Utah FOUNDATION RESEARCH BRIEF

Thoughts on the Current Recession: Post-Keynesian Economics

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This brief is part of a series of research briefs Utah Foundation is publishing on the economy. The series examines the current economic recession from a variety of schools of economic thought. These schools of thought represent different approaches to understanding how the economy works and what actions to take when the economy falters. We began the series with a discussion of Keynesian and Austrian economics, and are now examining the Post-Keynesian school. The series will conclude by studying the theories and observations of the Chicago school. Understanding these different schools of thought will help readers further understand the roots of the economic crisis and potential solutions.

Post-Keynesian Thoughts on the Current Recession

The Post-Keynesian school of economic thought derives it origins from John Maynard Keynes' principle of effective demand. The principle of effective demand is the idea that output is constrained by a scarcity of demand, rather than a scarcity of resources–implying demand creates supply, not supply creates demand. Post-Keynesians argue that because demand creates supply, changes in demand have an effect in both the long run and the short run, meaning there is no automatic tendency toward full employment in a competitive economy.[1]

Unlike mainstream economists who tend to generalize demand as primarily being a function of price, Post-Keynesians believe demand is heavily influenced by income, class, and production. They argue income, which is affected by its distribution among social classes, is the key to influencing effective demand and aggregate economic output. Consequently, Post-Keynesian policy prescriptions tend to focus on the level and distribution of income and wages, as well as changing the institutions that influence their distribution.[2]

Emphasizing effective demand is the one of the most distinctive features of the Post-Keynesian school, but it draws heavily from two other economic traditions as well. The first is an inclusion of uncertainty in economic models. Post-Keynesians argue uncertainty is an inherent aspect of all events, which prevents agents from making objective and rational decisions. As a result, Post-Keynesians are not concerned about obtaining equilibrium, but focus on how people behave and organize in order to satisfy their needs. The second tradition is a focus on institutionalism, which emphasizes the class structures of economic systems. These structures largely determine how resources are allocated within the system and therefore have a direct impact on economic output and economic growth.[3]

Because the school derives its origins from Keynes' principle of effective demand, Post-Keynesian theories are closely connected to those of the traditional Keynesian school. However, Hyman Minksy, a prominent economist associated with the Post-Keynesian movement, developed an alternative explanation of economic recessions to the one used by conventional Keynesians. While Minsky's ideas do not necessarily reflect the theories and policy prescriptions of all Post-Keynesian economists, this paper largely focuses on his Financial Instability Hypothesis as it presents a clear theory of the causes and solutions to economic recessions.

Keynesian economists generally believe recessions are triggered by external shocks to the economy. Hyman Minsky, however, argued that capitalistic economies have an inherent tendency to develop instability even in the absence of such shocks.[4] It is this instability which leads to economic downturns.

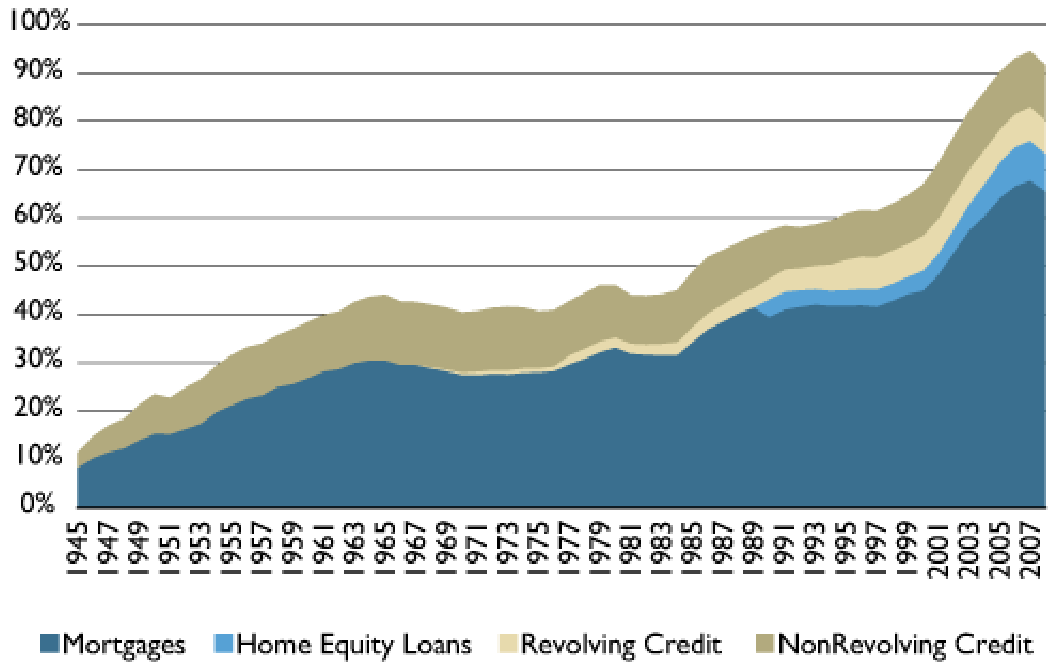
Minsky argued the key mechanism that pushes the economy toward instability and eventual economic crises is the accumulation of debt. This is because during economic booms, businesses can increase profits by raising their level of debt. Interest rates are low and companies can easily borrow money from banks to invest. Rising profits encourage other businesses and entrepreneurs to raise their level of debt, and increasing cash flows, indicating an ability to easily pay back the money, encourage lenders to increase the amount of money they loan.[5]

Eventually, the pace of debt accumulation rises faster than the borrowers' ability to repay their debt. This is especially true for borrowers who invest in risky projects or portfolios because of the promised high rate of return (such as subprime mortgage-backed securities). In order to limit their risk and losses, lenders respond by reducing the amount of money they loan. As a result, borrowers are unable to access the money they need to sustain their investments and payoff their debt–and are eventually pushed toward bankruptcy. Total investment falls, consumption is curtailed, and the foundation for a self-reinforcing economic recession is set.

Causes of the Current Recession

U.S. firms and households accumulated excessive amounts of debt in the years leading up to the current recession. For instance, between 1980 and 2007, household debt as a percent of GDP increased from 46% to 95% (Figure 1). The increase in debt accumulation by both households and firms was the result of several factors–decreased economic volatility, appreciation in the value of real assets (such as stocks and houses), and decreased financial regulation, which increased access to credit markets.[6]

Figure 1: U.S. Household Debt as Percent of GDP



Sources: Federal Reserve Bank. U.S. Bureau of Economic Analysis.
Calculations by Utah Foundation.

Of these factors, Minsky would most likely argue that decreased financial regulation was largely responsible for the rapid increase in debt. He criticized the decline in government regulation starting in the early 1980s, arguing it promoted inflationary tendencies and financial instability. The recent housing bubble is a current example of this effect; while deregulation in the housing market was initially praised for providing low-income households with the opportunity to become homeowners, it also allowed for the emergence of extremely risky home financing and fraud, some of which led to the economic and banking crisis in 2008.[7] It is argued by Minsky that greater government oversight could have prevented such schemes, and government-sponsored programs could have developed more sustainable methods for helping low-income households achieve homeownership.

Another factor which influenced the depth of the current recession was the length of the preceding economic boom. It is argued that the financial structure of a capitalistic economy becomes increasingly fragile during long periods of prosperity because higher levels of risky investments can be undertaken for longer periods of time. In his writings on the Financial Instability Hypothesis, Minsky stated "over a protracted period of good times, capitalistic economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance."[8] The low number of economic recessions experienced over the last couple of decades led to increasingly risky investments being undertaken by households, investors, and banks. This created a large, extended, and unsustainable boom, resulting in a deep and prolonged recession.

Solutions to Recessions

Like many conventional Keynesian economists, Minsky believed discretionary fiscal and monetary policies are appropriate for reversing economic downturns and moving the economy toward full employment.[9] However, rather than reacting with large amounts of spending only during economic downturns, Minsky felt the government should attempt to stabilize full employment by continuously intervening in the economy. He viewed government intervention as a necessary complement to private sector operations because of the tendency of free-market mechanisms to promote inflation and financial fragility.

> Minsky's solution to smoothing the effects of the business cycles was to establish a form of government that limits political discretion, limits inflationary pressures, and promotes work habits and individual initiative through programs that directly manage the labor force, investment projects, and financial developments.[10]

In terms of the labor force, Minsky promoted the creation of an "employer of last resort," a permanent, decentralized employment program that would hire anybody willing to work but unable to find a job in the private sector. Wages would be uniform and positions always available. In terms of investment projects, Minsky argued the government should supervise housing, infrastructure, and other socially-needed projects by allocating resources to the most needed projects and limiting rewards received by investors. Private companies would still develop the projects and handle the construction, but the investment portion would be overseen by government.[11]

In terms of financial developments, Minsky proposed that the government should implement policies to control wage bargaining and the payout ratios of firms, specifically banks. This would prevent both financial instability and inflation by ensuring the retained earnings of banks do not grow too rapidly. Minsky also argued the government should control the growth and distribution of financial institutions' assets through cash-flow regulation and flexible capital requirements.[12]

Making these proposed programs and polices permanent and structural, rather than discretionary, would isolate their operations from political influence. Minsky felt these programs would smooth the business cycle because they manage economic stabilization directly, rather than indirectly like changes in the interest rate, tax incentives, or indirect spending.

Post-Keynesian Solutions to the Current Recession

Because of the ability to increase effective demand, many Post-Keynesian economists believe fiscal and monetary policies are useful tools in mitigating the effects of economic downturns. However, in the case of the current economic recession, the macro-modeling team at the Levy Economics Institute of Bard College argues the 2008 stimulus package will not do enough to reverse the recession because it fails to address the growing external global trade imbalances. They believe one way to address these imbalances is by increasing U.S. exports through a significant devaluation of the dollar.[13] This will increase effective demand for U.S. goods and services, which will result in economic growth.

Randall Wray, a Post-Keynesian professor of economics at the University of Missouri–Kansas City, agrees with the Levy Economics Institute's analysis that a large, but short-lived fiscal stimulus is not enough to correct the economic downturn. He argues that a larger fiscal presence is needed both during the downturn, to stimulate effective demand, and during the recovery period, to ensure that good jobs, better infrastructure, and public services in the areas of health, education, and child and elder care are provided.[14] Wray believes these are areas that will permanently employ millions of women and other minorities who were chronically left behind during the postwar employment booms. Creating such jobs will push the economy toward full employment and ensure that effective demand is maintained.

Wray also agrees with Minsky's admonition that "stability is destabilizing," meaning a successful resolution of this crisis without medium and long-term policies will encourage businesses and households to return to risky investment practices. The long-term policies Wray suggests the United States government implement include reducing the country's need for oil, reducing payroll taxes, eliminating state and local "regressive" taxes by increasing federal funds, reducing income inequality, providing nationally funded and universal access to healthcare, directing government funds to infrastructure and social programs, and imposing stricter financial regulation. Wray also believes the government should provide jobs to anyone willing to work. He argues a government-sponsored job program can avoid causing inflation by setting a fixed, nominal wage (which includes a living wage and basic benefit package), floating the quantity of jobs available, and not bidding against the private sector for employees. This will allow the jobs program to operate like an unemployment buffer, expanding in recessions and shrinking in economic booms.[15]

Historical Notes on Post-Keynesian Thought

While the Post-Keynesian school primarily derives it origins from John Maynard Keynes' The General Theory of Employment, Interest and Money, it is also based on the works of Michal Kalecki and Joan Robinson (United Kingdom), Piero Sraffa (Italy), Sidney Weintraub, Hyman Minsky, and Paul Davidson (United States).[16] A united opposition to the neoclassical synthesis and an interest in Keynes' theory of money and other philosophical writings has brought many economists to this group.[17] Because Post-Keynesian theory is not based on the teachings of one specific leader, there is some debate about whether it can legitimately be classified as a school of economic thought. However, since its emergence, the field has made many positive contributions to the theories of income distribution, growth, trade, and development.

Endnotes:

[1] Philip Arestis, "Post-Keynesian Economics: Towards Coherence," *Cambridge Journal of Economics* 20, no. 1 (1996): 111-135.

[2] Arestis.

[3] Arestis.

[4] Frank Shostak, "Does the Current Financial Crisis Vindicate the Economics of Hyman Minsky?" *Ludwig Von Mises Institute Daily Archive*, 27 November 2007, http://mises.org/story/2787 (accessed 15 April 2009).

[5] Shostak.

[6] "Growth in Household Debt: An Analysis of Saving and Spending in Utah and the U.S.," *Utah Foundation* no. 689 (2009), http://www.utahfoundation.org/img/pdfs/rr689.pdf (accessed 17 April 2009).

[7] Tymoigne.

[8] Hyman P. Minsky, "The Financial Instability Hypothesis," Working Paper No. 74 (Annandale-on-Hudson, New York: The Levy Economics Institute, 2008), http://www.levy.org/pubs/wp74.pdf (accessed 8 April 2009).

[9] Janelia Tse, "Minsky's Financial Instability Hypothesis," *Oeconomicus* IV, no. 4 (2001): 77-81.

[10] Eric Tymoigne, "Minsky and Economic Policy: "Keynesianism" All Over Again?" Working Paper No. 547 (Annandale-on-Hudson, New York: The Levy Economics Institute, 2008).

[11] Tymoigne.

[12] Tymoigne.

[13] Wynne Godley, et al., "Prospects for the United States and the World: A Crisis that Conventional Remedies Cannot Resolve," *The Levy Economics Institute Strategic Analysis* (December 2008), http://www.levy.org/pubs/sa_dec_08.pdf (accessed 9 April 2009).

[14] L. Randall Wray, "The Return of Big Government: Policy Advice for President Obama," *The Levy Economics Institute Public Policy Brief* no. 99 (2009), http://www.levy.org/pubs/ppb_99.pdf (accessed 9 April 2009).

[15] Wray.

[16] L. E. Johnson and Thomas Cate, "A History of Post Keynesian Economics Since 1936: A Review Article," *Atlantic Economic Journal* 34, no. 1 (2006):115-123.

[17] The neoclassical synthesis is an academic movement that combined Keynesian theory with microeconomic foundations.
