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Paris, Université Sorbonne Nouvelle, April 9, 2015

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Economics Seminar: Gerald Friedman, "Economics and Policy in the Obama Era: The Return of Austerity Economics and the Final Collapse of the New Deal Coalition"

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- 1 This seminar was co-hosted by the Institut des Amériques, the Centre de Recherche et de Documentation sur les Amériques (CREDA), and the Centre d'Études et de Recherches sur la Vie Économique des Pays Anglophones (CERVEPAS). It was part of a series of research seminars entitled *Économies des Amériques: Regards Nord-Sud*, co-organized by Martine Azuelos (professor emeritus at Sorbonne Nouvelle University), Robert Boyer (economist at the Institut des Amériques), and Carlos Quenan (professor at Sorbonne Nouvelle University). The theme of the 2014-2015 series was the evolution of North and South American economies since the 2008 financial crisis.
- 2 The speaker, Gerald Friedman, Professor of Economics with a PhD from Harvard University, recently became Chair of the Department of Economics at the University of Massachusetts at Amherst. He has published a number of books and articles on the labor movement in the United States and France during the nineteenth and twentieth centuries, including *Reigniting the Labor Movement: Restoring Means to Ends in a Democratic Labor Movement* (London and New York: Routledge, 2007) and *State-Making and Labor Movements: The United States and France, 1876-1914* (Ithaca: Cornell University Press, 1998).

A Slow Recovery after the Great Recession

- 3 Friedman began his presentation by discussing the severity of the Great Recession of 2008 in relation to all other recessions since the end of World War II. While the

pre-2008 average fall in GDP from peak to trough had been -1.9%, the recession of 2007-2009 resulted in a decline of -4.3%. However significant this slump might be, it is actually fairly mild compared to the fall of -26.7% in GDP during the Great Depression (1929-1933). "What exactly is everyone complaining about, then?" Friedman asked. The answer is simple: although recovery began much sooner after the Great Recession than after the Great Depression, it has also been much slower and weaker.

- 4 Indeed, 22 quarters after the trough of the Great Recession, the GDP was more than 10% below the average recovery level for every recession between 1947 and 2001. Growth in per-capita GDP between 2006 and 2013 was 11% lower than it would have been if the economy had continued to grow at the 1995-2006 rate. Europe was just as bad off, with the Eurozone also lagging 11% behind the 1995-2006 rate, though with great disparities between the different countries. While income was 1% lower in Germany and 9% lower in France, it was 25% lower in the "Eurozone periphery" (Greece, Ireland, Italy, Portugal and Spain), where a new Great Depression was indeed taking place. As for the UK, its income was actually 16% lower, worse than the US and the Eurozone average.
- 5 Things appear even grimmer when we look at the slow recovery in employment levels. In the US, five years after the beginning of the recovery, even though the GDP had begun to grow again, the employment rate was still below pre-recession levels. If official figures made the 2013 unemployment rate look less worrisome, this was because many people had simply given up looking for a job and had left the labor force, which meant they were no longer counted as "unemployed." Many young people in their twenties have never held a full-time job and have been resorting to multiple short-term "gigs"—which, of course, in addition to being precarious, also offer no employee benefits, such as health insurance, sick leave, or retirement benefits. In 2013, only the "Eurozone periphery" was worse off than the US in terms of restoring the pre-recession employment rate, whereas the UK was close to restoring it, and France and Germany had fully restored it.
- 6 Average wages have also been down in relation to past trends. In 2013, they were dramatically lower than if they had continued to grow at the pre-recession rate: -7.2% in the US, -5.2% on average in the Eurozone, -2.8% in France, -2.0% in Germany, -9.1% in the "Eurozone periphery," and a staggering -17.3% in the UK. Wage stagnation has actually persisted in the US since the early 1970s, when average hourly earnings ceased to keep up with gains in productivity, which they had done since virtually the beginning of the Republic. While productivity has continued to rise rather consistently since the 1980s, average hourly earnings actually declined during the Reagan-Bush years, and the Clinton "boom" had an almost negligible impact on wage increases. If average hourly earnings had kept up with productivity, they would have been \$ 20.60 in 2013 instead of \$ 8.78. This is still \$ 0.50 lower than the peak of real average hourly wages in 1973.
- 7 "Where are all those productivity gains going to, then? Who is buying all of those products?" Friedman asked. It cannot be the workers if their wages are down. The US has not been exporting all the extra production either, for it has had a trade deficit since the early 1970s as well. The answer, according to Friedman, is that productivity gains have mainly been fueling managerial salaries, corporate profits, and stock prices. Not only that, but if we look at the figures, only the stock market has fully recovered from the Great Recession. It has even done better than in previous recoveries: while GDP, employment and wage recovery have all been below average levels, by 2014 the

stock market was already 30% above its pre-crisis level. In short, recovery has been slow and painful for everyone except the wealthy.

From Stimulus to Austerity

- 8 At this point in the presentation, Friedman turned to the reasons for the slow economic recovery. How is it that a second Great Depression was avoided, and yet recovery has been so sluggish? According to Friedman, the initial monetary and fiscal responses to the crisis are what steered the American economy away from depression; however, politics and misguided economic policies, based on erroneous and outdated theories, then got in the way of boosting the recovery.
- 9 Ben Bernanke, whom George W. Bush had appointed to the Chair of the Federal Reserve in 2006, was committed to averting another Great Depression. As financial institutions began to fail in 2008, rather than standing by passively, the Fed began to sell short-term US Treasury Bills to buy up failing financial firms. However, in September 2008, the situation quickly degraded when the Fed decided to let Lehman Brothers fail. The argument was that if the Fed bailed out everyone, everyone would continue to engage in moral hazard, since they knew they could count on a federal bailout. This explains why Lehman Brothers stock was relatively high right up until its failure; people assumed the company would be bailed out. When the Fed let it fail, however, not only did its stock price plummet, but the \$ 700 billion it had in commitments to foreign and American banks alike could no longer be honored. This sent a shockwave throughout the entire international financial system and severely worsened the crisis.
- 10 After this, the Fed did not make the same mistake twice. In order to put out the fire, it tripled the money supply overnight: it bought up toxic financial assets and guaranteed both money market accounts (even if it had no legal basis to do so) and credit default swaps (like the ones AIG was heavily engaged in). Massive monetary expansion thus helped to thwart off a depression.
- 11 Fiscal stimulus and automatic stabilizers also boosted the recovery. Automatic stabilizers, which include non-discretionary federal spending on unemployment insurance, food stamps, etc., compensated 40% of the fall in income. The American Recovery and Reinvestment Act of 2009, one of the first initiatives of the Obama administration, then provided \$ 800 billion in fiscal stimulus.
- 12 For Friedman, deficit spending through fiscal and monetary stimulus was the right thing to do to head off another Great Depression, even if it increased the federal debt. However, the turn toward austerity policies shortly afterward is what hampered the recovery from then on.
- 13 The political context of the Obama administration can partially account for the shift to austerity policies, which aim to balance the federal budget within a relatively short period of time. In relation to other reform presidents, such as Abraham Lincoln, Woodrow Wilson, Franklin D. Roosevelt, and Lyndon B. Johnson, Obama only narrowly won the presidential election and had slim congressional majorities at the beginning of his first term. There were also no left-wing movements significant enough to pressure the administration to pursue an ambitious social and economic agenda. On the Right, however, extreme animosity to Obama and the rising Tea Party movement succeeded in obstructing the administration's more progressive initiatives. Once Democrats lost

their majority of the House to Republicans in 2010 and later the Senate in 2014, the hopes of enacting any progressive legislation or economic stimulus became even bleaker.

- 14 In 2010, the Right's focus on balancing the federal budget led to the appointment of the National Commission on Fiscal Responsibility and Reform, whose role was to make recommendations to balance the budget by 2015. The report made almost no mention of unemployment, which was near 10% at the time the commission was appointed. The social cost of cutting off government stimulus and balancing the budget within five years was thus ignored.

The Role of Economists in the Turn to Austerity

- 15 For Friedman, the turn to austerity was also evidence that orthodox economists were giving misguided policy recommendations. Mainstream economists had first failed to predict the crisis. Robert Lucas, for example, claimed in 2003 that macroeconomics had succeeded in eliminating the possibility of depression. The outbreak of the crisis disproved his claim. Nevertheless, in 2009, Lucas dismissed the very macroeconomic stimulus policies that had steered the economy away from depression. He and John Cochrane argued that if the government increased its spending today, consumers would expect it to raise taxes tomorrow; they would therefore limit their spending, and this would cancel out the effect of the stimulus. Thus was the "logic" of austerity.
- 16 Friedman ridiculed the idea that people actually modified their consumption habits based on the taxes they may or may not expect to pay a couple of years later. The theory can actually be traced back to David Ricardo (1772-1823) and is called "Ricardian Equivalence." Ironically, Ricardo himself did not actually believe that it was relevant in practice. Today's orthodox economists and political leaders, however, seem to assume otherwise.
- 17 Friedman also criticized contemporary orthodox economists' persistent belief in another theory that Ricardo did support, the law of markets, commonly known as Say's Law. Jean-Baptiste Say (1767-1832) argued that there could never be a depression in a market economy, only temporary disruptions. The idea is that the production of goods and services on the supply side creates an equal amount of revenue on the demand side that can be used to consume the products. There can therefore not be a general lack of demand in the economy, only temporary imbalances due to the overproduction of certain products that people do not wish to consume. Such imbalances are automatically corrected by market forces as production is shifted away from products consumers are not buying and toward ones for which there is more demand. It is therefore individual consumption choices that determine production. The only thing that can disrupt the process is if someone who works without consuming gets involved, i.e., the state. Indeed, the state is an obstacle in this scheme of things because by regulating prices or enacting stimulus packages, it prevents markets from naturally moving back to equilibrium.
- 18 These ideas, which form the basis of neoclassical microeconomics, were discredited during the Great Depression, as markets were clearly not self-correcting. In this context, John Maynard Keynes (1883-1946) founded modern macroeconomics by rejecting Say's Law and the idea that production was determined by individuals' choice to consume. Keynes argued that production was mainly determined by companies'

decision to invest. Firms invest based on their speculation on the future, on the gains they can expect to make and on the clients they can expect to have. This is completely separate from individuals' decision to consume, for if a company has no reason to believe that there will be enough demand to sell its products, it has no reason to invest. As such, it is perfectly possible for there to be a general lack of demand if overinvestment creates a speculative bubble. As the bubble bursts, this leads companies to halt their investments and to reduce their payrolls, which only further aggravates the lack of demand at the origin of the bubble. This vicious circle is what can spiral the economy into depression. Keynes argued that state intervention through macroeconomic policy could prevent this from happening. Indeed, if companies are not investing due to a lack of demand, and consumers not consuming due to a lack of income, the government can set the economy back into motion through monetary and fiscal stimulus.

- 19 Keynesian economics dominated throughout the post-WWII era. However, with the rise of neoliberalism since the 1970s, there has been a return to neoclassical microeconomics, to Say's Law and to non-interventionism. Friedman accused the proponents of neoclassical microeconomics of not sufficiently taking into account the mounting evidence against the relevance of such theories in today's economic context. Indeed, there is no evidence that Ricardian Equivalence is true in reality, whereas there is a lot of evidence that austerity does not work. GDP growth since the beginning of the recovery has been the weakest in countries where austerity policies have been the strongest. Friedman therefore concluded his presentation by affirming that austerity had made things worse for all of us, and that economists have had an important responsibility in this.

Discussion

- 20 The presentation was then followed by a 45-minute discussion session. The first question involved the success of Iceland in getting out of the crisis. For Friedman, Iceland's success was mainly due to the fact that it had nationalized its and cancelled most of its debts. This could be something to keep in mind when considering the situation between Greece and the European Union.
- 21 The second question involved explaining the difference between money market accounts and banking accounts, since Friedman had mentioned that the Fed had chosen to guarantee money market accounts in response to the 2008 crisis. Friedman explained that New Deal financial regulations had separated commercial and investment bank activities, created the FDIC that guarantees bank deposit accounts, and placed ceilings on the interest rates that banks can offer on deposit accounts to prevent excessive speculation. However, financial accounts managed outside of banks ("shadow banking") were not subject to this regulation. Money market accounts fit into this category. They became popular in the late 1970s, in a time of high inflation, because they had no interest rate ceilings and could offer higher returns than banks and thus attract more customers. As banks successfully pushed for the deregulation of interest rate ceilings in order to become more competitive, deregulation allowed both banking and non-banking financial activities to expand into unknown and riskier territory. In the 1980s and 1990s, this dynamic eventually led to the elimination of most New Deal-era financial regulations and paved the way for the 2008 crisis.

- 22 Friedman then explained that another problem with the financial regulatory system in the US is the stark difference between civil servants' salaries and bankers' salaries. When a regulator who makes \$ 80,000 per year is sitting across the table from a banker who makes \$ 2 million per year, the regulator has more interest in convincing the banker to hire him or her in the private sector than in enforcing strict regulations! Plus, while the staff and size of regulatory agencies has been reduced, the size and complexity of the institutions they are expected to regulate have grown tremendously. The heads of the banks themselves often do not understand the activities their banks are involved in because most of them were trained in the 1980s, and the financial sector has drastically evolved since then. Finally, the bankers responsible for the failure of their banks have gone virtually unpunished and have even been able to keep the bonuses they received just prior to the crisis. They therefore tend not to worry about the future consequences of their lucrative, though potentially reckless, activities.
- 23 The third question was on the motivations for orthodox economists to defend their positions. Friedman first pointed out that the economics profession has no official code of ethics. Unlike other professions, nothing forces economists to reveal their sources of income. A study was made on a number of economists who had testified to Congress on financial deregulation, and by looking at corporate reports, the study revealed that a vast majority of these economists were on the payroll of financial service companies and that these companies were paying them lavish amounts of money to defend their interests. In other words, money plays a large role in encouraging economists to identify their own personal views and interests with the companies that pay them. Another reason why many economists have returned to neoclassical orthodoxy can be found in certain declarations of Keynes himself. Indeed, Keynes claimed that once macroeconomic policy had succeeded in bringing markets back to equilibrium, neoclassical microeconomics would then become more relevant once again. Other economists study microeconomics quite simply because it is intellectually stimulating. Kenneth Arrow, for example, worked on a theory of perfect market equilibrium for precisely that reason, but his intention was actually to show that perfect equilibrium could only exist in theory and never in the real world. Others, however, used his work to advance the case against state intervention. Finally, the social recognition that goes with working within orthodoxy is another aspect that can motivate certain economists.
- 24 The fourth question pointed out that the economic consensus that had reigned until 2008 seemed to collapse with the crisis, and yet nowadays everyone seems to have gone back to the old orthodoxy. Why is that? Friedman responded that some economists only seemed to change their thinking, but never actually did. Martin Feldstein, a conservative economist who initially supported the stimulus and then criticized it a few months later, is a good example. Secondly, the quick return to orthodoxy had a lot to do with the recovery itself. When it was unsure whether or not a new depression was on our hands, people started to break away from the old consensus; but since a complete collapse did not happen, many economists concluded that their theories still held true. Friedman then pointed out that most university economics departments had purged out heterodox economists over the past decades. Orthodox economists therefore face virtually no resistance within their institutions.
- 25 The fifth question involved giving a more precise account of the growing gap between wages and productivity since the 1970s. If most of the extra production is going toward profits and wealthy individuals, then what are they doing with all that money? And

how sustainable is such a gap? Friedman first pointed out that some of the gap was actually going toward healthcare expenses, which is deducted from Americans' paychecks instead of being paid to them in wages. The escalating healthcare costs can therefore explain where some of the extra production above wages is going. The rest, however, is indeed mostly going to corporate profits. Could it be that companies are using it to invest in equipment and new technology? Friedman did not think this could account for much of it because most of the American economy has shifted away from capital-intensive industries and toward the less capital-intensive service sector. He then pointed out that the calculation of average wages only included hourly workers; managers' and CEOs' salaries, which have skyrocketed since the 1970s, were not included, so this means that more and more production has been paying management's higher salaries. How much of that do they actually consume, though? They obviously cannot consume all of it, so much of it is made available to be lent to households. In other words, much of the extra profits and higher salaries of the top 1% have been transformed into household debt, which has indeed exploded since the 1970s.

- 26 The sixth question was on a particular source of household debt that has been increasing significantly in recent years: student loans. Some people fear that a student loan crisis may be on the near horizon. However, Friedman affirmed that student loans were essentially different from mortgages because you cannot default on them. By law, if they are not paid on time, the IRS can add them to your taxes. However, if people do not have any income, then it is impossible to collect money from them. Thus, there is still a concern.
- 27 In his final remarks, Friedman returned to the issue of the rising gap between wages and productivity. If that gap keeps being filled with debt, it will come back to bite us at some point because people stop spending once they have too much debt, and no one wants to lend to people who owe too much. A new model for economic growth, with new economic thinking that breaks away from neoclassical microeconomics, is therefore necessary if we wish for more sustainable development.

Conclusion

- 28 Friedman's presentation satisfied the seminar's aim to situate the evolution of the US economy within historical, political, and ideological developments. Indeed, he demonstrated that it was not enough to focus uniquely on economic indicators such as GDP growth, employment and wages. It is also necessary to take into account policy decisions, such as fiscal and monetary stimulus v. austerity; the political context in which such decisions were made, including the presence or lack of social movements; as well as the economic theories used to justify policy decisions, in an ideological context dominated by neoclassical microeconomics. The discussion that followed the presentation allowed to enrich each of these dimensions. As such, Friedman provided a more complete picture of the current state of the American economy with all of its complexities.

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Subjects: Actualité de la recherche

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