

FINANCE, DISTRIBUTION, AND THE ROLE OF GOVERNMENT: HETERODOX FOUNDATIONS FOR UNDERSTANDING THE CRISIS

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Abstract

Heterodox economists have produced important theories and empirical analyses that helped to anticipate the 2007–9 crisis and to critically evaluate the policies adopted in its wake. This brief note covers three such contributions: Wynne Godley’s analysis of seven unsustainable processes; Hyman Minsky’s work on financial fragility and “Big Government”; and neo-Kaleckian models of how income distribution affects aggregate demand.

Introduction

Around the trough of the Great Recession in 2009, Paul Krugman famously complained that “Few economists saw our current crisis coming,” and lamented “the profession’s blindness to the very possibility of catastrophic failures in a market economy.”¹ However, Krugman paid scant attention to those economists who actually did anticipate the crisis (the only one he cites is Robert Shiller, for his work on the housing bubble²). Krugman’s critique was directed at mainstream academic macroeconomists, who (as he correctly noted) were blinded by their faith in mathematical models of self-regulating market economies, their assumption of purely rational behavior, and their belief in the ability of monetary policy to easily smooth out any economic

fluctuations. However, economists working in heterodox traditions not only saw the warning signs of a crisis well in advance, but also had a ready-made analytical apparatus that enabled them to identify the flaws in the policy responses adopted in most of the affected countries.³

Marc Lavoie's keynote lecture reviews several strands in post-Keynesian economic analysis that help to understand the causes and consequences of the 2008-09 financial crisis and the limitations of the subsequent policy responses by central banks and governments. Indeed, Lavoie's work, embodied comprehensively in his *Post-Keynesian Economics: New Foundations* (2014), has made an enormous and lasting contribution to our knowledge about heterodox approaches to these issues. In responding to Lavoie's overview, I will discuss three additional heterodox contributions that further deepen our understanding of the crisis. Moreover, by drawing out the political and economic dimensions of the interactions between financial markets and the state, as well as the impact of distributional conflict on macroeconomic performance, these three approaches highlight the continuities between the post-Keynesian analytical approaches summarized by Lavoie and other traditions in radical political economy. The three contributions I will review include: Wynne Godley's analysis of "seven unsustainable processes"; Hyman Minsky's concepts of "financial fragility" and "Big Government"; and the neo-Kaleckian approach to income distribution and aggregate demand.⁴

Godley's Seven Unsustainable Processes

In the late 1990s, most mainstream macroeconomists in the US were celebrating what was then called the "Goldilocks" or "new" economy, which was later deemed to have been the beginning of the "Great Moderation." US unemployment and inflation were at their lowest rates since the 1960s, while real gross domestic product (GDP) and labor productivity (output per worker) were both growing at rates well above their averages from the 1970s and 1980s. The federal

government budget “improved” from a deficit to a surplus, while the Federal Reserve under Chairman Alan Greenspan was believed to have achieved a remarkable degree of control over the economy through its “new consensus” policies.

Just as these celebrations were reaching a fever pitch in 1999, Wynne Godley released his prescient warning that these favorable trends were built upon the unstable foundation of seven unsustainable processes:

- (1) the fall in private saving into ever deeper negative territory, (2) the rise in the flow of net lending to the private sector, (3) the rise in the growth rate of the real money stock [using the broad definition M3 as an indicator of credit expansion], (4) the rise in asset prices at a rate that far exceeds the growth of profits (or of GDP), (5) the rise in the budget surplus, (6) the rise in the current account deficit, (7) the increase in the United States’s net foreign indebtedness relative to GDP.⁵

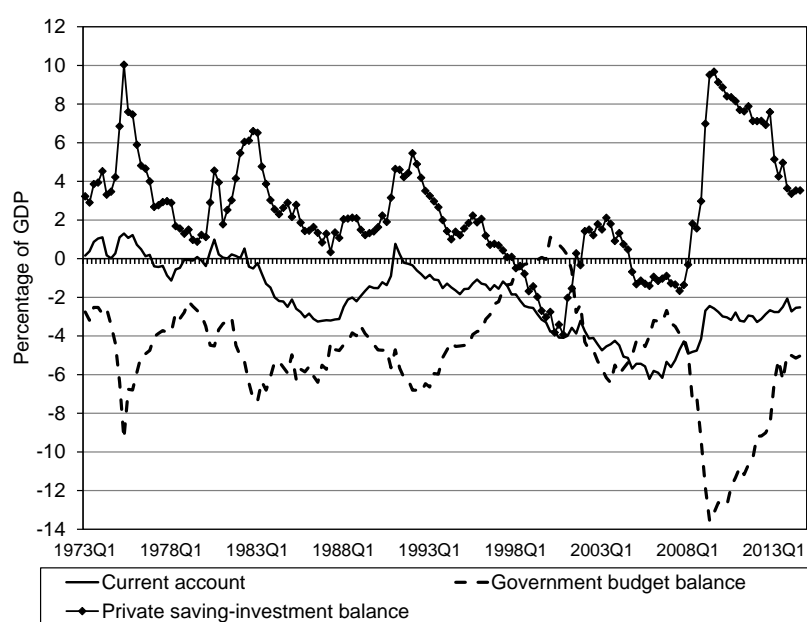
The second of these trends is based on Godley’s analysis (inspired in part by the earlier work of Minsky and Michal Kalecki⁶) of the three major sectoral balances in a capitalist economy: the private sector (the difference between saving and investment), government (budget surplus or deficit), and external (current account) balances. By the conventions of national income accounting, these balances must sum to zero. In other words, not all three sectors can experience simultaneous surpluses, as indicated in the following identity:

$$(1) \quad (\text{Exports} - \text{Imports}) = (\text{Saving} - \text{Investment}) + (\text{Tax revenue} - \text{Government spending})$$

Figure 1 shows these three balances for the US economy using quarterly data for the period 1973–2014. Until the mid-1990s, the private sector (saving–investment) balance was always positive, although it fluctuated countercyclically (rising in recessions when investment falls more than saving, and falling in expansions when the opposite occurs). What Godley emphasized (and considered unsustainable) was the unusual decline in the private sector balance

to the point where it became negative in the late 1990s, a phenomenon that was briefly interrupted by the recession of 2001 but then re-emerged during the housing bubble in 2004–7. Figure 1 also illustrates that the private sector and government budget balances have largely been mirror images of each other—moving mostly in opposite directions—while the trade balance has deteriorated more steadily with smaller cyclical fluctuations.

Figure 1 Sectoral balances for the US economy, quarterly, 1973Q1 to 2014Q4



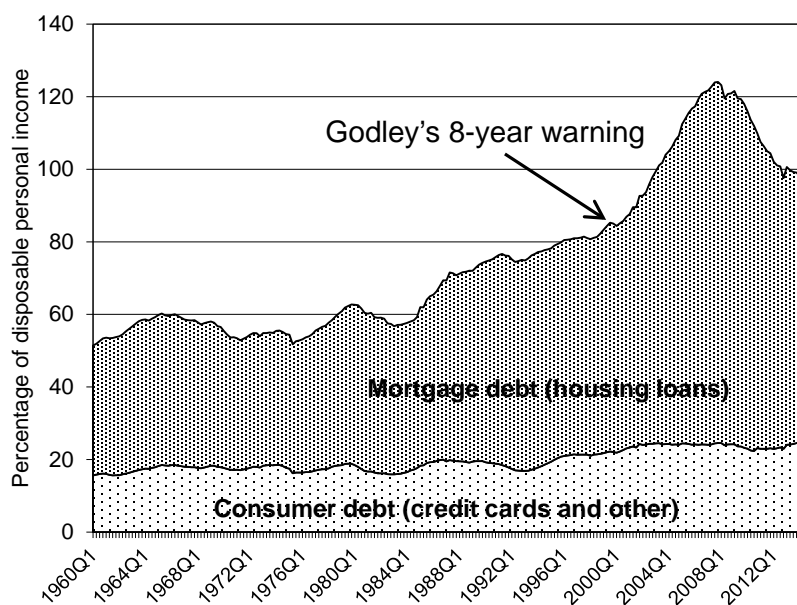
Source: US Bureau of Economic Analysis (BEA), NIPA Tables 1.1.5, 4.1, and 5.1, www.bea.gov, data release of February 27, 2015, and author's calculations.

Digging deeper into the data, Godley showed that “most of the fall in the private balance and the entire [private sector] deficit has taken place in the household sector. It is the excess of personal consumption and housing investment over personal disposable income that is now much larger than ever before.”⁷ The same conclusion also holds for the 2004–7 period, when the US

economy was being driven by the housing bubble. Considering that Godley was writing in 1999, his words were truly prophetic when he wrote:

given unchanged fiscal policy and accepting the consensus forecast for growth in the rest of the world, continued expansion of the U.S. economy requires that private expenditure continues to rise relative to income. Yet ... it seems impossible that this source of growth can be forthcoming on a strategic time horizon.... Moreover, if, *per impossibile*, the growth in net lending and the growth in money supply growth were to continue for *another eight years*, the implied indebtedness of the private sector would then be so extremely large that a *sensational day of reckoning* could then be at hand.⁸

Figure 2 US household debt (consumer + mortgage) as a percentage of disposable personal income, quarterly, 1960Q1 to 2014Q3



Source: US Federal Reserve, Z.1 Statistical Release for December 11, 2014, <http://www.federalreserve.gov/econresdata/statisticsdata.htm>; BEA, NIPA Table 2.1, www.bea.gov, data release of February 27, 2015, and author's calculations.

It is probably a coincidence that Godley chose a period of eight years for predicting this “sensational day of reckoning,” but in hindsight the accuracy of his foresight is amazing. Figure 2 shows that he published this prediction right around a point of inflection in the ratio of

household debt to disposable income for US households, just before this ratio began to rise even more rapidly in the early 2000s. The peak in this series came in the third quarter of 2007, almost exactly eight years after Godley's paper was published, and most of the increase in debt was attributable to residential mortgages. House prices had already peaked (in real, inflation-adjusted terms) early in 2006, and by the fourth quarter of 2007 the financial crisis was breaking out as the New York stock market indexes and numerous other financial indicators began to decline while GDP reached its cyclical peak. The Great Recession officially began in January 2008, but it worsened following the rescue of Bear Stearns (March), the collapse of Lehman Brothers (October), and the general financial panic and freeze-up of lending that ensued in the fall-winter of 2008–9.

Minsky's Concepts of Financial Fragility and Big Government

There can be little doubt that the specifics of this crisis differed in significant ways from the earlier crises analyzed by Minsky before his untimely death in 1996. Nevertheless, the crisis generally confirms not only the broad outlines of his theory of financial fragility, but also the continued relevance of his approach to fiscal policy and the role of the state – what he called “big government.”

Financial Fragility: Minsky's theory of financial fragility was famously framed around his idea of a transition from what he called “hedge” finance of firms' activities to “speculative” and eventually “Ponzi” finance during a period of economic expansion.⁹ In a nutshell, what Minsky called hedge-financing firms have low levels of debt, so that they expect to be able to meet all required debt service obligations (including repayment of principal as well as interest payments)

out of current receipts. In contrast, speculative firms have higher levels of debt to such an extent that they may not always be able to pay more than the interest on the debt in some time periods, and Ponzi firms are so highly indebted that they may be unable to meet all their payout obligations in some periods and hence are often forced to borrow simply to cover interest payments (thus further increasing their debt).

Importantly, firms utilizing the three types of finance differ in their vulnerability to economic shocks, such as increases in interest rates or decreases in sales revenue, with hedge firms being the least adversely affected and Ponzi firms being the most highly impacted (and the most likely to be driven into bankruptcy). In addition, the weight of the three types of finance varies cyclically, as a crisis eliminates many Ponzi units and induces any surviving ones as well as the speculative units to become more conservative in their financial policies and return to hedge practices, while a period of relative tranquility and steady growth leads firms to forget the lessons of previous crises (as they recede further back in time) and to be willing to take on more risky financial structures based on overly optimistic expectations.

Taken literally, the idea of a hedge-speculative-Ponzi progression cannot tell the story of the 2007–9 financial crisis because it was meant to be applied to non-financial corporations, whereas that crisis was (as Godley recognized) largely concentrated in the household sector and specifically in the housing market and the financial markets for securitized mortgages and derivative assets based on mortgage-backed securities. Nevertheless, there is no reason why the concept of economic agents adopting increasingly risky financial positions during a cyclical expansion cannot be applied to households as well as to firms, with suitable modifications (e.g., income depends primarily on employment of family members rather than sales of goods or services produced using capital assets). As shown in Figure 2, the US household sector as a

whole transitioned from having relatively low (or only gradually rising) debt-income ratios between the 1960s and the mid-1980s to much higher (and more rapidly rising) debt-income ratios starting in the late 1980s. By the early 2000s, many individual households had progressed from being able to easily meet all debt service payments out of current income to having those payments eat up a rising share of income, to the point where by the last few years before the crisis many families were struggling merely to pay the interest on their current debt.

As a result of these rising debt ratios and increasing debt service burdens, by the middle of the first decade of the new millennium an increasing proportion of US households had become severely vulnerable to an adverse shock such as a job loss for a family member, a rise in interest rates, or a fall in housing prices, given that such an event could easily push them into default on their mortgages and/or overall bankruptcy. Especially, those who had taken out variable-rate mortgages on overpriced homes were highly vulnerable to interest-rate hikes, while those who had borrowed exorbitant amounts relative to their income (e.g., through sub-prime loans) to buy homes that were expected to rise continuously in value during the bubble were vulnerable to a failure of those expectations to materialize as house prices stopped rising so fast and eventually collapsed. Thus, even if the hedge-speculative-Ponzi triad does not apply literally to households, it is clear that the US household sector experienced increasing financial fragility in a qualitatively similar fashion during the late 1990s and early 2000s.

Moreover, two other elements in Minsky's view of financial fragility also played important roles in the build-up to the 2007–9 crisis. First, he emphasized the tendency of banks and other financial institutions to evolve and innovate in efforts to escape from the restraints imposed by existing regulatory regimes. Indeed, the huge accumulation of household debt and the associated rise in systemic risk could not have occurred without a large number of key

financial innovations, ranging from the securitization of residential mortgages to the proliferation of exotic instruments such as collateralized debt obligations and credit default swaps. Even before his death in 1996, Minsky had seen that the global economy was morphing into what he called “Money Manager Capitalism,” which was characterized by the ascendancy of financial markets over traditional banks and the dominance of new types of financial institutions that were not subject to standard prudential regulation.¹⁰

Second, Minsky stressed that apparently tranquil economic times were likely to be the proverbial calm before the storm. In a period of relative stability and sustained expansion, expectations gradually become more optimistic while potential risks begin to be discounted or ignored, leading to the creation of unsustainable financial positions in the private sector (firms and banks in Minsky’s original analysis, households and broader financial markets in the more recent period). In Minsky’s words,

As a previous financial crisis recedes in time, it is quite natural for central bankers, government officials, bankers, businessmen, and even economists to believe that a new era has arrived.... Nevertheless, in a world of uncertainty, given capital assets with a long gestation period, private ownership, and sophisticated financial practices of Wall Street, *the successful functioning of an economy with an initially robust financial structure will lead to a structure that becomes more fragile as time elapses.*¹¹

The period that became known as the “Great Moderation” (roughly 1994–2007) provided exactly the right circumstances for such endogenous destabilizing forces to emerge in the US economy. During this period, overall growth was relatively steady, with only a mild recession in 2001, while unemployment and inflation were both low. Housing prices, stock market indexes, and other financial indicators generally trended sharply upward, and recovered quickly after dipping during that recession. In these conditions, households were prone to ignore the risks of taking on more debt while financial markets eagerly extended credit to borrowers who did not meet standard lending criteria (most infamously through sub-prime mortgages). Warning signs

such as the “jobless” nature of the recovery in 2002–3, the stagnation of real wages, rising inequality, the housing bubble, and growing household debt were ignored by all concerned, with devastating consequences once the bubble burst and the economy collapsed.

Big Government: Although it is less well known than his theory of financial fragility, Minsky’s defense of a large government role in the economy is equally important not only for explaining the crisis but also for understanding the role of fiscal policy in either ameliorating or worsening it. As Figure 1 shows, the US budget deficit reached a peak of 13.6% of GDP (or rather, the budget balance was –13.6%) in the third quarter of 2009. Minsky’s analysis showed why such a large budget deficit is not only a natural response to an economic downturn, but also an essential vehicle for preventing a recession from worsening into a deeper depression.

Minsky argued that an increased fiscal deficit during a recession has three types of positive impacts, only the first of which is recognized (often insufficiently) in mainstream analysis:¹²

1. The “income and employment effect,” which is the boost to aggregate demand created by government expenditures in excess of tax revenues (traditional automatic stabilizer and fiscal stimulus effects), and the multiplier effects thereof on total national income.
2. The “budget” or “cash flow” effect, which operates by generating a private sector surplus (excess of saving over investment) roughly equal to the government deficit (aside from any discrepancy caused by changes in the external balance); this effect is easily seen in Figure 1 where the private sector balance jumps up to a surplus of nearly 10 percent of GDP at the same time as the government balance falls to about –13 percent in 2009 (the difference of –3 percentage points is accounted for by the current account deficit).

3. The “portfolio” or “balance sheet” effect, which is the increase in public holdings of safe government assets (bonds) created as the government borrows to finance its deficit; this replenishes private sector assets at a time when the value of existing assets (for example, equity or housing) may have fallen.

The third effect of the fiscal deficit is an important antidote to the so-called “Ricardian equivalence” view, in which government bonds are not seen as part of wealth because the public supposedly expects to pay future taxes to offset present deficits. However, perhaps the most important contribution of Minsky was the second effect, which was based on the earlier work of Kalecki (who originally saw that a public sector deficit necessarily implied a private sector surplus) and was an inspiration for the later work of Godley cited above. The increase in the private sector balance tends to restore corporate profitability and to improve conditions in goods markets, and hence helps to spark a recovery of investment that can potentially lead the economy out of the recession. Minsky was very critical of some aspects of US fiscal policies, especially the structure of a tax system that gives incentives to acquire debt (via the deductibility of interest payments for corporate income taxes) and disincentives to employment (through the payroll taxes used to finance Social Security and Medicare), but he believed strongly in the positive role that a large public sector with built-in countercyclical properties could play in stabilizing the economy.

Unfortunately, the conventional wisdom about fiscal policy among both mainstream economists and most policy makers runs completely contrary to Minsky’s insights. Conventional wisdom lauded the rise in the US budget surplus under President Bill Clinton in the late 1990s (shown in Figure 1), but as Godley pointed out this contributed to the simultaneous decline in the private sector balance that was financed by the unsustainable accumulation of debt in the

household sector. Similarly, there was much misplaced panic over the rise in the budget deficit during the 2008–9 recession, which generated an extreme reaction against the public sector in US politics in 2009–10 (the Tea Party phenomenon and its virtual capture of the Republican Party). A deficit that was partly a symptom of the crisis and partly a helpful response to it was portrayed in right-wing propaganda (and even in much centrist analysis) as a cause of the country's economic problems rather than part of the cure, which was preventing a worse collapse. As a result, President Barack Obama was only able to get a woefully inadequate stimulus package passed by Congress in 2009. Upon the return of a Republican majority to the House of Representatives in 2011, the US shifted to an austerity policy focused on restraining government spending—with a Democratic response that mainly involved tax increases on the wealthy.¹³ The fiscal deficit then shrank rapidly, but as Minsky's theory predicted, the spending cuts and tax increases merely helped to stall the recovery as they drained aggregate demand and financial flows from the private sector.

Wage-led demand and stagnation tendencies

Neo-Kaleckian macroeconomic models, combining a post-Keynesian emphasis on aggregate demand constraints with a structural analysis of power and distribution under capitalism, show how aggregate demand is determined in part by income distribution. Aggregate demand can be either wage-led (in which case higher wages lead to stronger overall growth) or profit-led (in which higher profit margins, possibly attained through lower wages, stimulate growth through positive impacts on business investment and exports), depending on various structural conditions.¹⁴ Most recent empirical studies in this tradition find that demand is normally wage-led in most countries, except for some small open economies.¹⁵ There are a few contrary results

claiming that demand is profit-led in the US and other countries, but these studies focus mainly on short-term cyclical fluctuations in demand (recessions and recoveries) rather than longer-term trends.¹⁶ If this finding of the importance of wage-led demand is correct, then the decreases in wage shares (and increases in broader measures of inequality) experienced in most of the industrialized countries in recent decades should have created incipient stagnation tendencies in those countries. However, prior to the crisis of 2007–9, these stagnation tendencies were offset by debt-led consumption (and/or housing) booms in the countries with trade deficits (e.g., US and UK) and mercantilist export-led growth in the countries with trade surpluses (e.g., Germany and China).¹⁷

Changes in the personal and functional distribution of income were not leading factors in the global expansion up to 2007, nor were they direct causes of the crisis; rather, rising property prices and growing household debt were the main driving factors in the boom that preceded the bust.¹⁸ Since the crisis, however, the deficit countries have been unable to resume the levels of borrowing reached earlier, while the surplus countries have experienced slower export growth due to the depressed conditions in the deficit countries which are their main markets. As a result, the offsetting factors that previously prevented the stagnation tendencies from emerging (debt in the deficit countries; exports in the surplus countries) have weakened substantially, and the depressing effect of greater inequality on aggregate demand has contributed to sluggish recoveries both in the US and globally. Recent studies by scholars at the Levy Economics Institute, working in the tradition of Godley (with its roots in Kalecki and Minsky), have verified that inequality is one of the chief factors depressing consumption spending in the US economy and—along with fiscal austerity and dollar appreciation—contributing to the weak overall

character of the recovery and the risks of another crisis as households (at least those below the top of the income distribution) continue to deleverage.¹⁹

Conclusion

Each of these three heterodox insights reflects, in different ways, the political-economic factors that underpin macroeconomic performance and stability. Government balances affect both overall aggregate demand and the evolution of private sector balances; the state (“big government”) has potential to offset (through both fiscal and regulatory interventions) some of the excesses of financialization, although the scope of its interventions will depend on political-economic outcomes; and ongoing distributional struggles between classes will shape demand, growth, and hence macroeconomic and financial stability. In various ways, therefore, these additional insights enrich the post-Keynesian tradition of macroeconomic and financial analysis with a deeper political-economic understanding.

Notes

¹ P. Krugman, “How Did Economists Get It So Wrong?” *The New York Times Magazine*, 6 September 2009.

² See R. J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It* (Princeton: Princeton University Press, 2008). Other economists whose work anticipated the crisis include Dean Baker, Nouriel Roubini, and Wynne Godley, the last of whom is discussed below.

³ See M. Lavoie, *Post-Keynesian Economics: New Foundations* (Cheltenham, UK: Edward Elgar, 2014).

⁴ A fourth contribution – post-Keynesian critiques of post-crisis monetary policies based on the theory of endogenous money – is equally important, and is explored in detail in the articles by Lavoie and Rochon in this symposium.

⁵ W. Godley, “Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World,” Levy Economics Institute, Strategic Analysis, January 1999,

<http://www.levyinstitute.org/publications/seven-unsustainable-processes>, p. 2. See also R. Pollin, *Contours of Descent: U.S. Economic Fractures and the Landscape of Global Austerity* (London: Verso, 2003).

⁶ See M. Kalecki, *Selected Essays on the Dynamics of the Capitalist Economy, 1933–1970* (Cambridge, UK: Cambridge University Press, 1971), and H. P. Minsky, *Stabilizing an Unstable Economy* (New Haven: Yale University Press, 1986; reprinted New York: McGraw-Hill, 2008).

⁷ Godley, “Seven Unsustainable Processes,” p. 5.

⁸ Ibid.

⁹ Minsky, *Stabilizing an Unstable Economy*, pp. 230–238.

¹⁰ See D. B. Papadimitriou and L. R. Wray, “Minsky’s *Stabilizing an Unstable Economy*: Two Decades Later,” in Minsky, *Stabilizing an Unstable Economy*, pp. xi–xxxv.

¹¹ Minsky, *Stabilizing an Unstable Economy*, pp. 237–238, emphasis added.

¹² See Minsky, *Stabilizing an Unstable Economy*, pp. 22–41.

¹³ See R. A. Blecker, “Economic Stagnation in the United States: Underlying Causes and Global Consequences,” *Brazilian Journal of Political Economy*, 34/4 (2014), pp. 689–725.

¹⁴ See R. A. Blecker, “Demand, Distribution, and Growth in Neo-Kaleckian Macro Models,” in M. Setterfield (ed.), *The Economics of Demand-Led Growth: Challenging the Supply-Side Vision of the Long Run* (Cheltenham, UK: Edward Elgar, 2002), pp. 129–152.

¹⁵ See M. Lavoie and E. Stockhammer (eds.), *Wage-led Growth: An Equitable Strategy for Economic Recovery* (Houndmills, Basingstoke, UK: Palgrave Macmillan, 2013).

¹⁶ Contrary studies include N. Barbosa-Filho and L. Taylor, “Distributive and Demand Cycles in the US Economy: A Structuralist Goodwin Model,” *Metroeconomica*, 57/3 (2006), pp. 389–411, and D. Kiefer and C. Rada, “Profit Maximising Goes Global: The Race to the Bottom,” *Cambridge Journal of Economics*, forthcoming, advance access doi:10.1093/cje/beu040 (September 2014); for a critique, see R. A. Blecker, “Wage-led Versus Profit-led Demand Regimes: The Long and the Short of It,” paper presented at Eastern Economics Association conference, New York, February 2015.

¹⁷ See Lavoie and Stockhammer, *Wage-led Growth*, and B. Cynamon, S. Fazzari, and M. Setterfield (eds.), *After the Great Recession: The Struggle for Economic Recovery and Growth* (New York: Cambridge University Press, 2013).

¹⁸ See E. Stockhammer and R. Wildauer, “Debt-Driven Growth? Wealth, Distribution and Demand in OECD Countries,” Kingston University London, Economics Discussion Paper No. 2015-2.

¹⁹ See D. B. Papadimitriou, G. Hannsgen, M. Nikiforos, and G. Zezza, “Fiscal Austerity, Dollar Appreciation, and Maldistribution Will Derail the US Economy,” Levy Economics Institute, Strategic Analysis, May 2015.