Introduction

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> Oh happy people of the future, who have not known these miseries and perchance will class our testimony with the fables.
>
> Petrarch on the Great Plague

The Global Financial Crisis (GFC) has come and gone, leaving behind a trail of damage and destruction that will take many years to repair. From the latter half of 2008 through until the first few months of 2009, the world's economy experienced an almost total breakdown of its financial and credit creation system. This was the GFC itself. But even when the financial crisis had departed and receded into history, the resulting recession has left every economy significantly worse off than it had been before. Unemployment is higher, growth is less robust, public debt has increased and the future seems less secure.

The basics of what went wrong to set the GFC in motion are now generally accepted. It was the combination of sub-prime mortgages in the United States, the securitization of such mortgage debt, followed by the worldwide sale of such assets which formed a large component of the balance sheets of financial institutions, large and small. When housing prices in the US collapsed, it left many of these assets nearly valueless, some actually valueless. The subsequent seizing up of the global financial system caused trust in even what were formerly the most rock solid financial institutions to disappear. Since no one knew who was solvent and who was not, credit creation across the world ground almost to a halt.

With the collapse of credit, productive activity, investment and employment all fell. While there were variations in the size and extent of the downturn, no part of the global economy was spared, with one forecast following another predicting a cataclysm to rival the Great Depression or possibly even worse. Already, only two years later, it is hard to conjure the panic that was almost universally experienced in the face of such uncharted waters, especially amongst those responsible for the formation of our economic policies. No one was sure where the world's economy was heading and no one knew with certainty what to do. The policies based on standard economic theory have seemed inadequate to the task in dealing with the problems that arose and which we now have. For those contributing to this volume, the fault lies in economic theory itself.

THE FOUR POLICY PHASES OF THE GFC AND SUBSEQUENT RECESSION

Four distinct phases surrounding the GFC and the subsequent policy response have contributed to and further amplified this mistrust of standard economic theory. There is, first, a strong belief amongst many of these authors that the economic theory that guided policies during the period leading up to the GFC were profoundly wrong. These authors argue that the management of our economies had in itself contributed to the financial meltdown which occurred and indeed made it inevitable.

Then, secondly, there are those who believe that once the financial meltdown commenced, the policies adopted during the GFC to restore calm were badly designed and poorly constructed. They believe that the theoretical considerations that went into these policies were misconceived. Rather than helping to solve such problems for the long term, the actions taken during the height of the crisis to bring the GFC to an end have themselves created conditions that will see similar problems repeated sooner rather than later.

Thirdly, there are those who believe that the policy actions taken since the end of the GFC to restore the needed integrity to financial markets have been misguided and inadequate. It is argued that there were lessons we ought to have learnt and used to frame new regulatory policies that have been ignored. Instead, the policy post-mortems and the regulatory response have done little that will make any significant difference to the future and have made another downturn along similar lines not only inevitable but likely to be sooner rather than at some stage long into the future.

Then finally, there are critics of the policies that were adopted once recessionary conditions had set in, to place our economies on a stronger platform for growth and to return unemployment to the lower rates that had prevailed in the period leading up to the GFC. These were the stimulus packages that were adopted almost universally as an integral part of the programme of recovery. It is argued that these policies have been an unmitigated failure which should lead to a search for a more secure theoretical foundation on which future policies ought to be based.

This book, like its predecessor, is about the adequacy of economic theory.[1] It is about the usefulness or otherwise of existing textbook economics to make sense of and then provide guidance to those who must decide on what actions need to be taken. But while every author in this volume disagrees with the standard mainstream model, it should also be understood that the different authors in this collection do not necessarily agree with each other. There is, in fact, a very wide disparity of views amongst contributors. The perspectives provided in these chapters range across the entire breadth of economic theory from free market to highly interventionist. The intention in putting this collection together has been to provide a single platform for the different sets of views that are often drowned out by the standard bearers of the mainstream.

Moreover, even before our present problems commenced, all of the economists whose chapters are found in this volume have had longstanding beliefs that today's standard economic models are inadequate, if not actually wrong. It is the ideas and theories of these economists, all of whom are serious scholars, which are being employed to provide alternative explanations of the economic events of the past two years and to discuss what we have learnt during this time.

THE STANDARD MODEL

But to understand the nature of this criticism, it is first necessary to understand the structure of mainstream economic theory. The focus here is placed on the introductory macroeconomic model taught to first year economists. This model, although refined with additional features and nuance in later years of study, nevertheless provides the core conceptual reasoning that underpins the shared framework of both academic economists and the makers of economic policy. It is what every economist learns and is the basis for the macroeconomics of virtually every student who has taken only a single course in economics.

The relevant theory is often called Keynesian, after the English economist John Maynard Keynes. It was his *General Theory of Employment, Interest and Money*, published in 1936, that became the point of origin for the standard macroeconomic model now in general use. Although there are fundamental disagreements amongst economists over the message that Keynes was trying to impart, there is no disagreement that it is from Keynes's scholarly work that modern macroeconomic theory began its voyage.

Yet in saying this, it should be emphasized that a significant proportion of those who describe themselves as followers of Keynes would not accept many, and possibly most elements of the standard macroeconomic model as their own.

The model that has descended to the modern textbook level is generally referred to as the neo-classical synthesis, the melding of Keynesian ideas with the ideas of Keynes's predecessors. As taught today, within this neo-classical model, the single most important factor in understanding fluctuations in the level of output is fluctuations in the level of aggregate demand, the demand for everything produced.

Moreover, the underlying assumption in such models is that in an economy in recession, if it were left to itself, the level of aggregate demand would not recover, or if it did, the recovery process would take far too long. Active government involvement to restore economic growth is seen as essential and overwhelmingly beneficial.

Even where supply-side factors may in the first instance have caused the economy to slow and unemployment to rise, for example through the higher cost of oil, it is nevertheless from a stimulus to aggregate demand that the solution is to be found. The basic framework for discussing macroeconomic theory and policy today is generally through a model based on aggregate supply and aggregate demand (AS–AD). To raise output and push employment higher requires an increase in either aggregate demand or aggregate supply, that is, either through an increase in total spending or an increase in the underlying productivity of the economy.

Positive changes in aggregate supply are, however, either relatively long-term in nature – such as requiring an increase in physical capital, improvements in technology or increased workplace skills and abilities – or are related to factors largely beyond the reach of a national economy, such as a general fall in the price of oil. Indeed, improvements in workplace productivity can even lead to a fall in the demand for labour.

It is for this reason that policies based on AS–AD are generally related to aggregate demand. These are seen to be more immediate and available for adjustment by those who manage the domestic economy. They are also seen as being more able to provide a direct stimulus to the level of economic activity since a response from business as an intermediary is not required but can be applied directly by the government on its own using its vast powers to spend.

Aggregate demand is related to expenditure. Increasing the level of spending is seen as the key to increasing the level of economic activity. Going back to its origins in the early Keynesian models, the components of aggregate demand are identified as consumption, investment, government spending and net exports (exports minus imports). The standard formulation as an equation, with national output designated by the letter Y, is this:

$$Y = C + I + G + (X - M)$$

It is entirely arguable that this is not an equation at all but an identity. The level of GDP is *defined* by the sum of consumption, investment, government spending and net exports but is not directly governed by them, which is why the same expression used in the national accounts is presented as an accounting identity:

$$Y \equiv C + I + G + (X - M)$$

But in treating this expression as an equation, economic policy has been designed to raise the level of production on the left-hand side by increasing the elements that appear on the right-hand side. Therefore, to raise the level of national output, policy has been centred around raising expenditures by consumers, investors, governments and international buyers of domestically produced goods and services. The more that is spent, the faster the economy would be expected to grow, with the faster growth rates leading to a rise in the number of persons employed.

TEXTBOOK EXAMPLES

Some examples from modern texts by leading authors provide an indication of the instruction given to economics students. The first is from the fourth edition of Gregory Mankiw's *Principles of Economics* (Mankiw, 2007: 772):

> Any event or policy that raises consumption, investment, government purchases, or net exports at a given price level increases aggregate demand.

Similarly, in the text co-authored by Ben Bernanke, the Chairman of the Federal Reserve in the United States, we find the same sentiment (Frank and Bernanke, 2007: 826):

> For any given value of inflation, an exogenous increase in spending (that is, an increase in spending at given levels of output and the real interest rate) raises short-run equilibrium output, shifting the aggregate demand (AD) curve to the right.

In a text co-authored by John Taylor, who had devised the Taylor Rule used in interest rate determination around the world, we find this (Taylor and Moosa, 2002: 310):

> Imagine that government expenditure rises. We know from our analysis of spending balance in the previous chapter that an increase in government expenditure leads to an increase in real GDP in the short run.

Then in the eighteenth edition of Samuelson (first published in 1948 and now Samuelson and Nordhaus, 2005: 489) is found:

> Only with the development of modern macroeconomic theory has a further surprising fact been uncovered: Government fiscal powers also have a major *macroeconomic* impact upon the short-run movements of output, employment, and prices. The knowledge that fiscal policy has powerful effects upon economic activity led to the *Keynesian approach to macroeconomic policy*, which is the active use of government action to moderate business cycles.

There are no end of caveats to these bare statements found in each of these texts as well as in the many others that tell the same story. And it is even more so the case that the further one studies economics, the more qualifications to these basic statements there are. But in the end there is no practical point to discussing aggregate demand and public expenditure unless the conclusion being reached is that in recession one of the actions that governments can take is to raise the level of its own demand. Standard macroeconomic theory is unambiguously clear: higher public spending during recession is one of the actions governments should consider when unemployment rises and the level of economic activity falls.

The fact that governments around the world have done exactly this is directly related to the economic theory that economists are almost universally taught. Governments have not taken this course on their own initiative. In increasing the level of public spending, they have taken the advice of their professionally trained economic advisors. If these policies are seen to have failed, there will be a major case to answer that it was the economic theories encouraging these actions that will have themselves been shown to have failed.

REGULATION

Just as important as the issue of the fiscal stimulus has been, so too has been the role of regulation of markets, and in particular financial markets. Although there have already been various actions taken to deal with perceived vulnerabilities, over the longer term there are certain to be ongoing debates on what governments can and should do to minimize economic instability while still maintaining healthy rates of growth.

Within economic theory there is a strong predisposition towards a generally hands-off approach to economic management. For most economic activities, the economist's response is to assume that intrusive regulation of markets is unnecessary and, whatever might be the perceived benefits, will tend to do more harm than good.

For all markets, it is assumed that the participants know more than any outsider could possibly know. Moreover, about the unknowable future, the assumption is that since no one can know what is going to happen next, and all actions based on the future must of their nature be a form of guesswork, markets are able to adjust to circumstances more smoothly, with more accuracy and with more assurance than any group of government officials could ever hope to do. If such judgements are left to people with their own money on the line, the incentive to get things right will lead to the optimal outcome, although surprises will frequently upset many an applecart along the way.

Regulators are too distant and lack the requisite knowledge to make appropriate real-time decisions. Regulation therefore inhibits markets and leads to a sub-optimal outcome. The economy is worse for there being too many regulations, and regulations of the wrong kind.

There is also the role of self-interest to be considered. Within economics, it is generally assumed individuals acting on their own behalf and risking their own money will be prudent in the risks they take. Government intervention by a nine-to-five bureaucracy will in most instances create more harm than good. Indeed, not only would such attempts at detailed regulation of markets cause them to perform poorly, they are unnecessary because the market itself is its own discipline.

It is now a central question whether the current crisis in the United States began because of the actions of market participants in the finance industry and the housing market, or whether it was due to specific decisions by governments that allowed, if not actually caused, forces to be unleashed that would otherwise have been contained. Many policy questions will ride on the answer to just this question alone.

Even recognizing the harm that has been done by the global downturn, the question still remains whether the business cycle is the price that must be paid for the benefits that accrue when markets are allowed to find their own level. Cyclical activity may be impossible to avoid. If there is little that can be done to prevent periodic downturns, or to dampen their amplitude, then intrusive regulation will only limit growth in real incomes but do nothing to prevent the instability and personal insecurities that are embedded in the nature of things.

There is therefore the predisposition within the economics mainstream towards the self-regulation of markets where a culling process of the unprofitable and less competent is expected to ensure that those who should not be in business are removed and the capital they have been employing set free for other businesses to use in their stead. That is part of what the recessionary phase of the cycle is intended to achieve.

The basic framework of a free enterprise economy is tied to the ancient notion of the 'invisible hand'. Adam Smith's most famous passage even today remains an important part of an economist's understanding of the operation of markets:

> [A merchant] generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . He intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. (Smith, 1976 [1776]: Book IV, Chapter II)

An important modern manifestation of this principle is referred to as the 'efficient market hypothesis'. Financial markets are so well constructed, it is argued, that all of the relevant information available is already part of the price of any financial product. No one can enter the market with more knowledge; increased regulation can only make markets less efficient since those who do the regulating will never know as much as those who are already engaged in the market and have their own money at stake.

It is this conclusion which is embedded within standard neo-classical theory that the global financial crisis has put on notice. Are there regulations that can be introduced that will make economies perform better, make them less susceptible to downturns, and which will make whatever downturn that does occur shallower and shorter?

Or is the attempt to add new regulations of financial markets to those which already exist futile? Would such regulations only cause net harm by reducing the ability of markets to respond to changed circumstances and limit financial market innovation? Would such regulation in fact diminish economic stability and make jobs less secure?

These are questions of the greatest significance which will be discussed for years on end just as similar questions were discussed following the Great Depression. These are the kinds of questions that are a perennial part of the discourse amongst economists.

THE INVITATIONS TO PARTICIPATE

All of the chapters in the present volume were specially written for this collection. Each of those who have contributed to this volume received some variant of the following letter which was emailed to a number of economists identifiable from their previous writings for their rejection of the standard neo-classical model. The message line read: 'Seeking your contribution to an Elgar publication on the World Financial Crisis'. The following represents the relevant part of the letters that were sent, with the example being the letter written to those who had contributed to the previous volume:

> It is now more than a year ago that I wrote to ask if you would be able to participate in a collection of articles I was then putting together on the Global Financial Crisis. It has now been published as *Macroeconomic Theory and its Failings: Alternative Perspectives on the Global Financial Crisis* (Edward Elgar 2010). What I believe made this collection unique is that it examined from a non-mainstream perspective the economic theories and public policies used to deal with the GFC.
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> Following the successful publication of this first collection, Edward Elgar has agreed to publish a follow up collection that continues to examine from a non-mainstream perspective the economic theories and public policies used to deal with the GFC but with the added perspective that the last eighteen months have given us. I am therefore hopeful that you will again be able to participate in this collection.
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> The core aims of this second volume will be, firstly, to examine the causes of the downturn now that we have had a longer perspective on events, and then, secondly and more importantly, to provide a critical examination of the approaches taken by governments to reverse the economic downturn that reached its lowest point at the beginning of 2009.
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> The specific questions to be addressed in each article could include a discussion of, but would not necessarily be limited to the following which I believe are the central issues at the present:
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> - given the perspective of hindsight, how would you now explain the origins of the Global Financial Crisis?
> - what, in your view, caused the world's economies to stabilise?
> - which policy measures taken by governments have provided the greatest contribution to stabilisation and in what way have they contributed?
> - in contrast, have any of the measures taken by governments added to the economic problems that must now be dealt with and, if so, which policies were these and what have been their harmful effects?
> - what lessons have we learned about economic management and stabilisation policies during the GFC?
> - given your own theoretical perspective, what should policy-makers now do to assist in the recovery process?
> - do you believe regulatory changes are needed and, if so, what kind of regulatory changes should be introduced?
>
> The article is not intended to require much if anything in the way of research. It seeks a brief summary of the framework you bring to economic issues and the application of this framework to the questions that have been outlined above.
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> The article should also not include statistics or mathematical analysis. The intention is to make each as accessible as possible to the widest range of readers, many of whom will not be economists but all of whom will be deeply interested

> in understanding the different perspectives on our current economic and financial circumstances.
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> This book is also intended to be of enduring interest long beyond the present when economic growth, prosperity and a feeling of general optimism have returned. It is intended to be a reflection of how contemporary issues were viewed from different economic traditions during the early months of 2011.
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> Let me just add that this collection is intended to include only those who have an economic perspective that would not be described as part of the mainstream neo-classical tradition. No one, for example, contributing to this volume would normally employ a standard textbook neo-classical model in trying to explain economic events or to formulate economic policy.

The enduring interest in a volume such as this is in having a series of essays contemporary with the events of the Global Financial Crisis. A major part of its value is to provide conceptual guidance to those who are making policy decisions to bring this recession to an end and then to ensure that mistakes that were made are not repeated.

LONGER-TERM PERSPECTIVE

But there is a longer-term perspective that is also an important part of the direct intent of putting these contributions together which is almost entirely unrelated to policy. The aim is to provide economists, historians and others in the future with a date-stamped on-the-ground perspective of these events as they were experienced by members of the economics community at the time.

None of us contributing to this volume know what will happen in the years to come. If we think in terms of the timeline of the Great Depression, the chapters have been written during the middle of 1931 while the world's economies were worsening but had not touched bottom. How comparable this is to that earlier timeline we cannot as yet know.

Even the name we use to describe our current situation has changed. The original period of economic upheaval has taken as its name, the Global Financial Crisis. But while this term is still used, the phrase now used more often is The Great Recession, in recognition that the depth and severity of the Great Depression are very unlikely to be repeated, but that this has been a very sustained period of economic disturbance far worse than any other since the 1930s. But we who have written our articles at the start of 2011 are in the dark about what will come next.

It is for those who live in times to come that this book is to an important extent intended. A major part of the reason that this collection has been brought together is to assist those who are interested in looking back at us from some vantage point in the future to do so. These are date-stamped articles that reflect the beliefs and attitudes of those who are living through these times. That is part of the value that these articles provide.

PERSPECTIVES ON THE CURRENT CRISIS

In spite of its reputation for disagreement, economics is no more fractious than any other science but with this one difference. It is within the public arena and amongst non-economists that a significant part of our economic debates take place. Moreover, the answers that economists provide have a major impact on the lives of millions. The conclusions reached by economists matter.

There is a mainstream. There are textbook theories and practices that are learned and understood by all economists. But whatever is the mainstream at any moment in time, some economists reach the conclusion that the mainstream – the core beliefs of the profession – is, in some important ways, wrong. This has always been the case. It is how economic theory develops. Some members of the profession disagree with the mainstream position, and over time their points of view becomes the mainstream in its place.

It is the macroeconomic side of these economic theories that is now under the microscope in this volume by economists who take sharply different points of view from the majority of the profession. But the different perspectives provided in this volume are not from a single direction but are from across the entire range of positions found in different economic traditions. The different traditions from which the chapters in this volume have been written are listed below in alphabetical order:

- Austrian
- Classical
- Environmental
- Institutionalist
- Marxist
- Minskyite
- Monetarist
- Post-Keynesian
- Schumpeterian.

No attempt is made to define any of these in this introductory chapter. That is for each author to take up on his own. The list of contributors provides a brief statement of the intellectual allegiances of each of the authors. Readers with a greater knowledge of economic theory and its sub-divisions will have no difficulty in recognizing the different points of view.

And although one might describe some of the members of this list as 'schools' of economic thought, it would be too confining in most cases to be constrained in that way. As the chapters make clear, there are overlapping points of view and a number of key concepts that are shared across a number of the perspectives presented. Each of the authors has been allowed to describe their own approach to economics in their own way. The chapters have been put in alphabetical order according to the author's name. No precedence has been given to any point of view.

But what is important is that each of the authors as a representative of one of these perspectives has something of value to contribute to this debate. For each of these, there is a historical tradition that goes back in time to the earlier years of the study of economics. Each of the economists is the present incarnation of a perspective on economic issues that has been pursued by a succession of economists who have learned their economics within those traditions. None of these perspectives was the invention of the economist who has written the chapter for this publication. Each is a descendant from a longer, older, deeper tradition.

Even so, amongst economists there is a common language. We can speak with each other because, by being economically trained, there is a framework within which discourse can take place. But when all is said and done, within each tradition there is a separate means of understanding the various dynamic operations of an economy. There are important differences on what matters and how it matters. There are differences over what governments can successfully do and what they cannot. There are differences over the consequences of different policies and there are differences over how policies will matter in the short run in comparison with the long run. There are differences in the categories in which to classify and aggregate. There are, in fact, differences over whether discussing economic issues in terms of aggregates is even coherent.

Yet so far as this collection is concerned, it has been designed to be read widely by those with no economic training whatsoever. The purpose has been to make these chapters accessible so that the different points of view can be understood by the interested non-economist. There would, in fact, be no point in having put this volume together if its only audience were other economists. The aim is to reach beyond the confines of the economics discipline to the wider community to present the diversity of views amongst economists on these major questions.

There is, it should be understood, not just one single school of economic thought. There isn't a single answer given by economists to the complex and perplexing issues that surround us. There is a wide variety of possible policy responses that ought to be examined and considered.

Those who make policy decisions usually do not have prior training in economics. They should therefore be aware of these other perspectives which are too often obscured by the mainstream. The narrowness of policy debates has often led to the adoption of a course of action that may have long-term consequences and potentially cause major damage to our productive potential because other options were not considered.

The aim of this book is to bring into focus views of other traditions within economics that those who must make policy in the midst of the rush of events would seldom consider in the normal course of events. But given the complexity of the task before us, and the distinct possibility that the policies which have so far been adopted will fail to bring about the desired result, this collection of articles has been brought together to ensure that we have comprehensively examined the effects of the policies that have already been put into practice and that alternative perspectives are examined as future decisions are made.

NOTE

1. Although this volume is linked thematically and by the overlap of many of the contributors with the volume published at the start of 2010, *Macroeconomic Theory and its Failings: Alternative Perspectives on the Global Financial Crisis*, this should not be seen as the second in a series. The chapters in the previous volume represented an immediate response to the GFC that was then at its peak of intensity. This volume contains a more reflective view of what took place and offers a more considered response to the events of the past two years. This introduction, however, follows the outline of that earlier volume.

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