New School Economic Review, Volume **4**(1), 2010, 3-6

WHAT DO FINANCIAL CRISES DO?

People are living longer than ever before, a phenomenon undoubtedly made necessary by the 30-year mortgage. – Doug Larson

It isn't so much that hard times are coming; the change observed is mostly soft times going. – Groucho Marx

What do financial crises do – to us? The hardship that people go through in the wake of financial crises – unemployment, poverty, mental and physical illness – can be harrowing. But do financial crises really increase inequality? There are many possible connections between the two.

Causality can run both ways, either crises engendering greater inequality, or inequality generating crises. Not even the sign of the effect is clear *a priori*: inequality can be reduced by financial crises at least in theory, as Jomo K.S. pointed out in the discussion following his presentation at the conference that gave rise to this issue of the *New School Economic Review*, since unequally distributed financial wealth is destroyed. Furthermore, inequality can refer to the functional income distribution between labor and capital, to the distribution of income or wealth between the rich and the poor, or to the inequality in income between countries.

This issue of the *New School Economic Review* arose from a conference at the New School in spring 2010 on 'The effect of crisis on distribution'. The conference was organized by a group of students in the Economics department around Lacey Keller, including Raphaele Chappe, Eloy Fisher, Bryce Geyer, Rashid Memon, Raul Prebisch, Christian Schoder, Lisa Selca and myself, who were not satisfied by the economic analysis of the crisis. The conference can be viewed at http://www.youtube.com/view_play_list?p=E4691C0A92190D7F, or alternatively http://tinyurl.com/4b7lnvv.

This *New School Economic Review* consists of selected papers and talks presented at the conference. Contributions to the conference spanned the breadth and depth of the topic, and this issue reflects this broad-minded debate among progressives. All presentations focused on the financial crises that started off within the United States in 2007, that has since spread globally, and that, it can be argued, is still ongoing – certainly if the cost of failing banks to the FDIC is any indicator for the severity of financial stress.

Mainstream economic theory has struggled – in my view rather unsuccessfully – to make sense of the financial crisis. Korkut Erturk's contribution in this issue takes a new look at the agenda for heterodox macroeconomics in the light of the financial crisis. Although heterodox macroeconomics has in many ways been vindicated by the crisis, Erturk argues that, on the theoretical side, understanding issues like the role of asset price inflation in profit-led growth regimes and a Minskian interpretation of the monetary system is essential for Post-Keynesian thought to remain relevant to real-world problems. He draws an interesting parallel between

Keynes' financial theory in the *Treatise* and the global financial imbalances, and gives a refreshing angle on the crisis as the breakdown of a global financial system, in which the U.S. was playing the role of the banker.

Thomas Palley's paper shows how the U.S. economic system was the manifestation of a profit-led growth model that relied on asset price inflation. Palley concludes that in the past three decades rising inequality has been a constitutive part of the U.S. growth model. The resulting lack in aggregate demand was made up for through asset price and housing bubbles that provided collateral against which U.S. American consumers could enter into debt. The paper highlights the need for an alternative way of generating aggregate demand. I believe that the need for a more sustainable solution than recurrent short-term stimulus programs that Palley calls for has not yet been addressed by U.S. economic policy.

Rick Wolff's analysis coincides in large parts with Palley's. From a Marxist perspective, he points out the divergence between real wage and productivity growth, and he argues highly plausibly that American workers who wanted to keep up the traditional American dream of moving up in life had no option but to indebt themselves. He conveys the imbalance of power and the inequalities that arise from this, and the economic, political and social system that allows it to continue. Wolff provides a wide range of policy alternatives.

At the time of writing, at the end of 2010, talk of the 'Great Recession' has subsided. The meadows of green economic shoots that were being called out in the spring of 2009, when we began the planning process for the conference, have turned into sturdy seedlings of GDP growth. However, hopes for a transformative moment that would lead to the redistribution of power and income have wilted and paled in the years following the meltdown. Banks all over the world were bailed out with barely perceptible conditionality as governments shouldered the costs of the financial crises, many of them staggering under the weight. In particular European public finances appear to have been overburdened by the cost of the bailouts in the past months.

In many respects, the costs of the crisis were passed straight on to taxpayers. The unemployment rates in most countries have since risen, and higher borrowing costs for government debt will be borne by the general public. In this respect, these crises of the center mirror financial crises in the periphery, in Latin America and Asia, but also historical crises of the center starting in the 1870's and the 1920's.

Labor market outcomes unfavorable to workers are one stylized result of financial crises that is explored in Peter Skott's paper. Skott's contribution on power-biased technical change criticizes the interpretation that rising unemployment is due to changing demands for skills for which workers are badly equipped to adapt to, the skill-biased technical change story. Skott uses efficiency wage models to illustrate, on the one hand, that technical changes may induce changes

in the relative power of different groups, which have then driven more unequal distribution of incomes. On the other hand, Skott provides a possible alternative for the empirical observations of persistent employee over-qualification, as well as the continuous co-existence of unemployment and unfilled job posts.

While Skott's paper focuses on wage inequality since the 1970's, a strand of the crisis debate in labor economics has since turned skill mismatch into the primary explanation for the increase in the unemployment rate, as the Minneapolis Fed president Kocherlakota recently asserted. In my view, Skott's rebuttal of the structural mismatch argument can be read as an even stronger refutation of the 'cyclical' mismatch story.

The contributions in the second part of this issue of the *New School Economic Review* are transcriptions of talks given at the conference. Authors of the first block of three papers place the crisis in a historical context and provide a theoretical and empirical framework for thinking about it, be it institutionalist, Marxist or Post Keynesian. Zacharias' paper is empirical.

Jane D'Arista places the crisis in a historical context from a distinctly institutionalist perspective. She looks at the deregulation in the international and U.S. financial system since the 1960's with the combination of an insider's knowledge and the outsider's sweeping oversight. She treats the reader to several insightful and – to me, at least – novel observations, such as the connection between inflation in developed countries in the 1970's and central bank intervention in currency markets. In the second half of her contribution, D'Arista picks out several systemic facets of financial crises that she underlies with numerous empirical examples. She ends with a poignant critique of the response to the current crisis, and a concrete, radical and convincing alternative.

Anwar Shaikh goes back furthest in history. He graphs a compelling theoretical Marxist argument of the inherent traits of capitalism that have precipitated crises on a regular basis since the mid-19th century, and seasons his long-term view with a salient critique of policy responses to the current crisis.

Ajit Zacharias takes a sophisticated and profound look at the distributional effects of the Obama administration's stimulus program of 2009. Using input-output analysis along with simulation, he argues that while the package is likely to dampen the impact of the crisis on the middle class, it is insufficient to fundamentally improve the situation of the U.S. economy, especially in distributional terms. His policy conclusions are well established.

The second block of the transcriptions, which also encompasses three papers, focuses on the worldwide aspects of the financial crisis. In the first one, Sanjay Reddy looks at the effects of the crisis both for developing countries and for international institutions. He highlights the growing importance of countries in the periphery.

Ilene Grabel investigates the consensus among economists in international institutions, especially the IMF. She reaches the encouraging conclusion that the crisis generated a 'productive incoherence' among analysts who realized that their long-held view, in particular with respect to capital controls and to the level of inflation targets, might be inappropriate. She rounds her contribution off by pointing out a number of inconsistencies in mainstream economic theory that were highlighted by the crisis, and which might result in greater policy leeway both for developed and developing countries.

Jomo Kwame Sundaram's analysis also focuses on the international economic system and imbalances that laid the ground for the disruption of economic activity beyond domestic U.S. factors. He lays out the effects of the financial crisis in particular on developing countries, showing that they have so far felt the impact of the crisis in the form of lower GDP growth, but also through higher unemployment, and a higher number of working poor. The policy conclusions for the international arena are forceful, yet differentiated.

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