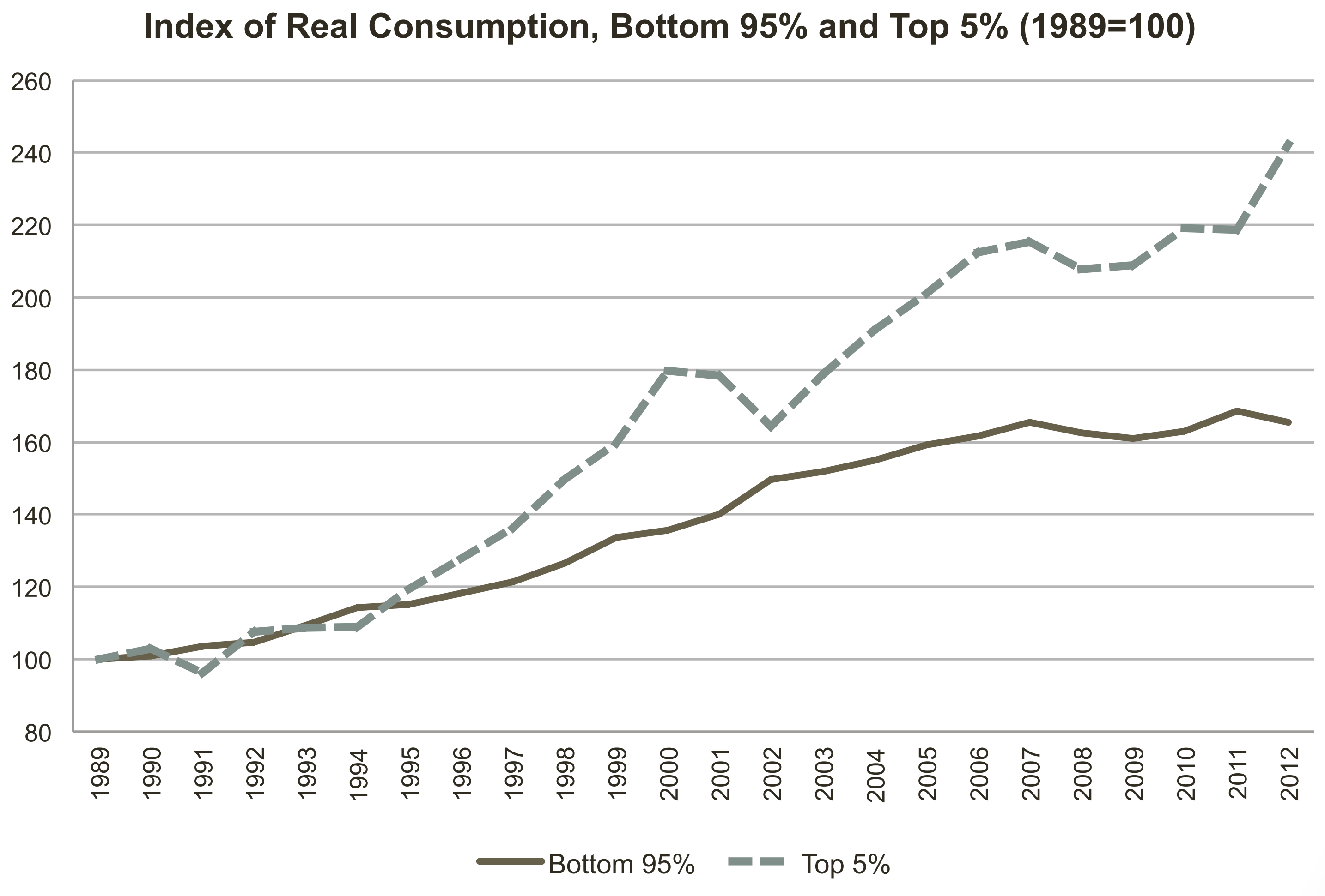
New Results (Fazzari-Ferri-Variato)

- Demand-led growth “supermultiplier” model
  - Review of Keynesian Economics, 2013
  - Harrod model with instability contained
- New paper adds endogenous adjustment of supply
  - Technology and labor supply channels
- Key results:
  - Growth driven by demand
  - Steady state growth led by autonomous demand
  - Supply accommodates different demand paths
  - Slow demand growth drags supply down with it
  - Acceleration of demand pulls supply up
  - Limits to how far supply can be pushed

Consequences

- A disappointing “recovery”
- Deleveraging not enough to restore robust demand growth
  - Does not fix root cause of rising income inequality
- Inconsistent call for smaller government without addressing demand gap
- Where is the engine of demand growth?
  - Recovery relies in large part on spending of the affluent

The Affluent as Growth Engine?



What to Do?

- Attention to demand growth necessary
- Skeptical about monetary policy and QE
- Full employment (Baker & Bernstein, Atkinson, many others)
  - Helps address inequality
- Public infrastructure
- Middle-class tax cuts, possibly money financed
- Employer of last resort
  - Quality jobs with adequate pay
  - Possibly contract with private sector
- Institutional changes to favor wage growth across the income distribution