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Resolving the US financial crisis: politics dominates economics in the New Political Economy

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The Modest US Stimulus Package

Most economists expected that the "Great Recession" produced by the financial meltdown of 2008 would usher in a resurgence of traditional Keynesian economics and a decline of what has come to be called "market fundamentalism". Traditional Keynesian demand management policies seemed to be the obvious response to the rapid decline in output and rising unemployment that quickly followed the paralysis of short-term money markets, and to the complete liquidity preference of financial institutions that left business firms without the borrowed funds necessary to meet their current expenses and to pay wages. While the urgency of the financial crisis did produce an emergency response in the form of the Troubled Asset Relief Program (TARP) in early October 2008 to accompany the Federal Reserve System's support of the financial system, it was only in February of the following year that a modest $787 billion government stimulus package "The American Recovery and Reinvestment Act," was introduced.[1] Most economists, even those within the Obama

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[1] The Act became law on February 17, 2009. The Act specifies appropriations for a wide range of federal programs, and increases or extends certain benefits under Medicaid, unemployment compensation, and nutrition assistance programs. The legislation also reduces individual and corporate income tax collections, and makes a variety of other changes to tax laws. Long-term investment goals include:
- Beginning to computerize health records to reduce medical errors and save on health-care costs;
- Investing in the domestic renewable energy industry;
- Weatherizing 75 percent of federal buildings and more than one million homes;

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Administration, considered the size of the expenditure package grossly inadequate, but the figure proposed was determined by what was believed to be acceptable to a US Congress increasingly skeptical of the efficacy of such action: (see for example what reported by Lizza, 2009).

But even the modest size of the stimulus package is misleading since over a third of the measure was concessions of tax benefits, and only around $500 billion involved contracts, grants, loans, and entitlements. And in difference from traditional stimulus, a number of the contracts and grants were linked to longer-term projects without immediate impact. Further, up to November of 2010 only around 60 per cent of the no-tax expenditures had been disbursed. Despite the relatively low immediate impact of the measure, between 600-750,000 jobs per quarter and a total of around 3.3 million full time job equivalents have been created.

While the introduction of zero policy interest rates and the extension of lender of last resort support to financial and non-financial institutions along with the TARP have stabilized the financial system, the stimulus package has had little success in reducing the unemployment rate which has stabilized at just below 10 per cent, with growth of GDP in the one to two percent range, far below the growth rates seen in previous recovery from recession. Around twenty per cent of the population is unemployed, underemployed or discouraged from seeking work.

The Long-term Decline of Keynesian Policies

As a result of the disappointing short-term impact on incomes and employment, the resurgence of support for Keynesian expenditure policies has been extremely short lived, and the pages of every newspaper

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- Increasing college affordability for seven million students by funding the shortfall in Pell Grants, raising the maximum grant level to $500, and providing a higher education tax cut to nearly four million students;
- Cutting taxes for 129 million working households by providing an $800 Making Work Pay tax credit for qualified individuals;
- Expanding the Child Tax Credit.

See http://www.recovery.gov/Pages/default.aspx for up to date details on the implementation of the Act.

and every news broadcast have turned to a discussion of the risks facing the global economy and in particular the US economy from the impact of stimulus measures on the size of the government debt. It is widely believed that the expenditure policies have not produced any benefit to the economy and have only created the risk of the bankruptcy of the United States: (see for example Lambro, 2009). Again, while most economists argue that the original stimulus package was too small, and that another package should be prepared, there is currently no political support for such a package. Instead the attention of politicians and political pressure groups has been centered on reducing the government deficit expenditures sufficiently to produce a surplus capable of paying down government debt. Rather than a resurgence of influence, Keynesian policies are now considered as discredited and outmoded (Boskin, 2009). The fact that the size of the deficit and the debt is due to the breakdown of the private financial system and its rescue has failed to register on the general public and politicians who believe that they are due to excessive government incursion into the private economy and thus should be sharply curtailed.

But the negative popular and political reaction should not have come as a surprise. There are three reasons for this:

– The design of the Obama stimulus plan and its difference from the expenditure policies of the Roosevelt Administration. Roosevelt's immediate objective was to create jobs and pay incomes directly to the unemployed as quickly as possible, while Obama's plan had to meet conditions of relevance and economic and environmental efficiency. Further, Roosevelt came to power at the depth of the Depression, and was given bipartisan support to approve his policies extremely rapidly – the famous 100 days –, while Obama's policies were forced through a rancorous partisan debate in Congress, despite the President's party holding at the moment a majority in both Houses of Congress.

– The political environment that has eviscerated fiscal policy and placed monetary policy at the centre of economic policy and produced "debt driven" growth. The political paralysis has meant that fiscal policy is no longer a counter cyclical policy tool, since it can never achieve Congressional support. This means that monetary policy has to carry the

entire burden to control the economy as well as to provide financial stability. The conflict between these two objectives has created innovations in financial markets that have reinforced financial fragility and virtually eliminated the efficacy of monetary policy in controlling the economy.

– The difference between policies appropriate to treating an income deflation and a debt deflation. The use of monetary policy to produce debt-led demand to ensure economic growth has led to an increase in financial layering and a shift in the distribution of income from wage-earning households to corporations and in particular financial institutions. But despite their weak income growth, or better because of it, households were the primary debtors supporting growth. The crisis thus has a dual aspect: the loss in wealth due to asset deflation, and loss of income due to declining employment following the breakdown in the financial sector and the negative impact on the real economy. Traditional Keynesian stimulus policy was designed to counter a generalized fall in income and employment, not an asset price deflation in which the economy delevers by cutting spending to repay debt and restore its balance sheets. An alternative to the traditional stimulus would have been more appropriate in these circumstances. Keynes himself had suggested such policies in 1937.

This latter point raises the importance of income distribution and the structure of production in designing appropriate stimulus packages to emerge from the crisis and restore growth.

The Stimulus Plan

The Obama stimulus plan differed in an important respect from the more successful experience of Roosevelt's New Deal policies. First, the new administration faced the possibility of domestic insurrection: the Hoover administration had brutally rebuffed in the summer of 1932 the veterans "Bonus Army" march on Washington seeking early payment of a bonus promised to world war veterans. As Roosevelt was to take office, a number of State governors has announced bank holidays. Thus despite

his campaign attacks on Hoover as being a profligate deficit spender and promising to restore balance the government budget as soon as possible, Roosevelt was faced with an emergency situation that combined the possibility of a domestic political insurrection and collapse of the financial system in conditions of rising unemployment. Roosevelt quickly changed his mind and resolved to take direct action to meet these dual problems with immediate results: a national bank holiday and the reopening of the "sound" banks, and increased government programs to hire unemployed workers. A myriad of direct employment programs were set up to provide immediate employment and immediate income support to all sectors of the population.[2] In the present environment it would not have been approved as fiscally responsible, but it could not be ignored by those who were suffering, and produced a tremendous impact on the majority of the population. In modern times only the *Jefes y Jefas de Hogares* program in Argentina has had a similar direct and visible impact on those who suffered most from the crisis.

As noted above, the Obama plan contained one third of its total expenditures in tax reductions, not actual expenditures. Recent opinion polls suggest that the general public did not even notice these reductions in taxation. This is obvious for the unemployed who do not pay taxes, but is also understandable if wages are falling or one is on part time employment. And the increased take home pay produced by the tax reductions paled against the difference between house prices and mortgages as households saw their equity "investment" in housing become negative. For popular impact, the previous Bush administration had sent tax reduction bonus checks to the population.

Further, the long-term expenditures and environmental expenditures had virtually no immediate impact on the unemployed in lower skill levels. Finally, the expenditure was gauged against the output it produced, while the Roosevelt policies simply aimed to provide incomes by hiring. It was not quite burying bank notes in

[2] An excellent description of how this was achieved in such a short period of time, in part because Roosevelt brought to Washington the individuals that had been in charge of employment policies in New York State while he was Governor, may be found in Cohen (2009).

bottles in the ground, but the focus was to generate jobs and incomes, not necessarily environment friendly expenditures. The program thus did little to support the incomes of households with negative net worth due to falling housing prices, or incomes to those who had lost employment. The package was politically and intellectually satisfactory, but burying bank notes would have had a bigger impact on the performance of the system and on the perception of the population that something positive was being done.

Finally, since Obama's economic team appears to have failed to assess fully the negative impact of wealth losses, they had made wildly optimistic forecasts of the employment impact of the package, predicting an unemployment rate that had already been surpassed by the time the stimulus bill was passed! This made it possible for the critics of the plan to argue that the stimulus had produced a negative impact on the unemployment rate, no benefit on incomes and had simply created more debt!

The political environment

The aura of crisis in the 1930s – Roosevelt took office as the impact of the crisis was at its worst, while Obama took office as it was breaking – led to a collaborative political environment. Opposition politicians were willing to put aside "partisanship and politics" and there was even a suggestion from all sides of the political *spectrum* that Roosevelt be given quasi-dictatorial powers to rescue the economy. The current political environment is far different. It is in reality just the application of a tactic that was initiated in the Reagan administration when a decision was taken to act to reduce taxation without reigning in government spending, and to use the resulting increase in the government deficit and the size of the outstanding debt as justification for subsequent measures to reduce the role and size of government in the economy. The political objective was to reduce the role of government by waging war on the debt and deficits caused by the tax reductions. The current response to the stimulus is just a repeat of this well-tried tactic. However,

what is of greater concern in the present context is that it is not only the political libertarians and Tea Party activists that are pursuing this tactic, it is also well-anchored in the Democratic party through the Concorde Coalition and the Hamilton Project. It was for this reason that despite his Congressional majority Obama had such difficulty gaining approval for his modest stimulus proposals.

The long-term impact of this tactical approach to government spending has had an even more important consequence for economic policy because it has all but eliminated fiscal policy as a countercyclical policy tool, with the exceptions of some small, temporally limited automatic stabilizers such as unemployment insurance. This has meant that the entire burden of policy management of the economy has been shifted onto monetary policy. The first problem this creates is the asymmetric nature of monetary policy. While restrictive monetary policy can eventually reduce income expansion or price expansion, it has much less impact in generating expansion. As shown by the failure of zero interest rates in Japan to restore growth after the collapse of the Japanese equity and real estate markets at the end of the 1980s, and the recent similar experience in the United States, monetary policy can influence the supply of liquidity, but it cannot generate the increase in demand for lending that is required to restore activity levels (Koo, 2008). Virtually all of the recent expansion in the Federal Reserve's balance sheet is represented by excess reserves of the banking system held at the Fed, representing both a lack of demand for accommodation and an unwillingness of banks to reduce liquidity.

However, there is a second consequence that is potentially more damaging to the recovery of the system. As Minsky (1986) has pointed out, there is an inherent conflict between monetary policies that support systemic financial stability and policies that seek to influence macro variables such as growth and employment. The absence of fiscal policy as an active tool of economic management has aggravated this natural conflict and has made it nearly impossible for the Federal Reserve to achieve either objective.

The result of the decline of fiscal policy since the Reagan Administration has been what many economists have called with

approval the "great moderation," that is the stabilization of inflation rates and real economic growth indicating the success of central bank monetary controls. However, rather than an indication of success, these monetary policies have produced a series of asset-price driven demand expansions – now known as bubbles – , each of which has culminated in a financial crisis, and finally produced even the loss of the control of monetary variables by the Federal Reserve. Thus, the tight monetary policies of the 1980s, along with deregulation, produced the saving and loan/commercial bank real estate crisis of the end of the 1980s, followed by the leaning against the wind low interest rate policies that funded the dot.com equity boom of the 1990s that produced the market crash of 2000, remedied by low interest rates that produced the commodity and mortgage market boom of the 2000's that finally brought the entire system to a halt in 2008. One can only surmise how the economy might have evolved had fiscal policy been available to replace/support these swings in monetary policy and the impact on asset prices. In a sense, the belief that monetary policy was able to control price inflation led to an inability to assess the risks of ignoring the impact on asset inflation Bernanke (2004). As a number of analysts have pointed out, monetary authorities throughout the world took credit for the impact on global inflation of the addition of the massive low-wage labour force of Asia and its supply to manufactured goods at declining prices.

Even more damaging, however, is that this environment supported excessive financial innovation in the economy. With increased competition and sustained low interest rates, financial institutions were led inexorably away from the traditional business of banking on the basis of net interest margins to concentrate on fee and commission income through the securitization of lending (see Sheng, 2009). While the "originate and distribute" business model was very beneficial to banks bottom lines, it also meant that the tools that the central bank had traditionally used to control system liquidity and lending became inoperative. When banks no longer hold their loans on their balance sheets, reserves no longer limit the ability to lend, and the shift to risk-based capital requirements just accelerated the process. Thus, not only was fiscal policy no longer an operative policy

tool, the central bank had lost the ability to influence monetary conditions. This led to a situation in which there were no policy controls over the economic performance of the system or of its financial stability. The growth of the economy became “debt driven”, with each expansion requiring the creation of an ever greater pyramid of debt which periodically collapsed, only to be restored by low interest rates and further financial deregulation and liberalization. In a debt driven expansion incomes *appear* to increase as financial innovation makes it easier and easier to convert expected future increases in asset prices – capital gains – into current spendable income. But, as Fisher (1906) had argued, capital gains are not income. If the expected price increases do not eventuate, the income that has been spent is automatically converted into unserviceable debt.

Income deflation versus debt deflation

The debt driven nature of demand in the US economy since the 1980s provides one of the most important explanations of the modest impact of the recent fiscal stimulus on economic activity. In difference from the traditional income deflation that Keynesian demand management is designed to combat, the current crisis started as a debt deflation or an asset price deceleration, followed by a deflation of assets prices and deleveraging of balance sheets. The initial impact of the mortgage crisis was a loss in wealth – households’ biggest asset is their house – rather than a loss in incomes. This was met by a policy response, similar to that Fisher had initially proposed to no effect in the 1930s (see Barber, 1996), of attempting to reverse the decline in asset prices, and to return them to their previous level, thus restoring the wealth losses and validating the expected capital gains that had already been coverted into incomes and spent. As many commentators have noted, this implied responding to the collapse of an asset price bubble by attempting to reflate the bubble. But, if the deflation in prices represented real losses, such a policy could not work.

The policy of reflation also did not work because it was primarily directed at the creditors: financial institutions who were holding the deflated assets, rather than the debtors: the households who were the leveraged owners of the underlying collateral. The response to a decline in real wealth is to attempt to restore it. This can only be done by increasing the share of saving in income, which in the absence of other measures will lead to a self-defeating decline in incomes and a further decline in asset prices. This is Keynes's *Treatise on Money* (1930) "Banana Parable." The decline in house prices by itself would have been enough to set off a decline in incomes. Any attempt to offset it by increasing government spending would simply have been saved to restore wealth positions. It would have stemmed the decline in incomes, but would have been able to offset it only if the size of the stimulus was of an equivalent size to the loss in wealth.

This natural decline in household expenditure was further exacerbated by the collapse in short-term lending through the commercial paper market that followed the Lehman bankruptcy and the extremely rapid business inventory adjustment that brought rapid declines in employment levels. These declines in employment then produced the standard Keynesian income deflation process. The process works not through a decline in the share of income spent, but through the loss of incomes due to the loss of employment. The decline in employment and income thus had a dual cause: the attempt to delever and restore balance sheets by reducing spending, and the decline in spending due to the loss in employment: a rise in the saving rate and a fall in incomes from employment. The TARP managed to provide support to asset prices held by the banks and offset those losses by their recapitalization , but it did nothing for the other side of the balance sheet the households holding the depreciated collateral. The stimulus bill even if appropriately designed would at best have been able to offset part of the rise in the savings ratio, but was totally inadequate to offset the income deflation and the rise in unemployment due to the collapse of lending to the business sector.

The paradoxical result was that while there was a super-multiplier during the expansion, the multiplier was reduced in the decline due to the

rising savings rate, leading to the conclusion that it was ineffective in combating the crisis. The only visible result was the stabilization of the financial system, the restoration of bankers' incomes and an increase in the government debt, leading to a refusal to continue to use stimulus to correct the economic slowdown.

Income Inequality, Imbalances and Disproportions

What is the explanation of this difference between the policy impact of government expenditure on an income inflation and a debt deflation? In a traditional income deflation the fall in expenditure produces a fall in employment and a decline in capacity utilization. Say an automobile plant. In a recession the plant goes on short-time working and profitability may fall due to returns to scale. The government injection of income leads to higher spending, the purchase of more automobiles and a recovery in capacity utilization, a rise in employment and a recovery of profits. The theory assumes that the economy can expand and contract with constant proportions with constant or increasing returns. The former was the implicit assumption in the *General Theory* (see Kregel, 2008). The difficulties that were caused by changing proportions with changes in demand and employment were only dealt with by Keynes in his discussion of the feasible target for post war unemployment levels. It has also been taken up by Luigi Pasinetti in his 1993 analysis of structural change and the conditions for long-period stable growth.

In 1937, with unemployment in the UK still over ten per cent, Keynes (1937) noted that more stimulus would not be required to solve the problem of unemployment "We are more in need today of a rightly distributed demand than of a greater aggregate demand." Keynes here was referring to the need to direct demand and incomes to those industries that could provide the greatest expansion in employment. The problem was a collapse in demand for Britain's major export industries: textiles, coal mining, iron and steel, machinery and shipbuilding. These industries accounted for some six per cent of the 9-10 percent unemployed in the 1920s, before the US stock market collapse. In some

sectors such as iron and steel, shipbuilding and coal, unemployment rates were 22 percent, 35 percent, and 16 percent respectively in 1928. An increase in overall government deficit spending could not substitute for the absent foreign demand and would provide little help in shifting demand from these declining sectors of industry to those capable of producing sustainable expansion in employment. What would be required is demand management differentiated by productive sector, but this requires a degree of government planning and directed intervention that has seldom been acceptable to governments. Paradoxically, those aspects of the Obama stimulus dealing with infrastructure and environmental investment meet this condition, but provided little impact in providing immediate employment.

Another aspect of the problems posed by the structure of production is the impact of the distribution of income on the structure of demand. Since Engels law economists have recognized that changes in income level will have an impact on the structure of demand. Leon (1967) has extended this idea to its impact on the stability of growth. In the present context the impact of changes in the distribution of income is on the level of debt and the structure of demand. After the profit squeeze of the 1970s, there has been a sharp restructuring of US industry. In the 1990s this resulted in a sharp upward shift in the rate of productivity growth accompanied by a stagnation of wages. But, there was no decline in household expenditures which continued to increase as a share of national income. The difference was made up by household borrowing against their net wealth – primarily real estate. This debt driven demand expansion also produced an increase in financial sector compensation producing a rise in the share of profits in that sector. The relative stability in goods prices made the failure of real wages to rise less obvious, while rising asset prices meant that household debt to asset ratios remained relatively stable. Basically, households were converting capital gains on their assets into current income. But as Irving Fisher had long insisted, capital gains are not income.

As Minsky has pointed out, any scheme of this sort is a non-sustainable Ponzi scheme. The capital losses on assets were transformed

into income losses. This was not the traditional demand deflation and the fiscal policy measures to rescue it by increasing incomes were inadequate. The error in policy was the attempt to validate the increases in income to the financial sector resulting from the fictitious capital gains by attempting to stabilize the value of the liabilities they held, while doing nothing to resolve the insolvency of household, allowing the value of their assets and incomes to fall.

How can we rethink Keynesian stimulus policies?

1) bring income distribution back into the center of policy it is a means of influencing demand that is not debt driven;
2) bring sectoral/structural analysis back. Demand has to be targeted to specific sectors to attain the maximum impact;
3) restrict monetary policy to financial stability;
4) make employment the center of economic policy.

Here a little known aspect of Hyman Minsky's work (e.g. 1986) is instructive: "The emphasis on investment and 'economic growth' rather than on employment policy is a mistake. A full-employment economy is bound to expand, whereas an economy that aims at accelerating growth through devices to induce capital intensive private investment not only may not grow, but may be increasingly inequitable in its income distribution, inefficient in its choices of techniques, and unstable in its overall importance." For Minsky, support of employment could be best secured through a direct Government Employment Guarantee Program in which the government offered employment to all those willing and able to work at a wage near the prevailing minimum. The idea was to support the cash flows that validate assets through actual sales rather than through increasing borrowing or increasing prices. The Levy Institute has continued to pursue this particular line of research with a separate research unit.[3] When faced with the current crisis, largely driven by

[3] See http://www.levyinstitute.org/research/?prog=9.

consumption spending, Minsky would certainly have replied that if consumption had been financed by wages increasing in step with productivity rather than being transferred to the financial sector, much of the crisis would have been avoided. Consumer debt would have been lower, and if banks had transferred their higher earnings to their reserves rather than paying large bonuses, their capital structure would have been more solid. For Minsky, the impact of income distribution on financial instability would have been a major factor. An employment guarantee program would certainly have met the condition of success of the New Deal policies of having a direct and immediate impact on household incomes. But, as seen above, despite what would seem strong popular support for such programs, politics has not been able to organize support for them and instead is pursuing the opposite course.

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