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The collapse of neoliberal capitalism: Causes and cures: A review article

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Lance Taylor, *Maynard's Revenge: The Collapse of Free Market Macroeconomics*. Cambridge, MA, and London: Harvard University Press, 2010; 285 pp.: 9780674050464, 9780674050460

Thomas Palley, *From the Crisis to Stagnation: The Destruction of Shared Prosperity and the Role of Economics*. Cambridge: Cambridge University Press, 2012; 238 pp.: 9781107612464, 9781107016620

Abstract
These books, different in style and content but united in purpose and major conclusions, analyse events from 2007 to 2010 to ascertain why the economic disaster happened and what must be done to put the United States economy (on which both books focus) on a more secure footing, and prevent any recurrence of the extended crisis of those years. Both target the increasing influence of market liberalism over the last 30 years, and the institutions of capitalist economies which they have encouraged. Taylor focuses more on the regulation of the international financial sector, and Palley on labour market policy. They agree that both need to be addressed if the United States economy is to be restored to health. Both argue that growing income inequality in the US must be reversed before the US economy can significantly improve. Finally, they stress the interrelationship between political ideology and economic explanation, and argue that value free positive economics is a myth.

JEL codes: E24, E32, E60

Keywords
Global financial crisis, income inequality, Keynesian economics, macroeconomic policy, neoliberalism

Introduction

Both books reviewed in this article, though varying in style and content, are united in their purpose and major conclusions. They analyse the events from 2007 to 2010, providing explanations as to why the crises happened as well as making suggestions as to how to restore the United States economy (on which both books focus) to a more secure footing while preventing any recurrence of crises. Neither is written primarily for professional economists, but for undergraduate students and interested lay persons. Both identify the increasing influence of market liberalism over the last three decades, and the institutions of capitalist economies which have emerged as a result, as major factors contributing to the crisis.

Taylor's focus is on the participants in the international financial sector, as well as those responsible for its regulation. For Palley, it is those who are responsible for labour market policies that bear the largest part of the responsibility. However, the authors agree that policy, particularly with respect to both labour markets and financial markets, played a major role in causing the events of 2007–2010 and need to be redesigned if the United States economy is to be restored. In addition, both authors argue that growing income inequality in the United States is a contributing factor to the crisis, which must be addressed. Finally, and perhaps most important of all, both books stress the interrelationship between political ideology and economic explanation, and argue that value free positive economics is a myth.

Taylor claims that his book is written with two main groups in mind. One is made up of people who are willing to '*think* about how Keynes and his closest followers … did macroeconomics' (p. vii, emphasis in the original), with the motivation of understanding the events of 2007–2009 and obtaining insights about the policies most likely to return the world economy to prosperity as soon as possible. 'The second group of potential readers comprise students who desire to be inoculated against what they are taught in [undergraduate] mainstream classes in economics' (p. viii).

Taylor's book is actually a history of economic thought from Adam Smith to the present day, containing much data about the United States economy, peppered throughout with comments about policy implications. It concludes with an analysis of the crisis starting in 2007. This analysis, Taylor claims, is largely self-contained with 'a little help from the rest of the book' (p. 337). Such may be the case for professional economists but if his intended readers are to understand the events of 2007 and the following years, they will require considerable help from much of the rest of the book. To read the concluding chapter in isolation, targeted readers must be prepared to accept many statements on trust, with little understanding of the supporting arguments. This problem is symptomatic of another characteristic of Taylor's book overall. Although his exposition is generally good, he overestimates the capacity of his readership to absorb large amounts of unfamiliar material. He suffers from the 'curse of knowledge' – the problem that 'once we know something we can't imagine ever thinking otherwise', making 'it hard for us to realise that what we know may be less than obvious to others who are less well informed' (Thaler, 2000: 133). Palley's book can be happily recommended to first year students. Taylor's book can be happily recommended to graduate students. For both authors, neoclassical economic theory's role in reinforcing neoliberal policies is the fundamental cause of the current economic crisis. For neither author is this an accident. For Palley, 'the capture of economics by business interests' means that 'power and wealth are applied to influence ideas, and ideas then support the existing structure of power and distribution of wealth' (pp. 205–206).

Reflecting the author's broader purpose, Palley's book is written in an extremely accessible style, never too technical and avoiding an undue use of jargon. It uses simple diagrams to explain complex ideas and presents its statistics in readily understandable tables. Importantly, the book is extremely America focused, laying the blame for the current crisis at the feet of American policymakers, and on the neoliberal ideology underlying their actions. It argues that a market liberalism that 'worships' markets and believes in shrinking government as much as possible has dominated American public policy since 1970s, and has been increasingly gaining global acceptance. Markets are seen as perfect allocators of resources, while governments, in contrast, are seen as being the fundamental cause of most economic problems. Because markets result in 'efficient' outcomes, then any government intervention must make people worse off. Even if markets fail, government intervention is unlikely to improve the outcome.

Table 1. Wage growth lagged behind productivity growth.

Period	Productivity growth (%)	Hourly wage growth (%)	Productivity–wage gap
1967–1973	2.5	2.9	−0.4
1973–1979	1.2	−0.1	1.3
1979–1989	1.4	0.4	1.0
1989–2000	1.9	0.9	1.0
2000–2006	2.6	−0.1	2.7

Source: Palley (2012: 37).

The primary cause of the crisis was the dismantling of what the book calls the post-World War II growth model which relied upon rising middle-class incomes to sustain increase in growth. This model was replaced in the 1970s by market fundamentalism which led to stagnant real wages and wage incomes, so that increased demand had to come from somewhere else. To quote Palley, 'between 1979 and 2006, the income share of the bottom 40 per cent of US households decreased significantly, while the income share of the top 20 per cent increased dramatically' (p. 37).[1] Real wages did not increase in the period from the 1970s, so that they were unable to keep up with productivity growth, as Table 1 shows. Since wages provide the main source of consumer demand, the impact of this increasing gap was that aggregate demand grew much more slowly than output. In other words, we would expect increasing inequality to reduce aggregate demand, because the average and marginal propensity to consume is much lower from high incomes than it is for low incomes. In addition, low wage growth reduces the ability of wage earners to increase consumption. However, in a financially sophisticated world, lower income growth may not hinder consumption if there is an increase in household debt. So the impact of lower income growth on aggregate demand can be compensated by a corresponding increase in debt. Clearly, though, without commensurate growth in income, the ability to repay this debt will become problematic,[2] with the trigger for the crisis coming from the financial sector.

Taylor's book is unusual in many respects. As the title suggests, the analysis is Keynesian, but not in the broad sense in which the term is often used today. It is written in the spirit of Keynes himself, drawing on his writings and on those of his closest disciples, particularly post-Keynesian economists. The book supplies large doses of economic history. The first chapter, simply titled 'Macroeconomics', focuses particularly on the work of Keynes, but discusses various schools of macroeconomics and brings out the essential difference between Keynes' theory and most other economists'. In this respect, a key point of Keynes' analysis is that investment determines saving rather than vice versa. A second is that financial factors have an important role to play in both the short run and the long run, whereas Keynes' opponents generally argue that financial factors only influence output when there are mistakes in peoples' expectations about prices. These mistakes are inevitably corrected, often in a manner that involves inflation so that long-run changes in the volume of money affect the price level but not output.

Real factors

In Palley's book, finance played a subsidiary role in generating the crisis. The book argues that while it was not the prime cause, financial deregulation and financial excesses were important in prolonging the bubble and therefore ensuring that the crash, when it came, was larger than it would otherwise have been. In particular, the role of finance was to sustain demand growth via increased debt.

Behind the 'Great Recession', according to Palley, lie 'bad economic ideas', in particular those associated with neoliberalism. In Chapter 2, 'The tragedy of bad ideas', Palley explains the inertia of economic ideas. It takes crises associated with 'social and economic dislocations' to change underlying ideas and political agendas. The 1970s was just such a time, and it was during that period that the 'flawed' ideas associated with neoliberalism were pushed particularly by Milton Friedman and the Chicago school of economics. The view which 'worships' markets and believes in shrinking government as much as possible has dominated American public policy since the 1970s, and has been increasingly gaining global acceptance. The practical result of this ideological shift has been a push to deregulate markets (particularly labour and financial markets), push for free trade and liberalisation globally and a reshaping of macroeconomic policy so that it was no longer concerned with reducing unemployment, but merely with fighting inflation. The fact these concerns favoured an empowered capital at the expense of labour was not accidental.

Palley considers some of the more important criticisms of neoliberalism. A profound critique is the Keynesian one. Palley distinguishes two different strands: textbook Keynesianism and structural Keynesianism. Textbook Keynesianism is related to the market failure school. It sees temporary disturbances, such as frictions in adjustments or uncertainty, as causing unemployment through insufficient aggregate demand. The solution to unemployment is for expansionary policy to increase demand to get back to full employment. Structural Keynesianism, on the other hand, believes that there are fundamental structural problems with the economy, in particular with its institutions, which cannot be solved simply by increasing demand. Structural Keynesianism finds its intellectual roots in the work of Kalecki, who linked the level of demand with income distribution.

In explaining the Great Recession, Palley's book stresses three alternative explanations. The neoliberal perspective, which is also labelled mainstream or orthodox, is divided into the hard-core Chicago view which emphasises government failure as the cause and a soft-core Massachusetts Institute of Technology (MIT) view which, by contrast, emphasises market failure. These two views are contrasted with a third view, the structural Keynesian perspective, which focuses on the destruction of shared prosperity. Unlike either variant of the neoliberal view, it is difficult to find representations of the structural Keynesian perspective either in major universities, or anywhere in the mainstream of economics.

The hard-core Chicago School explanation focuses on the housing bubble as a combination of 'failed monetary policy and failed regulatory policy, with the focus being bad interest-rate policy and excessive government intervention in the housing market' (p. 23). Related to this view is the argument that interventions in credit markets are likely to cause a crisis, for example, through the support provided to the giant mortgage securitisation firms Fanny Mae and Freddie Mac. The resultant policy response to this position is one of further deregulation and privatisation. If a stimulus is needed, then it should come from tax cuts which would improve the supply side of the economy, but the resulting budget deficit should be addressed mainly by cutting social security payments. The Federal Reserve should maintain a policy of inflation targeting, ignoring any impact on unemployment.

The soft-core explanation in terms of market failure also highlights the role of regulation, particularly in the housing and financial markets, but argues that the problem was that regulation was too weak, and generated issues of moral hazard – a key element in generating the crises. A related factor was the incentive pay structure in the financial sector, which rewarded and encouraged the quantity and size of transactions rather than their quality, encouraging an increase in total loans rather than the exercise of good judgement in issuing only good loans. This tendency was reinforced by the new financial instruments adopted by banks and financial firms, whereby the firm making loans bundled them into mortgage-backed securities and sold on the securities. As a result, lenders did not retain any stake in the loans and mortgages that they had made, so they had no incentive to guarantee the quality of loans issued, but simply to maximise their quantity. The new financial instruments encouraged extremely poor quality loans, and this tendency was reinforced by low interest rates. The policy recommendations following from the soft-core explanation would focus on strengthening regulation, particularly financial regulation. They would also support fiscal stimulus in the form of temporary spending programmes.

Both neoliberal perspectives believe in restoring the budget balance as soon as the crisis is over. Neither sees the need for major structural reform in the economy, but rather focuses on the need for a short-term solution to the current problem, so that normal operation of the economy may be resumed.

The structural Keynesian view, while accepting most of these market failure arguments, believes that they are not a sufficient explanation for the crisis. This view locates the seeds of the crisis in '… weak economic recovery and fragile expansion after the recession of 2001' (p. 27). This period has been described as one of 'jobless recovery', and it is seen as having led to falls in interest rates in order to prevent the economy stalling or falling back into recession. The resulting low interest rates contributed significantly to the housing bubble. In terms of policy, while sharing the market failure view of the need for stronger regulations and fiscal stimulus, the structural Keynesian policy response argues that in order to restore growth and prevent permanent stagnation, there needs to be fundamental changes to the structure of the US and the international system.

Palley traces the origins of the crisis to the election of Ronald Reagan in the 1980s, and the rise of the neoliberal model. Before this time, economic policy was designed to promote full employment, with wages rising in line with productivity. This led to a virtuous circle, where rising wages increased aggregate demand, which then helped maintain full employment. At the same time, full employment and a growing economy encouraged investment which promoted productivity growth, allowing higher wages. With the advent of neoliberalism, the commitment to full employment was abandoned, and in its place was put a commitment to fight inflation. In fact, the underlying purpose of neoliberal policy was to restore the balance of economic, social and political power in favour of capital over labour by creating a large pool of unemployment. This created a cowed and acquiescent labour force, restoring the effectiveness of the sack as a disciplinary measure. The resultant unemployment put downward pressure on wages and working conditions which provided the preconditions for increased profitability, but added to the problem of realising these profits because of the downward impact on aggregate demand.

Pressures for free trade led to increased global competition. Financial deregulation made debt more freely available throughout the economy. Cheaper imports started replacing American production, while increased borrowing helped maintain levels of demand. The results of these changes were increasing income inequality coupled with asset price inflation at the same time as there were growing levels of debt, particularly household debt.

Neoliberalism, according to Palley, also led to changes in the ways in which the US engaged with the global economy. Previously, US trade had been roughly in balance. The increase in household debt was used to purchase imports rather than to create domestic jobs, leading to a deterioration in the balance of trade. As part of the neoliberal global objective, there was significant leakage of employment from the US to cheaper international sources. This was the result of corporate globalisation, which had a third major effect, namely, to redirect new investment away from domestic production to cheaper alternatives, usually in developing economies. The net effects of these changes were large and growing trade deficits, and the replacement of a global marketplace in which US companies exported as well as imported, by one where American-owned companies produced outside the US in order to import cheaper goods back to the US. The result was an acceleration in the rate of decline of US manufacturing, and was a major reason why the recovery was jobless.

The combination of these factors led to a long-run weakening in the structure of the US economy. The effects of this weakening were postponed by speculative bubbles, particularly the housing bubble. The bubbles allowed aggregate demand to keep growing, despite the underlying structural weakness. However, because the bubble was vitally dependent on ever expanding debt, it was unsustainable, and when it burst, it pulled down the whole economy.

Taylor's analysis of the part played by real factors in the *General Theory* is relatively brief. He begins well by pointing out that Keynes usually ignored fundamental uncertainty in his analysis of real factors, although relationships could always shift unexpectedly in response to financial developments (pp. 147–148). This is an interesting and usually overlooked point. Also, of course, Keynes reached the key result that consumption obeys a 'fundamental psychological law' that makes 'changes in consumption depend directly on changes in income' (p. 151), with – for the economy as a whole – positive savings. However, most of Taylor's exposition of the basic model is explicitly in a Kaleckian framework and Keynes' analysis is to some extent explained in terms of how it differs from that of Kalecki. Taylor sums up his analysis of causal links in the *General Theory* with what he calls a figure (Figure 4.4, p. 149) but which looks more like a table. Many readers will find this confusing, despite the skills in exposition Taylor shows in his discussion of the figure in the text.

When moving from the short run, in which the stock of fixed capital is assumed to be constant, to a discussion of 'Keynesian growth, cycles and crises', Taylor starts by setting out Joan Robinson's distinction between equilibrium conditions and what actually happens (i.e. between what she calls logical time and historical time). This distinction is central to Keynesian/post-Keynesian growth theory and underlies much of the analysis in the chapter. After this promising start, Taylor stumbles. He starts with a simple model that he attributes to both Harrod and Domar. Then he rather infelicitously remarks, 'Keynes's condition for short macroeconomic balance is that investment minus savings is equal to zero' (p. 175), without specifying that this statement applies to planned levels of savings and investment, rather than to actual levels. Unfortunately, this slip is typical of Taylor's carelessness about distinguishing between logical and historical time when discussing the real factors determining cycles and growth.

In what he calls 'accounting for economic growth'. Taylor aims to set out what can be learnt from estimating 'the real stock of capital (say K) by a *perpetual inventory* method which boils down to summing flows of gross fixed capital formation … and subtracting reductions in capital due to depreciation and scrapping' (p. 175, emphasis in the original). What Taylor does is to use an extension of the system of national accounts based on Keynes' work in *The General Theory*, to include the additional information, now so prominent in national accounts, which focuses attention on rates of growth of aggregates rather than just the levels of these aggregates and in particular on the implications if we concentrate on the rate of growth of capital. Thus, he is clearly engaged in an exercise in historical time. This exercise uses equations very prominent in Keynesian growth theory. Taylor attributes these equations to Harrod and Domar, whom he correctly identifies as the pioneers of dynamic Keynesian analysis. However, for different reasons in each case, Taylor's analysis does not sit comfortably with the work of these two authors.

Taylor begins with a simple case in which there is no depreciation or scrapping, and in which savings is proportional to output. He then derives from the identity 'savings equals investment' the equation

$$su = g$$

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where s is the ratio of savings (and investment) to output, u is the output/capital ratio and g is the rate of growth. Taylor claims that Harrod called the su term on the left hand side of this equation the warranted rate of growth. But Harrod's warranted rate of growth was, among other things, an equilibrium condition: it could not be derived from an avowedly historical analysis. Moreover, Harrod's concept of capital was completely different from the one Taylor is using. It is not the stock of capital goods, obtained by a perpetual inventory method, but the total amount of all goods in existence at either the beginning or the end of the period, with the difference between the two being the flow of investment over the period. Thus, it includes consumer goods, including those with a very short life. While not of itself of overwhelming importance, this difference in definitions helps Taylor to make an error in interpreting Harrod's analysis which has very important implications for policy.

Domar's analysis is explicitly a search for an equilibrium condition. To quote from his 1947 paper, 'The present paper … attempts to find the conditions needed for the maintenance of full employment over a period of time, or more exactly, the rate of growth of national income which the maintenance of full employment requires' (p. 35). As an equation for the conditions which will ensure that growth of output continues, it is set in Joan Robinson's logical time. The historical analysis in which Taylor is engaging at this point is largely irrelevant.

Taylor goes on to consider a more complex type of growth accounting which focuses on the implications of changes in the distribution of income between wages and profits. Using some intricate algebra, he shows that the growth rate of output is equal to the weighted average of the growth rates of labour and capital plus surplus, where the surplus is the flow of real output resulting from productivity increases, often called total factor productivity, which is widely used by mainstream economists. It would be better, he argues to 'think in terms of separate rates of labor and capital productivity increases' (p. 179). Taylor then introduces Kaldor's stylised facts. According to Taylor, the ones that apply to the United States are that the capital/output ratio is constant in the longer run and labour productivity has a trend growth of around 2% a year. He adds that productivity growth increases after the lower turning point of a business cycle and that Kaldor's stable share of wages in income has not held in the United States in the last 30 years or more. All of these stylised facts are probably intended to refer to more recent experience.

In any case, Taylor returns to Kaldor as a major example of a theorist who uses changes in distribution to bring about adjustments in key parameters. If investment demand increases, then income distribution shifts in favour of profits. This is assumed to increase investment, further leading to an unstable economy. The same assumptions ensure that if there is a shift in distribution towards wages, the economy moves towards a stable state after such a shock. If the economy has constant wage and profit shares, the real wage will grow at the same rate as labour productivity and all Kaldor's stylised facts will hold. Taylor also discusses Kaldor's later growth models and reaches similar conclusions.

The other model Taylor discusses before turning to cyclical growth is Joan Robinson's so-called banana diagram. This shows the relationship between two curves which enclose a space which looks like a banana. However, following Harcourt (2001: 274), the essence of her analysis can be expressed in words. On the one hand, following Kalecki, the rate of growth of the capital stock depends on the rate of profit that generates it. On the other hand, Keynes' argument in *The General Theory* was that investment depended on 'animal spirits'; that is, the expected rate of profit on investment is a function of the rate of accumulation that generates it. Given quite plausible assumptions about the shapes and positions of the two curves, Joan Robinson showed that there was a stable intersection at either a moderate or a high rate of growth. However, she also pointed out that this might not necessarily be the case and discussed other possibilities. There was also, she thought, likely to be an intersection at a very low growth rate. However, this is an unstable equilibrium. Anywhere above it, the rate of growth will return to the upper equilibrium position. Below it, the rate of growth will decline still further.

Taylor then returns to his 'Harrod-Domar' equation and shows that irrespective of whether demand is led by increases in wages or profits and whatever the distributive effects, the rate of growth of the economy is 'highly unstable' (p. 181). He makes no reference to the fact that Harrod himself discusses distributional change including using the rate of interest to stabilise the system, which he thinks is a weak reed that needs to be supplemented by fiscal policy (Harrod, 1939: 32).

Taylor refers to one article, Harrod (1939), and complains that it is 'notoriously difficult to read; he [Harrod] is trying to talk through complicated and tedious, (though not particularly difficult) growth rate algebra in English' (p. 180). The 1939 article was not the easiest to read, but on the first page, there is a clear statement that the article is 'a development and extension of certain arguments in my [1936 book] *Essay on the Trade Cycle*'. Moreover, basic ideas in it were recapitulated (Harrod's term) in a more readable form in a small (169-page) book published in 1948. In fact all of Harrod's dynamic analysis is primarily about the trade cycle. It started with his 1936 book. While his famous equations for the equilibrium rate of growth and the instability of that rate were first published in his 1939 *Economic Journal* article, he always held that 'the trade cycle we know is conditioned by its occurrence in a dynamic (growing) economy' (Harrod, 1948: 12). The growth equations which became identified as the core of Harrodian dynamics were developed as part of trade cycle analysis. Harrod's (1948) book was the first extended systematic publication of the role of his growth equations. In it, he states that it

> … is far from my purpose to give a finished theory of the trade cycle. Lags, psychological, monetary and other factors, no doubt play their part. I should suggest that no theory can be complete which neglects the fundamental causes of instability expressed in the equations which have been set out. (Harrod, 1948: 89)

The influence also went the other way. Harrod's fundamental growth theorems were very general. Any complete analysis required consideration of the cycle: 'the value of [the] warranted rate depends on the phase of the trade cycle and the level of activity' (Harrod, 1939: 30). The policy implications of this are clear. Harrod makes a strong case that responses to cyclical fluctuations and trends cannot be divided into two separate spheres – they are indissolubly mixed. They must be considered as a joint response by intertwined parts of the economy. Unfortunately, the dominant school of thought among both academic economists and policy advisors takes precisely the opposite view, which helped to cause the global financial crisis and will hinder or more likely prevent a satisfactory recovery from it.

Monetary factors

According to Palley, the 'flawed model of financial markets' was the third component of the Structural Keynesian explanation of the recession, along with the flawed growth model and model of global economic engagement. As a result, financial markets played a significant role in the lead up to the crisis of 2007. They postponed the crisis, as the bubbles these markets generated promoted demand over the short run, but at the expense of increased indebtedness (financial fragility) and of asset price inflation (particularly in housing prices). In other words, the role of the financial system was to help maintain demand via an increase in debt, to overcome the stagnation tendencies discussed earlier:

> It was accomplished by financial deregulation, financial innovation, and increased risk-taking by borrowers, lenders, and investors. This is where finance enters the picture, and the catalogue of financial deregulation and innovation over the period between 1980 and 2008 is striking. (Palley, 2012: 59)

The effect of these changes was to remove 'regulatory constraints' increasing the supply of finance. According to Palley, 'The argument was that consenting adults in credit markets know best and their decisions also produce the best outcomes for the economy as a whole' (p. 61). Related to this was the changed behaviour of market participants both in terms of their perceptions and of their psychology. This was analysed by Minsky with his financial instability hypothesis which Palley summarises as follows: 'in financial markets success breeds excess, which breeds failure' (p. 65).

Overall, these changes created what was, effectively, a perpetual motion finance machine which generated increasing asset prices and accelerating debt. This turned the financial structure into a Ponzi scheme,[3] which, as Minsky had predicted, increased the fragility of the financial system.

Underlying the changes to the financial system, Palley argues, were three major 'ingredients' which ensured that the crash would occur. First was a flawed system of incentives where financial agents had a strong incentive to generate as many loans as possible, regardless of the likelihood of whether they would ever be repaid. The second ingredient was excessive leverage (the debt-to-equity ratio), which increased the fragility of the financial system. The final ingredient was maturity mismatching, reinforced by financial institutions borrowing 'large sums for short periods of time' (p. 70). This meant that if there was a loss of confidence, then the banks would find it extremely difficult to roll over their borrowings, forcing them to repay – which would push many banks into insolvency.

As a result of these ingredients, the financial system was extremely prone to a crisis, with the build-up of toxic loans providing the catalyst. The crisis was transmitted globally through a number of channels. As the United States had become a major importer, its economy slowing down led to a collapse of world trade and falling demand in its trading partners. The resultant slowdown in international economic activity also led to falls in foreign direct investment, and in remittances from foreign workers to their homes. Finally, the financial channel ensured transmission of the crises mainly through financial contagion – the failure of the US stock market leading to collapse of confidence around the world – and through the losses on US investments held by foreign investors – particularly banks. Europe had been major purchasers of US assets – including toxic ones – and these led to the banks making major losses, often compelling their governments to bail them out. These bailouts were a contributing factor in the subsequent recessions.

Palley outlines a 10-point plan for financial reform, but also highlights an important paradox of reform: because the underlying neoliberal model is subject to stagnationist tendencies, financial reform will exacerbate these tendencies, as it will prevent financial exuberance from boosting demand: 'Stabilizing the neoliberal model exacerbates the problem of stagnation' (p. 78).

Unlike his treatment of real factors, Taylor's focus on monetary factors is sure-footed and provides a wealth of valuable points. The most fundamental is that *The General Theory* is primarily a book about monetary theory. Moreover, Taylor shows how liquidity preference, the key financial variable in *The General Theory* is rooted in Keynes' *Treatise on Probability* which brings out the distinction between uncertainty and risk.[4] Keynes argued that two methods were widely, and sensibly, used to determine prices and output. One is that the conditions currently in place reflect correctly future prospects, but this only holds until something new, and thought to be relevant, occurs. This approach was one that Keynes often used himself, although only as a convenient simplifying assumption. The second is to rely on views widely held by others – a 'conventional judgement'. The implications of this latter approach were illustrated by Keynes with his famous example of a beauty contest: a beauty contest where the prize is for the person who predicts the result closest to the average views of all those engaged in the competition. However, the major point is that Keynes thought that expectations determined by either of these methods would be likely 'to change violently as a result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady' (Keynes, 1936 [1973]: 154). Taylor points out that this view of the determination of market prices is in essence the same as that held by Soros (2009).

In addition to the point that liquidity preference is the result of uncertainty – a premium people pay because they fear the rate of interest may change in a way they cannot rationally forecast – there is a second important point. The money that people hold to satisfy their desire for liquidity preference is a stock not a flow. This makes the behaviour of professional traders more important and, as Keynes implied and Taylor points out, this increases volatility in the short run.

When Taylor moves from a discussion of the short run, in which the stock of fixed capital is given, to a longer run, in which growth and cycles are considered, his discussion of finance is based on the work of Minsky (1985, 1994). Global financial crises follow a typical pattern. They are preceded by a period of increasing asset prices. Business balance sheets improve as a result of the increased value of their assets. This improved business confidence encourages investment. Banks, at the same time, are increasingly happy to lend money for this investment. Financial crises are often precipitated by banks reassessing their liabilities and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. The result is a re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets and to significant falls in asset price (Minsky, 1985). Such a causal sequence not only had a large part to play in 2007 but is still an important feature of the economic landscape today.

However, Minsky also emphasised that, as the years passed after a large recession or depression, relatively successful macroeconomic policy would lead to greater and greater risk taking as memories of the previous major contraction receded, leading in time to another major downturn. On the other hand, as Taylor points out, in the case of this 2007 crash, there were two important differences to the usual Minsky scenario. First, households, as well as firms went into significant debt; and second, there was an accumulation of so-called 'toxic assets' associated with subprime mortgages. What Taylor does not emphasise is the role of credit rating agencies in exacerbating the second factor. The new and very complex instruments were given triple-A ratings, although in fact they were anything but triple-A. Many financial institutions were heavily exposed to such assets, so that their assets were in fact worth substantially less than their current valuation (Kriesler and Nevile, 2009). Nevertheless, Taylor's own conclusion on financial factors and the global financial crisis provides a fitting end to this section:

> Along the lines argued by the French sociologist Pierre Bourdieu, finance theory, with its key assumption of fully efficient, completely deregulated markets, dominated the discourse about financial practices. It supported a 'complicitous silence' that allowed bankers to engage in destabilizing transactions without any criticism being raised. Small wonder there was a crash. (pp. 344–345)

Policy implications

A major concern of Palley's book is the dominance of neoclassical economics and how the resulting tolerance of high unemployment over the last 30 years, 'destroyed shared prosperity' (Palley, p. 216) and led to the crisis of 2007. In Chapters 6 and 7, he contrasts the orthodox perspective on the crisis, according to which the underlying 'economic system is basically fine, and all that is needed is a patch' (p. 81) with the structural Keynesian perspective which highlights the 'fundamental failings' of the system and stresses the need for structural reform.

Part II of Palley's book contains his analysis of what is necessary if America is to avoid the 'Great Stagnation'. In this part, he shows how the interplay of conventional economic ideas with neoliberal political ones has led to the crisis, and, unless economic policy, politics and economic theory all change, will lead us to further severe problems. In the final section of the last chapter, Palley argues that '[e]scaping the prospect of the Great Stagnation necessitates a great rebalancing. This requires a new set of economic ideas' (p. 216). The first rebalancing is with respect to income and wealth. 'Income distribution must be rebalanced to ensure demand adequate for full employment'. The other major imbalances which require redressing are 'the global financial imbalance, exemplified by the U.S.–China trade deficit'; 'the worrying long-term budget outlook that confronts the United States and many other countries'; 'the dominance of speculation over enterprise'; 'the relation between the economy and the environment'; and the problems resulting from 'fundamental structural imbalances' (pp. 216–217).

In commenting on 19th century economics, Taylor states that in an economy ruled by Say's law and in which labour and capital are the principal inputs, and for simplicity assuming constant output, an increase in the real wage must be met by a fall in the profit rate. This 'contest', he claims, 'was an important factor leading into the crisis of

2007–2009' (Taylor, p. 38). Taylor's book is focused on unemployment. There is no significant conflict between the two authors about the theoretical underpinnings of full employment policy in today's world. Taylor's statement, 'If there is ongoing labor productivity growth, then demand per capita must increase to prevent ever-growing unemployment' (p. 171), could have been inserted after Palley's table in the introduction to this review without any break in continuity. Moreover, both authors agree that there is no hope of achieving any lasting solutions to the current problems in the US, and hence to those of the rest of the Western world, without reversing the increasing inequality in the US and increasing labour's share of national output.[5]

According to Taylor, while more regulations, including the imposition of high capital requirements on large institutions, would be desirable, the immediate policy challenge is to build a firewall to shield the rest of us from the excesses of the finance sector (Taylor, pp. 355–356). How to do this is not so clear. Taylor makes suggestions about various measures that could play a part. These include a Tobin tax, a capital levy and a tax on banks' financial activities. More widely he suggests progressive income and capital gains taxes, strengthening unions and perhaps intervention by the Fed to devalue the dollar, with selective capital controls (see, for example, Taylor, p. 356). Taylor's final thought is that 'all these and similar policies will not be applied unless the world and national economies go through a double movement, towards a more egalitarian and anti-liberal socio-political regime' (p. 356).

The policy recommendations flowing from Taylor and Palley's analysis are mirrored in a speech the Managing Director of the International Monetary Fund (IMF), Christine Lagarde, gave at the Davos meeting in 2013 (Lagarde, 2013). She started with a quotation from Franklin Roosevelt: 'The test of our progress is not whether we add more to the abundance of those who have much; it is whether we provide enough for those who have too little'. She then pointed to the World Economic Forum's survey, which put 'severe income disparity' at the top of global risks over the next decade, and reaffirmed that in her view '[e]xcessive inequality is corrosive to growth; it is corrosive to society'. After stressing the importance of 'universal access to decent education', she set out what the major thrust of policy should be. 'Above all, inclusive growth must also be job-rich growth. This is really a symbiotic relationship – we need growth for jobs and jobs for growth'. While Christine Lagarde was completely convinced of her overall diagnosis, she thought the practical details of policies were 'less clear'. The suggestions in the two books reviewed in this article provide a good place to start in removing this lack of clarity.

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Notes

1. Page numbers not otherwise referenced refer to the books under review.
2. There is an extensive literature on income inequality as a major cause of the global financial crisis (GFC), which is surveyed in Van Treeck and Sturn (2012) and Van Treeck (2014).
3. A fraudulent investment operation, named after Charles Ponzo, who used such a scheme in 1920. Returns to original investors are paid, not out of profits, but out of funds contributed by new investors, enticed by new high short-term returns.

4. This was the same difference as that set out in Knight (1921).
5. The increased inequality resulting from neoliberal policies has become a matter of public controversies following the publication of Piketty (2014).

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