Book review

Thomas Palley, *From Financial Crisis to Stagnation: The Destruction of Shared Prosperity and the Role of Economics* (Cambridge University Press, New York 2012) 256 pp.

Brian K. MacLean

Department of Economics, Laurentian University, Canada

This book brings a distinctive ‘structural Keynesian’ perspective to bear on the financial crisis of 2008 and the Great Recession, especially in the United States. It claims that overcoming stagnation will require more than just expansionary macroeconomic policies because the US economy is suffering from an exhausted economic model, not just a shortfall of aggregate demand. With its potential as a vehicle to bring together different schools of thought, this book surely warrants a symposium issue in an economics or political economy journal.

Since the crisis, small but growing numbers of economists have taken seriously a central claim of this book: that the growth of income inequality since the 1980s is a key source of macroeconomic instability. For example, Joseph Stiglitz has recently written that:

It is perhaps no accident that the crisis, like the Great Depression, was preceded by large increases in inequality: when money is concentrated at the top of society, the average American’s spending is limited, or at least that would be the case in the absence of some artificial prop. ... Moving money from the bottom to the top lowers consumption because higher-income individuals consume a smaller proportion of their income than do lower-income individuals. ... The result: until and unless something else happens, such as an increase in investment or exports, total demand in the economy will be less than what the economy is capable of supplying – and that means that there will be unemployment. In the 1990s that ‘something else’ was the tech bubble; in the first decade of the [twenty-first] century, it was the housing bubble.¹

But while Stiglitz and others have been prompted by the crisis to argue that inequality is linked to instability, *From Financial Crisis to Stagnation* author Thomas Palley has been advocating a well-developed version of this argument at least since the publication of *Plenty of Nothing*, his 1998 book.²

Palley’s 2012 book *From Financial Crisis to Stagnation* analyses developments since 1998, of course, such as the rise and fall of the housing bubble, but the structural Keynesian perspective underlying the 1998 and 2012 books is essentially the same. Palley believes that while the unfolding of macroeconomic events in recent years has called into question much of mainstream macroeconomic theory it has provided further evidence in favour of structural Keynesianism.

1. Joseph Stiglitz, *The Price of Inequality* (W.W. Norton, New York 2012), pp. 84–85.

2. Thomas Palley, *Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism* (Princeton University Press, Princeton, NJ 1998).

Palley distinguishes structural Keynesianism from textbook (or traditional) Keynesianism. The two forms of Keynesianism have in common the basic propositions that the level of economic activity depends on the level of aggregate demand, and from time to time a capitalist economy will experience a shortfall of aggregate demand that will not be overcome by market forces but requires expansionary macroeconomic policy.

Structural Keynesianism adds to textbook Keynesianism a concern with the aggregate demand-generating process, a process that depends on income distribution. As Palley (p. 16), puts it: 'Taking its lead from the great Polish economist Michal Kalecki, Structural Keynesianism adds concern with income distribution that affects the level of demand'. But income distribution depends on institutions and arrangements such as those affecting workers' bargaining power and those governing the financial sector. The importance of these institutions and arrangements accounts for the 'structural' in the term 'structural Keynesianism'. When the structure of a capitalist economy changes, as the US economy has changed through the implementation of neoliberal policies since the late 1970s, it can develop a systemic aggregate demand shortfall that cannot be fully remedied with expansionary macroeconomic policies but in addition calls for new institutions and arrangements.

The twelve chapters of *From Financial Crisis to Stagnation* are divided between two parts. Part I, covering chapters 1 to 7, is entitled 'Origins of the Great Recession'.

The brief first chapter – 'Goodbye financial crash, hello stagnation' – sets out the core thesis of the book (p. 4): the 'roots of the financial crisis of 2008 and the Great Recession can be traced to a faulty US macroeconomic paradigm that has its roots in neoliberalism, which has been the dominant intellectual paradigm'.

An economic structure with an adequate income and aggregate demand-generating process, as experienced in the generation after World War II, produces shared economic prosperity. Beginning in the late 1970s, however, the old post-World War II growth model based on middle-class incomes rising with productivity growth began to be replaced by a market fundamentalist or neoliberal model.

Under the neoliberal model, wage growth has not kept up with productivity growth, and the model of engagement of the US economy with the global economy has produced persistent US trade deficits. The result has been the hollowing-out of the income and demand-generating process, which accounts for the words *Destruction of Shared Prosperity* in the subtitle of the book.

This hollowing-out has been obscured by financial developments permitting an accumulation of debt to finance spending growth adequate to avoid stagnation. In the last decade, for example, financial deregulation and financial excess contributed to the housing bubble, which prolonged expansion of the US economy. But the US economy is now debt-saturated and has lost the means to generate self-sustaining private sector growth.

According to Palley, the time is ripe to rebuild the income and demand-generating process, and restore shared prosperity with a new economic paradigm informed by structural Keynesianism. But there is no guarantee the political system will generate a left-wing response as it did during the 1930s with the New Deal. A hard right response is also possible.

The second chapter is 'The tragedy of bad ideas', and the third is 'Overview: three perspectives on the crisis'. Together with chapter 11, 'Economists and the crisis – the tragedy of bad ideas revisited', these provide most of the material related to the *Role of Economics* in the subtitle of the book.

Palley argues that mainstream or orthodox economics can be usefully divided into two camps: a hardcore neoclassical camp emphasizing government failure and most

closely associated with the Department of Economics at the University of Chicago, and a softcore neoclassical camp that gives greater recognition to market failure and is most closely associated with the Department of Economics at the Massachusetts Institute of Technology (MIT).

Palley stresses that differences between hardcore and softcore neoclassical economists are of degree rather than kind, as both camps share an analytical framework that is incompatible with structural Keynesianism. Both camps have provided intellectual support for the neoliberal model, both exhibited blindness of macroeconomic reality in the run-up to the financial crisis, and both support a neoclassical monopoly in academic economics and economic policy advice. They so limit that range of expert economic opinion in the United States that the country risks falling into a closed-society trap, unable to come up with solutions to changed economic circumstances and destined to economic stagnation.

The longest chapter in the book is chapter 4, 'America's exhausted paradigm: macroeconomic causes of the crisis', which contains 16 of the book's 26 tables. Palley argues that in explaining the crisis it is a mistake to focus only on microeconomic causes such as regulatory behaviour and flawed incentives in financial markets. A satisfactory explanation cannot ignore the deeper macroeconomic causes in terms of the flawed US economic growth model and its forms of engagement with the global economy.

Palley describes the current US economic model with the metaphor of a neoliberal policy box (Figure 4.2) with four sides that have pressured workers and severed the wage-productivity growth link that characterized the post-World War II growth model. The four sides are less than full employment, small government, labour market flexibility, and globalization. After presenting a range of evidence on how wage growth has lagged and how stagnation was postponed, Palley (p. 43) summarizes the evidence as follows:

In sum, the new growth paradigm put in place after 1980 involved squeezing worker incomes, squeezing household savings rates, raising debt levels, persistent asset price inflation in excess of CPI inflation, and reliance on ever lower nominal interest rates. This logic made it economically unsustainable.

The chapter concludes with a table ranking the US expansion of 2001–2007 in comparison with other US expansions since World War II. By almost all measures that 2001–2007 expansion was the weakest since World War II, which is presented as evidence of the structural weakness of the US neoliberal model.

Chapter 5 provides a succinct discussion of the role of finance in the crisis. It concludes with a ten-point plan to increase financial stability in the United States, but emphasizes that implementation of the plan would not be sufficient to overcome economic stagnation.

Chapters 6 and 7 deal with various 'myths and fallacies' about the US economy and about the international economy. For example, the section in chapter 6 on 'The flawed monetary policy hypothesis' (pp. 90–93) provides a solid demonstration of the superficial nature of the claim by Stanford University economist John Taylor that the Federal Reserve caused the housing bubble by cutting interest rates too low and keeping them low for too long.

Part II of the book is titled 'Avoiding the great stagnation' and it begins with chapter 8, 'The coming great stagnation', which provides details on why Palley is concerned about the possibility that the US economy could face a lengthy period of stagnation. It is noteworthy that in an April 2012 interview about the book Palley stated that it was written and his prediction of stagnation was made in 2010 when many commentators were

mentioning 'green shoots' and a 'V-shaped recovery' so the prediction of stagnation 'has already been proven right'.³

In chapter 9, 'Avoiding the great stagnation: rethinking the paradigm', Palley presents an alternative to the neoliberal US economic model. Extending the metaphor of the neoliberal policy box of chapter 4 that pressures workers from all sides, he argues that workers must be taken out of the box and corporations and financial markets must be put into a structural Keynesian policy box. The four sides of the structural Keynesian policy box are full employment, balanced government, solidarity labour markets, and managed globalization. He argues (p. 152) that this policy box 'constitutes a system in which the parts are mutually reinforcing, which means policies must be implemented together to be fully effective'.

Chapter 10, 'The challenge of corporate globalization', presents the elements of an alternative form of globalization. It discusses reforms such as core labour standards, a global minimum wage system, managed exchange rates, capital controls, and new trade rules.

The book concludes with a chapter on 'Markets and the common good: time for a great rebalancing'. Having challenged the economic theory and evidence used to support neoliberalism, Palley wraps up with a critical evaluation of the political philosophy behind neoliberalism. He particularly emphasizes insights from Adam Smith's *Theory of Moral Sentiments* about how a properly functioning capitalist society requires a sense of justice among its citizens that will induce them to behave according to a code of ethics. Neoliberalism, Palley argues, undermines ethics and thereby produces major efficiency losses.

Given the huge subject it tackles, this is a slim book at 256 pages (including front matter, references and index). Many issues it touches upon warrant additional discussion. Most significantly, the structural Keynesian perspective is not applied to explaining developments in capitalist economies other than the United States. The only country mentioned in the index of the book is China, which is mentioned regarding the hollowing-out of US manufacturing. Other countries are mentioned, but only in passing or to explain the role of the United States in the global economy (see, for example, pp. 164–165). Yet surely the persuasiveness of any broad economic or political economy theory can only be strengthened through supporting case studies of different economies or cross-national statistical analysis.

Another important issue is the relationship between structural Keynesianism and other forms of heterodox economics on the one hand, and what Palley (p. 199) describes as 'soft-core MIT economists like Paul Krugman and Joseph Stiglitz' who 'share values with heterodox economists...'. Palley shows relatively little appreciation of the values such economists share with many heterodox economists, and expresses great concern that attention to such economists creates the false impression of pluralism within the mainstream of economics and thereby contributes to neoclassical domination of the discipline. Although Palley (pp. 204–205) offers a useful discussion of 'sociological obstructions' to overcoming neoclassical domination of academic economics, he does not consider the implication for structural Keynesians and other social-democratic heterodox economists of the role played by Austrian economics in the rise of the neoliberal model. If Austrian economists lacking strong representation within academia could work effectively with hardcore neoclassical economists to promote the neoliberal model,

3. See Philip Pilkington, 'From financial crisis to stagnation: an interview with Thomas Palley', *Naked Capitalism* blog, April 18 2012, <http://www.nakedcapitalism.com/2012/04/from-financial-crisis-to-stagnation-an-interview-with-thomas-palley.html>.

why could not social-democratic heterodox economists work with softcore MIT-type economists in advocating a new ‘golden age’ model? After all, the older generation of softcore MIT-type economists were supporters of the original ‘golden age’ model. Also, if not just economic theory but ‘political philosophy’ were essential to the rise of neoliberalism (pp. 10–13), would not ‘political philosophy’ or shared values be relevant for the rise of an alternative to neoliberalism?

This review will conclude by returning to an assertion with which it began: Thomas Palley’s *From Financial Crisis to Stagnation* provides a vehicle for bringing together different schools of economic thought. One reason it has this potential is that it offers a broad framework for investigating how growth of income inequality since the 1980s may be a key source of macroeconomic instability, a topic that has come to attract the interest of economists of various theoretical persuasions.

But, more specifically, it offers a framework for bringing post-Keynesian economics and radical political economy, two key schools of heterodox economics, into a closer alliance.⁴

On the one hand, Palley is the author of *Post Keynesian Economics*,⁵ so naturally the Keynesianism of ‘structural Keynesianism’ is not about, say, the price rigidity of New Keynesianism but is in the post-Keynesian tradition that studies (p. 15) ‘a monetary economy marked by fundamental uncertainty, and it is also peopled by emotional human beings who are motivated by the ebb and flow of animal spirits’. Structural Keynesianism is compatible with much of post-Keynesian economics, but aims for greater attention to traditional social democratic concerns than is displayed by strands of post-Keynesian economics heavily focused on money and finance.

On the other hand, structural Keynesianism shares with the social structure of accumulation approach (pioneered by Gordon, Edwards, Reich, and others) of radical political economy a concern with the real economy, class conflict, and income distribution. As radical political economy has evolved to incorporate a greater role for the financial system, it has come closer to structural Keynesianism. Indeed, structural Keynesianism as advanced by Palley might benefit from incorporating some of radical political economy’s attention to productivity growth and corporate profitability, and its materialist explanation for the rise of neoliberalism.

At the very least *From Financial Crisis to Stagnation* provides many of us with an effective label – ‘structural Keynesian’ – to describe ourselves and our shared perspectives.

4. For an interesting attempt by Palley to foster dialogue and consensus among different schools of thought, see Thomas Palley, ‘The limits of Minsky’s financial instability hypothesis as an explanation of the crisis’, *Monthly Review*, 61 (11), April 2010, <http://monthlyreview.org/2010/04/01/the-limits-of-minskys-financial-instability-hypothesis-as-an-explanation-of-the-crisis>.

5. Thomas Palley, *Post Keynesian Economics: Debt, Distribution, and the Macro Economy* (Macmillan, New York 1996).