Introduction: instability, prosperity and economics after the Great Recession

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The recent global financial crisis was a devastating event. It was costly in economic and human terms, and it exposed fundamental weaknesses in conventional economics. This book responds by offering a fresh approach to economic theory and policy.

CRUSHED STOCKS, BROKEN DREAMS, AND USELESS THEORIES

On 28 September 2008, a lingering credit crunch was transformed into a worldwide crisis. The value of corporate stocks tumbled on Wall Street, and investors watched helplessly as US$1.2 trillion in market value evaporated. The Dow Jones industrial average suffered its largest single-day point loss ever, and the Standard and Poor’s 500 index plummeted nearly 9 per cent (Twin, 2009). The losses spread quickly to other financial centres around the globe, and a CNN.com headline told the story in two words: ‘Stocks Crushed’.

The financial losses associated with the crunch and subsequent crisis were staggering. The US stock market lost more than half its value between October 2007 and March 2009. And the Russell 3000 index was still 20 per cent below its October 2007 peak as recently as mid-November 2010.1 The crisis led to a Great Recession that reduced the value of household financial-market investments by as much as $10 trillion.2 It also produced trillions in losses from loan and debt-securities write-downs as well as falling housing prices, which helped raise mortgage foreclosures to record levels.

The output and employment costs of the crisis have also been huge. Real gross domestic product (GDP) in the US did not expand in 2008, and fell 2.6 per cent in 2009, the year overall world economic output fell for the first time since the Great Depression (from peak to trough, real US GDP fell 4.1 per cent, the largest decline among post-war US recessions). The unemployment rate reached double digits in the US and many other countries, while large
numbers of those still employed saw their work hours cut. The US unemployment rate averaged 9.6 per cent in 2010, despite both falling labour-force participation (the result of discouraged jobseekers leaving the labour market) and an economic ‘recovery’ that began in mid-2009.

The most troubling part of all this is the human impact. The stock market decline and related financial losses eroded individual and family well-being, forcing countless households to lower their short-term expectations and reassess their longer-term aspirations. The explosion in foreclosures distressed communities, traumatized families, and shattered lifelong dreams. Persistent macroeconomic stagnation and a high jobless rate continue to diminish economic opportunity and thwart the pursuit of self-reliance and personal responsibility (see, for example, Peck, 2010).

Meanwhile, most of the economics profession had no idea a crisis was brewing until the economic storm arrived at full force. Using the dominant theories of the pre-crisis era, economists were simply unable to anticipate, analyze and address the problem. ‘It’s not just that they missed it; they positively denied it would happen’, says professor of finance Franklin Allen (Knowledge@Wharton, 2009; see also Krugman, 2009a).

POST-KEYNESIAN INSTITUTIONALISM

The alternative economic perspective offered by this book is Post-Keynesian Institutionalism (PKI). That approach builds on key insights offered by two overlapping traditions in economic thought: the Institutional school and Post Keynesianism. For the PKI movement, the writings of Hyman P. Minsky (1919–96) provide a valuable guide to contemporary theory and policy.

The Institutional school of economics – a tradition also called Evolutionary economics – originated in the US in the early twentieth century. Major early contributors included Thorstein Veblen (1857–1929) and John R. Commons (1862–1945). Veblen stressed the dynamic nature of the economic system and the central role that institutional adjustment plays in coordinating economic activity. He also developed a theory of business cycles that emphasizes fluctuations in profit expectations, business capitalization, and confidence. Commons appreciated the economics profession’s attention to theory building, but sought to orient that work towards the analysis and resolution of practical problems. He also shared Veblen’s interest in business cycles: Commons was a labour economist who concluded that business cycles and unemployment were the most important of all labour problems.

Post Keynesian economics emerged in the UK and US in the 1970s as a response to the worsening problem of stagflation (inflation and high unemployment) and to the profession’s movement away from the core insights of John
Maynard Keynes (1883–1946). Joan Robinson – Keynes’s colleague at Cambridge University – was a central figure in the Post Keynesian camp in the UK, while Sidney Weintraub and Paul Davidson founded the *Journal of Post Keynesian Economics* and emerged as pioneering US Post Keynesians. The Post Keynesians departed from their mainstream colleagues by stressing the importance of uncertainty as a starting point for economic analysis and by emphasizing important interdependencies between money supply and money demand.

From the outset, Institutionalists and Post Keynesians recognized they had much in common – and a number of economists felt at home in both camps. This group included Wallace C. Peterson (1977), who used a 1976 address before the Association for Evolutionary Economics to focus on how Institutionalism and the economics of Keynes can be viewed as ‘two trains on parallel tracks toward a common destination’. The group also included Charles K. Wilber and Kenneth P. Jameson (1983), who responded to the dominant economic theories and policies of the early 1980s by composing the first book to outline a synthesis called PKI – *An Inquiry into the Poverty of Economics*.6

Unfortunately, much of Wilber and Jameson’s book was so closely tied to the immediate problem of stagflation that the volume and its important insights on PKI were largely overlooked once high inflation abated (Whalen, 2008a: 47–49). Instead of concentrating on the phenomenon of stagflation, PKI needed a more dynamic focus. And that is precisely what Institutionalists and Post Keynesians found in the work of Minsky.7

At the heart of Minsky’s research agenda was the study of financial-system evolution and its impact on business cycles and capitalist development. He considered himself a ‘financial Keynesian’, yet also maintained that monetary economics ‘cannot escape being Institutional economics’ (Minsky, 1982: 280). Today, Minsky is best known for the financial-instability hypothesis, which argues that financial systems evolve endogenously from being robust to fragile; this evolution makes the overall economy susceptible to financial crises and deep recessions.8

In the 1990s, Minsky directed much of his attention to what he called ‘money-manager capitalism’. It emerged in the 1980s as the latest phase of US capitalist development, an era characterized by the economic dominance of institutional investors preoccupied with short-term goals (Minsky, 1993). Minsky argued that money-manager capitalism fuels worker insecurity, income inequality, and economic instability (Minsky, 1996).9

When the credit crunch hit global markets in 2007, the economics of Minsky – who had by then been dead for more than a decade – became fashionable almost overnight. And attention to Minsky increased as the economic situation deteriorated. Financial analysts peppered their reports with his insights; journalists wrote features on his ideas; and prominent economists discussed his contributions in major addresses.10 However, most commentators gave his
work a superficial treatment and it appears few of them took time to read much of what Minsky wrote.

In contrast, nearly all contributors to this volume have a long and deep association with the economics of Minsky as well as with the broader literature on Institutionalism and Post Keynesianism. They understand that Minsky’s works contain a compelling critique of conventional economics, a penetrating look at economic life, and a starting point for broader policy options than those offered by most economists. They also believe it is hard to look back on the recent crisis without pausing to regret that economics did not gravitate to Minsky’s ideas much sooner.11

OVERVIEW

This volume is organized as follows. Part I explores the foundations of PKI. Part II focuses on the US economy. Part III extends PKI to the world economy. Part IV closes the book with the contributors’ thoughts on the future of PKI.

Foundations

Steven Kates (Chapter 1) begins Part I by demonstrating that Commons’s Institutional economics provided Keynes with insights that serve as the basis for *The General Theory of Employment, Interest and Money*. To the existing evidence connecting Keynes and Commons, Kates adds a vital and previously ignored link: Harlan L. McCracken, a student of Commons. Kates demonstrates that McCracken shared with Keynes what he learned from Commons, and that Keynes then applied McCracken’s reasoning to attack Say’s Law.

W. Robert Brazelton and Charles J. Whalen (Chapter 2) bring the discussion of foundations forward by identifying key elements of Institutional economics and showing how those ideas manifest themselves in the more recent Post Keynesian tradition, which rests heavily on insights contained in *The General Theory*. They also look across traditional disciplinary boundaries to identify valuable socio-economic insights in psychology and sociology. Their chapter closes by combining insights from all the traditions examined and suggesting some essential features of PKI.

Glen Atkinson and Whalen (Chapter 3) wrap up the exploration of foundations by probing the origin and development of Common’s notion of futurity, which they identify as a cornerstone of PKI. Their chapter dovetails with that of Kates because futurity – which indicates expectations and anticipation – is at the heart of what McCracken shared with Keynes. It also complements the Brazelton and Whalen essay by examining the role futurity can and should play in the further evolution of economic theory.
The American Economy

Fadhel Kaboub (Chapter 4) opens Part II by building on the earlier chapters to explain and address the economic instability observed in the US. The result is an analysis that rests on Minsky’s financial-instability hypothesis – with its emphasis on the volatility of finance and investment – but adds consumption and inequality to the conceptual framework. Kaboub’s chapter highlights public-service employment (which was central to Minsky’s conception of government as ‘employer of last resort’) as a policy option capable of contributing simultaneously to economic stabilization and the pursuit of full employment.12

David Zalewski and Whalen (Chapter 5) also extend the work of Minsky. Their chapter brings attention to a major predicament confronting states and localities during slumps: balanced-budget rules force those governments to exacerbate downturns by eliminating jobs and cutting public spending when tax revenues fall. Drawing on the notion of subsidiarity, that chapter introduces a new policy option: a federal/state policy partnership designed to promote more rapid recovery from future recessions.

Éric Tymoigne (Chapter 6) rounds out Part II by focusing on financial regulation from the standpoint of PKI. He begins by surveying the foundations of the current regulatory system. Then he critically assesses the widely held belief that improving capital and liquidity requirements would solve our financial instability problems. He concludes by outlining an alternative approach to financial regulation: a balance-sheet framework aimed at detecting (indeed, even preventing) what Minsky called Ponzi finance.

The Global Economy

Jan Toporowski (Chapter 7) begins Part III by extending Tymoigne’s emphasis on balance sheets to examine bank regulation in the international arena. Like Tymoigne, Toporowski begins by critically appraising the conventional wisdom in financial economics and its focus on bank capital adequacy. Then he outlines an alternative: a banking system in which contingent lending commitments to governments are an essential part of cross-border lending. Such a system is designed to reduce global financial fragility and foster emergence of an international lender of last resort.

John Marangos and Whalen (Chapter 8) continue the international focus by reviewing the evolution of the ‘Washington Consensus’ on international economic development policy. The authors explain and compare three incarnations of the Washington Consensus, highlighting key shortcomings of their common foundations. They also discuss elements of an alternative approach to development economics. The chapter stresses that applying PKI to international development requires attention to social goals, time, context, power, and participation.
Yan Liang (Chapter 9) brings Part III to a close with a chapter rooted in an appreciation of the elements mentioned by Marangos and Whalen. Liang examines the rise of money-manager capitalism as well as the flow of capital from countries where that system prevails and into emerging market economies (EMEs). She also explores the impact of those flows on financial development, market volatility and macroeconomic discipline in EMEs. What emerges is a critique of conventional economic theory and policy on capital flows and development, a critique that points to closer regulatory scrutiny of global money managers.

THEMES

Three themes emerge in this book: analyzing economic instability, securing broadly shared prosperity, and rethinking economics.

Analyzing economic instability has been at the heart of both Institutionalism and Post Keynesian economics from their inception; the same is true of PKI. According to PKI, business cycles are an inherent feature of advanced capitalist economies, and financial institutions play a key role in generating these cycles. The emphasis on fluctuations and finance is evident in this book’s sections devoted to the US and the global economy, but that emphasis is also reflected in the foundations section. Trace finance and cycles to their roots, and what do we find? Futurity.

Pairing the concept of futurity with the reality that the future is largely uncertain forms a foundation for Institutionalism, the economics of Keynes, Post Keynesianism, and contemporary PKI. Commons (1921: 268) wrote that modern capitalism rests on the credit system ‘and the credit system is nothing but confidence in the future’. Keynes (1937: 221) looked at the same matter from a different angle and placed changes in our views of the future – changes in ‘the state of confidence’ – at the centre of his theory of output and employment. PKI proceeds from the same starting point.13

Securing prosperity is also at the heart of PKI and its antecedent traditions. The prosperity these economists envision extends beyond rapid GDP growth. It is a widely shared prosperity of high employment, rising standards of living, and even meaningful work.

This perspective on prosperity is evident in the writings of both Commons and Keynes. They shared the goal of seeking to resuscitate and revitalize capitalism by (as Commons wrote) ‘making it good’. To that end, they wanted to influence the path of economic activity by using government as a creative and constructive force, but they also shared an abiding faith in markets and placed a high value on individual freedom (Whalen, 2008a: 44–46).

The same aims and values can be found in Minsky (1986), and in PKI.
Moreover, PKI stresses that broadly shared prosperity is a meaningful goal across the globe, not just within the most advanced industrial economies.

Rethinking economics, meanwhile, is not merely a theme in this volume; it is also its most immediate aim. Like Veblen, Commons, and Keynes, contributors to this volume strive to move beyond the outmoded theories of the past. Their goal is to shed fresh light on how our contemporary economy operates and to provide a foundation for more constructive thinking about public policy. Rethinking economics requires not only critical appraisal of the conventional wisdom, but also innovative reconstruction; readers will find some of both in each section of this book.

ROOM FOR FRUITFUL DISCOURSE

The value of an alternative economic perspective is determined by whether it can address the central challenges of contemporary theory and policy. This book’s contributors meet the theory test by offering precisely what Nobel laureate Paul Krugman (2009a) argues economics needs most: scholarship that questions the efficient-market view of the financial sector and that strives to incorporate the realities of finance into macroeconomics. They also meet the policy test by responding with constructive analyses and policy options relevant to the still lingering effects of the Great Recession and the possibility of yet another financial crisis.

In addition, there is another reason to have confidence in the value of PKI. Mounting evidence indicates that the mainstream of economics is moving more and more in its direction.

Minsky believed it was necessary to move the discipline by communicating with its leading practitioners. That is why he devoted attention to Thomas J. Sargent’s *Bounded Rationality in Macroeconomics* in an address delivered less than a year before his death in 1996. Minsky (1996) argued that although Sargent was part of the New Classical tradition in macroeconomics, which developed as an alternative to Keynesianism, room for a ‘fruitful discourse’ between the followers of Keynes and the New Classical economists emerged as a result of Sargent’s adherence to the notion of bounded rationality. According to Minsky, bounded rationality introduced recognition of uncertainty, and uncertainty brought with it the importance of history, expectations and learning over time. To be sure, there was still a wide divide between most of the economics of Minsky and the economics of Sargent, but the appearance of bounded rationality in Sargent’s research meant there was also common ground.

Since publication of Sargent’s book in 1993, there has been more mainstream movement in the direction of PKI. At the end of that same year, for example, Douglass North (1994) received the Nobel Memorial Prize in
Economics and used the occasion to stress that standard economics erroneously assumes institutions and time do not matter. The result, he argued, is a theory that says nothing about economic performance through time: ‘Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operation of markets, not with how markets develop’. To understand how markets evolve, he argued, economists must understand how choices are made ‘under conditions of uncertainty’ and how human learning shapes institutions.

Another example of movement in the direction of PKI is found in the work of Joseph E. Stiglitz (2002). His 2001 Nobel lecture focused on the pervasiveness of information imperfections in the real world and on how they undermine the notion that a market economy can be left to operate by an ‘invisible hand’. Stiglitz shared the Nobel award with two other economists who also contributed to the economics of information, including George Akerlof, whose work receives some attention in Chapter 2 of this volume. Embedded in their attention to information imperfections and asymmetries is the same element that Minsky highlighted in Sargent’s work: uncertainty.

An even more recent example of movement toward PKI is provided by Akerlof’s 2009 book, co-authored with Robert J. Shiller: *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*. Their notion of animal spirits is borrowed from Keynes, and in both *The General Theory* and *Animal Spirits* that term refers explicitly to how humans make decisions and respond to events in a world of uncertainty (Akerlof and Shiller, 2009: 3–4). In the preface to *Animal Spirits*, the authors explain that their book ‘draws on an emerging field called behavioral economics’ as well as on inspiration from Keynes. But before mentioning either of those influences, the authors cite another: Minsky. Noting that Minsky’s work sought to avoid a repeat of the Great Depression, they write, in a footnote to the preface’s opening paragraph: ‘He, like us, was especially concerned with the psychology of speculative bubbles. Our line of thinking in this book parallels that of Minsky’.

Of course, important differences still separate PKI from the economics of Sargent, North, Stiglitz, Akerlof, and Shiller. Nevertheless, room for fruitful discourse with such economists is clearly growing. And seeking to engage in such discourse is an important part of the ongoing PKI research agenda (see Chapter 10).

**CONCLUSION: TOWARDS A BETTER ECONOMICS – AND A BETTER WORLD**

Institutionalists and Post Keynesians have often maintained that the ultimate purpose of economics is to make the world a better place in which to live. The
same spirit can be found in PKI, whose adherents also believe in the need to advance economics. The authors of the chapters that follow strive to move towards a better economics, motivated by the hope that it will open up policy options and elevate academic and public discourse in a way that helps move us in the direction of that better world.

NOTES

1. This chapter was prepared in mid-November 2010 (portions were later updated in January 2011).
2. The estimate of $10 trillion in losses, arrived at by a number of financial economists, includes household investment in corporate equities and related mutual fund shares, as well as equity in non-corporate business and in life insurance and pension fund reserves.
3. The foreclosure crisis continues even as this book goes to print.
4. As Paul Krugman (2009b) stated in a lecture at the London School of Economics: ‘Most of what [mainstream economists] have done in macroeconomics for the past 30 or so years has turned out to be spectacularly useless at best, and positively harmful in some cases’. For a more recent critical look at macroeconomics, see Caballero (2010).
5. It is interesting to note that a student of Veblen – Wesley C. Mitchell – created the National Bureau of Economic Research, recognized today as the authoritative voice on US business cycle dating, and that Commons served as associate director of the organization for most of its first decade. Indeed, Mitchell was also an Institutionalist economist and could easily be included along with Veblen and Commons as major Institutionalist pioneers, especially with respect to the analysis of cycles.
6. According to Warren J. Samuels and Steven G. Medema (1990: 147), Gardiner C. Means (1896–1988) was both an Institutionalist and perhaps the first Post Keynesian. Their viewpoint underscores Peterson’s argument that Institutionalism and the economics of Keynes have always been headed in the same direction.
7. Alfred S. Eichner (1985; 1991) also appreciated the need for a reconstruction of economics that centred the economy as a dynamic system, and he explicitly sought to integrate Institutionalist and Post Keynesian ideas toward that end (see also Arestis and Eichner, 1988). But his untimely death brought that work to a premature end in early 1988 (though much of his work in the microeconomic realm has been ably carried forward by Frederic S. Lee, a former student; see, for example Lee, 1994). More recently, Cornwall and Cornwall (2001) explored what they call Evolutionary Keynesianism, drawing in part on Institutionalist and Keynesianism, and Niggle (2006) outlined common elements within Institutionalism and Post Keynesianism, showing how they differ from what he calls post-monetarist New Consensus macroeconomics (a synthesis of New Keynesian Economics and New Endogenous Growth Theory).
8. Drawing on Minsky’s financial instability hypothesis in the 1980s and 1990s, a number of economists generated important and often prescient analyses. For example, see Carter (1989), Wray (1990), and McClintock (1996).
9. Minsky was right about money-manager capitalism in relation to insecurity, inequality, and instability; for example, see Whalen (2008b), Wray (2009), and Zalewski and Whalen (2010).
11. The perspective of contributor Steven Kates differs from that of this volume’s other contributors, but there is still important common ground, especially a shared appreciation of money and uncertainty as fundamental elements in economics. Kates, a historian of economic thought, maintains that classical economics contains a long-overlooked theory of business cycles in which downturns are accompanied by high levels of involuntary unemployment.
(see Kates, 1998; and Kates, 2011). Kates’s viewpoint bears a resemblance to that of Joseph Schumpeter, who supervised Minsky’s Ph.D. thesis until his death in 1950 and whose influence is unmistakable in the economics of Minsky.

12. Prior to the Great Recession, the last time public-service employment (PSE) was tried on a large scale in the U.S. was the 1970s. For an assessment of that experience see Briggs (1981), who concludes that PSE was ‘an effective instrument of fiscal policy’. And for a more recent, supportive discussion of direct job creation from an unlikely source, see Thompson (2010).

13. Economic journalist Peter Coy (2010) underscores the central role of futurity in modern economic life in a recent Bloomberg BusinessWeek commentary. Examining the confusion over mortgage documentation that led some banks to suspend foreclosures, Coy writes that this was not merely a clerical problem; rather, it was a matter that ‘erodes certainty about property rights – the key to capitalism’. At bottom, capitalism rests on futurity.

14. For an essay that contrasts the view of financial crises found in this volume with the perspective of economists such as Shiller, Akerlof, and Stiglitz, see Tymoigne (2010).

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