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**How the Great Moderation Became a (Contained) Depression
and What to Do About It**

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Abstract

The Great Recession was deep and the subsequent recovery has been slower than most economists predicted. This article summarizes the message of a recent book that presents perspectives from a group of Keynesian economists who warned prior to 2007 of dangerous trends that could lead to these unfavorable outcomes. We discuss how the debt-fueled consumer boom leading up to the Great Recession was unsustainable and how rising inequality has compromised demand generation during the feeble recovery. We conclude the article by considering how public policy must respond in coming years.

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In December of 2007, the U.S. economy entered a recession.¹ Unemployment and financial instability worsened through the summer of 2008 and – following the dramatic collapse of Lehman Brothers (September 15, 2008) – the U.S. economy went into free fall. Job losses were the worst in generations, and the best that can be said *five years* since the onset of the Great Recession is that the threat of collapse has been replaced by that of stagnation.

The Great Recession caught most economists by surprise. Prior to its onset, thinking had converged to the idea that the U.S. (and other developed countries) were experiencing a “Great Moderation” – a marked reduction in the volatility of the aggregate economy as compared with the 1970s and early 1980s.² While the mainstream applauded this accomplishment, a group of Keynesian macroeconomists repeatedly warned that gradual but strong forces were leading the U.S. economy toward a deep recession. These economists emphasized the central roles played by aggregate demand, uncertainty about the future, and finance in determining the path of the economy through time. They argued that robust and stable growth would not continue indefinitely under the prevailing conditions and attributed the relatively strong performance of the U.S. since the deep recession of the early 1980s to unique historical circumstances – most prominently, a high rate of demand growth financed by unprecedented household borrowing. The consumption-led and debt-financed engine of aggregate demand growth has since ground to a halt. Indeed, it was the breakdown of this mechanism that led to the Great Recession, and concern about where sustainable demand formation will come from is the most pressing issue the U.S. faces going forward. If policy is to address this situation, it will require significant intervention to create demand growth. A true recovery may be possible only with deep structural change, particularly in the distribution of income, that induces healthy demand growth without unsustainable borrowing by American families.

What is the Source of Demand Growth in the Long Run?

We begin from the observation that no automatic mechanism exists to assure demand adequate to purchase full-employment output. Those economists who take a different view argue that declining wages and prices will endogenously boost demand, eliminate unemployment, and eventually restore the economy to a supply-determined growth path. But there was never much theoretical or empirical support for this view. Keynesian economists have written for decades about how deflation (or disinflation) might actually *reduce* demand. For example, because deflation raises the real value of nominal debts, it re-distributes wealth from borrowers to lenders – that is, from high spenders to low spenders. Since we do not believe the price mechanism can reliably guide demand to potential output, we look elsewhere to find the mechanisms that ensure demand is sufficient to keep the economy growing and unemployment low.

It is instructive to sketch the idiosyncratic ways that the challenge of creating demand to match potential output has been met in the U.S. over the past century. The Roaring 1920s were fuelled by a debt-financed consumption boom and strong asset price growth. Of course, this particular model for demand growth ended spectacularly with the Great Depression. The original New Deal seemed to turn things around in the mid-1930s, but it ultimately took massive demand from World War II to get the economy back to its pre-Depression trend. The Marshall Plan that created an international market for American exports, the Cold War military-industrial complex, hot wars in Korea and Vietnam, and a wave of consumerism in the baby-boom years, generated strong demand growth through the 1960s.³ High oil prices and a wage-price spiral created trouble in the 1970s as demand growth faltered and then was deliberately suppressed by policy to rein in inflation during the monetarist experiment of the early 1980s.

Demand Formation and the Onset of the Great Recession

The massive U.S. tax cuts during the early Reagan years were sold politically as supply-side policy designed to raise saving rates. But the result was exactly the opposite. Indeed, the share of U.S. disposable income devoted to consumption rose almost without pause through 2007. Unfortunately, the relentless rise of household spending was not a sign that the majority of American families were “getting ahead” economically. Instead, the consumption-led demand regime arose from the interplay of two forces: the real income *stagnation* suffered by households across most of the income distribution on one hand, and deregulation and institutional change in the financial sector on the other. These factors resulted in massive debt accumulation by US households seeking to supplement stagnant incomes in their pursuit of increasing consumption aspirations. Household borrowing was spurred on by a financial sector rendered ever freer of inter- and post-war financial regulations that came to be seen as unnecessary fetters on an inherently self-regulating free market. Ultimately, these developments proved deadly. Rather than creating an optimal path for household consumption facilitated by the removal of regulatory hurdles, they led to the steady accumulation of financial fragility. As this trajectory progressed, its apparent success made it seem all the more plausible and reasonable to households and financiers alike, even as it became increasingly precarious.

What all this implied, in the language of the financial instability hypothesis developed by Hyman Minsky,⁴ was that by the late 2000s, the growth regime in the U.S. economy was thoroughly dependent not just on the “ordinary workings of the goods and labor markets” (necessary to generate the income flows required to service outstanding debt), but also what came to be perceived as the “ordinary workings of financial markets” – more specifically, their

proclivity to roll over existing debt, and continue expanding new credit. The entire U.S. economy was, as a consequence, increasingly vulnerable to any bad news in the short run that would give pause for thought to the households and/or financial institutions participating in the run-up of indebtedness that undergirded seemingly impressive macroeconomic performance.

In the end – and perhaps not surprisingly given the mixture of real- and financial-sector forces that gave rise to the preceding boom – the trigger for the Great Recession arose from an untimely (and interrelated) confluence of real and financial events: rising short-term interest rates undermined the ability of households to repay adjustable rate mortgages;⁵ the end of the housing bubble meant rising home values would no longer replace earned income as a source of purchasing power; the collapse in home construction left many workers jobless; and the consequent writing down or writing off of many mortgage-backed securities threatened to crash the interconnected worlds of banking and finance.

What followed was a sharp lesson in the fundamental Keynesian maxim that money and finance matter for the demand-formation process. As wealth was destroyed and, in particular, as credit froze in the initial stages of the financial crisis, so aggregate demand fell – both as the direct result of wealth destruction and the credit freeze, and indirectly, as wealth destruction and the credit freeze suddenly diminished confidence. Even solvent and liquid households and firms began cancelling expenditure plans. The decline in aggregate demand and consequent rising unemployment only worsened conditions in the housing market, making the whole process dangerously self-reinforcing. And so the Great Recession began in late 2007, with a frightening downward acceleration in late 2008 and early 2009.

At this point, raw fear, if not a well-informed understanding of what was happening among policy makers, ignited the most significant Keynesian policy interventions in decades.

Whatever the faults in its design – and there were arguably many – the monetary and fiscal stimulus response to the events of 2008-09 actually engineered something of a “soft landing” (though not before U.S. employment had dropped by 6 percentage points, more than double the average employment decline during earlier postwar recessions.) The primary objective of these policies was to stabilize aggregate demand, both directly by raising government spending and indirectly by putting more money into consumers’ pockets and by containing the panic created in the most severe outbreak of economic uncertainty since the early 1930s. Ultimately, we were spared the experience of a second Great Depression.

What next?

Public policy put a floor under the downward trajectory of a structurally flawed growth and financial regime. But now its task is to pick up the pieces and to reconstruct the U.S. economy so that it is once again capable of generating widespread and sustainable prosperity going forward. Policy has already faltered in the pursuit of this agenda. The national debate in the U.S. has been hijacked by “austerity buzzards”,⁶ whose laser focus on public deficits and debt is either misguided, because they fail to understand that the biggest current challenge is adequate demand generation, or disingenuous, because they use “fiscal responsibility” to cover their politically unpopular objective to curtail the social safety net. Much of Europe has already gone further along the path to repeating the errors of the late 1930s, when fiscal retrenchment motivated by a perceived need for “sound finance” repeatedly threatened recovery from the Great Depression. So where do we go from here?

First, the polarizing debate “government as the problem” versus “government as the solution” is false, misleading and unhelpful. The simple fact is that government is quite capable

of playing both roles – that of hindrance and help. Ideologically-motivated rules expressing “zero tolerance” for government intervention, or proclaiming government as the universal solution for economic problems, are no use. Informed public policy needs to formulate and promote policies that will aid recovery, while remaining wary of and seeking to eliminate those that will obstruct it. But beyond this general rule, what, specifically, should be done?

Financial Reform

Financial instability played a central role in creating the conditions that led to the Great Recession. It therefore seems clear that rethinking financial regulation is necessary and appropriate. The Dodd-Frank reforms have some useful elements, but so far the approach taken to financial reform has been both too weak and, in certain fundamental respects, misguided.

Above all, the economy needs finance to better serve the public purpose, which requires structures that create both a stable payments (banking) system and effective channeling of finance to foster the economy’s capital development. This means returning banks to their traditional role of “underwriting,” that is, assessing risk and project quality as a means of determining the directions that capital development will follow. This role was largely lost in the decades prior to the Great Recession as banking shifted from an “originate and hold” model, in which the bank assessed risks to hold on its balance sheet, to an “originate and distribute” model, in which loans were sold off in secondary markets. In addition, financial sector remuneration must be reformed to prevent financial reform from “sabotage from within” by inappropriate managerial behavior that is actively incentivized by dysfunctional compensation schemes.

But while financial reform is undoubtedly important, it is not a panacea. In particular, financial reform – indeed, *any* policy – that has as its objective simply “getting the private sector

borrowing and spending again” isn’t what we need. The objective is not to create another unsustainable, debt-fueled growth episode that serves only to leave us wondering when the next crisis will occur (and lamenting its destructiveness when it does). Instead, the process of demand formation in the US economy needs to be reconstituted.

Monetary and Fiscal Policy

Monetary policy as practiced for much of the past two decades has been singularly ineffective in its ability to cure stagnation in the aftermath of the Great Recession. Moreover, it seems clear in retrospect that when monetary policy did restore demand after macroeconomic hiccups in the decades prior to the Great Recession, it did so by fueling unsustainable private-sector debt accumulation. We cannot rely exclusively on monetary policy to emerge from the current stagnation.⁷

Aggressive fiscal stimulus is an alternative source of demand that can at least partially offset the spending lost as the household sector retrenches to repair its collective balance sheet. In sharp contrast to current political rhetoric in Washington, large deficits in times like these *are* fiscally responsible. The goal of fiscal policy is not to achieve some artificial and arbitrary target for deficits or debt. Instead, fiscal policy should be functional, that is, designed to achieve specific goals – in the current era to boost demand.

A first step toward understanding this perspective is to assess what evidence tells us about the size of deficits and debt and the effects they have on actual macroeconomic activity. Consider the widespread criticism of the Reagan administration’s supposed fiscal irresponsibility in the 1980s. At that time the politics of deficit bashing favored the Democrats, but the arguments were similar in direction (if not intensity) to recent rumblings: a profligate

government living beyond its means would saddle future generations with unsustainable debt service, high interest rates, and low productivity as deficits “crowded out” capital investment. A full generation has passed since those fears were rampant; what has happened? Interest rates are down; federal debt service is a smaller fraction of GDP; and productivity has risen. The debt legacy of the Reagan years hasn’t hamstrung the current generation.

Because of deeply compromised private demand generation after the Great Recession, the U.S. economy is likely to need large federal deficits well into the future. The sense that this is impossible – that austerity must be immediate because “we’re broke” – has no basis in fact. Debt service would be easily manageable for the U.S. with a debt to GDP ratio of 100% or more.⁸ Government debt critics often point to the long-term future liabilities of entitlement programs, particularly Medicare, as the reason that we need current fiscal austerity. We agree that society will have to come to terms with the future resource cost necessary to provide adequate health care. But destroying jobs today does nothing to make this task easier.

Wages, Productivity, and Global Engagement

While fiscal policy can and should play a central role in demand generation, larger government alone is unlikely to fully and indefinitely replace the pre-Great-Recession consumption and housing boom as a source of adequate demand growth. The demand problem is simply too big. As such, part of the policy challenge in the aftermath of the Great Recession is to reconstitute *private* aggregate demand on a more sustainable basis. This means reducing the dependence of U.S. households on debt accumulation as a source of rising consumption expenditures and increasing the extent to which rising consumption can be funded by income growth.

Public policy should strive to revive the income share of working and middle-class households, and to realign wage and productivity growth. This would allow for sustainable growth in household consumption expenditures. On the domestic front, rethinking the changes in labor law that weakened the bargaining power of workers over the past 30 years could help reach this goal. But domestic initiatives alone will not suffice: the unsustainable, debt-fueled US growth regime that policy must now seek to replace has a distinctly *global* dimension.⁹ In the first place the reliance of the U.S. economy on household debt accumulation not only provided a temporary salve for its own latent demand deficiency. It also topped up inadequate domestic demand in countries such as Germany and China, as US households became “consumers of the last resort” for the world economy. Second, global phenomena have contributed to the structural flaws in the aggregate demand generating process that have come to plague the US. Trade agreements, for example, have created an anything-but-level global playing field on which footloose corporations can credibly threaten to relocate between national political jurisdictions. This sets up a “race to the bottom” that has contributed – both directly through the resulting pressure on wages, and indirectly through its distortion of the tax system – to wage stagnation. In short, fixing the private aggregate demand generating process likely requires concerted international action.

If it is not already obvious, implementing the sort of policy initiatives discussed above constitutes an enormous task. It is well to remember, then, that some progress can be made through more modest means. For example, by targeting the distribution of after-tax income, fiscal policy can, at least to some extent, offset imbalances created by the distribution of pre-tax income. Finally, it is important to remember that however achieved, restoring robust real income growth to working- and middle-class families will reduce their debt-dependence and enhance

their ability to service the debts they *do* carry – developments that are obviously conducive to financial stability. Revitalizing real income growth across the entire income distribution therefore has an important role to play in both fixing structural flaws in the demand formation process and restoring the financial sector of the US economy to good health.

Towards a Better Future

The Great Recession and subsequent stagnation has created profound social adversity. Tens of millions of Americans have been forced to confront unemployment or significant under-employment directly. Tens of millions more must deal with the stress of unemployment, either because they fear threats to their own jobs or because the incomes of other members of their household have been directly affected.

What is particularly tragic is that there is no constraint on productive capacity requiring that people bear these costs. Workers are neither less motivated nor less skilled than they were in 2006 or 2007. We have not suddenly forgotten how to apply modern technology to produce high living standards. Our capital has not been destroyed by natural disaster. It is our economic system that has failed to coordinate our ability to produce with our ability to purchase. The unstable dynamics of the debt-fueled, consumption-led growth engine have shuddered to a halt, crippling the aggregate demand generating process that the U.S. and world economies came to rely on over the past 30 years.

We need a new model to sustain demand growth in coming years. That model requires a greater public role in guiding finance to socially useful activities. It also needs mechanisms to generate more government demand. Perhaps most important, the new model must find a way to

share more equally the fruits of a highly productive economy, to ensure that steady growth in consumption is funded by steady growth in real incomes across the board.

The results of recent years have been tragic. The immediate prospects for significant improvement are also unfavorable, as it seems that the economic policy establishment has yet to come to terms with the challenges of reconstituting the process of demand formation. But it is important to remember that while robust and sustainable recovery is not assured, nor is it impossible to achieve: it won't come about automatically, but the right policy interventions *can* help resolve the current crisis. It is only to be hoped that in the years to come, the US economy is able to break free of stagnation and realize its immense potential.

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5. Conventional 30-year mortgage rates rose very little between 2004 and 2006, but the one-year adjustable rate rose almost 250 basis points from its trough in early 2004 to its peak in mid-2006.
6. This phrase is taken from Epstein, G. (2013) “Confronting the Kindleberger moment: credit, fiscal, and regulatory policy to avoid economic disaster”, in Cynamon, B.Z., S.M. Fazzari and M. Setterfield (eds) *op.cit.*, pp.219-43.
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