Crisis and long-term stagnation: Questions for Keynesian theory
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ABSTRACT

The financial crisis and the 2008-2009 recession is taking the form of a long term stagnation in the most part of the advanced industrial economies. This poses fundamental questions of theory and policy and they are not much addressed in the current debate and research.

The paper asks the question of the nature of the crisis and why it is indeed different from those of the last thirty years. Because of that it is hardly manageable by the tools of standard theory and also by mild Keynesian policies. Thus the second point is that it requires reconsideration of theory and policy.

In the US the Federal Reserve despite criticism continues to pursue a strong policy of monetary easing that reflects the concern for a persisting high unemployment. In Europe the reestablished doctrine of fiscal restraints intersects with the conflicting interests within the euro-zone that seem at times to call into question the very existence of the common currency.

Both approaches have severe limitations. That applies also to the advise of prominent Keynesian such as Krugman that have argued for a much stronger stimulus. Indeed the perspective of long run stagnation calls for a rethinking of Keynesian theory and policy.

The main question to be addressed is indeed that of a new possible growth pattern. The paper discusses that by focusing on the leading sectors that are most promising in the way of a sustained growth of private investment, which has close links to technological development. It then discusses the need of a change in the role of government.

1. Introduction

The crisis that started in August 2007 in the US has already a short history. Though technically over – lasting in the US from the last quarter 2007 to the third quarter 2009 – it is far from clear whether it was really overcome. Neither financial markets nor the real
economy are really showing a strong recovery. Especially high unemployment is a matter of concern.

Various possible shapes were a matter of debate in the middle of the recession. Alternatives included a V shape (sharp down, sharp up), a U shape (plunge, then flat, then sharp recovery), or an L (sharp down and stay down), or a W shape (a false recovery in the middle). Though still hard to judge it seems that the crisis is now heading to a long-term stagnation in the most part of the advanced industrial economies. This poses fundamental questions of theory and policy and they are not much addressed in the current debate and research. Underneath is the question of the nature of the crisis, whether and why it is different from those of the post-war period, and how appropriate is the parallel with the Great Depression, much more in vogue just a couple of years ago and now somewhat fading away.

We have argued that the fundamental question is that of the new markets and discussed the reasons why now more than in the past they are difficult to materialize. A new round of investment and growth is not in sight because of the circumstances dominating the technology-investment-consumption relationship. (Gualerzi and Nell, 2010a; Gualerzi, 2011) In this paper we focus on the problems that stand in the way of a boost of private investment. This reinforces the idea that the crisis is hardly manageable with the tools of standard economic theory and Keynesian policies. It also puts in a different light the debate on the stimulus and calls for a reconsideration of theory and policy, including the role of government.

2. The ongoing crisis

Although beginning in 2007 with subprime crisis and the burst of the real estate bubble the financial crisis did not explode until the late summer 2008 and especially with the collapse of Lehman Brothers. The downturn was marked by the collapse of the stock market that reached its lowest point in March 2009. Governments and central banks run at the rescue of the financial institutions but that did not prevent the economy to enter a severe recession. The Paulson plan to save the banks (September 2008, approximately 750 billion) the last act of the Bush Administration did not succeeded in restarting the real economy. In January 2009 the new administration announced the “Obama New Deal” (the president himself drawing a parallel with Roosevelt), a fiscal stimulus directed to the private sector. Worth approximately 800 billion the American Recovery and Reinvestment Plan was a combination of tax cuts (for households and companies) and Government (public sector) investment. Broadly defined the areas of spending were energy, health and education.

The idea behind it was enough deficit spending, together with enough liquidity pumped into the banking and financial system, the stimulus would lift the US economy out of the slump. It can be said that the implementation of the plan contributed to end the recession, but certainly did not restart the industrial economies on a sustained growth path. In particular, the effects on investment and employment in the private sector are unclear. What we observed was rather the improvement of the banking industry, the new profits of investment banking and the rebound of the stock market.

The crisis did enter a new phase in 2010. The scenario was complicated by the crisis in Europe and of sovereign debt in particular. The speculative attack on sovereign debt shifted
the attention from the US to Europe and from private debt to public debt. Although clearly related this has not become the focus of the discussion. Instead the focus shifted from stimulation policies to fiscal austerity. Cutting the public debt and structural adjustment policies, echoing the prescriptions of the IMF to developing countries in the 1990s, has become the main priority of Governments in Europe, with the corollary of renewed calls for revamping economic growth. But with stagnant private consumption and investment where is growth coming from?

In June 2010 the US government expressed its concern that austerity may results in a new depression. Negotiations at the Seoul meeting of the G20 did not result in new policy except for more flexibility of the Yuan exchange rate announced by the Chinese government. The headlines on the possibility of a currency war confirmed the stall of “global governance”.

In the US the Federal Reserve continued in an expansionary monetary policy to fight persisting high employment. “…on its current economic trajectory the United States runs the risk of seeing millions of workers unemployed for many years …As a society, we should find that outcome unacceptable:” [since] “the ultimate purpose of economic growth is to deliver higher living standards at home” (Federal Reserve Chairman Ben S. Bernanke, The New York Times, November 19, 2010, p. B1-B2) Its Chairman and other top officials have defended such a policy in the face of the fears of fueling inflation. If indeed the worst enemy is now high and persistent unemployment, the not so hidden message is that more stimulation might be necessary. That however has faced the mounting pressure to reduce the deficit supported by the new Republicans-led Congress. Indeed the issue of the government deficit made a rapid comeback in the US also.

In April 2011 the confrontation over the government budget led to a last minute deal averting a government shut down. However, severe cuts are part of the agreement and that called into question also the prospects of a strong stimulus coming from public investment. It appears that the effort to cut the deficit will be a major topic in the confrontation that will dominate President Obama effort to seek reelection in 2012.

In Europe the reestablished doctrine of fiscal restraint intersects with the conflicting interests within the euro-zone, at times calling into question the very existence of the common currency. The leading position occupied by Germany is reinforced by an exports-led recovery that however creates a divide with the weak growth of other EU economies, not to mention the precarious state of the badly hurt economies of the so called PIGS countries at the center of the speculative attacks. We can speak of the materializing of a debt-trap.

After Greece and Ireland, in April 2011 also Portugal asked the EU for aid. This was after the Prime Minister Socrates resigned over the difficulties to pass severe budget cuts. So far, only one of the “PIGS” countries is missing, Spain. The problem is that aid comes in the form of loans at high interest. It appears more a way to safeguard the German, French, Dutch and British banks holding a large share of PIGS’ sovereign debt than a support to weakening economy. Indeed we are observing something that is almost surreal. Since loans are granted on the basis of severe public spending cuts, the “markets” anticipate a worsening of the economy. That is swiftly mirrored in debt rating. Rating agencies have consistently downgraded the debt of the countries receiving European emergency loans. The

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1 Letter of President Obama to the European leaders before the G20 meeting June 18, 2010.
debt trap is then made of two parts: first debt piles up as you are rescued; second, the bail out is necessarily associated with fiscal austerity that worsens the outlook on the economy, which makes even more difficulty to pay the debt.

The above bail out formula was applied already to Greece and Ireland, where severe measures to cut public spending were then first enacted. The result is that rather than revitalizing the economy austerity is paralyzing it. It should be stressed that these are the traditionally weaker economies outside the core of European economy. Their budget crisis should lead to discuss the position they occupy in the building of the market of the Euro-zone.

But austerity as a crisis remedy is not working even in economies such as that of the UK. The UK passed austerity measures a year earlier, but in April 2011 the forecasts spoke of a real household income falling by 2% in 2011. Government growth estimates were slashed from 2.4 % to 1.7 %. Stagnant growth, weak wage growth and inflation are making a double dip recession possible. (The NYTimes, front page, April 15, 2011)

The possibility of long-term stagnation is then suggested by two converging trends: a deflationary scenario materializing in Europe; an ongoing battle over cutting the government deficit in the US. They have to seen in the context of the absence of clear growth scenario driven by private investment.

3. The stimulus and the nature of the crisis

The stimulation policy enacted in the US, although reflecting concerns largely set aside in Europe, has nevertheless severe limitations. It relies on the monetary policy of the Federal Reserve and on a fiscal policy subject to much criticism. That applies also to the advise of prominent Keynesian such as Paul Krugman who has repeatedly argued for a much stronger stimulus. Indeed the perspective of long run stagnation calls for a rethinking of Keynesian theory and policy.

A first issue concerns the size of such a stimulus, in absolute terms and compared with the support given to the banking system; a second concerns the split between lower taxes and public investment, given the modest expansive effects of the former, especially on private investment (more sensitive to demand conditions). Even more important is where public investment is directed.

The American Recovery and Reinvestment Plan focuses on public works (roads, bridges, sewage systems), health and education buildings, that is, infrastructures in a broad sense of the term. It also aims at expanding access of schools and hospitals to Internet. Investment in the broad band and the development of the network is therefore also part of the picture. Energy, health and new infrastructures are seen as condition to improve long-term competitiveness. There a are a number of intersections and feedback effects between these lines of investment. Energy implies production of hardware and systems for alternative, natural sources. But it calls also for an energy efficiency restructuring of the public buildings. New infrastructures such as broadband Internet access may improve considerably health and education services, not to mention access to government services.

The President has spoken of five objectives: doubling the production of renewable energies, rebuild infrastructures, bring informatics to hospital, modernize schools, cut taxes on household payrolls. A central position is however assigned to save the US auto industry. So
here we have another feedback mechanism: how is saving an old industry the basis for a new industry that of energy efficient and alternative transportation?

In the budget presented in February 2011 by the Obama administration the stimulation policy is made of more spending for training and research and investment in infrastructures, including the broad-band, wireless access and rapid train lines. The budget includes measures to reduce the deficit, which is almost 11% of GDP. Cuts concern marginally military spending, more substantially many federal agencies, for example NASA, and federal social programs, including Medicare. On the other hand, unemployment benefits have been extended to one year. Under the pressure of cutting the deficit you might say you could not expect more than this. Still, this is not much of a policy of public investment to speak of.

Gerald Epstein has argued that the policy for job creation is primarily based on the stimulus coming from lower taxes and the plan to increase exports. Exports do indeed have positive impact, he says, but the policy of free trade agreements the administration is pursuing more than exports benefits further outsourcing - via investment abroad of Us companies. Outsourcing severely damaged employment at home. The key point, he notices, is domestic demand. That is why the Federal policy towards infrastructures – with the creation of a National Bank for infrastructures – and clean technologies - aiming at one million electric cars in 2015, offer better hopes for employment.

Indeed public investment has a crucial role to play for the recovery. But an extensive recovery cannot be based on public investment only, especially under the pressure to cut the deficit. Fiscal austerity is becoming a priority in the US also, after the Republicans regained control over at least Congress. After many promises the fiscal stimulus may result into much less than a “new deal”.

These observations bring to the fore one of the major issue: is this policy capable of sustaining a decisive turn in the recovery? Can it contribute to restarting private investment on a large scale? It might be well the case that quantitative easing may have prevented an even worse unemployment. But will it be sufficient to restart the economy on an acceptable growth path?

The fundamental question is the nature of the crisis and why indeed it may result in a long-term stagnation. The seriousness of the downturn and the persisting uncertainties strongly suggests that this is not just another cycle in an otherwise positive long-term growth trend.

To examine what a new long trend might be it is necessary to look into the question of new markets (Gualerzi and Nell, 2010b); this is the key element for an understanding of the crisis. Even if we assume that the short-term crisis is overcome, the question is really the new pattern it will settle in, thus the characteristics of a new expansion phase.

4. The possibility of a new growth pattern.

2 In December 2010 the Obama Administration had already worked out an agreement to extend benefits and tax cuts. (The New York Times, December 7th)

3 The analysis here concerns industrial economies and the US in particular. Although the suggested view of market growth can be extended to developing economies a separate account is necessary, as the example of China suggests. (Gualerzi, 2011)
For a new pattern of growth to emerge we might want to consider the sectors that are most promising in the way of a sustained growth of private investment. We have argued (Gualerzi and Nell, forthcoming) that these are: ICTs, Bio-tech, the Green Economy, and Healthcare.

**ICTs**

It was said above that in the 2000s the diffusion of ICTs and some trends of transformation continued. We observed: a) a continuation of the ICTs technological trajectory; b) a consolidation of the ICTs research-industrial complex; c) a deeper and deeper restructuring of the industries affected by the Internet.

In general, the move towards the Internet continued, highlighting the importance of research engines, the rise of on-line auctions, and a general phenomenon associated with a robust and evolving network culture, the rise of *social networks and the spread of blogs*. A major issue is *whether and how these* channels of communication, debate and aggregation can be turned into new markets and opportunities for investment, a largely open question.

Technological innovation further established access and communication, mobility and virtual reality as important aspects of need development, but did not stimulate new markets as the emergence of a new frontier had done in the 1990s. (Gualerzi, 2010)

New products – newer generations of cell phones, the Ipod, IPAD 1 and 2 all go in the same direction, without opening new ones, they are instances of further development in a well set path. Something more could be probably said of new Internet services and companies, broad-band and WI-FI, indeed the effects of a now firmly established and increasing powerful technological infrastructure. Finally, research should assess what are in balance the employment effects of the massive industrial restructuring in such industries such as publishing, Media and entertainment.

Thus the fundamental question is whether the continuing impact of the Internet on economic and social life will reach another crucial point such to drive a new boom and sustained expansion.

**Bio-Tech**

After ICTs, this may be the most advanced of the sectors that might trigger a boom. There is a great deal of R&D, and a large amount of investment by venture capital, so that new company formation is high. A little reflection suggests fantastic possibilities: a cure for cancer? For diabetes? Regenerating the heart? Growing replacement organs? Repairing arthritic joints? Staving off old age, perhaps by genetic engineering…? Surely the markets would be endless… Nor is biotech only medical; there are new seeds, new pesticides, new crops, new or at least improved animals. There may even be biological computers, faster than anything we have now.

Unfortunately a little more reflection brings up huge and, given our present institutions, perhaps intractable problems. Life-saving, life-enhancing and life-lengthening procedures will surely be very costly; will they only be available to those who can afford them? They will also very likely be available in limited supply, at least initially, but perhaps for a long time; how will they be rationed? Will they go only to those who can pay the price? Public opinion would not accept a market solution. But if not decided by markets, then who will decide, and on what grounds? These are potentially very divisive questions. Solutions will
have to involve a large public debate and there will almost certainly be a substantial public sector role in providing the services in question.

As for genetic engineering, we already can see terrible problems emerging; the very successful weed-killers of a decade ago have now spawned very successful resistant weeds – in some cases not only successful but far more damaging than the ones they have replaced. Again there will have to be government regulation and a large public sector role.

Climate change affects also ecosystems. New issues concerns biodiversity, and the natural and human environment, often indispensable to the live hood of local population. Here the question crosses with that of agriculture, and especially agro industry and biotechnologies.

The Green Economy

Previously the environmental problem was mostly a matter of environment protection, i.e. contrasting air and water pollution and preserving the natural environment. Now, especially the climate change problem is a pervasive issue, calling into question the short-term sustainability of the economic system. The worsening of the environmental problem worldwide and the mounting pressure posed by global warming and climate change are the new defining trait of the move towards the green economy. Reaching a crucial stage are problems that need to be addressed urgently.

Global warming and climate change is the result of carbon dioxide (CO\textsuperscript{2}) emissions of industrial production and cattle breeding. So far discussion revolves around setting limitations on emissions (hoping that it will work backward on the choice of “clean” or at least cleaner technologies) and trading emission rights. But that really calls for a formidable problem of industrial reconverting.

Focusing on energy helps to narrow down the problem. Indeed energy and the environment are closely related issues. On the one hand energy production is responsible of much of CO\textsuperscript{2} emissions – more and more so since demand for energy grows rapidly. As other industrial activities it burns fossil fuels, but is the core of the general question because it extracts oil and produces oil products. This is intertwined with issues such as that of oil prices and oil reserves. On the other hand, we see the alternative energy industry stepping forward into a rapidly growing market.

Alternative sources of energy are available, but for a take off of a green economy it seems decisive taking over fossil fuels for home and industrial use and of course for transportation. Indeed the large question that seems ripe for further development is that of the alternatives to oil and the automobile. The latter is going through a deep crisis and consolidation, subject to the search for an alternative to the internal combustion engine.

We can conclude that such a take off depends on largely on the oil market and the alternatives to the combustion engine.

Healthcare

Healthcare of course intersects with biotech, but it will grow for another reason: as health improves, we have longer live spans and an aging of the population, both calling for more medical care. Fogel (2004) has argued that the industry of the future is going to be the health industry. There will surely be increased investment. Consider the capital intensive nature of investment in hospital and medical services; these require high technology equipment. Advanced medical and surgical equipment embodies the latest and best
advances in science and technology. How far that can translate in a decisive growth of jobs, and good jobs in particular, is an open question.

5. The role of government

Each of these possible areas of expansion has its own specific questions or if you like barriers – features that might promote or limit expansion. These are likely to involve to a large extent issues of externalities and thus the limitations of a development guided by the market, i.e. private investment. Market failure in general call for government intervention. And that is the discussion of a changing role of government.

On the one hand we have an Hi-Tech segment based on the advances of Information technologies and genetic engineering; on the other we are referring to: a) the vast process of restructuring implied by the notion of green economy, with a fundamental question being that of energy; b) one of the main trends of development in industrial economies, the rise of healthcare services. These sectors are all intertwined with the question of the economic and social impact of technology, although from rather different angles. Except all of them have interesting implications for the analysis of new markets development. Again that raises the question of the role of government.

So far green investment has not provided much of a push to growth, it might do so in the future. But it is hard to see how purely private investment can manage to provide what is needed. The development of health care industry may mobilize significant private investment. But just as surely it will involve a substantial increase in government spending and in government regulation. It will not be a largely private sector boom, driven by private incentives. As for Hi-tech the economies of scale on the side of consumption and externalities require government intervention and regulation.

6. Questions for Keynesian theory

This admittedly sketchy discussion of growth candidates is however sufficient to design the more general question of the challenges that the nature of the crisis poses to Keynesian theory. While in depth research can assess the barriers to private investment in these possible areas of expansion, it seems clear that public policy centered on the idea of a fiscal stimulus restarting the private economy is based on a misunderstanding of the nature of the crisis. As such it s hardly sufficient to sustain a recovery and is not in itself a reasonable approach to the unemployment problem.

The question of the size of the fiscal stimulus is only one of those to be addressed, what seems necessary is a more fundamental a re-thinking of government.

Parallel to the debate on policies is indeed the debate on economic theory stirred by the crisis. Krugman (2009) argues that the problem is with the approach of mainstream macro theory and the overwhelming role that financial economists have come to play. Ultimately both have to their roots on two hypotheses: agents’ rational behavior and market perfection. The idea that theory had it all under control, including the tools to overcome economic depression, completes the picture.

Precisely the Great Depression called into question trusting the market. Keynes challenged the idea that market economies could work without supervision. Especially he was skeptical
about financial markets that, Krugman recalls, he compared to Casinos. That contrasts with
the leading role played by the theory of financial markets, according to which market
operate efficiently, correctly pricing assets on the basis of all available information. The
rational investor would evaluate risk and returns; the capm (capital asset pricing model) has
become the basis not only of portfolio decisions but also for the pricing for derivatives.

Despite the periodical collapse of the stock market, such as those of 1974 and 1987, the
hypothesis of efficient markets virtually cancelled irrationality, bubbles and disastrous
speculation in the theory of financial markets. Keynes’ response to the great depression was
also almost completely forgotten. This had a lot to do with the fact that between 1985 and
2007 recessions were mild and inflation was under control. The current crisis has changed
all of that. It brought down the edifice based on rationality and perfect markets and called
into question the reliance on monetary policy only to handle the crisis. Whereas successful
in 1990 and 2001, lowering short-term interest rates is not working this time, since at the
end of 2008 the rates had already reached the “zero lower bound”. The crisis forced a
change of policy. The Obama administration refocused attention of the fiscal stimulus, re-
establishing a Keynesian orientation.

According to Akerlof and Schiller (2009) the main point is that Keynes thought that much
economic activity is driven by animal spirits. They ultimately account for economic
fluctuations and involuntary unemployment. Government intervention is required to
counteract the negative effects of animal spirits, and in particular episodes of exuberance
and panic. The difference between classicism and Keynesian theory is then the trust on
rationality as the key to economic decisions. They elaborate on the effects of the “irrational”
component and argue that it affects trust, equity, corruption and antisocial behaviour,
monetary illusion and finally the narratives that influence economic behaviour and are
rooted in who we are and what we do. Through these channels animal spirits can explain
phenomena like depression, unemployment, volatility in financial prices and investments,
cyclical patterns in the real estate market.

They argue that the current financial crisis is not just a shortage of demand, which is
customarily addressed by a mix of monetary policy and fiscal stimulus. The problem is the
contraction of credit. Its causes are in the change introduced by the “new finance”. The
narrative holding in the years of its rise was that new financial products were tools to
manage risk, which they were, at least at an initial stage. As these products spread and grew
more complex and complicated, the narrative changed; it suggested that these financial
products were ways to sell false remedies. As the new narrative about the nature of Wall
Street financial transactions took hold the demand for these “exotic” products collapsed and
the credit crunch began. Reconsidering Keynes’ notion of animal spirits is then fundamental
to manage what are indeed imperfect markets.

The very success of the Federal reserve in overcoming the 2001 recession after the burst of the
technological bubble seems to have contributed to discard the possibility of a new bubble developing in the
real estate sector. Both Greenspan in 2004 and Bernanke in 2005 ruled out such a possibility. Houses prices
were simply reflecting strong fundamentals.

Krugman criticism echoes the explanation of the collapse of the 1990s expansion by another Nobel Prize
winner, Joseph Stiglitz (2003). It was the perfect markets “mantra” that drove an increasingly misdirected
and ultimately wrong economic policy during the two Clinton administrations. He also concludes that we
need to go back to Keynes.
According to Akerlof and Shiller this approach is part of an emerging field of studies called behavioral economics, which attempts to explain the real functioning of the economy when the human element is taken into account. There is a remarkable similarity with the conclusion reached by Krugman. Economists must refocus attention on “mistakes and tensions”, trading elegance for relevance. What is relevant are the limitations of human rationality and economic institutions, the shortcoming of markets and the dangers created when regulators do not trust regulation. Behavioral finance stresses that investors are prone to exuberance and panic. Herd behavior dominates their choices and that is reinforced by problems of trust, credibility and limited warranty. Indeed, behavioral economics tries to explain investors’irrational behavior and how that leads to financial markets instability.

Facing possibly the most serious crisis of the post-war these are the lines of the “go back to Keynes” advocated by prominent Keynesians. Is this telling the whole story about the crisis? Isn’t the crisis opening a larger set of questions for Keynesian theory? We would argue that is cannot make a decisive come back unless it takes step forward in term of analysis and re-orientation.

The possibility of long run stagnation cannot be interpreted solely as the consequence of the negative effects of animal spirits and market imperfections. After all, we are not dealing with short term, relatively mild fluctuations. Behavioral economics offers an insight into the nature of the crisis but it does not seem to develop much he Keynesian research agenda on depression and effective demand. We have seen that there is another research agenda based on the principle of effective demand and that is what the approach centered on the question of new markets articulates. Markets are constructed in a social process where private investment has a central role to play. Although quite distinct, this investigation also might help to rescue economic thinking from fundamental irrelevance. Indeed, it more directly confronts the issue of how new unemployment opportunities might arise.

Concluding remarks

We are dealing with the possibility of a long-term stagnation because of a combination of factors: weak private investment and poor prospects of market growth; a persistent weakness on wages and employment, and an unequal income distribution. Government policy is hardly dealing with these issues. In the US it is entangled in a debate on a stimulus overshadowed by the question of cutting the government deficit.

The nature of the crisis and the causes of long term stagnation bring to the fore the fact that the role of government must change substantially, beyond the debate on the stimulus.

The problem is one of theory and policy at a more concrete level, dealing with the real phenomenon of technology development and its relationship to investment and demand. That is what is missing in the discussion of the employment policies.

References


