Heterodox Macroeconomics

Keynes, Marx and globalization

Edited by Jonathan P. Goldstein and Michael G. Hillard

Routledge
Taylor & Francis Group
LONDON AND NEW YORK

20 Heterodox macroeconomics and the current global financial crisis

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Introduction

This concluding chapter applies the integrated heterodox macrofoundations developed in this volume to explain the current global financial crisis. I argue that to effectively understand the current global crisis of capitalism requires the integration of various strands of heterodox crisis theory, particularly Keynesian, Marxian and Institutionalist approaches.[1] The chapters in Parts I, II and III of this book, particularly those authored by Goldstein (Chapters 3 and 8), Dymski (Chapter 5), Orhanganzi (Chapter 9), Boddy (Chapter 12) and Kotz (Chapter 13) provide an essential foundation for achieving this goal.

An integrated heterodox view of the current crisis

The world economy is in the grips of a financial crisis that has the potential to rival the Great Depression. Yet, the readily visible financial aspects of the crisis are merely the superficial expression of a deeper crisis that revolves around the nexus of under-consumption, over-investment and financial crises.[2] An integrated heterodox approach is uniquely suited to understanding these interconnected crisis components due to its focus on the interrelations between social classes, the distribution of income, effective demand, Marxian competition, crisis theory, Keynesian uncertainty, financial innovation and fragility, endogenous expectations, and structural and institutional change.

Let us consider the three interrelated crisis mechanisms currently operating. The decline of the Golden Age led to significant changes in the balance of power between social classes. First, industrial capitalists increased their power relative to labor. Second, the absolute rise to power of financial capitalists[3] resulted in the further weakening of labor and the relative weakening of industrial capitalists. This realignment of power resulted in a dramatic shift in the distribution of income against labor in the advanced capitalist economies, documented by Boddy (Chapter 12) and Kotz (Chapter 13), with the possible exception of the Asian economies but only prior to the 1997 East Asian financial crisis. This shift created the basis for a slowly evolving secular under-consumption crisis that would remain dormant until its countervailing tendencies were exhausted.[4]

At first, workers responded to reductions in their real income by transitioning to a two-income-earner household in the early 1980s. After that, the consumption of American families could only be maintained through increasing hours of work, a dependence on increasing levels of debt and most recently by wealth-induced consumption as a result of asset bubbles. When these mechanisms failed to maintain the growth in household consumption, credit, in the form of subprime mortgages, was extended to households on the margin of financial stability. This was done in an attempt to increase financial profits, but also had the effect of bolstering overall consumption.

Yet, this manner of sustaining consumption turned out to be far more risky than previous countervailing measures for under-consumption. In this case, financial innovation, in the form of these new mortgages, was more directly aimed at a weakened consumer market rather than an investor market. This qualitative difference in endogenous lending, occurring during the latter stages in the development of a potential under-consumption crisis, made the economy far more susceptible to a deep under-consumption crisis set off by a financial crisis.

At the same time that the potential for an under-consumption problem developed, industrial profit rates recovered slowly or stagnated after their late Golden Age decline. Despite the weakening of labor that supported higher markups, financial firms captured an increasing share of industrial profits (see Orhanganzi (Chapter 9)). International competition, both industrial and financial (see Crotty (2008)), increased as corporate free trade and financial liberalization policies gained favor. Thus, in addition to keeping consumption afloat via debt, the accumulation of industrial capital became heavily debt dependent. Industrial capitalists facing increased international competition found it necessary to defend their illiquid and already underutilized (due to slow growth in consumption) capital at a time when internal funds (profits) were inadequate. This set of outcomes is consistent with Goldstein's (Chapter 8) model of investment. Firms attempted to maintain their competitive position via debt-financed cost-cutting investment and destructive price wars. Thus, a tendency to over-investment emerges (Crotty (2003a, 2003b, 2005)). In order to ease the financing of this survival strategy and to improve the earnings outlook in the eyes of impatient financial markets (Orghangazi (Chapter 9)), industrial firms pursued a low road labor strategy, based on downsizing and wage and benefit concessions, that further weakened consumption demand. Crotty (2003a, 2003b, 2005) has referred to this over-investment/under-consumption dynamic as the Neoliberal paradox.

Simultaneously, now powerful financial interests (Epstein (2005) and Orhanganzi (Chapter 9)) pushed for the deregulation and liberalization of world financial markets. This resulted in intensified financial competition over increased household and firm demand for credit that in turn fed a wave of financial innovation (from junk bonds, securitization, collateralized debt obligations to credit default swaps). In Minskian fashion (Dymski (Chapter 5) and Orhanganzi (Chapter 9)), these financial market developments allowed under-consumption to be temporarily averted and furthered over-investment tendencies that were transmitted via liberalized financial markets to developing economies.

Continued macroeconomic growth now became dependent on a financially fragile debt structure that increasingly relied on consumption propped up by wealth effects induced by asset bubbles. These asset bubbles were internally generated by increases in endogenous credit facilitated by financial innovation. These bubbles were allowed to persist by competition-induced decreases in inflation that allowed monetary authorities to place a greater weight, than previously used, on GDP growth via lower interest rate policies. In the most recent period, such policies fueled both speculative and new demand for homes resulting in rising house prices.

Given the operation of these three crisis tendencies, I now consider how their interaction can result in a deep and prolonged economic downturn. In the above scenario, the reproduction of viable growth has relied heavily on debt-financed consumption and investment, luxury consumption and asset bubbles/wealth effects. Yet the inability to maintain a permanent bubble, despite capitulation by the Fed, sounds the death knell for the countervailing tendencies to the underlying under-consumption/over-invest crisis. While bubbles have popped before and the system has recovered with minor setbacks, it is the increasing dependency on debt and competition-induced and deregulation-inspired increases in the riskiness of financial innovation,[5] that suggests that the most recent burst in the housing price bubble will fully expose the deep-seated contradictions and unsustainable nature of Neoliberal macrodynamics.

In an economy where two-thirds of demand is consumption based, it becomes very difficult to sustain economic growth when consumption is propped up by inordinate levels of debt, asset bubbles and the extension of debt to marginally solvent households. As in the current situation, when an asset bubble that underlies the marginal extension of debt bursts,[6] it is not only the marginal borrowers that are affected. Additionally, the typical over-extended households that have hit their borrowing limits will also be constrained, particularly as the wealth effect that cushioned their expenditures disappears. Finally, when consumption demand collapses, industrial capitalists already laden with excess capacity must shift from an investment strategy geared at meeting the competition to a strategy geared at preserving cash flow. Thus investment also declines.

As the crisis unfolds, a Fischer–Keynes–Minsky debt-deflation mechanism will deepen the severity of the crisis. The widespread distribution of toxic assets and their derivatives that underlie the housing price bubble has resulted in fundamental uncertainty concerning the exposure of firms and institutions to such assets. Additionally, there exists the lack of a full understanding, even by the fundamental players, of the mechanisms of new financial instruments and the shadow banking system. As a result, credit markets have not only contracted during this crisis, but have frozen in a manner reminiscent of a Keynesian liquidity trap. Thus, limited economic activity during the downturn will be further constrained and when the conditions for the profitable accumulation of capital are finally re-established, the credit system may still act as a drag on the system.

This sketch of the current crisis relies heavily on argumentation from heterodox macroeconomic traditions and suggests that an integrated heterodox approach is most suited for developing a holistic understanding of Neoliberal macrodynamics. This approach also highlights a major heterodox proposition concerning the elusive nature of balanced growth (Goldstein (Chapter 3)). When the distribution of income significantly impacts effective demand in contradictory ways,[7] shifts in distribution/accumulation regimes from unbounded versions of wage-led to profit-led to finance-led regimes carry with them the seeds of unsustainable growth. The latter two regimes that engender under-consumption tendencies may take time to overcome countervailing tendencies, but once those defense mechanisms are exhausted, a significant crisis is likely to result. The finance-led regime that allows for debt/credit offsets to under-consumption only results in a deeper decline when a potential financial crisis brings an abrupt end to debt-supported consumption, particularly as debt-deflation erodes the foundations of those supports.

As discussed by Goldstein (Chapter 3), the conditions for balanced growth require bounded social relations, both competitive and industrial relations. These conditions are most likely to obtain in a bounded wage-led regime as experienced during the Golden Age. The Golden Age came to an end when both sets of social relations became unbounded. Given recent experience, the conditions for balanced growth must also exclude incursions from financial capitalists and financial institutions that undermine the bounded nature of these other social relations.

Thus the major policy conclusion from the recent global crisis experience is that the current corporate form of globalization must be replaced with a more balanced and equitable approach to trade – fair trade, where balance is achieved across classes and across countries with different levels of development. Additionally, financial markets must be regulated in the fashion discussed by Epstein (Chapter 18) and Grabel (Chapter 19).

Notes

1 For papers that specifically consider the current crisis using this approach, see Crotty (2003a, 2003b, 2005), Goldstein (2009), Kotz (2008, Chapter 13) and Orhangazi (Chapter 9).

2 Since 1980, the most visible sign of crisis has been a string of financial crises. These include the savings and loan crisis, the housing price bubble of the late 1980s, the stock market crash of 1987, Japan's real estate bubble, the Mexican currency crisis, the Russian currency crisis, the East Asian financial crisis, the dotcom stock market crash and now the sub-prime mortgage/housing bubble debacle. Yet, it would be myopic to ignore the class-based real sector factors underlying these more visible crisis tendencies.

3 The rise to power of financial capitalists is associated with the decline in industrial profit rates at the end of the Golden Age and the intensification of foreign competition and thus the need for firms to investment with diminished internal funds. In addition, the shift in focus of macroeconomic policy from unemployment to inflation, the deregulation of financial markets, the resulting unfettered financial innovation, the opening up of international financial markets and changes in consumer bankruptcy laws all contributed to this rise in power. A burgeoning heterodox literature on financialization has analyzed this transition. See Epstein (2005) and the papers within.

4 Also, see Goldstein (2000) for an analysis of the shift in the distribution of income and the potential and offsetting tendencies for an under-consumption crisis. These countervailing tendencies include luxury consumption, exports, a two-income-earner household, debt-led consumption and wealth effects induced by asset bubbles. Under-consumption crises are usually slow to evolve, but when they present themselves their impact on the economy can be devastating.
The flipside of Boddy's (Chapter 12) demonstration of the weakening of the profit squeeze mechanism is the evolution of an under-consumption tendency. While Kotz (Chapter 13) does not find evidence of under-consumption in the first two cycles of the Neoliberal era, this does not imply that such tendencies lie just beneath the surface. The success of counter-tendencies during the first two cycles underlies this result.

5 Additionally, continued shifts in the distribution of income, further competitive pressures on industrial capitalists and continued low-road labor strategies have played a role.

6 It is not my intention to imply that the bursting of a bubble is exogenous. There are numerous internal reasons, both real and financial, that can lead to the end of an asset bubble. See Crotty (1986) for a discussion.

7 An increase in labor's share of income stimulates consumption in the long-run, while it also dampens investment in the short and long-runs and vice versa.

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