Introduction

Capitalism, Macroeconomics and Reality: Understanding Globalization, Financialization, Competition and Crisis

BACKGROUND

There have been numerous seismic shifts in the structure and performance of the US and global economies over the past century. The global economic crisis that followed in the wake of the Great Financial Crisis of 2007-2008 and led to austerity macro policy and regressive structural economic "reforms" across the globe is just the latest such shift. In the aftermath of the Great Depression and World War II, a whole new form of capitalism was created. The post-WWII period began with an enormous increase in the role of government in the economy, a strong labor union movement and an emerging welfare state — a sea change from the economic system that existed in the US and Europe in the 1920s. These changes led to the "Golden Age" of modern capitalism in which economic growth rates rose substantially across much of the world and the prosperity that resulted was widely shared.

The full-employment profit squeeze and rising labor militancy in the US and parts of Europe in the late 1960s and early 1970s, along with rising inflation and the stagflation that followed, marked the beginning of the end of this era. (Some of the chapters in this book deal with the US, others with the global economy.) Increasing competition in global markets in the 1970s and afterward accompanied by a slowdown in the growth of global aggregate demand created a long decline in the corporate profit rate and in stock prices. Oil price shocks in the late 1970s led to another sharp rise in inflation, and the end of the Bretton Woods international financial system — which turned international financial markets into volatile speculative gambling casinos. Inflation and a run on the dollar led Paul Volcker, Chair of the US Federal Reserve System, to initiate a scorched-earth monetary policy in the early 1980s that brought on the Latin American debt crisis, a deep US recession and a financial-market crisis. Taking advantage of these crises, a US-led coalition forced both developed and developing countries to remove controls over cross-border direct investment, trade and financial flows. The creation of integrated world markets meant that workers anywhere had to compete with workers everywhere for scarce jobs without the protection of a global union movement. This increased the power of capital over labor almost everywhere. The end of restrictions on trade and capital flows also led to the deconstruction of the "East Asian" state-led growth model that had helped bring rapid growth and rising living standards to much of the global South. The elimination of capital controls and the emergence of casino financial markets soon led to the outbreak of financial crises across much of the world. The Latin American debt crisis of the late 1970s and early 1980s and the East Asian financial crisis of the late 1990s are cases in point.

By the early 1980s, the real value of stock prices in the US had fallen to half their mid-1960s peak. This led to the rise of corporate raiders and the hostile-takeover movement that substantially increased the influence of Wall Street over decision-making in nonfinancial firms. The hostile-takeover movement was soon followed by the "shareholder-value movement" in which the incentives of top corporate management, now largely in the form of stocks and stock options, and those of institutional investors were synchronized. Both sought to increase stock prices over the short to intermediate run in order to maximize their own wealth. By the 1990s, the "financialization" of the nonfinancial firm was well under way. The long-term time horizons, high-road labor relations, and domestic real-sector focus of large US firms in the Golden Age turned into the short-term horizons, union-busting, financial-market orientation, and outsourcing of jobs of the neoliberal era. Financialization also occurred in European countries, though not to the extent seen in the US.

These developments created a rapid rise in the inequality of income and wealth, not only in the US but in much of Europe. Rising inequality and slower income growth below the top of the income distribution also led to a decline in the rate of consumption spending by households after 1980 that contributed to a slowdown in the growth of income and employment. This problem would have been worse had it not been for an explosion of household debt that raised spending, but simultaneously created fragile household balance sheets. Much of this borrowing was in the form of residential mortgages, which eventually led to a housing bubble in the US starting around 2000. Wall Street transformed these mortgages into an explosion of mortgage-based securities and derivatives which the integrated global financial system spread across the globe.

By the late 1990s, financial markets had dramatically expanded in size, and were immensely fragile due to high leverage, toxic and inherently nontransparent securities, a perverse bonus-driven incentive system on Wall Street that rewarded maximum risk-taking, and systemic interdependence among large financial firms across the globe. By the mid-2000s, it had become clear to a few progressive economists and a small number of financial market observers that a global financial crisis could possibly breakout at some unknowable future date. (In the conclusion of a paper that appeared on the website of the Political Economy Research Institute at the University of Massachusetts in Amherst in March 2007, a version of which appears in this volume, I said that the probability of a global financial crisis was substantial.) Almost without exception mainstream financial economists insisted that all was well: the US was immune to crises because it had the most efficient and transparent financial markets in the world.

When the financial crisis erupted, the response of most governments was to impose austerity macro policies. This loaded the costs of the crisis onto their citizens while rescuing the financial institutions that created the crisis and protecting the bonuses of their traders and top executives. The combination of the crisis and reactionary policies in response to it led to a deep global recession that reached depression levels in the hardest-hit countries. Andrew Haldane, head of Britain's Office of Financial Stability, estimated in 2010 that "the present value of output losses for the world" from the crisis would be "between \$60 trillion and \$400 trillion." Conservative forces throughout the world took advantage of the crisis to achieve objectives they had pursued for decades — to cut taxes on corporations and the rich while slashing social spending on the middle class and the poor. Meanwhile, so-called "structural reforms" designed to slash safety nets, disempower unions, cut private and public pensions, privatize public assets, and weaken business regulation became the order of the day.

It would probably astound a non-economist to be told that as all these seismic institutional, policy and performance shifts were taking place in the post-1980 era, mainstream economics sustained and even increased its commitment to the deregulation of business and finance and the worship of "free markets." *Mainstream economics did not predict and cannot explain any of the disastrous outcomes of the global neoliberal economic and financial system because such crises are impossible in the fairy-tale world of mainstream theory.*

Early in the post-WWII era most economists believed the Great Depression had demonstrated that failure to tightly regulate financial markets, as in the 1920s, was a recipe for economic and political disaster. But as the decades passed, a conservative counter-attack against this idea won more and more adherents. Eventually much of the profession rejected core insights from Keynes's macro theory, which I argue in this book portrays modern capitalism as an inherently unstable system, and from the Keynes-Minsky-Marx theory of inherently unstable financial markets. These were replaced with old and new variants of classical free-market, laissez-faire theory. They included Milton Friedman's monetarism, the "rational expectations" revolution, real business-cycle theory, dynamic stochastic general equilibrium models, and "efficient" financial market theory. These theories were built on stunningly unrealistic assumptions chosen to demonstrate that all would be well if governments would only leave free-markets alone. Collectively they formed the dominant economics paradigm of the post Golden-Age era.

The "Keynesian" school did not completely die out, but it moved closer to the new mainstream paradigm by adopting many of its assumptions. It rejected Keynes's radical conclusion that capitalism can endogenously generate system-threatening depressions and severe financial crises. It argued instead that the government can use monetary and fiscal policy to hold the economy near full employment equilibrium, and assumed that financial markets would remain stable under the guidance of regulators and the Federal Reserve. "New Keynesian" theory arose in response to these reactionary developments, but it also accepted almost all the unrealistic assumptions of the new conservative economics. It did show that individual markets may be inefficient, but it is limited to static, single-market equilibrium analysis, allows all agents to optimize, and has few interesting policy implications.

The evolution of conservative mainstream economic theory after the 1960s helped facilitate the creation of the global neoliberal economy. Of course, the most powerful interests in our economic system were committed to these changes and it is not likely that even an economics profession determined to oppose them could have prevented their eventual victory. But if the economics profession had chosen to fight against the neoliberal regime rather than become its champion, it could have increased political resistance to its adoption, encouraged progressive opponents of neoliberalism, and facilitated the creation of more generous protections for the victims of the system.

At each stage of the evolution of the US and other economies from the Golden Age to the current era, there were alternative economic theories inspired by the work of non-mainstream economists. These included Keynes, Marx, Minsky, Kalecki and Schumpeter among many others. They helped progressive, radical and heterodox economists understand and write about the causes and effects of these dramatic economic changes. Their work generated ideas about how to transform economic institutions and policies to create a healthy economy that prioritizes the interests of the majority of people rather than those of the top one to ten percent of us.

The chapters contained in this collection analyze the deep flaws in the methodological foundation of mainstream theory, and explain how these flaws make mainstream economics more ideology than sound social science. They develop alternative theories built on realistic assumptions that can explain most of the disastrous economic and financial developments of the past four decades described in this Introduction. My intention in writing these chapters was to contribute to the collective creation of a solid theoretical foundation on which to build an understanding of the "laws of motion" of capitalism in the post WWII era. Knowing how and why the evolution of capitalism over recent decades took the destructive form that it did can help us design new policies and institutions to either reform present-day capitalism or replace it.

BROAD THEMES

The collection of papers in this volume covers a wide range of important topics in political economy and economic policy. Some deal with theory and some with policy. Many deal with both. Taken together they help explain many of the post WWII seismic shifts and evolving economic and financial problems and crises discussed in this Introduction. I list here some of the broad theoretical propositions that inform this work.

1. A basic objective of political economy should be to develop theories that can explain both the substantial achievements in the history of capitalism and the economic problems and disasters that have taken place in that history — instability, depressions, financial crises, mass unemployment, inequality, poverty and environmental destruction.
2. Explanations of the evolution of capitalism should be based primarily on theories of internal or endogenous dynamic forces of change rather than through unexplained "exogenous shocks" to an otherwise idyllic system.
3. I believe with Marx that the purpose of political economy is not just to understand the world, but to change it for the better through political, economic and social intervention.
4. Methodology is important. Friedman's positivist methodology insists that realistic theory can be built on absurd assumptions — such as, for example, that the future is already determined (stochastically) and is knowable in the present in the form of "rational expectations." Positivism is deeply flawed. Realistic assumptions are a necessary condition for the generation of realistic theories and effective policies.
5. The unknowability of the future, or Keynesian uncertainty, and the inability to reverse or undo mistaken actions without incurring substantial costs are essential assumptions for realistic theory. Keynes built his theory on these assumptions; mainstream theory assumes these troublesome realities away.
6. You cannot create an adequate theory of capitalism unless you have a realistic theory of competition. Mainstream theory does not have one. I attempt to provide one in these chapters.
7. Stable static-equilibrium models and comparative static analysis are analytical methods of modest insight. Marx, Keynes and Schumpeter were correct to stress that capitalism is an evolutionary system that alters it dynamic path endogenously from time to time. Much of this change is created by the pressure of competition. Static models cannot incorporate endogenous change.
8. Economic dynamics are path-dependent and non-determinist, but in any specific set of circumstances, some outcomes are more likely than others. This makes sensible policy intervention possible in a world of uncertainty.

9. You cannot construct an adequate theory of economic dynamics with flows alone. Firms and households carry their past along with them in the form of balance-sheet commitments. This is the foundation of Minsky's' theory of "financial fragility" and Marx's theory of financial "oversensitivity."
10. The economic role of the state is always and everywhere a crucial determinant of economic performance, and political decisions always reflect class interests.
11. The data show that financial markets are inherently more volatile and unpredictable than real-sector markets. Theory must explain the forces that create this historical fact.
12. All good theory is institutionally contingent and historically specific. You cannot model economic dynamics adequately without incorporating institutional specificity into your analysis. This insight is crucial for those who wish to understand the seismic historical shifts in the structure and performance of the US economy described above.
13. The evolution of useful economic theory in any period always builds to a significant degree on the contributions of economists who came before it. The chapters in this book were informed by the work of many economists, but among these Marx, Keynes and Schumpeter stand out. Conventional wisdom insists that Keynes, Marx and Schumpeter are incompatible, and along some dimensions they are. For example, Schumpeter accepts Say's Law. But Schumpeter also praised Marx for being a pioneer in the development of evolutionary economic theory and for his contribution to the theory of competition. Keynes, Marx and Schumpeter all wrote effectively on the destructive as well as the constructive dimensions of competition and on the inherent instability of financial markets. All three have something to teach us.

AN OVERVIEW OF THE CHAPTERS

PART I Methodology and Theory as If Reality Mattered: Friedman vs. Keynes, Marx and Minsky

1. "**The Realism of Assumptions Does Matter: Why Keynes-Minsky Theory Must Replace Efficient Market Theory as the Guide to Financial Regulation Policy**." From *Oxford Handbook of the Political Economy of Financial Crises*. G. Epstein and M. Wolfson editors. Oxford University Press, 2013.

2. "**Are Keynesian Uncertainty and Macrotheory Compatible? Conventional Decision Making, Institutional Structures and Conditional Stability in Keynesian Macromodels**." From *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman Minsky*. G. Dymski and R. Pollin editors University of Michigan Press, 1994.

3. "**The Centrality of Money, Credit and Financial Intermediation in Marx's Crisis Theory: An Interpretation of Marx's Methodology**." From *Rethinking Marxism: Essays in Honor of Harry Magdoff and Paul Sweezy*. R. Wolff and S. Resnick editors. Autonomedia, 1985.

Chapter 1 argues that mainstream economic theory was designed to prove that capitalism is an efficient economic system. This required the construction of fairy-tale economic theories based on crudely unrealistic assumptions, an approach justified by Milton Friedman's Positivist methodology. I demonstrate that positivism is ideology, not science, and show how Keynes and Minsky created theories of financial market instability based on realistic assumptions that can explain financial crises, including the one that broke out in 2008, something the mainstream's "efficient financial market theory" cannot do.

Chapter 2 explains how Keynes constructed a theory of the macro dynamics of capitalism based on realistic assumptions. One building-block assumption was that the future is unknowable. This assumption allowed him to create a revolutionary micro theory of behavioral or "conventional" agent choice. This essay explains how the union of his aggregate-demand driven macro theory with his theory of conventionally-determined expectations explains both periods of relative stability and the financial booms, busts and depressions that appear in the historical record from time to time.

Chapter 3 stresses the importance of money, credit and financial intermediation in Marx's theory of accumulation and crisis. It demonstrates that the relative neglect of money and finance in the traditional Marxian literature is based on a misunderstanding of Marx's analytical methodology. Marx's own work contains insights about the inherent instability of capitalist financial markets similar to those of Keynes and Minsky, but they are embedded in a superior theory of real-sector instability.

PART II Understanding the Great Financial Crisis of 2007-2008

4. "**If Financial Market Competition is Intense, Why are Financial Firm Profits so High?: Reflections on the Current 'Golden Age' of Finance**." From *Competition and Change*, June 2008.

5. "**Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'**." From the *Cambridge Journal of Economics,* July 2009.

6. "**How Bonus-Driven 'Rainmaker' Financial Firms Enrich Top Employees, Destroy Shareholder Value and Create Systemic Financial Instability**." From *After the Great Recession: Keynesian Perspectives on Prospects for Recovery and Growth*. B. Cynamon, S. Fazzari and M. Setterfield editors. Cambridge University Press, 2013.

Chapter 4 provides an answer to the question in its title based on: rapid growth in the demand for financial services; rising oligopoly pricing-power; increased risk-taking with rising leverage; perverse incentives; and rapid financial innovation that allowed giant banks to create and trade the complex products that led to the financial crisis. Originally written in late 2006, this chapter concluded that the onset of a global financial crisis was not unlikely.

Chapter 5 analyzes the structural flaws in the global financial system that helped bring about the current crisis and discusses prospects for financial reform.

Chapter 6 argues that the bonus-driven compensation structure in important financial institutions was a major cause of the recent global financial crisis. It provided powerful incentives for key decision makers in these firms to take excessive risk and employ excessive leverage.

PART III Keynes, the "Keynesians" and "New Keynesians" on Investment Theory

7. "**Is New Keynesian Investement Theory Really 'Keynesian'?: Reflections on Fazzari and Variato**" From the *Journal of Post Keynesian Economics*, Spring 1996.

8. "**Owner-Manager Conflict and Financial Theories of Investment Instability: A Critical Assessment of Keynes, Tobin and Minsky**." From the *Journal of Post Keynesian Economics*, Summer 1990.

Chapter 7 argues that although New Keynesian theory developed in reaction to the rise to dominance of conservative economic theory after the 1960s, it accepted almost all the unrealistic assumptions of that theory. The chapter demonstrates that New Keynesian investment theory is limited to static, single-market equilibrium analysis, allows all agents to optimize, and has few interesting policy implications.

Chapter 8 demonstrates that Minsky, Tobin and, at times, Keynes incorrectly theorized financial markets as the sole source of instability in investment spending. They either assumed managers and stockholders were identical — agent conflation — or that share prices determined investment when managers and shareholders disagreed – shareholder domination. The chapter argues that instability is rooted in both real and financial sectors, that conflation should be rejected, and that shareholder domination is institutionally and historically contingent.

PART IV Competition, Globalization, Accumulation and Financialization in the Spirit of Marx, Schumpeter and Keynes

9. "**Rethinking Marxian Investment Theory: Keynes-Minsky Instability, Competitive Regime Shifts and Coerced Investment**." From the *Review of Radical Political Economics*, March 1993.

10. "**Core Industries, Coercive Competition and the Structural Contradictions of Global Neoliberalism**." From *The New Competition for Inward Investment*. N. Phelps and P. Raines editors. Edward Elgar Publishing, 2003.

11. "**The Neoliberal Paradox: The Impact of Destructive Product Market Competition and Modern Financial Markets on Nonfinancial Corporation Performance in the Neoliberal Era**." From *Financialization and the World Economy*. G. Epstein editor. Edward Elgar Publishing, 2005.

Chapter 9 demonstrates that Keynesian-Minskyan ideas about uncertainty and financial fragility are incorporated in Marx's theory of capital investment. It also uses Marx-inspired theoretical innovations to break the iron-link in standard theory connecting intense competition to lower profit rate and less investment. I use his concept of "coerced" investment spending in the face of falling profits to explain the chronic reproduction of excess capacity in a long-term crisis.

Chapter 10 argues that the micro theory appropriate to an analysis of global neoliberalism is Joseph Schumpeter's theory of "natural oligopolies" stripped of its reliance on Say's Law and augmented by my interpretation of Marx's theory of destructive competition. The chapter utilizes an original integration of a Keynesian-Marxian macro perspective with a Schumpeterian and Marxian micro theory to identify the structural contradictions of global Neoliberalism and explain the chronic crises of the era.

Chapter 11 integrates the forces of intense competition in much of the neoliberal era that led to low profit rates and high excess capacity with the forces of financialization that pressured firms to disgorge an increasing share of their competition-squeezed cash flow to financial markets in the form of dividends, interest and stock buybacks rather than using it for long-term investment.

PART V Radical Theory, Class Conflict and Policy in the US and Abroad

12. "**Was Keynes a Corporatist?: Keynes's Radical Views on Industrial Policy and Macro Policy in the 1920s**." From the *Journal of Economic Issues*, September 1999.

13. "**Class Conflict and Macropolicy: The Political Business Cycle**." From the *Review of Radical Political Economics*, April 1975, with Raford Boddy.

14. "**The Great Austerity War in the US: What Caused the US Deficit Crisis and Who Should Pay to Fix It?**" From the *Cambridge Journal of Economics*, January 2012.

15. "**Was IMF-Imposed Economic Regime Change in South Korea Justified: The Political Economy of the IMF**." From the *Review of Radical Political Economics*, Spring 2009, with Kangkook Lee.

Chapter 12 demonstrates that Keynes's policy goal was not to save capitalism through the use of counter-cyclical macro policy as modern Keynesians teach. He considered himself to be a democratic or liberal socialist who believed capitalism was incapable of generating sustained full-employment and an equitable income distribution. His major policy proposals were: state control of the lion's share of large-scale capital investment; strict capital controls; managed trade; industrial policy; much more progressive income and wealth taxes; and persistently low interest rates.

Chapter 13 was written in the mid-1970s when Baran and Sweezy's theory of "monopoly capitalism" was still widely accepted by progressive economists. It assumed that tight labor markets no longer led to a rising wage share and declining profit share of corporate revenues, or that Marx's theory of the reserve army of labor was no longer valid in the new non-competitive capitalist regime. This chapter demonstrates to the contrary that Marx's full-employment profit squeeze was consistent with post-WW data. It also presents and defends the thesis that macro policy is dominated by capitalist class interests and uses this thesis to explain US domestic and international economic policy-making in the post-war era.

Chapter 14 argues that the rise of right-wing political forces in the US after the mid-1970s led to policies that slowed economic growth, cut taxes on large corporations and the rich, and caused rising deficits that were met by cuts in social spending and additional regressive tax cuts. When financial deregulation triggered a global crisis in 2008, governments around the world enacted fiercely regressive "austerity" policies. This whole process was, from the beginning, a one-sided class war designed to destroy social democracy.

Chapter 15 demonstrates that when South Korea was hit by the East Asian crisis in 1997, it had an efficient economy that needed only temporary liquidity assistance from the IMF. Instead, a coalition including domestic economic elites, the IMF and World Bank, global financial corporations and the US Treasury cooperated to impose a neoliberal model on the Korean people. The result was slower growth, rising poverty and inequality, and greater financial fragility.