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Crisis, Austerity, and the Role of Economic Theory in Policy

THE UNITED STATES FEDERAL RESERVE HAS RECENTLY ADMITTED publicly that interest rate policy is insufficient to coordinate desired economic outcomes. Central banks throughout the world are facing the same questions, although most cannot yet say this openly.

At the heart of this change is a growing recognition that the real problem lies in standard economic theory and in its insistent claim that unregulated markets give rise to the ideal social results. In the orthodox vision, optimal production and consumption outcomes arise from flexible commodity prices, the full employment of labor arises from flexible real wages, and price stability can be ensured by flexible monetary policy. These are the theoretical foundations of the standard prescription that inflation can be controlled by interest rate policy.

The history of market systems reveals recurrent patterns of booms and busts over centuries, emanating precisely from the developed world. Economic historians speak of the Great Depressions of the 1840s, 1870s, and 1930s, and of the Great Stagflation of the 1970s. And of course we are now living through the first Great Depression of the twenty-first century. Each of these cataclysmic social events originated in the rich countries, although with the spread of globalization more and more of the developing world has been caught up in the consequences.

The present crisis has exposed the weaknesses of orthodox economic theory. What we need at this critical juncture is more theoret-

ical diversity in classrooms, board rooms, the halls of government, and the media. Alternative viewpoints have been in the making for some time but have been almost entirely excluded from the above venues. We need to open up the discourse so that competing viewpoints can be openly discussed.

STRUCTURAL ELEMENTS AND RECURRENT PATTERNS

What is this element that can account for a recurrent pattern of booms and busts in a system that evolves all the time? Capitalism is constantly changing and adapting. It constantly seeks to get around the rules that are put in to place to structure and channel it. Its driving force is profitability—more precisely, the degree to which the profit rate exceeds the interest rate. The gap between these two variables is central to the arguments of economists as diverse as Smith, Ricardo, Marx, and Keynes.

The current crisis was not caused by the mortgage crisis. The subprime mortgage crisis in the United States *triggered* a collapse of a

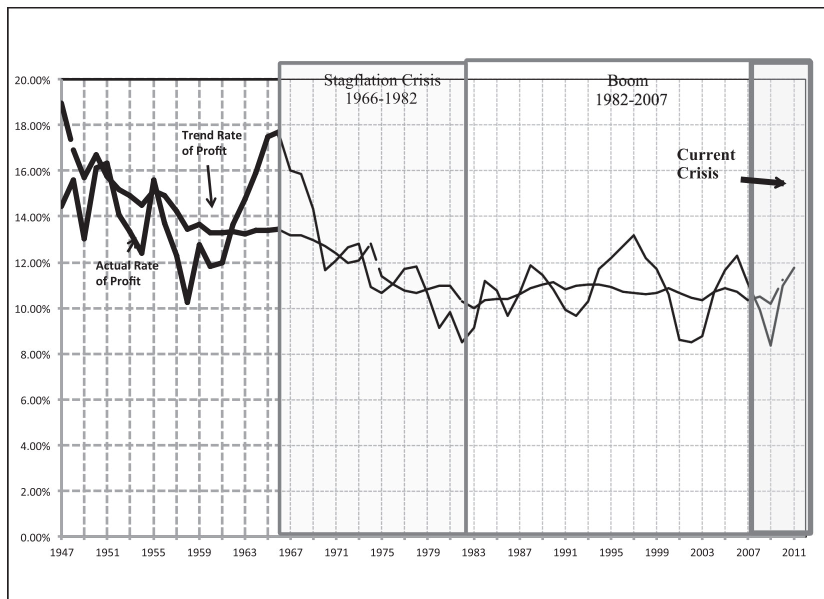

Figure 1: Actual and Trend Rate of Profit, US Nonfinancial Corporations 1947–2011 (Profit = Earnings Before Interest and Taxes)

RISKY FINANCIAL PRACTICES ON THE RISE AGAIN

"The alchemists of Wall Street are at it again," according to a recent report in the *New York Times*: "The banks that created risky amalgams of mortgages and loans during the boom—the kind that went so wrong during the bust—are busily reviving the same types of investments that many thought were gone for good. Once more, arcane-sounding financial products like collateralized debt obligations are being minted on Wall Street."

With interest rates on ultra-safe Treasury bonds near zero, investors are attracted to the higher returns promised by risky assets, banks are "turning out some types of structured products as fast or faster than they did before the bottom fell out" and supposed protections against a repeat of the previous disaster "are already dwindling, allowing some of the old excesses to creep back into the market." Thanks to the lax penalties imposed on previous offenders "[t]he players in the business are generally the same as they were before . . . [and] they know how to push the boundaries" (Popper 2013).

bubble that was built on a long boom from the early 1980s up to the late 2005–2006 period. Historical events played a role in this; for example, the undoing of regulation in the United States allowing banks to invest in risky activities implicated many more financial institutions in the bubble than would have been otherwise. Not all capitalist countries followed this path; Canada, for instance, has a different banking and mortgage structure and has suffered less of a financial impact so far. It has of course felt the impact on exports due to the global consequences of the crisis.

The central argument in classical (not neoclassical) economics and in Keynes is that the difference between the profit rate on new investment and the interest rate—the net profit rate—drives investment and hence capital growth. This net rate, which in Keynes is the difference between the marginal efficiency of capital and the interest rate, is the source of the "animal spirits" of business. Its movements can create a period of growth where the amount of net profit becomes stagnant; that is, where the profit rate on new investment is equal to the interest rate. Then the incentive for accumulation disappears and

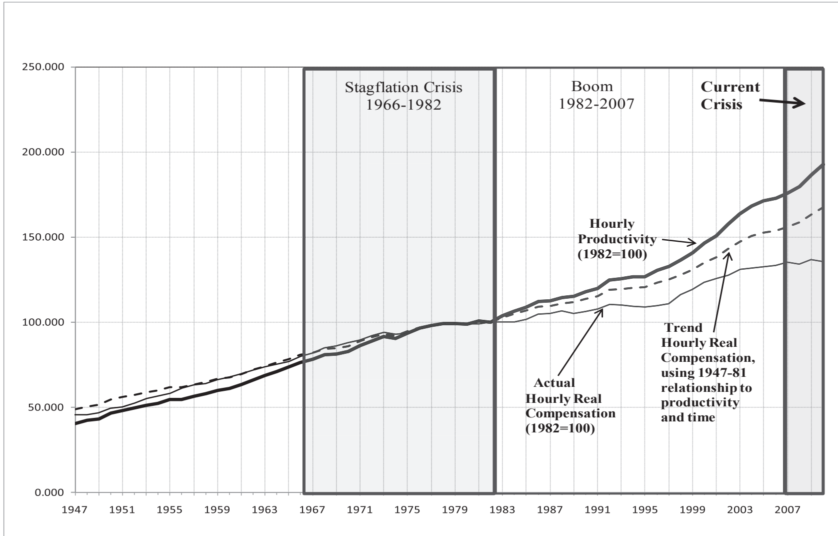

Figure 2: Hourly Wages and Productivity, US Business Sector, 1947–2010 (1992 = 100)

the system undergoes a phase change from healthy growth to decline and crisis.

Empirical evidence supports this argument (Shaikh 2011). Data for US nonfinancial capital in the period 1947–2007 (before the current crisis) shows a long-term decline in the trend of the net rate of profitability despite sharp fluctuations from such events as the Vietnam War boom from 1960 to 1968. The trend essentially continued through the period of Stagflation in the 1970s but, beginning in the 1980s, real wages were lowered tremendously relative to productivity through a concerted assault on unions and on government support for labor, the unemployed, and the poor. The slowdown in real wage growth raised the profit rate relative to its previous path, so after the 1980s it was stagnant rather than falling.

Second, the interest rate was drastically lowered through Federal Reserve policy after the 1980s. From 1947 to 1980 it rose with the price level (the dotted line in figure 3), in keeping with the general historical rule now called "Gibson's Paradox": the observation that there is a positive correlation between the price level and the interest rate. (This is

viewed as "paradoxical" because the widely accepted Fisher Hypothesis in orthodox economics predicts that there will be a negative correlation between the interest rate and the rate of change of prices [the inflation rate].) By the early 1980s the interest rate had peaked at 14 percent. But after that the paths of the price level and the interest rate diverge sharply, with the former continuing to rise while the latter falls sharply to about four percent in 2007 and then almost zero thereafter. This pattern is common to the United States and its major trading partners.

The key variable, which is the difference between the profit rate and the interest rate, is depicted in figure 4. As we can see, it undergoes a general decline until the 1980s, followed by a dramatic rise, which can be attributed to two variables: the reduction in growth of real wages relative to productivity and a decline in the interest rate. Both these variables are the results of policy changes. The objective of neoliberalism, which was an expeditor of these events, was not to attack the state

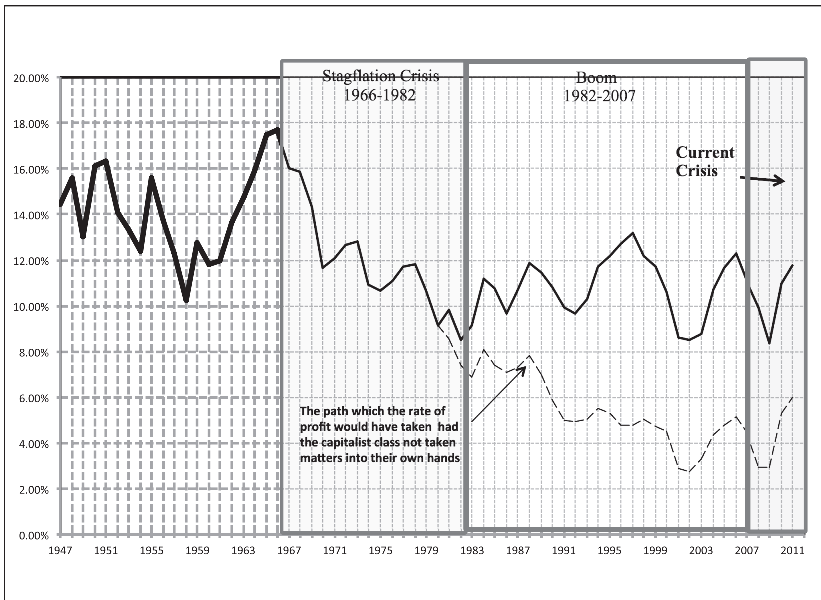

Figure 3: Actual and Counterfactual Rate of Profit of US Nonfinancial Corporations, 1947–2011 (Counterfactual Path if Real Wages Had Continued on Their Postwar Trend)

CHEAP CREDIT AS THE "HEROIN" OF POSTDEPRESSION CAPITALISM

David Stockman, formerly the director of the Office of Management and Budget for President Ronald Reagan, believes that while the "Fed's relentless campaign to keep interest rates artificially low may have deferred the day of reckoning . . . we cannot escape it forever." According to Stockman, cheap money is the "heroin" of the modern economy, and financial markets have become debt-driven engines of speculation. In his view the big crash is yet to come, so investors should "get out of the markets and hide."

Stockman is well aware that unregulated markets are prone to periodic "purges of excess and error" but he feels that intervening to modulate these intrinsic patterns only makes matters worse. One of his proposed solutions is to return to the gold standard because it limits the money creation options of central banks. The trouble, as others have pointed out, is that historically the gold standard era was replete with bubbles, busts, and booms. The reaction against these miseries is precisely what sparked the move to ameliorate the "pain" that Stockman (from his privileged position) wants the rest of us to bear (Surowiecki 2013).

but to realign it, concentrating its attention on what is most important to global capital. The drop in the interest rate greatly enhanced the globalization of financial capital. It made capital movement extremely cheap, which created not only a boom in accumulation due to a rise in the profit rate of enterprise but also bubbles in the stock market and the financial sector among others. With stagnant wages, cheaper, borrowing led to a boom in consumption and business spending, while the encouragement to borrow led to an increase in the debt-to-income ratio.

The limit to the tactic of reducing interest rates is that, at some point, they reached their objective policy limit of a near-zero interest rate. The historical result was a situation marked by two significant features: first, attacks on labor-supporting institutions that weakened workers' positions and depressed real wages; and second, globalization,

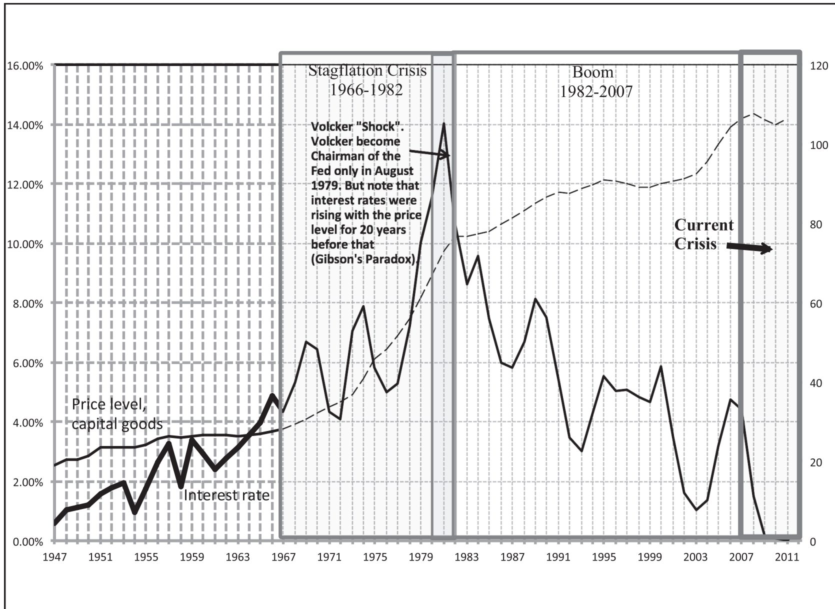

Figure 4: The Rate of Interest (3 Month T-Bill), United States, 1947–2011

which brought the world's large pool of cheap labor into competition with labor markets in the developed world and helped slow down the growth of real wages there. Household spending, the real estate bubble, the financial bubble, and the real growth of accumulation are all elements of the same story. The ultimate limit arises when labor cannot be squeezed further and interest rates cannot be lowered any more.

The global effects of the current crisis are uneven. Some countries like Iceland, Greece, and Spain experienced severe financial problems, despite their membership in the European Union. The rest of the developed world, including the United States and northwestern Europe, faced almost equally problematic financial situations. Norway and Canada had been more circumspect about loosening regulations and therefore avoided some of the financial difficulties but they still face unemployment due to the contraction in world exports. The developing world has been thrown backward after having emerged from

ON THE IMPACT OF CHEAP LABOR

According to US Bureau of Labor Statistics, in 2008 Chinese wages in manufacturing were less than 5 percent of comparable US wages. The China-based firm Foxconn, a major supplier to the hugely profitable US corporation Apple, alone employs more than 1 million workers. The basic salary is the Chinese minimum wage of $200 a month, which means that employees have to work more than 100 hours of overtime per month in order to survive, standing on their feet at assembly lines 11 hours a day for 7 days a week, including holidays in peak seasons. They are allowed one day off every month, and even that is not permitted for peak season months. Working conditions are generally hazardous: poorly ventilated and frequently thick with metal dust. Food is bad, unions are virtually unknown, and employers sometimes cheat on overtime payment. Temporary labor is acquired from Chinese "labor dispatchers" who in turn levy substantial fees against the income of these workers. Such workers are subject to even higher amounts of overtime and are often not compensated for injuries; they also do not receive severance or social insurance. This all serves to undermine efforts to create unions (China Labor Watch 2012).

In the meantime, US workers battered by persistently high unemployment and low-wage foreign competition have increasingly made concessions to their employers. According to the Boston Consulting Group, when one adjusts for productivity, Chinese unit labor costs in manufacturing are "only" 30 percent lower than in the United States. Adjusting further for nonlabor costs reduces the Chinese advantage to 10 or 15 percent and, when inventory and shipping costs are factored in, the advantage drops to 10 percent or less (Boston Consulting Group 2011). So the crucial question for manufacturing in both countries becomes one of whose costs will rise faster. At the moment, starting from their extremely low levels, Chinese wages are rising faster than US wages, so perhaps the Chinese cost advantage will be erased in the near future. On the other hand, Foxconn itself is already implementing plans to initiate production in Mexico and Brazil.

And of course employers in the United States and Europe have long directly imported and exploited cheap labor. In a recent telling instance, 3 Greek foremen on a strawberry farm in southern Greece have been accused of shooting and wounding 28 Bangladeshi workers who were seeking unpaid wages. Thousands of such migrant workers "work for low wages picking fruit in the region's farms, often living in cramped, dirty shacks" (Kitsantonis 2013).

a terrible decade in the 1980s. In the buildup of its problems, cheap finance became a way to expand employment through finance-related activities such as real estate booms, export-led growth, and foreign remittance growth. All of these resulted in increased inequality within most countries.

A realistic "good" outcome of the current crisis would be an end to the entire episode within a decade. A bad outcome would be if, after a decade, the world were even more deeply mired in unemployment and poverty. Over the next ten years, the balance of power might shift back to a focus on employment and the standard of living of the vast majority or it may slide even further to the right in support of the conservative interests previously exemplified by Ronald Reagan and British Prime Minister Margaret Thatcher. The future remains to be decided.

FURTHER CONSIDERATIONS ON THE CRISIS AND THE ROLE OF THE ECONOMICS PROFESSION

I wish to end by mentioning a few concerns that arise with respect to responses to the current crisis. There are serious issues regarding the composition of stimulus spending. Huge sums have been expended on shoring up and maintaining the global financial sector. Funds given to the banks have been largely sequestered because the banks have to protect large fictitious elements in their balance sheets. Financial transactions continue to grow at an unsustainable pace, and stock markets are booming despite the decline in employment and the stagnation of production. Funds awarded to failing businesses have also had little impact on output and employment; given their overflowing inventories and damaged balanced sheets, they have little incentive to expand production. On the other hand, state expenditures on new infrastructure and social care have a strong employment potential. Until just recently, what was missing from the current policy debate was a serious discussion of the solution adopted in the 1930s: direct employment through the state. Governments should undertake projects that directly provide employment rather than hoping for "trickle-down" effects of funds channeled through businesses.

THE ECONOMICS PROFESSION AND THE CRISIS

Paul Krugman has stated that much of macroeconomics over the past 30 years has been "spectacularly useless at best, and positively harmful at worst." In a recent commentary on a report entitled "The Systematic Failure of the Economics Profession," David Colander says that despite its "colossal failure . . . to develop models relevant to dealing with the crisis . . . the economics profession is unlikely to respond to the crisis with any sense that it should change" because the "institutional structure of the academic economics profession is not structured to reward economists . . . for their understanding of the real economy" (Colander 2010, 4).

Hence, "if left to its own devices, the mainstream profession will continue with what it is currently doing," which is to focus on approaches that reflect "too narrow an idea genetic pool and too much inbreeding" (7–8). Its incentive structure is embedded in institutions of promotion and research, including grant-giving agencies whose review process is dominated by the economic orthodoxy. Colander concludes that the methods of economics will not change unless the institutions reach out to the heterodoxy in the profession. The Initiative for New Economics Thinking (INET) has been a leader in this regard, but up to now most other institutions have been slow to broaden their scope. What is at issue is a range of economic approaches, not merely a diversity of topics.

Another issue is limits to government spending. In economic theory, there are at least three broad points of view regarding the effects of government deficits. The neoclassical idea is that government expenditure crowds out private investment, so it will not be stimulatory in the long run. The second view may be called the Keynes–Kalecki–post-Keynesian position, which is that the stimulus is fine as long as you have unemployment but once full employment levels are achieved, there might be inflation. Third is the classical view, which is that in order for a stimulus to have a lasting positive impact on output, employment, and real wages, the productivity of labor must also be raised so as to keep unit labor costs down. This would blunt the negative impact on domestic profitability and international competiveness. The solution is

not to lower real wages but to raise real wages and productivity hand in hand, as was done in Sweden, Japan, and South Korea on their historical paths to riches.

The final issue has to do with the accountability of the economics profession. The period since the 1980s has been one of untrammeled market worship in which orthodox economists became priests constantly issuing incantations about perfect market, perfect knowledge, and perfect foresight. This kind of magical thinking has dominated the profession for too long. It is time to accept that the very starting point of orthodox economic theory is wrong because it systematically misrepresents the basic operations of competition and markets. The invention and elaboration of real world "imperfections" have become the major activities of modern economic orthodoxy on both the left and the right. I would argue that this only serves to cover up the fact that the fundamental imperfection lies in the theory itself. At the very least, the current hegemonic approach must be confronted with alternatives constructed from different foundations altogether. This is the only proper scientific method.

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