Chapter 2  

America’s Exhausted Paradigm: Macroeconomic Causes of the Financial Crisis and Great Recession\(^1\)

*Thomas I. Palley*

The Great Recession and the financial crisis that triggered it are widely recognized as being tied to the bursting of the house price bubble and the debts accumulated in financing that bubble. Most commentary has therefore focused on market failure in the housing and credit markets. But what if the house price bubble developed because the economy needed a bubble to ensure continued growth? In that case the real cause of the crisis would be the economy’s underlying macroeconomic structure. While instability in housing finance was undoubtedly central to dynamics of the Great Recession, as discussed in detail elsewhere in this volume, a singular focus on the microeconomics of market failure in housing and credit markets would miss other important aspects of the crisis that are critical to not only our understanding of what has happened but also effective design of policy going forward.\(^2\)

Despite the relevance of macroeconomic factors for explaining the financial crisis, there is resistance to such an explanation. In part, this is because such factors operate indirectly and gradually, while microeconomic explanations that emphasize regulatory failure and flawed incentives within financial markets operate directly. Regulatory and incentive failures are specific, easy to understand, and offer a concrete

---

\(^1\) An earlier version of this paper was originally released in July 2009 by the New America Foundations’ Economic Growth Program, whose permission to use it is gratefully acknowledged. An abbreviated version of the paper was published in *Empirica*, 38 (1), 2011.

\(^2\) Financial instability and its role in the Great Recession are discussed extensively by other chapters in this volume. See in particular the chapters by Crotty ##, Kregel ##, and Wray ##.
“fixit” agenda that appeals to politicians who want to show they are doing something. They also tend to be associated with tales of villainy (such as Bernie Madoff’s massive Ponzi scheme or the bonus scandals at AIG and Merrill Lynch) that attract media interest and are easily understood by the general public. Finally, and perhaps most important, a microeconomic focus does not challenge the larger structure of economic arrangements, while a macroeconomic focus invites controversy by placing these matters squarely on the table.

But, an economic crisis of the current magnitude does not occur without macroeconomic forces. That means the macroeconomic arrangements that have governed the U.S. economy for the past 25 years are critical for explaining the crisis. As illustrated in Figure 2.1 two factors in particular have been important. The first concerns the U.S. economic growth model and its impact on the pattern of income distribution and demand generation (see related discussion in the chapter by Setterfield in this volume ##). The second concerns the U.S. model of global economic engagement and its impact on the structure of U.S. economic relations within the global economy (a theme also addressed by Blecker’s ## contribution).
The macroeconomic forces unleashed by these twin factors have accumulated gradually and made for an increasingly fragile and unstable macroeconomic environment. The brewing instability over the past two decades has been visible in successive asset bubbles, rising indebtedness, rising trade deficits, and business cycles marked by initial weakness (so-called jobless recovery) followed by febrile booms. However, investors, policymakers, and economists chose to ignore these danger signs, and resolutely refused to examine the flawed macroeconomic arrangements that led to the cliff’s edge. The challenge now, which is discussed briefly at the end of this chapter, is to design a new macroeconomic architecture that delivers shared prosperity without financial instability.

1. The Flawed U.S. Growth Model

Economic crises should be understood as a combination of proximate and ultimate factors. The proximate factors represent the triggering events, while the ultimate factors represent the deep causes. The meltdown of the subprime mortgage market in August 2007 triggered the current crisis, which was amplified by policy failures such as the
decision to allow the collapse of Lehman Brothers. However, a crisis of the magnitude now being experienced requires a facilitating macroeconomic environment. That macroeconomic environment has been a long time in the making and can be traced back to the election of Ronald Reagan in 1980 that symbolized the inauguration of the era of neoliberal economics.

*The Post-1980 neoliberal growth model*

The impact of the neoliberal economic growth model is apparent in the changed character of the U.S. business cycle (Palley, 2005). Before 1980, economic policy was designed to achieve full employment, and the economy was characterized by a system in which wages grew with productivity. This configuration created a virtuous circle of growth. Rising wages meant robust aggregate demand, which contributed to full employment. Full employment in turn provided an incentive to invest, which raised productivity, thereby supporting higher wages. Setterfield’s ## chapter in this volume explores this process in detail.

After 1980, with the advent of the new growth model, the commitment to full employment was abandoned as inflationary, with the result that the link between productivity growth and wages was severed.3 In place of wage growth, borrowing and asset price inflation became the new engine of demand growth. Adherents of the neoliberal orthodoxy made controlling inflation their primary policy concern, and set about attacking unions, the minimum wage, and other worker protections. Meanwhile,

---

3 The change in policy is evident in changed language. After 1980 the term “full employment” gradually disappears from the lexicon of economic policy and is replaced by the “natural rate of unemployment” (see Palley, 2007).
globalization brought increased foreign competition from lower-wage economies and the prospect of off-shoring of employment, as also discussed in the chapter by Blecker ##.

The new neoliberal model was justified by appeal to neoclassical economics and its claims that unfettered markets automatically generate full employment, wages are equal to labor’s contribution to production, and money is neutral. Yet in reality economic growth came to rely on financial booms and cheap imports. Financial booms provided consumers and firms with collateral to support debt-financed spending. Borrowing was also sustained by financial innovation and deregulation that ensures a flow of new financial products, allowing increased leverage and widening the range of assets that can be collateralized (see the chapter by Wray). Meanwhile, cheap imports ameliorated the impact of wage stagnation, thereby maintaining political support for the model. Additionally, rising wealth and income inequality make high-end consumption a larger and more important source of the demand necessary to support employment and growth, leading to the development of what Ajay Kapur, a former global strategist for Citigroup, termed a “plutonomy.”

These features have been visible in every U.S. business cycle since 1980, and the business cycles under presidents Reagan, Bush père, Clinton, and Bush fils have robust commonalities that reveal their shared economic paradigm. Those features include asset price inflation (equities and housing); widening income inequality; detachment of worker wages from productivity growth; rising household and corporate leverage ratios measured respectively as debt/income and debt/equity ratios; a strong dollar; trade deficits; disinflation or low inflation; and manufacturing job loss.
The changes brought about by the post-1980 economic paradigm are especially evident in manufacturing employment (see Tables 2.1 and 2.2). Before 1980, manufacturing employment rose in expansions and fell in recessions, and each expansion tended to push manufacturing employment above its previous peak. After 1980, the pattern changed abruptly. In the first two business cycles (between July 1980 and July 1990) manufacturing employment rose in the expansions but did not recover its previous peak. In the two most recent business cycles (between March 1991 and December 2007), manufacturing employment not only failed to recover its previous peak but actually fell over the entirety of the expansions.

Table 2.1: Manufacturing Employment by Business Cycle, October 1945 – January 1980

<table>
<thead>
<tr>
<th>Trough</th>
<th>Employment (Millions)</th>
<th>Peak</th>
<th>Employment (Millions)</th>
<th>Change (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct. 1945</td>
<td>12.5</td>
<td>Nov. 1948</td>
<td>14.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Oct. 1949</td>
<td>12.9</td>
<td>Jul 1953</td>
<td>16.4</td>
<td>3.5</td>
</tr>
<tr>
<td>May 1954</td>
<td>15.0</td>
<td>Aug 1957</td>
<td>15.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Apr. 1958</td>
<td>14.5</td>
<td>Apr 1960</td>
<td>15.7</td>
<td>1.2</td>
</tr>
<tr>
<td>Feb. 1961</td>
<td>14.8</td>
<td>Dec 1969</td>
<td>18.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Nov 1970</td>
<td>17.0</td>
<td>Nov 1973</td>
<td>18.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Mar. 1975</td>
<td>16.9</td>
<td>Jan 1980</td>
<td>19.3</td>
<td>2.4</td>
</tr>
</tbody>
</table>

4 The 1950s are an exception because of the Korean War (June 1950-July 1953), which ratcheted up manufacturing employment and distorted manufacturing employment patterns.

5 Defenders of the neoliberal paradigm argue that manufacturing has prospered and the decline in manufacturing employment reflects healthy productivity trends. As evidence, they argue that real manufacturing output has increased and remained fairly steady as a share of real GDP. This reflects the fact that manufacturing prices have fallen faster than other prices. However, this is due in part to hedonic “quality adjustment” statistical procedures that count improved information technology embodied in manufactured goods as increased manufacturing output. It is also due to increased use of cheap imported components that are not subject to the same hedonic statistical adjustments. As a result, the real cost of imported inputs is understated, and that has the effect of making it look as if real manufacturing output is higher. The stark reality is that the nominal value of manufacturing output has fallen dramatically as a share of nominal GDP. The United States has also become more dependent on imported manufactured goods, with imported manufactured goods making up a significantly increased share of total manufactured goods purchased. Moreover, U.S. purchases of manufactured goods have risen as a share of total U.S. demand, indicating that the failure lies in U.S. production of manufactured goods which has lost out to imports. See Bivens (2004).
This dramatic change in the pattern of real economic activity was accompanied by change in policymakers’ attitudes, most clearly illustrated by the changed attitude toward the trade deficit. Under the earlier economic model, policymakers viewed trade deficits as cause for concern because they represented a leakage of aggregate demand that undermined the virtuous circle of growth. However, under the new model, trade deficits came to be viewed as semi-virtuous because they helped to control inflation by increasing supply and competition. Trade deficits also reflect the choices of consumers and business in the marketplace, and according to neoliberal economic theory those choices represent the self-interest of economic agents, the pursuit of which is good for the economy. As a result, the trade deficit grew steadily from virtually zero prior to 1980 to nearly 6 percent of GDP prior to the Great Recession in 2007, hitting new peaks as a share of GDP in each business cycle after 1980.

The effect of the changed growth model is also evident in the detachment of wages from productivity growth, as shown in Table 2.3 (also see Setterfield, ## this volume, pp. xx – yy). It is also evident in rising income inequality, as shown in Table 2.4. Between 1979 and 2006, the income share of the bottom 40 percent of U.S. households

### Table 2.2: Manufacturing Employment by Business Cycle, July 1980-December 2007

<table>
<thead>
<tr>
<th>Trough</th>
<th>Employment (Millions)</th>
<th>Peak</th>
<th>Employment (Millions)</th>
<th>Change (Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1980</td>
<td>18.3</td>
<td>July 1981</td>
<td>18.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Nov. 1982</td>
<td>16.7</td>
<td>July 1990</td>
<td>17.7</td>
<td>1.0</td>
</tr>
<tr>
<td>Mar. 1991</td>
<td>17.1</td>
<td>Mar. 2001</td>
<td>16.9</td>
<td>-0.2</td>
</tr>
<tr>
<td>Nov. 2001</td>
<td>15.8</td>
<td>Dec. 2007</td>
<td>13.8</td>
<td>-2.0</td>
</tr>
</tbody>
</table>
decreased significantly, while the income share of the top 20 percent increased dramatically. Moreover, a disproportionate part of that increase went to the 5 percent of families at the very top of income distribution rankings, and the top 1 percent gained even more.

**Table 2.3**: Hourly Wage and Productivity Growth, 1967–2006 (2007 dollars)

<table>
<thead>
<tr>
<th>Period</th>
<th>Productivity growth</th>
<th>Hourly wage growth</th>
<th>Productivity - wage gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>1967-73</td>
<td>2.5%</td>
<td>2.9%</td>
<td>-0.4</td>
</tr>
<tr>
<td>1973-79</td>
<td>1.2</td>
<td>-0.1</td>
<td>1.3</td>
</tr>
<tr>
<td>1979-89</td>
<td>1.4</td>
<td>0.4</td>
<td>1.0</td>
</tr>
<tr>
<td>1989-2000</td>
<td>1.9</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>2000-06</td>
<td>2.6</td>
<td>-0.1</td>
<td>2.7</td>
</tr>
</tbody>
</table>


**Table 2.4**: Distribution of Family Income by Household Income Rank, 1947–2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Bottom 40%</th>
<th>Next 40%</th>
<th>Next 15%</th>
<th>Top 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>16.9%</td>
<td>40.1%</td>
<td>25.5%</td>
<td>17.5%</td>
</tr>
<tr>
<td>1973</td>
<td>17.4%</td>
<td>41.5%</td>
<td>25.6%</td>
<td>15.5%</td>
</tr>
<tr>
<td>1979</td>
<td>17.0%</td>
<td>41.6%</td>
<td>26.1%</td>
<td>15.3%</td>
</tr>
<tr>
<td>1989</td>
<td>15.2%</td>
<td>40.2%</td>
<td>26.7%</td>
<td>17.9%</td>
</tr>
<tr>
<td>2000</td>
<td>14.1%</td>
<td>38.1%</td>
<td>26.6%</td>
<td>21.1%</td>
</tr>
<tr>
<td>2006</td>
<td>13.5%</td>
<td>38.0%</td>
<td>27.0%</td>
<td>21.5%</td>
</tr>
</tbody>
</table>

The Role of Economic Policy

Economic policy played a critical role in generating and shaping the new neoliberal growth model, and the effects of that policy boxed in workers.\textsuperscript{6} The new model can be described in terms of a neoliberal policy box (see figure 2.2), the four sides of which are globalization, small government, labor market flexibility, and retreat from full employment. Workers are pressured on all four sides, and it is this pressure that led to the severing of the wage/productivity growth link.\textsuperscript{7}

\textbf{Figure 2.2:} The Neo-Liberal Policy Box

\begin{center}
\includegraphics[width=0.5\textwidth]{policy_box.png}
\end{center}

\textit{Globalization}, in part spurred by policies encouraging free trade and capital mobility, means that American workers are increasingly competing with lower-paid foreign workers. That pressure is further increased by the fact that foreign workers are themselves under pressure owing to the so-called Washington Consensus development policy, sponsored by the International Monetary Fund (IMF) and the World Bank, which

\textsuperscript{6} Palley (1998) analyzes in detail how economic policy has impacted income distribution, unemployment, and growth. The metaphor of a box is attributable to Ron Blackwell of the AFL-CIO.

\textsuperscript{7} There is a deeper political economy behind the neo-liberal box that has been termed “financialization” (Epstein, 2001; Palley, 2008). The policy agenda embedded in the box is driven by financial markets and corporations which are now joined at the hip, with corporations pursuing a narrow financial agenda aimed at benefiting top management and financial elites.
forces them into the same neoliberal box as American workers. Thus, not only do neoliberal policies undermine demand in advanced countries, they also put pressure on demand in developing countries by promoting policies that squeeze workers there too. This is clearly evident in China, which has been marked by rising income inequality and a sharp decline in the consumption to GDP ratio.\(^8\) The net result of global implementation of neoliberal orthodoxy is the promotion of deflationary global economic conditions. That is because neoliberal globalization increases global supply but suppresses global demand. The underlying assumption is that demand generation is largely “automatic,” at least over a horizon of a few years, and therefore demand will always be sufficient to absorb supply, a problematic theoretical perspective addressed elsewhere in the introductory chapter to this volume by Cynamon, Fazzari and Setterfield ##.

Small government policies undermine the legitimacy of government and push privatization, deregulation, and light-touch regulation. Though couched in terms of liberating the economy from detrimental governmental interference, “small government” policies have resulted in the erosion of popular economic rights and protections. This is exemplified by the 1996 reform of U.S. welfare rights that stripped workers of the right to a minimal level of support in the event of destitution. Moreover, the government’s administrative capacity and ability to provide services have been seriously eroded, with many government functions outsourced to the private sector. This has led to the creation of what Galbraith (2008) terms the “predator state,” in which corporations enrich themselves on government contracts, while the out-sourced workers employed by these corporations confront worsened work conditions.

---

\(^8\) International Monetary Fund (2006).
**Labor market flexibility** involves attacking unions, the minimum wage, unemployment benefits, employment protections, and employee rights. This is justified in the name of creating labor market flexibility, including downward wage flexibility, which according to neoliberal economic theory is supposed to generate full employment. Instead, it has led to wage stagnation and widening income inequality.

**Abandonment of full employment** means having the Federal Reserve emphasize the importance of keeping inflation low over maintaining full employment. This switch was promoted by the economics profession’s adoption of Friedman’s (1968) notion of a natural rate of unemployment.\(^9\) The theoretical claim is that monetary policy cannot affect long-run equilibrium employment and unemployment, so it should instead aim for a low and stable inflation rate. In recent years, that argument has been used to push the adoption of formal inflation targets. However, the key real-world effect of natural rate theory has been to provide the Federal Reserve and policymakers with political cover for higher actual unemployment, which has undermined workers’ bargaining power (Palley, 2007).

Moreover, this natural rate logic is now being invoked to explain and justify permanently higher unemployment after the Great Recession. The reasoning is the financial crisis and Great Recession constitute a structural shock that has (allegedly) raised the natural rate of unemployment, because, for example, worker skills in the previously booming home construction industry cannot be easily transferred to other activities.

---

\(^9\) The natural rate of unemployment is also referred to as the NAIRU or non-accelerating inflation rate of unemployment.
The Neoliberal Bubble Economy

The implementation of neoliberal economic policies destroyed the stable virtuous circle growth model based on full employment and wages tied to productivity growth, replacing it with the current growth model based on rising indebtedness and asset price inflation. Since 1980, each U.S. business cycle has seen successively higher debt/income ratios at the end of expansions, and the economy has become increasingly dependent on asset price inflation to spur the growth of aggregate demand.

Compared to the period 1960–81, the period 1981–2007 saw enormous increases in the debt/GDP ratios of both the household and nonfinancial corporate sectors. This issue is discussed in greater detail in the chapter by Cynamon and Fazzari (##). And as shown in Table 2.5, debt service, measured by the Federal Reserve’s Financial Obligations Ratio increased from 10.9 percent of disposable income in 1980 to 14.3 percent in 2007. That this ratio trended upward despite declining nominal interest rates is evidence of the massively increased reliance on debt by households.

Table 2.5: Household debt service and financial obligations as percent of disposable income (DSR) by business cycle peaks, 1981 – 2007.
Source: Federal Reserve Board.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>DSR</td>
<td>10.9%</td>
<td>12.0%</td>
<td>13.4%</td>
<td>14.3%</td>
</tr>
</tbody>
</table>
Table 2.6 shows the pattern of house price inflation over the past 20 years. This table is revealing in two ways. First, it shows the extraordinary scale of the 2001–06 house price bubble. Second, it reveals the systemic role of house price inflation in driving economic expansions. Over the last 20 years, the economy has tended to expand when house price inflation has exceeded CPI (consumer price index) inflation. This was true for the last three years of the Reagan expansion. It was true for the Clinton expansion. And it was also true for the G. W. Bush expansion. The one period of sustained house price stagnation was 1990–95, which was a period of recession and extended jobless recovery. This is indicative of the significance of asset price inflation in driving demand under the neo-liberal model.

### Table 2.6: CPI inflation and house price inflation based on the S&P/Case-Shiller National Home Price Values Index

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>House price inflation (%)</td>
<td>6.7</td>
<td>0.6</td>
<td>5.7</td>
<td>10.9</td>
</tr>
<tr>
<td>Average CPI Inflation (%)</td>
<td>4.5</td>
<td>3.5</td>
<td>2.5%</td>
<td>2.5</td>
</tr>
<tr>
<td>Excess house inflation (%)</td>
<td>2.2</td>
<td>-2.9</td>
<td>3.2</td>
<td>8.4</td>
</tr>
</tbody>
</table>

Along with rising debt ratios, households progressively cut back on their savings rates, as shown in Table 2.7. Figure #1 in Cynamon and Fazzari’s chapter (##) in this volume shows the substantial rise in consumption relative to disposable income during the neoliberal period, which is the complement of a falling saving rate. Lower saving

---

10 S&P/Case-Shiller index data is only available from 1987.
provides another source of demand growth, but one that is ultimately unsustainable as saving rates get close to zero.

**Table 2.7:** Personal saving rate (PSR).

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>PSR (%)</td>
<td>7.3</td>
<td>7.8</td>
<td>10.5</td>
<td>10.0</td>
<td>10.9</td>
<td>7.3</td>
<td>1.8</td>
<td>0.6</td>
</tr>
</tbody>
</table>
Lastly, the disinflation produced by the Federal Reserve’s monetary policy created space for lower nominal interest rates and this, too, was critical for the new paradigm. That is because in recessions and financial upheavals, U.S. economic policymakers were quickly able to restore growth by lowering interest rates and opening the spigot of credit. This pattern is captured in Table 2.8, which shows three long cycles governing the Federal Reserve’s federal funds interest rate over the period 1981 – 2010.

**Table 2.8: Brief history of the federal funds interest rate, June 1981 – January 2010.**

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1981</td>
<td>19.10%</td>
<td></td>
</tr>
<tr>
<td>December 1992</td>
<td>2.92%</td>
<td></td>
</tr>
<tr>
<td>November 2001</td>
<td>6.51</td>
<td></td>
</tr>
<tr>
<td>May 2004</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>July 2007</td>
<td>5.26</td>
<td></td>
</tr>
<tr>
<td>January 2010</td>
<td>0.10</td>
<td></td>
</tr>
</tbody>
</table>

Beginning in 1981, the Federal Reserve had enormous latitude to lower interest rates during recessions, while rates were raised during recoveries (but without restoring their previous peaks). It was this asymmetric process that lay behind the so-called “Great Moderation” and the perceived success of monetary policy. However, the reality was that the Federal Reserve was consuming the disinflation dividend. That could not last forever and, during the Great Recession, the process of interest rate reduction has come to an end because the Fed’s nominal policy interest rate has reached its zero lower bound.

In sum, though justified in terms of market efficiency, the reality of the neoliberal growth model is that it redirects income from lower- and middle-income households to corporate profits and upper-income households. Asset prices are bid up by a host of
measures, including higher profits, savings by the super-rich (the top 1% of the income distribution) that are directed to asset purchases, borrowing to buy assets, and institutional changes such as the shift from traditional defined benefit pension plans to defined contribution pension plans. Consumption is maintained by lower household savings rates, by borrowing that is collateralized by higher asset prices, and by the introduction of new sources of consumer credit (see Cynamon and Fazzari ##, this volume, pp. xx – yy). The reduction in savings rates is partly a response to squeezed incomes and partly rationalized on the grounds that households are wealthier because of higher asset prices (including house prices).

The problem with the model is it is unsustainable. Maintaining the growth of consumption spending requires continued excessive borrowing and continued reduction in savings rates. Continued excessive borrowing requires ever increasing asset prices and debt/income ratios: hence, the systemic need for bubbles (which eventually burst). Meanwhile, when the savings rate hits zero, little further reduction is possible. Consequently, both drivers of demand eventually exhaust themselves.

The current financial crisis is different and deeper from earlier crises in two ways. First, the impact of earlier burst bubbles—such as the 2001 stock market and dot.com bubbles—was contained because their debt footprint was not that deep. Though financial wealth was destroyed and economic activity was temporarily restrained, the financial system remained intact. However, the housing bubble of 2001–07 was debt financed and massive in size, and its bursting pulled down the entire financial system. Moreover, since housing wealth is such a large component of household wealth, the collapse in house prices devastated household wealth in a way that the stock market and dot.com bubbles
did not. That has had an enormous negative wealth effect on consumption spending that was absent in the 2001 stock market bust (Baker’s chapter in this volume ## emphasizes similar forces).

Second, the drivers of aggregate demand are now exhausted because of the scale of debt accumulation and the way that the savings rate has been run down. In earlier crises, households still had unused borrowing capacity they could call upon and room to further reduce their saving. Both of those channels are now exhausted, making recovery a much more difficult task. Indeed, if households try to rebuild their financial worth the savings rate will rise in a sustained way for the first time since the dawn of the neoliberal era, which will weaken demand and further prolong stagnation.

The economic growth model adopted after 1980 lasted far longer than might have been expected because of our capacity to expand access to debt and increase leverage. That is the real significance of deregulation and financial innovation. However, delaying the day of reckoning also made the financial crisis more severe when it eventually arrived. When the subprime detonator tripped, the economy’s financial structure—25 years in the making and integrally linked to the economic logic of the neoliberal growth model—proved to be extremely fragile.

2. The Flawed Model of Global Economic Engagement

Though prone to instability (i.e., to boom and bust), the neoliberal growth model might have operated successfully for quite a while longer were it not for a U.S. economic policy that created a flawed engagement with the global economy. This flawed engagement
undermined the economy in two ways. First, it accelerated the erosion of household incomes. Second, it accelerated the accumulation of unproductive debt—that is, debt that generates economic activity elsewhere rather than in the United States.

The most visible manifestation of this flawed engagement is the goods trade deficit, which hit a record 6.4 percent of GDP in 2006. This deficit was the inevitable product of the structure of global economic engagement put in place over the past two decades, with the most critical elements being implemented by the Clinton administration under the guidance of Treasury Secretaries Robert Rubin and Lawrence Summers. That eight-year period saw the implementation of the North American Free Trade Agreement (NAFTA), the adoption (after the East Asian financial crisis of 1997) of the “strong dollar” policy, and the establishment of permanent normal trade relations (PNTR) with China in 2000.

These measures cemented the model of globalization that had been lobbied for by corporations and their Washington think-tank allies. The irony is that giving corporations what they wanted undermined the neoliberal model, and with it the favorable conditions for doing business, by exposing the model’s contradictions. The model would likely have eventually slumped because of its own internal dynamic, but the policy triumph of corporate globalization accelerated this process and transformed it into a financial crash.

The Triple Hemorrhage

Flawed global economic engagement created a “triple hemorrhage” within the U.S. economy. The first economic hemorrhage, long emphasized by Keynesian economists, was leakage out of the economy from spending on imports. Household income and
borrowing was significantly spent on imports, creating incomes offshore rather than in the United States. Consequently, borrowing left behind a debt footprint but did not create sustainable jobs and incomes at home.

The second hemorrhage was the leakage of jobs from the U.S. economy as a result of offshore outsourcing. Such activities directly reduced the number of higher-paying manufacturing jobs, cutting into household income. Moreover, even when jobs did not move offshore, the threat of off-shoring could be used to secure lower wages, thereby dampening wage growth and helping sever wages from productivity growth (Bronfenbrenner, 2000; Bronfenbrenner and Luce, 2004).

The third hemorrhage concerned new investment. Not only were corporations incentivized by low foreign wages, foreign subsidies, and under-valued exchange rates to close existing plants and shift their production offshore, they were also incentivized to shift new investment offshore. That did double damage. First, it reduced domestic investment spending, hurting the U.S. capital goods producing sector and employment therein. Second, it stripped the U.S. economy of modern industrial capacity, disadvantaging U.S. competitiveness and reducing employment that would have been generated to operate that capacity.

A further unanticipated economic leakage from the flawed model of global engagement concerns energy prices. Off-shoring of U.S. manufacturing capacity has often involved the closing of relatively energy-efficient and environmentally cleaner production and its replacement with less efficient and dirtier foreign production that then must also be shipped half way around the globe. These developments added to energy demand and contributed to the 2005–08 increase in oil prices, which added to the U.S.
trade deficit and effectively imposed a huge tax (paid to OPEC) on U.S. consumers. Additionally, 2008 saw a bubble in oil prices as speculative excess migrated from financial markets to commodity markets (Palley, 2008).

The flawed model of global economic engagement broke with the old model of international trade in two ways. First, instead of having roughly balanced trade, the United States ran persistent, large trade deficits. Second, instead of aiming to create a global marketplace in which U.S. companies could sell their products, the purpose of the new model was to create a global production zone in which U.S. companies could produce offshore and from which they obtained inputs. In other words, the main purpose of international economic engagement was not to increase U.S. exports, but rather to substitute cheaper imported inputs for US domestic production and to facilitate American-owned production platforms in developing countries that could export to the United States.

As a result, at the bidding of corporate interests, the United States joined itself at the hip to the global economy, opening its borders to an inflow of goods and threatening its manufacturing base. This was done without safeguards to address the problems of exchange rate misalignment and systemic trade deficits, or the mercantilist policies of trading partners such as China.

**NAFTA**

The creation of the new system of global engagement took off in 1989 with the implementation of the Canada-U.S. Free Trade Agreement that established an integrated production zone between the two countries. The 1994 implementation of NAFTA (North
American Free Trade Agreement) was the decisive next step. First, it fused Canada, the United States, and Mexico into a unified North American production zone. Second, and more importantly, it joined developed and developing economies, thereby establishing the template U.S. corporations wanted.

NAFTA also dramatically changed the significance of exchange rates. Before, exchange rates mattered for trade and the exchange of goods. Now, they mattered for the location of production. That in turn changed the attitude of large U.S. multinational corporations (MNCs) toward the dollar. When U.S. companies produced domestically and looked to export, a weaker dollar was in their commercial interest, and they lobbied against dollar overvaluation. However, under the new model, U.S. corporations looked to produce offshore and import into the United States. This reversed their commercial interest, making them proponents of a strong dollar. That is because a strong dollar reduces the dollar costs of foreign production, raising the profit margins on foreign produced goods sold in the United States at U.S. prices.

NAFTA soon highlighted this new dynamic because Mexico was hit by a financial crisis in January 1994, immediately after the implementation of the free trade agreement. To U.S. corporations, which had invested in Mexico and planned to invest more, the peso’s collapse vis-a-vis the dollar was a boon, making it even more profitable to produce in Mexico and re-export to the United States. With corporate interests driving U.S. economic policy, the peso devaluation problem went unattended—and as a result it also created a critical precedent.

The effects of NAFTA and the peso devaluation were immediately felt in the U.S. manufacturing sector in the form of job loss, the diversion of investment, firms using the
threat of relocation to suppress wages, and an explosion in the goods trade deficit with Mexico. As shown in Table 2.9, the United States was running a modest goods trade surplus with Mexico prior to the implementation of the NAFTA. Immediately afterward the balance turned negative, reaching a deficit of $74.6 billion by 2007.

Table 2.9: US goods trade balance with Mexico before and after NAFTA ($ billions)
Source: Census Bureau.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>2.1</td>
<td>5.4</td>
<td>1.7</td>
<td>1.3</td>
<td>-15.8</td>
<td>-17.5</td>
<td>-24.5</td>
<td>-49.7</td>
<td>-74.6</td>
</tr>
</tbody>
</table>

These events helped contribute to the jobless recovery of 1993–96, though the economy was eventually able to overcome its sluggishness with the emergence of the stock market bubble in 1996, the emergence of the internet investment boom that morphed into the dot.com bubble, and the tentative beginnings of the house price bubble (which can be traced back to 1997). Together, these developments spurred a consumption and investment boom that masked the adverse structural effects of NAFTA.

The Response to the East Asian Financial Crisis

The next fateful step in the flawed model of global engagement came with the East Asian financial crisis of 1997, which was followed by a series of rolling financial crises in Russia (1998), Brazil (1999), Turkey (2000), Argentina (2001-02), and Brazil (2000). In response to these crises, Treasury Secretaries Rubin and Summers adopted the
same policy that was used to deal with the 1994 peso crisis, thereby creating a new global system that replicated the pattern of economic integration established with Mexico.\textsuperscript{11} Specifically, large dollar loans were made to the countries in crisis to stabilize their economies. At the same time, the collapse of their exchange rates and the appreciation of the dollar was accepted and institutionalized in the form of a “strong dollar” policy.\textsuperscript{12} This increased the buying power of U.S. consumers, which was critical because the U.S. consumer was now the lynchpin of the global economy, becoming the buyer of first and last resort.\textsuperscript{13}

The new global economic architecture involved developing countries exporting their production to the United States. Developing countries embraced this export-led growth solution to their development problem and were encouraged to do so by the IMF and the World Bank. For developing countries, the new system had a number of advantages, including: the ability to run trade surpluses that allowed them to build up foreign exchange holdings to defend against capital flight; providing demand for their output, which led to job creation; and providing access to U.S. markets that encouraged multinational corporations to redirect investment spending toward them. The latter was

\textsuperscript{11} It cannot be overemphasized that the policies adopted by Treasury Secretaries Robert Rubin and Lawrence Summers reflected the dominant economic paradigm. As such, Rubin and Summers had the support of the majority of the U.S. political establishment, the IMF and the World Bank, Washington’s premier think tanks, and the economics profession.

\textsuperscript{12} China had already gone this route with a large exchange rate devaluation in 1994. Indeed, there is reason to believe that the Chinese devaluation contributed to the East Asian financial crisis by putting other East Asian economics under undue competitive pressures and diverting foreign investment from them to China.

\textsuperscript{13} The strong dollar policy was also politically popular, constituting a form of exchange rate populism. Boosting the value of the dollar increased the purchasing power of U.S. consumers at a time when their wages were under downward pressure due to the neo-liberal model. Households were under pressure from globalization, yet at the same time they were being given incentives to embrace it. This is why neo-liberalism has been so hard to tackle politically.
especially important as it transferred technology, created jobs, and built up developing country manufacturing capacity.

U.S. multinationals were also highly supportive of the new arrangement as they now gained global access to low-cost export production platforms. Not only did this mean access to cheap foreign labor, but the overvalued dollar lowered their foreign production costs, thereby further increasing profit margins. Large importers, like Wal-Mart, also supported this arrangement. Furthermore, many foreign governments offered subsidies as an incentive to attract foreign direct investment (FDI).

In effect, the pattern of incentives established by the response to the East Asian financial crisis encouraged U.S. corporations to persistently downsize their U.S. capacity and shift production offshore for import back to the United States. This created a dynamic for progressively eroding U.S. national industrial capacity, while foreign economies were encouraged to steadily expand their capacity and export their way out of economic difficulties.

As with NAFTA, the adverse effects of this policy were visible almost immediately. As shown in Table 2.10, the goods trade deficit took a further leap forward, surging from $198.4 billion in 1997 to $248.2 billion in 1998, and rising to $454.7 billion in 2000. In particular, as shown in Table 2.11, there was a surge in imports from Pacific Rim countries, the US trade deficit with the Pacific Rim deteriorating from $108 billion in 1995 to $215 billion by 2000. Part of the surge in the trade deficit was due to the boom conditions sparked by stock market euphoria, the dot.com bubble, and house price inflation, but the scale of the trade deficit surge also reflects the flawed character of U.S. engagement with the global economy. The proof of this last claim is that manufacturing
employment started falling despite boom conditions in the U.S. economy. Having finally started to grow in 1996, manufacturing employment peaked in March 1998 and started declining three full years before the economy went into recession in March 2001. That explains why manufacturing job growth was negative over the entirety of the Clinton expansion, a first in U.S. business cycle history.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td>-174.2</td>
<td>-191.0</td>
<td>-198.4</td>
<td>-248.2</td>
<td>-347.8</td>
<td>-454.7</td>
</tr>
</tbody>
</table>

*Source: Census Bureau.*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td>-108.1</td>
<td>-101.8</td>
<td>-121.6</td>
<td>-160.4</td>
<td>-186.0</td>
<td>-215.4</td>
</tr>
</tbody>
</table>

*Source: U.S. Census Bureau.*

As with NAFTA, these adverse effects were once again obscured by positive business cycle conditions. Consequently, the Clinton administration dismissed concerns
about the long-term dangers of manufacturing job loss. Instead, the official interpretation was that the U.S. economy was experiencing—in the words of senior Clinton economic policy advisers Alan Blinder and Janet Yellen—a “fabulous decade” significantly driven by policy. According to the ideology of the decade, manufacturing was in secular decline and destined for the dustbin of history. The old manufacturing economy was to be replaced by a “new economy” driven by computers, the internet, and information technology.

*China and PNTR*

Though disastrous for the long-run health of the U.S. economy, NAFTA-style corporate globalization plus the strong dollar policy was extremely profitable for corporations. Additionally, the ultimate costs to households were still obscured by the ability of the U.S. economy to generate cyclical booms based on asset price inflation and debt accumulation. That provided political space for a continued deepening of the global engagement model, the final step of which was to incorporate China as a full-fledged participant.

Thus, corporations now pushed for the establishment of permanent normal trading relations with China, which Congress enacted in 2000. That legislation in turn enabled China to join the World Trade Organization, which had been established in 1996.

---

14 Blinder and Yellen (2001). To the extent there was concern in the Clinton administration about manufacturing, it was about the hardships for workers regarding job dislocations. Additionally, there was political concern that produced some sweet talk (i.e., invitations to policy consultations) aimed at placating trade unions. However, there was no concern that these outcomes were due to flawed international economic policy. Not only did this policy failure contribute to eventual disastrous economic outcomes, it may well have cost Vice President Al Gore the 2000 presidential election. The Clinton administration’s economic advisers may have downplayed the significance of manufacturing job loss but blue-collar voters in Ohio did not.
The significance of PNTR was not about trade, but rather about making China a full-fledged part of global production arrangements. China had enjoyed access to the U.S. market for years and its entry into the WTO did generate some further tariff reductions. However, the real significance was that China became a fully legitimate destination for foreign direct investment. That is because production from China was now guaranteed permanent access to the U.S. market, and corporations were also given internationally recognized protections of property and investor rights.

Once again, as shown in Table 2.12, the results were predictable and similar to the pattern established by NAFTA—though the scale was far larger. Aided by a strong dollar, the trade deficit with China increased dramatically after 2001, growing at a rate of 25 percent per annum and jumping from $83.1 billion in 2001 to $201.5 billion in 2005. Moreover, there was also massive inflow of foreign direct investment into China so that it became the world’s largest recipient of FDI in 2002—a stunning achievement for a developing country (OECD Observer, 2003). So strong was China’s attractiveness as an FDI destination that it not only displaced production and investment in the United States but also displaced production and investment in Mexico (Greider, 2001).

Table 2.12: US Goods Trade Balance with China before and After PNTR ($ billions).

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>-56.9</td>
<td>-68.7</td>
<td>-83.9</td>
<td>-103.1</td>
<td>-124.1</td>
<td>-161.9</td>
<td>-201.5</td>
<td>-256.2</td>
<td></td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau.
According to academic and Washington policy orthodoxy, the new global system was supposed to launch a new era of popular shared prosperity. Demand was to be provided by U.S. consumers. Their spending was to be financed by the “new economy” based on information technology and the globalization of manufacturing, which would drive higher productivity and income. Additionally, consumer spending could be financed by borrowing and asset price inflation, which was sustainable because higher asset prices were justified by increased productivity.

This new orthodoxy was enshrined in what was termed the “New Bretton Woods Hypothesis,” according to which the global economy had entered a new golden age of global development, reminiscent of the postwar era.\textsuperscript{15} The United States would import from East Asian and other developing economies, provide FDI to those economies, and run large trade deficits that would provide the demand for the new supply. In return, developing countries would accumulate financial obligations against the United States, principally in the form of Treasury securities. This would provide them with foreign exchange reserves and collateral that was supposed to make investors feel secure. China was to epitomize the new arrangement.\textsuperscript{16}

The reality is that the structure of U.S. international engagement, with its lack of attention to the trade deficit and manufacturing, contributed to a disastrous acceleration of the contradictions inherent in the neoliberal growth model. That model always had a problem regarding sustainable generation of demand because of wage stagnation and high income inequality. Flawed international economic engagement aggravated this

\textsuperscript{15} See, for example, Dooley, Folkerts-Landau, and Garber (2003); Dooley, Folkerts-Landau, and Garber (2004a); Dooley, Folkerts-Landau, and Garber (2004b).

\textsuperscript{16} For a critique of the New Bretton Woods hypothesis that explains why it was unsustainable, see Palley (2006).
problem by draining consumer spending, manufacturing jobs, and investment and industrial capacity: the triple hemorrhage. This in turn compelled even deeper reliance on the unsustainable stopgaps of borrowing and asset price inflation to compensate and accelerated the process that culminated in the Great Recession.

As for developing economies, they embraced the post-1997 international economic order. However, in so doing they tied their fate to the U.S. economy, creating a situation in which the global economy was flying on one engine that was bound to fail. Consequently, far from creating a de-coupled global economy, it created a linked economy characterized by a concertina effect: when the U.S. economy crashed, other economies were significantly impacted (Palley, 2008).

3. America’s Exhausted Macroeconomic Paradigm

The twin macroeconomic factors of an unstable growth model and a flawed model of global economic engagement were put in place during the 1980s and 1990s. However, their full adverse effects took time to build up, and the chickens only truly came home to roost in the 2001–07 expansion. From that standpoint, the Bush administration is not responsible for the financial crisis. Its economic policies represented a continuation of the policy paradigm already in place. The financial crisis therefore represents the exhaustion of that paradigm rather than being the result of specific policy failures on the part of the Bush administration.

In a nutshell, the U.S. implemented a neoliberal growth model that relied on debt accumulation and asset price inflation. As the neo-liberal model slowly cannibalized
itself, the economy needed larger speculative bubbles to grow, culminating in the need for a huge bubble, the likes of which only housing could provide. However, when that bubble burst it pulled down the entire economy.

In many regards the neoliberal paradigm was already showing its limits in the 1990s. An extended jobless recovery marked the early stages of the 1990s business cycle, and the subsequent boom was accompanied by a stock market bubble and the beginnings of significant house price inflation. The recession of 2001 saw the bursting of the stock market and dot.com bubbles. However, although investment spending was hit hard, consumer spending was largely untouched, owing to continued household borrowing and continued moderate increases in home prices. Additionally, the financial system was largely unscathed because the stock market bubble involved limited reliance on debt financing.

Yet, despite the relative shallowness of the 2001 recession and aggressive monetary and fiscal stimulus, the economy languished in a second extended bout of jobless recovery. According to the National Bureau of Economic Research, the recession ended in November 2001, when employment was 130.9 million. Two years later (November 2003) total employment was 130.1 million, a decrease of 800,000 jobs. Over this period, manufacturing lost 1.5 million jobs, and total manufacturing employment fell from 15.83 million to 14.32 million. A critical factor was the trade deficit and off-shoring of jobs resulting from the model of globalization that had been decisively implemented in the 1990s.

The failure to develop a robust recovery, combined with persistent fears that the economy was about to slip back into recession, prompted the Federal Reserve to lower
interest rates. Beginning in November 2000, the Fed cut the federal funds rate significantly, lowering it from 6.50 percent to 2.10 percent in November 2001. However, the weakness of the recovery drove the Fed to cut the rate still further, pushing it to 1.00 percent in July 2003, where it was held until June 2004.

Ultimately, the Federal Reserve’s low-interest-rate policy succeeded in jump-starting the economy by spurring a housing price boom, which in turn sparked both a construction boom and consumption boom. The house price boom became a bubble which burst in the summer of 2007. However, what is important about this history is that the economy needed an asset price bubble to restore full employment, just as it had needed the stock market and dot.com bubbles to restore full employment in the 1990s. Given the underlying structural weakness of the demand-generation process, which had been further aggravated by flawed globalization, a bubble was the only way back to full employment. Higher asset prices were needed to provide collateral to support borrowing that could then finance spending.

A housing bubble was particularly economically effective for two reasons. First, home ownership is widespread, so the consumption wealth effects of the bubble were also widespread. Second, higher house prices stimulated domestic construction employment by raising prices above the cost of construction.

The Federal Reserve is now being blamed by many for the bubble, but the reality is that it felt compelled to lower interest rates for fear of the economy falling back into recession. Additionally, inflation—which is the signaling mechanism the Federal Reserve relies on to assess whether monetary policy is too loose—showed no indication of excess demand in the economy. Indeed, all the indications were of profound economic

---

17 See, for example, Taylor (2009).
weakness and demand shortage. Finally, when the Federal Reserve started raising the federal funds interest rates in mid-2004, the long-term rate that influences mortgages changed little. In part this may have been due to recycling of foreign country trade surpluses back to the United States, but a larger factor was likely bond market expectations of weak future economic conditions that kept the lid on long-term interest rates.

This reality is confirmed by a look back at the expansion of 2001–07 compared to other expansions. By almost all measures it ranks as the weakest business cycle since World War II. Table 2.13 shows “trough to peak” and “peak to peak” measures of GDP growth, consumption growth, investment spending growth, employment growth, manufacturing employment growth, profit growth, compensation growth, wage and salary growth, change in the unemployment rate, and change in the employment/population ratio of this business cycle relative to other postwar cycles. The 2001–07 cycle ranks worst in seven of the ten measures, and second worst in two measures. If the comparison is restricted to the four cycles lasting 27 quarters or more, the 2001–07 cycle is worst in nine of ten measures, and best in one measure only—profit growth. This weak performance occurred despite a house price and credit bubble of historic proportions. That is the clearest evidence possible of the structural weakness of the U.S. macroeconomic model and why a bubble was needed to sustain growth.
Table 2.13: Rank of last business cycle relative to cycles since World War II (1 = best; 10 = worst).

<table>
<thead>
<tr>
<th></th>
<th>Expansion only (1 = best, 10 = worst)</th>
<th>Full Cycles (1 = best, 10 = worst)</th>
<th>Full Cycles (1 = best, 4 = worst)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All</td>
<td>All</td>
<td>Cycles lasting more than 27 quarters</td>
</tr>
<tr>
<td>Number of Cycles</td>
<td>10</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>Rank of 2001-07 cycle</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth</td>
<td>10</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Consumption growth</td>
<td>9</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Investment growth</td>
<td>10</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Employment growth</td>
<td>10</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Manufacturing employment growth</td>
<td>10</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>Profit growth</td>
<td>4</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Compensation growth</td>
<td>10</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Wage &amp; salary growth</td>
<td>10</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Change in unemployment rate</td>
<td>9</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Change in Emp/population ratio</td>
<td>10</td>
<td>10</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Bivens and Irons (2008); author’s calculations.

IV. Conclusion: Where Next?

Recognizing the role of macroeconomic factors in the current crisis raises critical questions. Deregulation and massive unsound lending by financial markets are important parts of the crisis story, but they were not the ultimate cause of the crisis. Instead, financial deregulation and financial excess facilitated the bubble and are better understood as extending the life of the neoliberal growth model by supporting demand growth based on debt accumulation and asset price inflation. Absent that support, the model would have ground to a halt earlier.

At this stage, repairing regulatory and microeconomic incentive failures can limit future financial excess. However, it will not address the problems inherent in the
neoliberal U.S. growth model and pattern of global economic engagement. Worse, focusing on regulation alone diverts attention from the bigger macroeconomic challenges by misleadingly suggesting that regulatory failure is the principal cause of the crisis.

The case for paradigm change has yet to be taken up politically. Those who built the neoliberal system remain in charge of economic policy. Among mainstream economists who have justified the neoliberal system, there has been some change in thinking when it comes to regulation, but there has been no change in thinking regarding the prevailing economic paradigm. This is starkly illustrated in the debate in the United States over globalization, where the evidence of failure is compelling. Yet, any suggestion that the United States should reshape its model of global economic engagement is brushed aside as “protectionism.”

That leaves open the question of what will drive growth once the economy stabilizes. The postwar growth model based on rising middle-class incomes has been dismantled, while the neoliberal growth model has imploded. Moreover, stripping the neoliberal model of financial excess by means of regulation and leverage limits will leave it even more impaired. The U.S. economy needs a new growth model.

The outlines of that new model are easy to see. The most critical need is to restore the link between wages and productivity growth that drove the 1945–80 virtuous circle model of growth. This will require creating a new policy box that takes workers out and puts corporations in.

The outlines of such a box are easy to envisage and involve restoration of worker bargaining power in labor markets through strengthened unions, a higher minimum wage, and stronger employee protections; restoration of full employment as a macroeconomic
policy objective; restoration of the legitimacy of regulation and increased government provision of public goods; a new international economic accord that addresses the triple hemorrhage problem created by the flawed model of global economic engagement; and reform of financial markets and corporate governance that ensures markets and corporations work to promote national economic well-being.

While the economics are clear, the politics are difficult, which partially explains the resistance to change on the part of policymakers and economists aligned with the neoliberal model. The neoliberal growth model has benefitted the wealthy, while the model of global economic engagement has benefitted large multinational corporations. That gives these powerful political interests, with their money and well-funded captive think tanks and politicians, an incentive to block change. 18

Judging by its top economics personnel, the Obama administration has decided to maintain the system rather than change it. The administration may yet manage to create another bubble, this time probably an interest-rate bubble in Treasury bonds that might weakly jump-start the borrowing cycle one more time. However, even if that were to happen, it will not fix the underlying structural problem. Most importantly, even if the neoliberal model is revved up one more time, it will not deliver shared prosperity because the model was never constructed to do so.

The bottom line is macroeconomic failure rooted in America’s flawed economic paradigm is the ultimate cause of the financial crisis and Great Recession. Financial market failure played an important role in the making of the crisis, but its role was supportive and part of the flawed paradigm. Now, there is a grave danger that

18 Even domestic manufacturers who are harmed by the international economic agenda may abstain from opposing that agenda because they are net beneficiaries from the overall neo-liberal model.
policymakers only focus on financial market reform and ignore reform of America’s flawed economic paradigm. In that event, though the economy may stabilize, it will likely be unable to escape the pull of economic stagnation. That is because stagnation is the logical next stage of the existing paradigm.
References


“America's Exhausted Growth Paradigm,” The Chronicle of Higher Education, April 11, 2008a


