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Orthodoxy versus Heterodoxy: Inflation, Unemployment, Growth, Profit

Prof. Carlos Manera*
University of the Balearic Islands

Abstract:
Institutions like the IMF, the ECB and many finance ministries and private banks in the world’s richest countries are sending out unequivocal calls for strict control of prices to be addressed urgently, given their intrinsic relationship with how the budget deficit and government debt evolve. These messages allow very little room for nuances or interpretations, stating categorically that price stability is the essential factor that guarantees economic growth and therefore plays a key role in enabling countries to achieve good living standards. Nevertheless, inflation, which nobody doubts needs to be kept under control, requires a much deeper analysis to avoid over-mechanical, over-simplistic applications for the present situation. We mustn’t fall into what Paul Samuelson called basing economic policy on “shibboleths” – that is, hard and fast slogans that take over serious, thoughtful discussion and exchange of opinions. Especially since in economics slogans become hallmarks that are constantly repeated, and this repetition gets in the way of the obvious truth. This trend has led to the sale of intellectual products with no scientific backing. A case in point is David H. Fischer’s book on prices. Addressing business leaders, he asserts categorically that economic cycles and crises have ended, but the actual economic events have disproved this. As Robert Solow warns, there is not one set of laws of economics applicable to all times and all places, and the part of economics that is not dependent upon economic history and the social context is very small and of little interest.

JEL Classification: B50; B410; N1.
Keywords: Inflation; economic growth; heterodox view.

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ORTHODOXY VERSUS HETERODOXY: INFLATION, UNEMPLOYMENT, GROWTH, PROFIT

1. Does the focus on prices mean ignoring unemployment?

The evolution of the economic crisis is placing the discipline of economics in a cloudy, turbulent place. Economists’ predictions regarding economic and financial decisions that will be taken are not even close to being accurate. The tools we have at our disposal are not sufficient and have proven to be totally powerless in the times in which we are now living. Government ministers around the world, research centres, prestigious university departments, and prestigious members of the intellectual and political elite are still shooting in the dark in ever-changing circumstances that are difficult to predict. The perceptions – little more than perceptions – that filter through to consumers are that the measures taken will bring the desired results, and light will appear at the end of the tunnel. Economists’ arrogance could not be more pronounced: they try to convincingly and coherently explain that the multi-phase roadmap is in place and will lead us to the end of the problem once those phases are behind us. This belief prevents any possible understanding or influence from other social or experimental sciences. The petulance leads people to believe that with all the mathematical tools it has available, economics alone can solve doubts and uncertainties. That is a great fallacy.

Economic theory is in a certain state of “normality”, in the sense of its ability to predict the behaviours of people and economic players, who act based on the principles of utilitarianism, the notions of equilibrium points and the rationality of actions. However, those processes are often difficult to explain and therefore difficult to map as clear sequences of events, but could perhaps be understood if other parameters were involved. Economics has always maintained strong links with technological changes. It should be noted that this perspective, in which technology becomes the famous Prometheus unleashed, should be accompanied by everything that affects institutional frameworks – factors that are not always tangible, but that do spur growth. However, the major routes are found in the knowledge of past developments: the analytical capacity that determines the past to identify long-term patterns that help us understand processes occurring today.
In this context, the economic crisis has already inspired numerous and varied contributions to the literature.\(^1\) This crisis, this reality, changes over time, and the diagnoses made in different spheres have no option but to change too. In the more serious contributions, two major positions emerge. Some authors say the current crisis is unusual, unprecedented, and different from all the major economic crises of the past. Others argue that there are regularities in the way crises evolve, so in the current crisis we know how the waves of technological change will be assimilated. Some viewpoints even distil doses of optimism in the face of the current cataclysm. In her magnificent book on financial capital and technological changes,\(^2\) Carlota Pérez concludes that the current crisis is marking a transition from a wild, turbulent golden age run by financial capital to a more harmonious period driven by production capital in an institutional framework that is more inclined towards the real economy. This is certainly an innovative idea, a welcome change from the downpour of defeatist messages and bad news if the guidelines set by the IMF, the ECB and the European Commission are not adhered to (guidelines which, right now, provide few signs that the economy will recover and be discharged from the intensive care unit).

The sense of constant improvisation caused by a lack of economic planning and an inability to plan ahead for more than even a few weeks created uncertainty in society. There are some voices crying in the wilderness – economists and social scientists of an academic mould – warning of the folly of Europe’s economic policy.\(^3\) It is a policy that

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responds specifically to the interests of the German and French economies, but has one very worrying feature: the lack of a true leadership in a Europe that ought to increasingly be seen as a major world region rather than as a fragmented group of states with different interests. Basically there are two major positions regarding economic schools of thought applied to the real economy: the neo-Keynesian viewpoints, exemplified in the works of Krugman and in more resolute works such as those of Stiglitz, which emphasize economic growth to reduce unemployment, even though it can lead to inflationary pressures; and the viewpoint that has prevailed, led by the ECB, in which the main concern is to contain inflation and reduce budget deficits, the ultimate goal being balanced budgets. It is important to note that concern for budget deficits is not unique to more orthodox positions: everyone knows perennial or very severe deficits are unsustainable. But those of us with – let’s say – a more heterodox perspective also know that balanced budgets should not be sought after religiously, regardless of the cost, as suggested in the more conservative discourse on both sides of the Atlantic.

Institutions like the IMF, the ECB and many finance ministries and private banks in the world’s richest countries are sending out unequivocal calls for strict control of prices to be addressed urgently, given their intrinsic relationship with how the budget deficit and government debt evolve. These messages allow very little room for nuances or interpretations, stating categorically that price stability is the essential factor that guarantees economic growth and therefore plays a key role in enabling countries to achieve good living standards. Nevertheless, inflation, which nobody doubts needs to be kept under control, requires a much deeper analysis to avoid over-mechanical, oversimplistic applications for the present situation. We mustn’t fall into what Paul Samuelson called basing economic policy on “shibboleths” – that is, hard and fast slogans that take over serious, thoughtful discussion and exchange of opinions. Especially since in economics slogans become hallmarks that are constantly repeated, and this repetition gets in the way of the obvious truth. This trend has led to the sale of intellectual products with no scientific backing. A case in point is David H. Fischer’s book on prices. Addressing business leaders, he asserts categorically that economic

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cycles and crises have ended, but the actual economic events have disproved this. As Robert Solow warns, there is not one set of laws of economics applicable to all times and all places, and the part of economics that is not dependent upon economic history and the social context is very small and of little interest.\footnote{R.M. Solow, “How Did Economics Get That Way and What Way Did it Get?”, in T. Bender and R.E. Schorske, American Academic Culture in Transformation: Fifty Years, Four Disciplines (Princeton University Press: Princeton, NJ, 1998), 57-76, especially p. 74.}

Indeed, as we have already discussed, EU recommendations lean towards strict control of inflation, with the commendable objective of keeping the economy competitive. In Spain, currency devaluation – so effective in the past at times when the economy was less competitive due to disparities in inflation rates – is no longer used. Today’s scenario is quite different, and prices, and therefore inflation, have become the key indicator that should cause most concern, since if year-on-year inflation is projected to rise it generates all kinds of anxieties and uncertainties. However, cases studied from economic history, especially in the United States, show that moderate inflation is not necessarily negative. Quite the opposite: it can even benefit economic structures. In other words, controlled inflation that is kept below 4% is a good compromise if growth is positive and unemployment is in decline. Some of the most prestigious American academic economists have examined this idea, which is somewhat of a break from the more widely accepted, more orthodox interpretations of economic developments.

The 2001 Nobel Prize in Economics winner George Akerlof wrote in 1996, in an article about the American economy co-authored with William Dickens and George Henry, that the cost of keeping inflation low, as close as possible to zero, would result in negative growth, and recommended that completely stable prices should in no circumstances be the Federal Reserve’s main objective. Akerlof wasn’t criticizing price control. In fact, he unashamedly praised it. But he was questioning the obsession for achieving a rate of inflation close to zero, especially when unemployment was rather high, at around 6% when his article was published. His theory is that reducing inflation when it is high increases unemployment very little, so it is better to keep inflation low, which improves forecasts since it barely raises the number of unemployed. However, when there is a certain level of productivity and you try to keep inflation low – bearing in mind the German hyperinflation in the 1920s, which is still an awful memory – the costs in terms of employment are very high. The main reason, according to Akerlof, is

believed what they wanted to believe, even if it was nonsense (see P. Krugman, The Accidental Theorist and Other Dispatches from the Dismal Science, pp. 127-134).
that inflation that is too low has high political and social costs, since companies are against wage cuts in certain circumstances. In fact, it seems employers rarely cut wages since they fear it could knock the company’s and its leaders’ morale. In other words, bringing inflation down to 3% is cheap in terms of employment, but if inflation dips below 3% the costs shoot up. The authors draw on economic history, and specifically the 1929 crisis and its repercussions, to give a more convincing argument for their model, and they stress that in terms of prices and employment, the strong negative inflation was accompanied by massive unemployment, affecting a quarter of America’s workforce. Peter Temin’s research confirms this, showing that the stubborn policy of wanting to maintain the gold standard was one of the main factors that made the Great Depression last so long. The monetary and fiscal authorities introduced contractionary policies, whereas our 20/20 hindsight shows that expansionary policies were needed. However, any alternative approach had to fit into the gold standard system, which politicians and economists claimed was untouchable but which was shaken by the harsh reality. No alternatives to the gold standard were taken seriously, neither by government when they were put forward, nor by investors or consumers when they were introduced. Everyone believed they were folly compared to the stability offered by the monetary standard.

Paul Krugman made similar arguments to Akerlof’s, breaking away from the prevalent viewpoint of academia. The 2008 Nobel Prize winner argues that the benefits of price stability are relative. Once again, Krugman bases his arguments on the lessons learned from economic history: the major American recession in the 1980s, which pushed down prices by 4-10%, occurred after a long period of high unemployment and excess capacity. The data are very clear: in the United States, the 1979 unemployment rate was not achieved again until 1988 (it was higher for almost a decade), so there was a sacrifice, a huge cost of almost a trillion dollars to achieve a very small long-term gain. The author’s conclusions are startling: the belief that completely stable prices are a blessing that provides major benefits at very little cost rests more on faith than on evidence. The real effects of stable prices, with inflation close to zero, are tiny gains that are more than cancelled out by side effects that punish the economy. Krugman analyses simple correlations to support his assumptions: first between economic growth and job

creation between 1980 and 1995, with results showing that growth cut unemployment; and second between inflation and unemployment from 1985 to 1995, finding that there is no correlation at all. So, the slogan the leading author coined is simple but eloquent: growth cut unemployment, inflation didn’t. On this point, Akerlof and Krugman owe much to Arthur Okun: the relationship between growth and job creation is one of the few “laws”, if indeed there are any laws, that exist in economic science, and it was Okun who developed this law. Reducing inflation had a significant negative effect on wages, incomes and living standards between 1979 and 1990, as shown by Samuel Bowles, David M. Gordon and Thomas E. Weisskopf, using monetary indicators and other indicators related to what we call “human development”.

Stiglitz takes a similar standpoint. A country can have low inflation but zero growth and high unemployment. According to Stiglitz – who also won the 2001 Nobel Prize in Economics alongside Akerlof – most economists agree that such a country would be in a disastrous macroeconomic position. They believe inflation is more a means than an end: since inflation that is too high often results in poor growth, which in turn leads to high unemployment, inflation is systematically stigmatized. In his critique, Stiglitz refers to the positions held by the IMF with respect to poor countries and the remedies it invariably and acritically applies to those countries’ economic structures, under the distant supervision of its bureaucrats. However, since Stiglitz published his contributions, the IMF has adopted different approaches. One of its reports in February 2010 warned critically against over-confidence in monetary policy rather than fiscal policy and called for a more flexible rate of inflation (which should be increased from 2% to 4%) to give macroeconomic policies more leeway.

10 In his opus magnum, *The Political Economy of Prosperity* (Brookings Institution, 1970), Okun analyses real GDP in the United States in the 1950s, at the start of the Korean War, when unemployment and inflation were very low. He extrapolates national production from those years to the future, taking into account the long-term trend of productivity improvements. Okun thus obtains ceilings for maximum production capacity and full employment for the 1950s and 1960s. He concludes that when GDP changed by 3%, unemployment moved by 1% in the opposite direction. In other words, if unemployment rose 1%, GDP would fall 3%. This approach, known as “Okun’s Law”, infers that the unemployment elasticity with respect to GDP is 3. This figured remained unchanged throughout the 1970s and 1980s, and only in the 1990s did the elasticity fall to 1.5. See J. Tobin, “Arthur M. Okun (1928-1980)”, in S.N. Durlauf, and L.E. Blume (eds.), *The New Palgrave Dictionary of Economics*, 2nd edn. (Palgrave Macmillan: Basingstoke 2008).


13 See O. Blanchard, G. Dell’Ariccia and P. Mauro, *Rethinking Macroeconomic Policy*, International Monetary Fund Staff Position Note, 12 February 2010, SPN/10/03.
We are aware that there are serious contributors to economics literature whose arguments are very different from those we have discussed so far. Indeed, it is their discourse that is prominent in economics when the relationships between prices, inflation and growth are discussed. And it is essentially this viewpoint that is taught in most university economics departments. But I believe it is interesting to discuss these other viewpoints, which could serve as an incentive to analyse other cases in greater detail, provided that they are built on equally well-founded and well-respected discourses in applied economics and can effectively and tangibly be translated into policy. In this regard, we must remember that in 1996, the US presidency adopted as its own the conclusions advocated by Akerlof, Dickens and Perry for the theory on the decline in inflation, which, as we have seen, had a positive effect on Clinton’s economic policy during his final years of office.

2. The need for growth

We thus see that there is a kind of conflict among major economic variables, which are interpreted in many different ways. Naturally, however, no economist or economic policymaker is willing to renounce economic growth or degrowth.\textsuperscript{14} The difficulty lies in deciding which levers need activating most to trigger a recovery. And here we find a major ideological perspective that is most intense among the neo-liberal school of thought. Because when people talk about orthodoxy, that is precisely what they mean: a balanced budget come what may, strictly controlling the budget deficit, constantly invoking legal certainty as a kind of all-powerful mantra, reducing the size of the public sector, which means cutting public services, and defending the recurring idea of economic freedom. The cornerstone of this economic viewpoint is that the market is always efficient, and many kinds of contributions have been published to try to justify this position, which still believes that points of equilibrium eventually form when there is an open economy. The same authors also insist that government intervention is usually harmful and undesirable.

\vspace{1cm}
\textsuperscript{14} In relation to degrowth, we must distinguish between well-reasoned arguments such as those found in the monograph of the journal \textit{Ecología Política} (vol. 35, 2008), and in C. Taibo, \textit{En defensa del decrecimiento} (Catarata: Madrid, 2009), and works aimed at the general public such as S. Latouche, \textit{Le parti de la décroissance} (Fayard: Paris, 2006). Nicholas Georgescu-Roegen’s interpretation is innovative in this respect, both in how he rethinks what “economic man” is and in terms of technology applied to economics – and therefore, to growth – and in turn, the thermodynamic, revolutionary view of economic processes. See the valuable summary in O. Carpintero, \textit{La Bioeconomía de Georgescu-Roegen} (Montesinos: Barcelona, 2006).
In times of economic crisis, the dichotomy between keeping accounts “in good health” (i.e. balanced, adjusted according to income) and fostering stimulus strategies (even if it means working under the umbrella of deficit and debt) has formed a set of crossroads for politicians and the economists who advise them. At such times it is also common to hear that the crisis is something unknown, with aspects not seen before, which to a large extent determines the responses made. The highly improvised nature of these responses is nearly always criticized, but is perfectly understandable. Anyone who believes that the person in charge of a country’s or a company’s finance or economy always has the perfect way out of all possible scenarios is mistaken. Those who claim they do are lying. The crisis leads to spasmodic movements on the stock and financial markets, which pervade production. This in turn leads to vague, spontaneous, often immature replies. Such misguided behaviour is caused by the lack of knowledge of economic history, since the unique features of each economic crisis still follow certain regular patterns that can be spotted from a historical perspective. The current Chairman of the Federal Reserve, Ben Bernanke, is a leading expert on the 1929 crisis and has published works of great scientific value on the topic.\textsuperscript{15} His wisdom helped him make certain decisions around September 2008 with the fall of Lehman Brothers. One important decision was to inject liquidity into the system to avoid short-circuiting the flow of credit. The Federal Reserve was resolute, and thus prevented even greater shocks to the American financial system, and therefore to much of the world. Another question altogether is what the financial system should give in return for being held together by taxpayers. This is another reform that should be debated and tackled without delay.

Whatever the criticisms that can be levelled at the present behaviour of the Federal Reserve, the policy adopted by Bernanke was not tried by any of his predecessors during the 1929 crisis. None except for one vital figure. There is one little-known period in the economic history of the Wall Street crash in which the prominent figure was a small, Mormon banker from Utah by the name of Marriner S. Eccles. It is not unusual for people who were key figures in the past, who were innovative in the decisions they took and visionary in one form or another, to be rediscovered at a later time having passed almost unnoticed in between, with contemporaries of theirs having

claimed all the fame.\textsuperscript{16} I have no intention of reviewing the causes of the 1929 crisis and how it panned out, but I would like to draw attention to the economic debates that took place, which were very similar to those we are witnessing today: the dilemma was whether to adopt an orthodox policy or explore other ways of dealing with the depression.\textsuperscript{17} It was in this context of uncertainty that Eccles emerged, a “small, slender man with dark eyes and a pale, sharp face” as Robert B. Reich described him, and a man who was Keynesian before Keynes himself.\textsuperscript{18}

Eccles ran a small banking institution, but his career path led him to amass a large fortune. The Wall Street crash in October 1929 took many economic sectors by surprise; much the same happened in 2008, when international bodies and all the world’s governments were predicting sustained economic growth and were ignoring the clear signs of a slowdown until the whole thing erupted in September 2008 when, as we have already discussed, major US banks went bankrupt. The fall of the banks was an eye-opener. In the 1930s, discussions focused on whether to protect the financial system or let it collapse. Many of the philosophical elements of liberal economics were at stake, including the gold standard, which had helped keep the international markets balanced. Both Peter Temin and Charles P. Kindleberger have written enlightening chapters on the whole affair, and Carmen M. Reinhart, Kenneth S. Rogoff and Carlos Marichal have made interesting contributions from the field of social science, adding the depth of economic history as a crucial piece in our understanding of what is happening right now.\textsuperscript{19} The conclusion is most striking: everything we’re seeing in the media, in

\textsuperscript{16} A similar case to Eccles is the economist George Warren, an agricultural expert who advised President Franklin D. Roosevelt to devalue the dollar to raise commodity prices, effectively forcing the US out of a strict adherence to the rules of the gold standard. The topic was the subject of intense controversy, but the American leader listened to what was the most heterodox position in the 1930s, a time when the myth of the rigid gold standard was considered somewhat of a sacred cow. See Ahamed, L., \textit{Lords of Finance: the Bankers who Broke the World} (William Heinemann: London, 2009).

\textsuperscript{17} It is worth remembering – as the winner of the 2010 Pulitzer Prize Liaquat Ahamed has done – that it was the key decisions of five men between 1920 in 1933 that contributed most to the global economic ruin. The names cannot be ignored: they were the chiefs of the central banks of the United States (Benjamin Strong), Britain (Montagu Norman), France (Émilie Moreau) and Germany (Hjalmar Schacht). The list of illustrious men should include President Hoover, whose contribution was that of inactivity and snap decisions. “The worst is over”, he claimed in May 1930, when – to use today’s terminology – green shoots began to appear. Two years later, the shoddy housing and living conditions of thousands of Americans had come to be known as Hoovervilles. There was also a marked rise in domestic migration among miserable, impoverished farmers with no property, which was masterfully described in John Steinbeck’s enlightening writings and the expressive drawings of the broken cities by Edward Hooper. L. Ahamed.


\textsuperscript{19} P. Temin; C.P. Kindleberger, \textit{Manias, Panics and Crashes}, 6th edn. (Palgrave Macmillan: Basingstoke, 2011). The amount of literature providing a historical review of crises is immeasurable. Recent works
specialist articles, in debates among professionals and in politicians’ speeches has all been seen before. There’s nothing new at all.\textsuperscript{20}

But let us turn back to the Mormon banker Eccles. In the heat of the controversy regarding how best to tackle the crisis, Eccles, who had concrete experience in the banking market, understood that refusing loans and shutting off the credit tap would make the depression even deeper. Furthermore, the businessman, who because of his family background and ideology had always believed the state should not interfere with the economy, stated in 1933 that the only plausible way out of the crisis was to allocate more money to unemployment benefits, public works, farms and refinancing mortgages. He believed this would require taking monetary powers away from regional financial bodies and centralizing them within the Federal Reserve Board of Governors, and giving government the capacity to boost public spending. According to Eccles, liquidity was the only measure of the usefulness of money, so you had to give money a social purpose while helping it to circulate through investments and transactions. And it is the federal government – with the power to issue money or request capital – that can channel efforts to generate the demand urgently needed for a recovery. In other words, with the heavy recession, the budget deficit was becoming the only appropriate formula to inject this capital into the system and improve the stagnant economy.\textsuperscript{21} All these recommendations were made three years before John Keynes published his \textit{General Theory}. There is a very clear, twofold lesson to learn from this: sticking doggedly to a certain type of economic policy has not always given satisfactory results, while considering new measures has led to tangible improvements.

Spain is a case in point. Measures to boost the Spanish economy had been in place for quite a while, and were backed up by relatively healthy public finances, as shown in Table 1, especially for 2009.

<table>
<thead>
<tr>
<th>Deficit to GDP</th>
<th>Debt to GDP</th>
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</table>

Table 1. Deficit and debt of some European countries as % of GDP


<table>
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<tbody>
<tr>
<td>Germany</td>
<td>-3.4</td>
<td>-5</td>
<td>-4.6</td>
<td>73.1</td>
<td>76.7</td>
<td>79.7</td>
</tr>
<tr>
<td>Austria</td>
<td>-4.3</td>
<td>-5.5</td>
<td>-5.3</td>
<td>69.1</td>
<td>73.9</td>
<td>77</td>
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<tr>
<td>Belgium</td>
<td>-5.9</td>
<td>-5.8</td>
<td>-5.8</td>
<td>97.2</td>
<td>101.2</td>
<td>104</td>
</tr>
<tr>
<td>Spain</td>
<td>11.2</td>
<td>-10.1</td>
<td>-9.3</td>
<td>54.3</td>
<td>66.3</td>
<td>74</td>
</tr>
<tr>
<td>France</td>
<td>-8.3</td>
<td>-8.2</td>
<td>-7.7</td>
<td>76.1</td>
<td>82.5</td>
<td>87.6</td>
</tr>
<tr>
<td>Greece</td>
<td>-12.7</td>
<td>-12.2</td>
<td>-12.8</td>
<td>112.6</td>
<td>124.9</td>
<td>135.4</td>
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<tr>
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<td>-5.6</td>
<td>59.8</td>
<td>65.6</td>
<td>69.7</td>
</tr>
<tr>
<td>Ireland</td>
<td>12.5</td>
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<td>-14.7</td>
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<td>82.9</td>
<td>96.2</td>
</tr>
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<td>-5.3</td>
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<td>114.6</td>
<td>116.7</td>
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<tr>
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<td>-8.7</td>
<td>77.4</td>
<td>84.6</td>
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<tr>
<td>Eurozone</td>
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<td>-6.9</td>
<td>-6.5</td>
<td>78.2</td>
<td>84</td>
<td>88.2</td>
</tr>
<tr>
<td>EU-27</td>
<td>-6.9</td>
<td>-7.5</td>
<td>-6.9</td>
<td>73</td>
<td>79.3</td>
<td>83.7</td>
</tr>
</tbody>
</table>

SOURCE: By the author based on European Commission data.

Spain was enjoying a significant budget surplus compared to the negative average for the Eurozone (-6.4%) and the 27-member EU (-6.9%). Also, its national debt was below the Maastricht Treaty limit, and more than twenty percentage points below the EU average. In other words, as the crisis was taking off in earnest and the lethal consequences had not yet set in, 2009 closed with the Spanish economy in a much more promising state than that of other, more powerful countries. A wave of measures had been introduced to reduce the impact of the credit crunch that were slowly but surely working (the “Plan E” for the construction sector through local councils, support for car sales, support for long-term unemployed people, the investment lines of the Spanish government’s Official Credit Institute (ICO), etc.). The measures compensated the sluggish private investment, which had a serious lack of circulating capital and, obviously, difficulties with obtaining preferential credits for investment policies.
Figure 1

![Spanish Economic Growth](image)

European Commission forecasts, 2005-2013

<table>
<thead>
<tr>
<th>Year</th>
<th>Oct-09</th>
<th>Oct-10</th>
<th>Oct-11</th>
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<td>4.0</td>
<td>3.5</td>
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<tr>
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<td>3.6</td>
<td>0.9</td>
</tr>
<tr>
<td>2007</td>
<td>3.6</td>
<td>0.9</td>
<td>-3.7</td>
</tr>
<tr>
<td>2008</td>
<td>0.9</td>
<td>-3.7</td>
<td>-0.8</td>
</tr>
<tr>
<td>2009</td>
<td>-3.7</td>
<td>-0.2</td>
<td>0.7</td>
</tr>
<tr>
<td>2010</td>
<td>-0.8</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>2011</td>
<td>1.0</td>
<td>1.7</td>
<td>1.4</td>
</tr>
</tbody>
</table>

SOURCE: By the author based on European Commission data.

Table 2. Government spending, 1970-2010, as percentages of GDP (five-year averages)

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<tr>
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<td>42.93</td>
<td>43.37</td>
<td>41.41</td>
<td>45.98</td>
<td>49.7</td>
<td>47.22</td>
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<td>50.98</td>
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<td>32.55</td>
<td>33.52</td>
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<td>38.27</td>
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</tr>
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<td>55.63</td>
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<td>44.7</td>
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<td>41.84</td>
<td>44.87</td>
<td>53.4</td>
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<td>67.91</td>
<td>64.41</td>
<td>67.31</td>
<td>62.89</td>
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<td>49.11</td>
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<td>OECD-25</td>
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<td>37.08</td>
<td>39.46</td>
<td>39.12</td>
<td>40.51</td>
<td>20.28</td>
<td>39.49</td>
<td>39.35</td>
<td>44.8</td>
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</tbody>
</table>

Government Spending as % of GDP, 1970-2010

2010 data are provisional
Table 3. Government spending by function, 1970-2005, as percentages of GDP (five-year averages)

<table>
<thead>
<tr>
<th>Spending by function</th>
<th>Spain</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>UK</th>
<th>Sweden</th>
<th>EU-15</th>
<th>OECD-25</th>
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<tbody>
<tr>
<td>Defence</td>
<td>1.26</td>
<td>2.05</td>
<td>2.7</td>
<td>1.33</td>
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<td>3.1</td>
<td>2.51</td>
<td>3.11</td>
</tr>
<tr>
<td>Public order and safety</td>
<td>1.15</td>
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<td>1.89</td>
<td>2.2</td>
<td>1.05</td>
<td>1.51</td>
<td>1.53</td>
<td></td>
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<tr>
<td>Economic affairs</td>
<td>4.42</td>
<td>4.59</td>
<td>2.94</td>
<td>5.39</td>
<td>4.36</td>
<td>5.17</td>
<td>4.6</td>
<td>4.49</td>
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<td>Environment protection</td>
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<td>0.79</td>
<td>0.52</td>
<td>0.71</td>
<td>0.76</td>
<td>0.18</td>
<td>0.68</td>
<td>0.74</td>
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<td>Housing and comm. amenities</td>
<td>0.82</td>
<td>0.86</td>
<td>1.3</td>
<td>1.06</td>
<td>1.84</td>
<td>2.1</td>
<td>1.18</td>
<td>0.98</td>
</tr>
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<td>Health</td>
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<td>5.44</td>
<td>5.02</td>
<td>5.73</td>
<td>5.84</td>
<td>6.06</td>
<td>5.32</td>
<td>5.06</td>
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<td>Recreation and culture</td>
<td>0.88</td>
<td>0.72</td>
<td>0.87</td>
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<td>0.8</td>
<td>1.87</td>
<td>0.87</td>
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<tr>
<td>Education</td>
<td>3.31</td>
<td>4.14</td>
<td>5.84</td>
<td>4.94</td>
<td>5.9</td>
<td>8.57</td>
<td>5.18</td>
<td>5.25</td>
</tr>
<tr>
<td>Social protection</td>
<td>12.37</td>
<td>18.47</td>
<td>18.76</td>
<td>15.47</td>
<td>16.2</td>
<td>23.49</td>
<td>17.3</td>
<td>10.73</td>
</tr>
<tr>
<td>Total</td>
<td>34.46</td>
<td>43.99</td>
<td>45.92</td>
<td>46.75</td>
<td>50.38</td>
<td>60.83</td>
<td>46.41</td>
<td>38.52</td>
</tr>
</tbody>
</table>


Throughout this process, government spending as a percentage of GDP continued the upward trend that began in the 1970s. The starting point for the Spanish economy was not good: Government spending stood at almost 20% in the five-year period from 1970 to 1974, nearly twenty points below the EU average, and thirteen below the OECD average. The government stepped up its spending considerably during Spain’s political and economic transitions, as shown in Table 2 and the accompanying graph, before reducing it by six percentage points between 1995 and 2004. Spending began to increase again in 2005, reaching 47.2% in 2010 (although the 2010 figures are still provisional). This figure places Spain almost two percentage points below the EU-15 average, and just over two points above the OECD average. It is a level of spending similar to Germany’s, but still far behind France’s, Sweden’s and the UK’s. Because the margins of spending cuts have different bases, so the sacrifices required of member states reveal different paths and therefore different capacities to cope with strict austerity measures. This is clear to see in Table 3, which lists indicators from 1970 to 2005. In 2005 (and probably in 2010 too), Spain was spending significantly less than the EU average on health, education and social security, and much less than the biggest European economies. Even if we look further afield and compare Spain with the OECD (which includes countries with very different political, social and economic situations such as Mexico and South Korea), Spanish spending on health and education is still below average and spending on social security is only slightly above average.
In early 2010, the general diagnoses issued by the non-governmental institutions with the most meticulous economic forecasts said that Spanish economic growth was performing better than predicted for the final quarter of 2009, even saying that the downturn was slowing. The improved performance, according to the institutions, was thanks to the slowdown in the fall of retail sales and improved consumer confidence. Meanwhile, there was an unexpected fall in industrial production, which in March 2009 had been expected to recover. Production capacity did begin to recover thanks to the upturn in spending by foreign tourists coming to Spain from countries whose economy had already improved. Ten million euros were invested in the ICO to provide liquidity to companies working on sustainability projects. The current-account balance was reduced (to little over 6% by September 2009). Prices were kept down. And finally, there was a slowdown in the rate at which unemployment was growing, while there were signs of a boost to the jobs market.\(^{22}\) Figure 1 provides a summary of the process: despite all the difficulties in 2009, which is when the downward curve is steepest and there was a latent danger of the dreaded L-shaped recession, the variables began to recover to form a tenuous but tangible V shape. Nevertheless, we must realize that the signs were very superficial, responding to a period in which there was a big increase in public spending. This additional public spending should have been accompanied by joint, coordinated policies by the main European economic institutions to help the flow of credit, thus boosting private investment. Table 3 reveals just how fragile those data were, as Spain lost its entire surplus in a year and turned it into a big deficit in 2010, exceeding the EU average.\(^{23}\) The failure of the Spanish growth model, built around a construction sector that was infected by perverse speculative practices fuelled by excessively lax lending policies (despite the greater regulation in the Spanish financial system), resulted in redundancies and devastated the economy when tax revenue plummeted and spending linked to automatic stabilizers rose, thus widening the deficit and debt.

3. Profit indicator

It is widely known that under the capitalist system capital investment in new production methods arises when a certain amount of profit is expected. If expansion

\(^{22}\) These data are based on La Caixa, *Monthly Report*, 331 (2010); Servicio Público de Empleo Estatal; Instituto Nacional de Estadística; and Banco de España.

\(^{23}\) See S. Bentolilla et al., *La crisis de la economía española* (Fedea: Madrid, 2010), which provides a critical review of economic policies around the time the recession broke out.
continues but profits do not meet forecasts, the end result is obvious: investment stops, and as expansion grinds to a halt, the negative chain reactions escalate. This reduces demand for machinery, raw materials and labour, and eventually sends unemployment sky high. This very synthetic process takes a crucial factor into account that the dominant economic approach has ignored in recent years: the existence of a cycle as an essential part of the accumulation process, and the confirmation of uneven periodic depressions resulting from the perennial need for investment, which goes beyond the conditions that determine profits based on accumulated capital. In this respect, Karl Marx said that capitalism hadn’t reached the limits of its capacity to increase production forces, but rather the uneven rate of growth instigated periodic crises that, sooner or later, would show themselves to be incompatible with the mode of production used to push the economy forward, resulting in serious social conflicts. In other words, capitalism becomes unproductive when the essential contradiction in the economic system is identified: the struggle between the development of production forces and the return on capital. This becomes manifest in a wide range of situations, so trying to find clearly defined patterns all too often results in frustration. It is by analysing economic history that we can obtain a better understanding of crises that take place over time. On this crucial aspect, it is important to note the following points, in line with Marx’s ideas mentioned above:

a) Economic recessions drastically reduce profits. Indeed, there is a strong agreement on this among both Keynesian economists and Marxian economists like Maurice Dobb and

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24 According to Marx, the capitalist mode of production has several obstacles to tackle at a certain scale of production, to the extent that it can even stagnate when business profits are hit, but not to satisfy social needs. This distinction is crucial because it focuses attention not on the greater or lesser benefits that government can offer people (which are now so maligned by neo-liberal precepts) and their impact on government budgets, but rather on the profits of business people, who at certain times can tangibly see their production get blocked, drop back or stagnate. At such times, the solution must not be to cut back support for social needs. See M. Dobb, *Capitalismo, crecimiento económico y subdesarrollo* (Oikos Tau: Barcelona, 1975); and K. Marx, *El Capital*, (Siglo XXI: Mexico, 1975), especially the third volume.

25 We should not be too alarmed by this warning by Marx, now that his works no longer seem very popular, but he does offer enlightening analyses of the genesis and development of economic crises that have significantly shaped later economists. Interestingly, for instance, the first theory of a centralized socialist economy was developed in 1908 by an Italian economist who was not a socialist, Enrico Barone. Likewise, non-Marxian thinkers like Sidney and Beatrice Webb (they were Fabians, to be precise) predicted a gradual shift from capitalism to socialism brought about by a series of irreversible, cumulative reforms, following the arguments of Marx. Finally, we shouldn’t forget the words of the venerable Nobel laureate John Hicks, who said, “Most of those [who wish to fit into place the general course of history] would use the Marxian categories, or some modified version of them, since there is so little in the way of an alternative version that is available.” See E. Hobsbawm, *How to Change the World: Tales of Marx and Marxism* (Little, Brown: London, 2011).
Michal Kalecki. A fall in profits is seen as the inevitable cause of capitalist crises. As we have seen, this is directly related to economic cycles, so the idea of profits is associated not only with short-term, one-off phenomena, but also with more long-term events. The issue is of great interest regarding the different viewpoints on the nature of the Great Recession: here too we can observe lines of research that go beyond financial descriptions and delve deeper into the structural factors of the economic system. In this respect, the Kalecki model is suitable both for its simplicity and its content. John King describes it thus:

\[
\begin{align*}
B &= C+A \\
C &= C' + \lambda B \\
hence B &= C' + A + \lambda B; \\
therefore B &= (C' + A)/(1-\lambda)
\end{align*}
\]

“Real gross profit (B)...is the sum of capitalist consumption (C) and accumulation (A) [which is equivalent to gross capital formation, or in simple terms, investment]. Consumption by capitalists consists of a constant part (C1) and a variable part that is proportional to real gross profits (\lambda B)...[The equation] tells us that real gross profit is proportional to the aggregate expenditure of capitalists on consumption and accumulation....

Since capitalist consumption is ‘not very elastic’, it follows that the principal factor causing fluctuations in aggregate profits is changes in investment activity. Kalecki maintained that investment decisions depend on the expected net yield.”

According to Kalecki’s formula, investment orders (I) are a positive function of capitalists’ expenditure (C1 + A) and a negative function of the existing capital stock (K):

\[
I = m (C^1 + A) - nK
\]

The relationship between the net profit and the change in the interest rate determines a company’s propensity to invest and their strategies to obtain the necessary credit.

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27 M. Kalecki, “A Macro-Dynamic Theory of Business Cycles”, *Econometrica*, 3 (1935), 327-44. J.E. King, pp. 35-37. See also A. Bhaduri, which states that of the various methods used to manage demand, the quickest and most convenient is to step up public spending and take on a financial deficit, a move that would be considered a heresy in the current phase of the Great Recession.
Clearly, then, the economy is unstable. Variabilities in investment have a substantial influence, a multiplying effect, in determining how total production will evolve. In a clever play on words, Kalecki said “investment is not only produced but also producing”. King added, “Investment expenditure increases aggregate demand, which improves business conditions and stimulates further increases in investment.” As you can see, in this area, Kalecki’s position is very close to that of Keynes, even though the Pole ferociously criticized the Briton.28 But perhaps one of the major discrepancies lies in Kalecki’s interpretation in terms of society and social class. In a worrying reminder of the Great Recession, the Polish economist goes as far as to say that business leaders appreciate production discipline (or “discipline in the factories” as he puts it) and political stability more than profits. “Their class instinct”, he adds, “tells them that lasting full employment is unsound from their point of view and that unemployment is an integral part of the ‘normal’ capitalist system.”29

Many approaches to economic policy put forth between the outbreak of the crisis in 2008 and the abrupt removal of all stimulus policies in May 2010 are based on premises like the ones seen above, even if those who promote these policies are unaware of it. The same can be said of current investor distrust in sectors of the real economy.

b) Between 1850 and 2008, recessionary phases in the US resulted in significant falls in profits as a percentage of GDP.30 The immediate repercussion is that it limits

28 The controversy between Keynes and Kalecki was toned down somewhat by Joan Robinson, a direct disciple of the Cambridge economist. Robinson, an economist with a socialist political background, undertook the solid task of melting together Marxist and Keynesian precepts, with Kalecki (who she affectionately called “my Pole”) playing a vital influential role. J.E. King. An informative work providing an excellent synthesis of Robinson’s positions that is very useful for teaching is J. Robinson and J. Eatwell, Introduction to Modern Economics (McGraw-Hill: London, 1973).

29 These ideas, which the pensée unique has rejected as obsolete and anachronistic, are still relevant due to the present economic and social situation, well known to recent economic historians. The increase in profits derived from capitalist accumulation is thanks to the fall in production costs, with considerable increments in value described by Paul Baran and Paul Sweezy as the “law of rising surplus”, the essence of monopoly capital. This surplus, say the two economists, cannot be absorbed by growing demand or by investment (remember Kalecki’s equations), but increasing sales and strong military spending are the only natural outlets when investment is blocked by over-accumulation. There is a marked “Kaleckian” influence on these contributions. P. Baran and P. Sweezy, Monopoly Capital: An Essay on the American Economic and Social Order (Monthly Review Press: New York, 1966). Similarly, another heterodox economist, Joseph Steindl, asserts that public spending on weapons between 1940 and the 1970s prevented another dip in the world economy, while in the 1970s crisis unemployment rates were being used to tackle (or as the author put it, as a “weapon” against) inflation, making such a tactic a deliberate, conscious economic policy. See J. Steindl, Economic Papers 1941-1988 (Macmillan: London, 1990), especially pp. 165-80; and A. Bhaduri.

30 Angus Maddison’s works do not present profit-to-GDP series, but they do include indicators that indirectly link negative economic growth to dips in business activity and economic activity in general. See A. Maddison, The World Economy: A Millennial Perspective/Historical Statistics (OECD Publishing:
companies’ investment capacity, with careful analysis of the period from 1950 to 2008 also revealing a direct correlation between investment and profits. In so-called “normal” circumstances, companies can compensate for lost profits by turning to the credit markets. But when the financial markets are highly volatile, companies have more problems and find it much harder to acquire the capital they need to make investments that during expansionary phases could be better guaranteed by positive results in their operating statements. Thus a vicious circle is formed.

Nevertheless, in the second half of the 1980s and the start of the 21st century there was a marked increase in profits in the financial sector as a proportion of total business profits. The figure rocketed to between 33% and 45%, despite rarely averaging more than 20% at any time since 1950. Put another way, the lion’s share of total company profits was not held by the real economy per se but by the parts of the economy directly or indirectly tied to the new sectors being created by the financial economy. A more detailed view of the data thus suggested that, apart from the instability caused by a highly deregulated financial system, there could be deeper problems that were holding back profits. This meant we were likely to face a situation in which not only would finances need adjusting but also the over-accumulation of investment in areas that were no longer providing the necessary profit for the perpetuation of the economic system. In the early months of 2008, non-financial and non-agricultural US firms already saw quarterly profits slip 24% compared to the same quarter in 2007, so there was already explicit evidence that this was happening. The causes were diverse and included a sharp rise in the prices of raw materials, the rising cost of credit, financial-sector losses (due to revised valuation of banks’ balance sheets), and the spread of the crisis around the globe, which essentially affected exporters. None of this was predicted by financial analysts, despite the clear signs that profits were entering a downward cycle, and amazingly they were unaware of key data regarding the over-indebtedness of households and companies and failed to take them into account in their projections.\(^3\)

At this crossroads in the European and global economies, the key parts of the ideological precepts of economic policy began to re-emerge, as we have seen. Although this topic seems a world away from the offices of technocrats, it has taken hold of them
all. In the context of the economic crisis, the question of economic ideology is more prominent than ever, and a major struggle is taking place whose consequences are of great interest to the social sciences in general and economics in particular.
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