Introduction

You cannot see a crisis coming if you have theories and models that assume that the crisis is impossible. (Adair Turner 2016, p. 246)

I decided to write this book because the economists’ attitude towards the current crisis struck me as somewhat passive. With this, I do not mean that economists failed to deal with the crisis – indeed, thousands of studies have been published on this topic. What I am actually suggesting is that the economics profession is learning nothing from this crisis. I believe there are two fundamental lessons that we, as economists, should learn from the current crisis. First, we should recognize the limitations of the mainstream economic theory developed over the last 40 years. According to this theory, in a market economy in which the price system is free to work without major obstacles, a disastrous crisis, such as the recent one, cannot occur. The attitude of the majority of the economics profession before the eruption of the crisis can be described by the opening words of Robert Lucas’s presidential address to the annual meeting of the American Economic Association in 2003:

Macroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: its central problem of depression prevention has been solved, for all practical purposes. (Lucas 2003, p. 1)

The adoption of a theoretical model which maintained that market economies are structurally stable implied, of course, that the economists were not able to predict the onset of a catastrophic crisis. This is why public opinion fiercely criticized the economics profession. Nevertheless, the economists’ responsibilities go beyond their inability to foresee the crisis since, by elaborating a theoretical model which ruled out the occurrence of this event, the economics profession enabled the paralysis of the financial system and the subsequent deep recession. In fact, this theory led the vast majority of economists to neglect the signs of instability that emerged during the Great Moderation and provided the theoretical endorsement for the behaviours and choices that created the
conditions for the outbreak of the crisis (see, for example, Madrik 2014; Wolf 2014).

The first lesson to be learnt from this crisis is that economic theories are not abstract constructions, extraneous to the real world, but they produce significant consequences for the welfare of a society. After the outbreak of the crisis, even some of the economists who were more closely linked to the mainstream theory acknowledged the limits of the orthodox theory. Alan Greenspan, who chaired the Federal Reserve from June 1987 to January 2006, is one of the most important examples. Before the crisis, Greenspan had always shown a deep trust in the markets’ self-regulating abilities. Nevertheless, during a hearing before the House Committee on Oversight and Government Reform of the United States Congress, Greenspan admitted that the financial crisis had led him to question the validity of the mainstream theoretical model:

I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms. … The problem here is something which looked to be a very solid edifice, and, indeed, a critical pillar to market competition and free markets, did break down. And I think that, as I said, shocked me. I still do not fully understand why it happened and, obviously, to the extent that I figure out what happened and why, I will change my views. … I found a flaw in the model that I perceived as the critical functioning structure that defines how the world works, so to speak. … That’s precisely the reason I was shocked. Because I had been going for forty years, or more, with very considerable evidence that it was working exceptionally well. (Quoted in Cassidy 2009, pp. 5–6)

Greenspan’s words highlight the second lesson that economists should learn from the crisis, namely the necessity of developing a new theoretical approach that can provide a sound explanation of the phenomenon of economic crises and of the role of finance in modern market economies.

1. THE CRISIS AND THE NEED FOR A NEW THEORETICAL MODEL

Looking at the last hundred years, one can identify at least two historical moments in which the economics profession was driven by significant and unexpected phenomena to abandon the then generally accepted theory and to replace it with a different paradigm. The first dates back to the 1930s, when the Great Depression undermined confidence in the
neoclassical theory, according to which economic crises were nothing more than accidental phenomena, bound to die out spontaneously thanks to the normal functioning of the markets. In 1936, the publication of John Maynard Keynes’s *General Theory of Employment, Interest and Money* brought to the fore a revolutionary theoretical approach whereby economic crises were structural phenomena. Keynes stated that, if left to themselves, market economies typically produce significant fluctuations of output and employment. During the 1950s and 1960s, the neoclassical theory was replaced by a new orthodoxy, consisting in a specific interpretation of Keynes’s thought that became known as the Neoclassical Synthesis.

The second turning point occurred in the 1970s, when the Western economies were hit by a new global crisis characterized by a combination of low growth and high inflation, known as ‘stagflation’. This new phenomenon led economists to question the assumption that Keynesian policies can ensure high output growth rates coupled with low, or at least stable, inflation rates. In those years, Milton Friedman developed a strong criticism of the then dominant theoretical approach, emphasizing how Keynesian policies were substantially ineffective in situations in which workers were not affected by the ‘monetary illusion’.

Friedman’s criticism did not generate a theoretical revolution, but rather a counterrevolution that drove the economics profession to re-accept the conclusions of the pre-Keynesian neoclassical theory. The return to the old theory was based on an apparently sound argument: if the levels of output and employment were not influenced by Keynesian policies, then they evidently depended only on the working of unfettered markets. Accordingly, the only effective policy consisted in eliminating every barrier that prevented markets from functioning efficiently. The new version of the neoclassical theory became known first as ‘monetarism’ and then as ‘new classical macroeconomics’. This modern reformulation of neoclassical principles formed the theoretical foundation of the neoliberal ideology that led industrialized countries, beginning with the administrations of Ronald Reagan in the United States and Margaret Thatcher in the UK, to adopt a series of policies aimed at liberalizing capital movements, deregulating markets and privatizing public enterprises.

Because of recent events, economists are now in a situation similar to that experienced during the 1930s and the 1970s. The question economists now face is whether this crisis has uncovered substantial limits of the currently dominant theory. The answers to this basic question are splitting the economics profession. ‘Conservative economists’ believe that recent events should not question the foundations of the theoretical
model developed in the last few decades, while ‘critical economists’ maintain that this crisis has emphasized fundamental flaws in the mainstream theory and that it is time for a significant change in the dominant paradigm. With different arguments and varying intensity, the latter thesis is supported by Nobel laureates such as Akerlof, Krugman, Phelps, Shiller, Solow and Stiglitz, and by other prominent economists.

Nevertheless, almost ten years after the outbreak of the crisis, most of the economics profession continues to accept the mainstream theoretical model. There is a deep contradiction between a theory that denies even the possibility of a disastrous crisis and the factual reality. This contradiction becomes apparent if one looks at the explanations of the crisis elaborated by mainstream economists. In fact, it is not easy to identify the origins of the crisis by using a theoretical model which states that market economies cannot be subject to significant turbulences. In the first part of this book, I will show that, in order to explain the causes of the financial crisis and the subsequent Great Recession, mainstream economists are forced to use concepts and relationships that are inconsistent with the dominant theory. The deep contradiction between the analysis of the origins of the crisis made by conservative economists and the orthodox theory, highlights the inability of most of the economics profession to explain the functioning of modern economic systems and the need to develop an alternative theoretical model.

2. THE LIMITS OF THE MAINSTREAM THEORY

To overcome the contradiction between theory and reality, mainstream economists consider the current crisis as an accidental event, a phenomenon that is external to the normal functioning of the economic system. This argument is developed by interpreting the crisis in two ways: 1) as the result of an unpredictable shock, a ‘black swan’ (see Taleb 2007); and 2) as a consequence of the mistakes made by the Federal Reserve and the US banking system. Depending on the degree of responsibility assigned to these two culprits, three different explanations of the crisis can be identified.

The first explanation blames the US monetary authorities for adopting an overly expansive policy after the collapse of the stock market in 2000 and the terrorist attacks on the Twin Towers on 11 September 2001. According to this explanation, the Federal Reserve favoured the development of the real estate bubble that burst in the summer of 2007. The second explanation assigns the main responsibility for the crisis to the...
US banking system. The most rigorous version of this interpretation was elaborated by Raghuram Rajan (2006, 2010), who claims that, under the pressure of a system of distorted incentives, the US banking system created an excessive amount of risk that, in the end, triggered the crisis. Finally, the third explanation is provided by Ben Bernanke, the successor to Alan Greenspan as Chairman of the Federal Reserve from 2006 to 2013. Bernanke (2005, 2007b, 2010a) states that the huge amount of liquidity that fuelled the housing bubble was not the by-product of the Fed’s expansive monetary policy, but it was rather generated by an excessive accumulation of savings in the oil-producing countries and in the emerging Asian countries, particularly China.

All these explanations regard the crisis as an exogenous phenomenon that is unrelated to the normal dynamics of a market economy (see Galbraith 2014). The position of mainstream economists can be compared to the attitude of those that, after a plane crash, immediately rule out the possibility that it may have been caused by a structural problem, and that, consequently, attribute the responsibility to the pilot. Nevertheless, this parallelism is unconvincing, as the ‘drivers’ blamed for the eruption of the crisis were considered to be the best in the world. In fact, until the outbreak of the crisis, Alan Greenspan was acclaimed as the best Chairman since the institution of the Federal Reserve. In addition, the US financial system was unanimously recognized as the most advanced in the world, a benchmark for the financial sector of every other country. Thus, it is difficult to understand how the best pilots, who were flying the most sophisticated aircraft in the world, could have caused a catastrophe.

Furthermore, the explanations based on the idea that the current crisis is the result of mistakes made by specific economic actors must be questioned because they are inconsistent with the mainstream theory. In the economic system described by mainstream economists, neither the monetary authorities nor the banking system is supposed to make mistakes resulting in a catastrophic crisis. The monetary authorities have no reason to adopt policies that contrast with the goal to achieve stability in the general price level, while the banking system is not expected to suddenly lose its ability to channel resources collected from savers towards the most productive investments.

The interpretations of the crisis elaborated by mainstream economists are based on concepts and relationships that are completely at odds with the fundamental propositions of the orthodox economic theory. In other words, they refer to an economic reality that is very different from the world described by the mainstream theory. The interpretation that blames the Federal Reserve is in contrast with the neoclassical theory of money, which coincides with the quantity theory of money. According to this
theory, the monetary authorities control the amount of money but not the
supply of credit, which instead depends on saving decisions. Neverthe-
less, when mainstream economists explain the origins of the crisis, they
assume the existence of a relationship between the expansionary mon-
etary policy implemented by the Federal Reserve, the increase in the
supply of credit by the banks and the housing bubble that developed in
the United States.

The explanation that identifies the roots of the crisis in the behaviour
of the US banking system is also in sharp contrast with the traditional
theory of finance. In Rajan’s (2006, p. 52) view, the US banking system
generated a real ‘iceberg of risk’. However, in the orthodox theory of
finance, the banks are mere intermediaries that transfer resources from
savers to businesses. Banks thus do not create any risk; on the contrary,
they are supposed to reduce the risks associated with the transfer of saved
resources, since, compared with savers, they develop a special expertise
in evaluating the borrowers’ characteristics.

Finally, even Bernanke’s interpretation of the origins of the crisis is not
consistent with the mainstream theory. Bernanke argues that the accumu-
lation of a huge amount of savings in the emerging Asian countries
accounts for the development of both the dot.com bubble that burst in
2000 and the housing bubble that exploded in the summer of 2007. But,
again, the existence of a relationship between an increased propensity to
save in the emerging countries and the development of speculative
bubbles in the United States is inconsistent with the standard theory of
finance. According to this theory, an expansion of the flow of savings is
highly positive, as it causes an increase in the flow of investments.
Furthermore, the identification of a link between saving decisions and the
development of a bubble presupposes the introduction of the concepts of
’speculation’ and of ‘speculative bubbles’ in the orthodox theoretical
model. However, as the first part of this book will explain, these concepts
are completely neglected in the traditional macroeconomic theory.

Hence, all the interpretations of the origins of the crisis elaborated by
mainstream economists are in sharp contrast with the fundamental pillars
of the orthodox theory of finance. In the neoclassical world, the monetary
authorities do not control the supply of credit, which instead depends on
the economic agents’ saving decisions, and the banks do not create risks,
as they act as intermediaries allocating saved resources to the most
profitable uses. In such an economy, a crisis cannot occur, since the
monetary authorities are responsible for fixing the rate of growth of the
money stock in accordance with the targeted inflation rate. Moreover,
the assumption that the whole banking system suddenly loses its ability to transfer saved resources to the most competitive enterprises is quite unrealistic.

Paradoxically, the Great Recession can only be explained by considering an economic system featuring the characteristics highlighted by the conservative economists’ interpretations of the crisis, even though such a system greatly differs from the world described by the neoclassical theory of finance, as: 1) the supply of credit does not depend on saving decisions, but on the decisions taken by the monetary authorities and the banking system; 2) the banks can create risks; and 3) the phenomenon of speculation is highly relevant. Therefore, the conclusion drawn in the first part of this book is that the current crisis should lead the economics profession to develop an alternative theoretical approach capable of explaining the functioning of an economic system that features these three characteristics.

3. AN ALTERNATIVE THEORETICAL APPROACH

The development of an alternative theory is discussed in the second part of this book, which will focus on the ideas of a group of ‘heretical’ economists such as Marx, Keynes, Schumpeter, Kalecki, Kaldor and Minsky. In order to develop what Keynes called a *Monetary Theory of Production*, a special emphasis will be placed on the need to revive the elements of Keynes’s work that were neglected by the advocates of the Neoclassical Synthesis. We will show that Schumpeter’s analysis of the role of credit is essential to explain Keynes’s insights concerning: 1) the importance of uncertainty; 2) the principle of effective demand; 3) the importance of the process of wealth accumulation and of the phenomenon of speculation; and 4) the structural instability of modern market economies.

The third part of this book emphasizes two specific aspects of the endogenous nature of the current crisis. First, it shows how the same factors described by Schumpeter as characterizing the development of capitalist economies also explain economic systems’ inherent instability and their tendency to be exposed to deep crises. Hyman Minsky is the contemporary economist who best analysed the endogenous nature of the crisis. Minsky’s analysis highlights the limits of Bernanke’s view whereby theoretical models reflect the characteristics of the historical period observed by scientists. As a result, in Bernanke’s opinion, during an extended period of stability, the economists’ choice to develop models ruling out the occurrence of economic crises was justified. Nevertheless,
Bernanke’s approach overlooks the fact that, as Minsky underlined, it is precisely during periods of ‘fair-weather conditions’ that the factors that will cause the next crisis are at work.6

Secondly, the last part of this book will point out that the endogenous nature of the current crisis does not imply that, like earthquakes, it is necessarily an unavoidable event. Recently, the equivalence between economic crises and earthquakes has been frequently used by economists to defend the category against the accusation of their alleged inability to anticipate what was going on: economic crises, like earthquakes, are not predictable. This metaphor is not at all convincing because, while earthquakes are natural events, economic crises are the outcome of social dynamics. This difference has major consequences. In fact, earthquakes are not only unpredictable but also inevitable. This means that the probability of their occurrence is completely independent of the theories developed by seismologists to explain their origin. This is not true for economic crises, as the likelihood of their occurrence is not at all independent of the way economists theorize the functioning of a market economy.

Chapter 8 will discuss how the elaboration of a theory whereby an economic crisis cannot occur increased the probability of the outbreak of the Great Recession in two ways. First, economists were led to completely underestimate the signs of instability that emerged during the period of the so-called Great Moderation. Second, the popularity of the mainstream theoretical approach fostered behaviours and choices that paved the way to the crisis.

The analysis of the nature of the current crisis is not only a matter of academic interest, but also has important consequences with regard to the definition of the policies needed to overcome it. The mainstream economists’ conclusion that the crisis was determined by exogenous factors led them to advocate the implementation of the following policies: 1) a drastic reduction of public deficits and debts; 2) ‘structural’ reforms aimed at removing the constraints that inhibit the working of the price mechanism with the purpose of ensuring a smooth functioning of the markets, most especially the labour market; and 3) a remarkable increase in the banks’ regulatory own capital, which would enable them to better counter the effects of a sudden reduction in their asset value in the future.

The third part of this book shows that the fundamental limitation of these policies consists in the fact that they are designed on the basis of the economic system described by the mainstream macroeconomic theory, in which, as was anticipated above, the contemporary crisis could not have happened. Paradoxically, these policies originate from the same theoretical model that contributed to cause the Great Recession. This


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ccontradiction can only be eliminated by developing policies that are consistent with the structural nature of the contemporary crisis. Therefore, the last chapter of this book outlines the characteristics of a set of policies aimed at achieving the two-fold objective of creating the conditions for a ‘good life’ and reducing the structural instability of contemporary economies.

4. STRUCTURE OF THE BOOK

This book is divided into three parts and nine chapters. The first chapter offers a brief description of the most important aspects of the financial crisis that erupted in 2007 and of the subsequent Great Recession. The second chapter provides a more detailed explanation of the origins of the crisis elaborated by mainstream economists, while the third emphasizes the contrast between these interpretations and the fundamental pillars of the orthodox theory of finance.

The fourth chapter opens the second part of the book, which accurately describes a theoretical framework that, drawing on the thought of Keynes and of other heretical economists, may offer a sound explanation of the structural nature of the current crisis. The fifth chapter shows how Keynes’s and Schumpeter’s theories clarify the relationship between monetary policy and credit supply which characterizes the first explanation of the causes of the crisis elaborated by mainstream economists. It also argues that Schumpeter’s theory on the role of credit explains the importance of the Keynesian concept of uncertainty and the relationship between finance and risk that characterizes the second interpretation of the crisis formulated by conservative economists. The sixth chapter discusses the relationship between saving decisions and wealth accumulation, and the phenomenon of speculation. Keynes’s analysis of speculation is key to defining the origins of the subprime mortgage crisis. Based on the evidence presented in the previous chapters, the seventh chapter explains the structural nature of the economic crises that characterize modern capitalist economies.

The third part of this book begins with the eighth chapter, which offers a description of the endogenous nature of the Great Recession, and an illustration of how the dissemination of neoliberal ideology in the 1970s helped to create the conditions for the development of the current crisis. The ninth and last chapter points out how the criticism of the traditional macroeconomic theory has important consequences in the definition of the policies needed to overcome the crisis.
NOTES

1. Ben Bernanke, for example, has claimed that: ‘the recent financial crisis was more a failure of economic engineering and economic management than of what I have called economic science. … I don’t think the crisis by any means requires us to rethink economics and finance from the ground up’ (Bernanke 2010b, p. 2). See also Taylor (2009), Chari (2010) and Cochrane (2011).

2. See Akerlof and Shiller (2009); Buiter (2009); Colander (2011); Colander et al. (2009); De Grauwe (2010); Fitoussi (2013); Galbraith (2014); Goodhart (2010); Harcourt and Kriesler (2011); Hodgson (2009); Kirman (2011); Krugman (2009, 2012); Laidler (2010); Lawson (2009); Leijonhufvud (2009, 2011); Palley (2012); Pasinetti (2011); Phelps (2009); Roncaglia (2010); Roubini and Mihm (2010); Sachs (2009, 2011); Skidelski (2009, 2011); Solow (2010); Spaventa (2009); Stiglitz (2011); Taylor (2010); Turner (2012, 2016).

3. See Palma (2009); Kates (2010); Krippner (2011); Leclaire et al. (2011); Bellamy Foster and McChesney (2012); Lin (2013); Gamble (2014); Cynamon et al. (2013); Mirowsky (2013); Bellofiore and Vertova (2014); Bougrine and Rochon (2015).

4. See, for example, Rajan and Zingales (2003a, 2003b, 2003c) and Blinder and Reis (2005).

5. ‘Economic models are useful only in the context for which they are designed. Most of the time, including during recessions, serious financial instability is not an issue. The standard models were designed for these non-crisis periods, and they have proven quite useful in that context. Notably, they were part of the intellectual framework that helped deliver low inflation and macroeconomic stability in most industrial countries during the two decades that began in the mid-1980s’ (Bernanke 2010b, p. 6). See also Caballero (2010) and Ascari (2011).

6. As noted by Borio (2011, p. 22): ‘The processes that underlie financial instability have macroeconomic roots. That episodes of systemic financial distress are rare does not imply that we can live with two types of model, a fair-weather and stormy-weather one. That might be acceptable if the stormy weather was the result of outsize exogenous shocks. It is not, however, if, as argued here, the stormy weather is generated during fair-weather conditions; if, in other words, the boom does not just precede, but causes the bust.’