Introduction

Steven Kates

The financial crisis that is spreading out from countries with the most ‘advanced’ financial systems to the rest of the world has not been well served by economic theory.

Jan Toporowski (this volume, Chapter 13)

This is a book about the global financial crisis and the economic theories that have been used first to understand its causes and thereafter to contain the damage it has brought. But it is more than that. It is a book about the inadequacies of the economic theories that are being used to deal with the present global economic meltdown. The one and only unifying feature of the articles collected together within these covers is that each and every one of the authors disagrees with the standard mainstream neoclassical macroeconomic models that have been applied in attempting to comprehend what has gone on and then, more importantly, have been used to devise policies to bring this recession to an end.

This book is thus about the usefulness or otherwise of existing textbook economics to deal with the present crisis. But while all disagree with the standard mainstream model, it should also be understood that the various authors in this collection do not necessarily agree with each other. There is, in fact, a very wide disparity of views. The perspectives provided 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, all the contributors to this volume have had longstanding beliefs, even before our present problems began, 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, that are being employed to provide alternative explanations of the economic events of the past two years and to discuss alternative remedies that might now be applied.

Theory in economics is indispensable. Little about the operation of economies is understandable without being viewed through the lens of
Macroeconomic theory and its failings

an economic theory to make sense of what is actually taking place. Until theory brings them together, most things that happen within an economy are no more than a set of unrelated economic events. What the contributors to this collection have done is to apply their own theoretical understanding to the facts of the world to comprehend what has gone on and to think through what policies now need to be adopted.

Not only is there an economic crisis, there is also a major crisis potentially brewing in economic theory itself. The adequacies of existing theories are being tested as seldom before. Whether textbook theory as it is now taught will remain unaffected by the events of the world which that theory is intended to depict and explain is far from certain. Concerns aplenty will build should there not be a reasonably rapid return to strong rates of non-inflationary growth accompanied by low rates of unemployment.

First, there are the concerns that surround the management of our economies in the lead-up to the financial crisis. Even with the wisdom of hindsight, it is far from clear what went wrong. There is no consensus on what caused these problems or why they spread so rapidly.

There is certainly no consensus on what ought to have been done instead to prevent these problems from building. At its most basic, there is not even a consensus on whether the problems were due to inherent flaws in the economic system or were instead due to the policies adopted by governments.

But these are questions about the past – only a prelude to thinking about what to do next. The more important questions are about the future. The questions that are mounting deal with the actions that ought now to be taken to fix our present problems, whatever may have been their origins. Beyond that, there may now be further questions that relate to repairing any additional damage caused by the first sets of policies used to deal with the downturn. Lastly, there are the questions for the longer term, surrounding what should be done to forestall a repetition of the present downturn, assuming anything can be done at all.

There are two central issues that in many ways overlap. There are, first, questions that relate to whether governments should take actions to hasten growth by adding to the level of aggregate demand. A second set of questions relates to the extent to which greater regulation of markets, particularly financial markets, is needed. Both sets of questions come back to the basic question of economic theory: whether markets should be left to sort things out or whether more direct government involvement can push them in particular directions to achieve better results sooner and to ensure that the actions of participants in particular markets do not undermine the common good.
THE ECONOMIC STIMULUS

The first set of questions relates to the economic stimulus that governments across the world have been injecting into their economies to encourage a return to faster rates of growth and lower unemployment. There is certainly no agreement within the economics community over whether the increased levels of public spending and the massive increases in deficits have been the proper response to our problems; nor is there agreement on the longer-term implications. This is despite the fact that at the core of mainstream analysis is a model of the economy that at some level endorses every step that has so far been taken. It is a model that instructs governments to increase expenditure without guidance on what that expenditure ought to be on. Anything, so far as these models are concerned, will apparently do. These models support deficit financing and increased public debt without indicating what that spending should be on, or how high debt may go before it needs to be reined in.

It is a model that governments have therefore embraced during the current downturn without obvious concern for the implications about the long-term potential for harm. Whatever short-term benefits there may be, and even the existence of such short-term benefits remains debatable, the question is whether future costs, involving, for example, the repayment of debt or additional inflationary pressures, will be so high that they far exceed any short-period good that may have been done.

THE STANDARD MODEL

Some sense of the structure of the modern macroeconomic model and the kinds of guidance it gives are useful in understanding the actions that governments have taken. The focus here is 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 among 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.

It should however 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 neoclassical synthesis, the melding of Keynesian ideas with the ideas of Keynes’s predecessors. As taught today, within this neoclassical 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 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 have in the first instance caused the economy to slow and unemployment to rise, for example through the higher cost of oil, it is nevertheless in a stimulus to aggregate demand that the solution is to be found.

The basic framework for discussing macroeconomic theory and policy today is generally 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 through an increase in the underlying productivity of the economy.

Positive changes in even short-run 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 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. Almost all policies that have been adopted during the early stages of the present economic downturn have therefore involved taking steps to encourage an increase in aggregate demand.
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 on raising expenditures by consumers, investors, governments and international buyers of domestically produced goods and services. The more that is spent, the faster the economy is 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 USA, 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 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 is 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. Moreover, the further one studies economics, the more qualifications to these basic statements one finds. 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 unambiguous: 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 advisers. If these policies fail, 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

As important as the issue of the fiscal stimulus has been, so too is the role of regulation of markets, and particularly financial markets. Although
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various actions have already been 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 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 deep within economic theory’s DNA 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 suboptimal outcome. The economy is worse for being subject to too many regulations and regulations of the wrong kind.

We should also consider the role of self-interest. Within economics, it is generally assumed that individuals acting on their own behalf and risking their own money will be prudent. Government intervention is by a nine-to-five bureaucracy whose involvement will in most instances do 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 supplies its own discipline.

It is now a central question whether the current crisis in the USA 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 this question alone.

While one may recognize the harm that has been done by the global downturn, the question 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 limit growth only 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 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 neoclassical 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 make whatever downturn that does occur shallower and shorter?

Or is the attempt to add new regulations to those that already exist futile? Would such regulations cause only 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 that will be discussed for years on end, just as similar questions were discussed following the Great Depression. They are the kinds of question that are a perennial part of the discourse among economists.
THE INVITATIONS TO PARTICIPATE

All contributions to the present volume were specially written for inclusion within this collection. Each contributor 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 neoclassical model. The message line read: ‘Seeking your Contribution to an Elgar Publication on the World Financial Crisis’. This was the relevant part of the letters that were sent:

I am writing to ask if you would be willing to participate in a publishing venture that I believe could have enduring interest and value.

I am editing a book to be published by Edward Elgar with the provisional title: *Alternative Perspectives on the World Financial Crisis*. The aim of this book is to gather together in one place the views of members of non-neoclassical schools of economic thought dealing with the financial and economic upheavals that are presently taking place across the world. The definition of the neoclassical model being used as the basis for this analysis is outlined below.

What is being sought is an article of around 5000 words divided into three separate sections, not necessarily of equal length, which would cover each of the following issues:

1) How does your understanding of the operation of the economy differ from the standard neoclassical model?
2) From your understanding of how economies work, what have been the fundamental causes of the global financial crisis and the sharp downturn in economic activity and employment?
3) From your understanding of how economies work, what policies should governments now follow in returning the world economy to prosperity?

These are amongst the major economic questions of our time. Governments will be taking action based on some variant of the standard neoclassical model which, for the purposes of this analysis, encompasses the following principles:

- the most appropriate framework for macroeconomic intervention is some version of the aggregate supply–aggregate demand model
- based on the AS–AD model, higher levels of government spending, involving large and increasing budget deficits, may be required to hasten recovery if not actually allow recovery to take place at all
- although the market mechanism and individual decision making are the appropriate means to allocate resources in the vast majority of cases, greater levels of government regulation of the financial sector, as well as increased regulation of other sectors of the economy, may nevertheless be necessary to maintain economic stability in the future.

This is obviously only a first approximation, but it is based on the models found in the majority of introductory texts on economics in use today. If you believe there are any other aspects of the standard model that are relevant, please include these in your own analysis.
The article being sought will hopefully not 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 understanding our present economic problems.

The article would also ideally not include statistics or mathematical analysis. The intention is to make each article 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 troubles.

This book is intended to be of enduring interest long beyond the present. It is intended to be a reflection of the range of economic understanding at the start of 2009.

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

There is a longer-term perspective that is also an important part of the direct intention of putting these contributions together, but 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 in the first half of 1930. It is early days in what may be a recession of relatively short duration or in what may end up being the start of a period of prolonged instability with many different bends in the road before we again reach satisfactory levels of output growth and employment.

Even the term we now use to describe our economic conditions, calling it as we do the ‘global financial crisis’, may not last the distance. A crisis is a momentary event of great intensity. A long-drawn-out recession would eventually lead to a new name being given to what many at this moment believe will be no more than a brief downturn, followed by a return to robust economic health. Only time will tell whether this is the same bravado that accompanied the soldiers of the First World War to the battlefields of Europe, who believed they would be home by Christmas. In 1930, the Great Depression was not called by that name either.
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.

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 among non-economists that a significant part of our economic debates takes 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 – are 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 become 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 here are not from a single direction but 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
- Islamic
- Marxist
- Minskyite
- Monetarist
- Post-Keynesian.

No attempt is made to define any of these in this introduction. That is up to each individual author. 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 subdivisions will have no difficulty in recognizing the different points of view.

And although one might describe some of the members of this list as belonging to ‘schools’ of economic thought, that would be too confining in most cases. As the chapters make clear, there are overlapping points of view and a number of key concepts shared across a number of the perspectives are presented. Each author has been allowed to describe his own approach to economics in his own way. The chapters are 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 an historical tradition that goes back 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, deeper tradition.

Even so, economists have a common language. Because they have been 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 way 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 and cannot do successfully. There are differences over the consequences of different policies and over how policies will matter in the short run in comparison with the long run. There are differences in the categories by 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 essays accessible so that the different points of view can be understood by the interested non-economist. There would be no point to this volume 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 among economists on these major questions.

There is, it should be understood, not just one school of economic thought. There isn’t only one answer given by economists to the complex and perplexing issues that surround us. There is a wide variety of possible policy responses that should 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 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 events would seldom normally consider. But given the complexity of the task before us, and the distinct possibility that the policies that have so far been adopted will fail to bring about the desired result, these chapters have been brought together to ensure that alternative perspectives are examined as future decisions are made.

REFERENCES