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Working Paper

The US economy: From crisis to stagnation

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Working Paper

Thomas I. Palley¹

The US Economy: From Crisis to Stagnation

Revised April 2015

Abstract

This paper examines the major competing interpretations of the economic crisis in the US and explains the rebound of neoliberal orthodoxy. It shows how US policymakers acted to stabilize and save the economy, but failed to change the underlying neoliberal economic policy model. That failure explains the emergence of stagnation, which is likely to endure. Current economic conditions in the US smack of the mid-1990s. The 1990s expansion proved unsustainable and so will the current modest expansion. However, this time it is unlikely to be followed by financial crisis because of the balance sheet cleaning that took place during the last crisis.

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Abstract

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I The crisis and the resilience of neoliberal economic orthodoxy

The financial crisis that erupted in 2008 challenged the foundations of orthodox economic theory and policy. At its outset, orthodox economists were stunned into silence as evidenced by their inability to answer the Queen of England's simple question (November 5th, 2008) to the faculty of the London School of Economics as to why no one foresaw the crisis. Six years later, orthodoxy has fought back and largely succeeded in blocking change of thought and policy. The result has been economic stagnation.

This paper examines the major competing interpretations of the economic crisis in the US and explains the rebound of neoliberal orthodoxy. It shows how US policymakers acted to stabilize and save the economy, but failed to change the underlying neoliberal economic policy model. That failure explains the emergence of stagnation in the US economy and stagnation is likely to endure. Current economic conditions in the US smack of the mid-1990s. The 1990s expansion proved unsustainable and so will the current modest expansion. However, this time it is unlikely to be followed by financial crisis because of the balance sheet cleaning that took place during the last crisis.

II Competing explanations of the crisis

The Great Recession, which began in December 2007 and includes the financial crisis of 2008, is the deepest economic downturn in the US since the World War II. The depth of the downturn is captured in Table 1 which shows the decline in GDP and the peak unemployment rate. The recession has the longest duration and the decline in GDP is the largest. The peak unemployment rate was slightly below the peak rate of the recession of 1981-82. However, this ignores the fact that the labor force participation rate fell in the Great Recession (i.e. people left the labor force and were not counted as unemployed)

whereas it increased in the recession of 1981-82 (i.e. people entered the labor force and were counted as unemployed).¹

Table 1. Alternative measures of the depth of US recessions.

Source: http://en.wikipedia.org/wiki/List_of_recessions_in_the_United_States

Recession dates	Duration	GDP decline (peak to trough)	Peak unemployment rate
Nov 1948 - Oct 1949	11 months	-1.7%	7.9% (Oct 1949)
July 1953 - May 1954	10 months	-2.6%	6.1% (Sep 1954)
Aug 1957 - April 1958	8 months	-3.7%	7.5% (July 1958)
April 1960 - Feb 1961	10 months	-1.6%	7.1% (May 1961)
Dec 1969 - Nov 1970	11 months	-0.6%	6.1% (Dec 1970)
Nov 1973 - March 1975	16 months	-3.2%	9.0% (May 1975)
Jan 1980 - July 1980	6 months	-2.2%	7.8% (July 1980)
July 1981 - Nov 1982	16 months	-2.7%	10.8% (Nov 1982)
July 1990 - March 1991	8 months	-1.4%	7.8% (June 1992)
March 2001 - Nov 2001	8 months	-0.3%	6.3% (June 2003)
Dec 2007 - June 2009	18 months	-4.3%	10.0% (Oct 2009)

Table 2 provides data on the percent change in private sector employment from business cycle peak to trough. The 7.6 percent loss of private sector jobs in the Great Recession dwarfs other recessions, providing another measure of its depth and confirming its extreme nature.

¹ Over the course of the 1981-82 labor force participation rose from 63.8 percent to 64.2 percent, thereby likely increasing the unemployment rate. In contrast, over the course of the Great Recession the labor force participation rate fell from 66.0 percent to 65.7 percent, thereby likely decreasing the unemployment. The decrease in the labor force participation rate was even sharper for prime age (25 – 54 years old) workers, indicating that the decrease in the overall participation rate was not due to demographic factors such as an aging population. Instead, it was due to lack of job opportunities, which supports the claim that labor force exit lowered the unemployment rate.

Table 2. U.S. private employment cycles, peak to trough.

Source: Bureau of labor statistics and author's calculations.

Peak date	Employment peak (thousands)	Trough date	Employment trough (thousands)	Percent change	Peak to trough duration (months)
1948 - 9	39,489	1949 - 7	37,568	-4.9%	10
1953 - 7	43,813	1954 - 8	41,933	-4.2%	13
1957 - 4	45,537	1958 - 6	42,986	-5.6%	14
1960 - 4	46,278	1961 - 2	44,969	-2.8%	10
1969 - 12	58,763	1970 - 11	57,579	-2.0%	11
1974 - 6	64,363	1975 - 4	61,668	-4.2%	10
1980 - 3	74,695	1980 - 7	73,414	-1.7%	4
1981 - 8	75,448	1982 - 12	72,775	-3.5%	16
1990 - 4	91,274	1992 - 2	89,557	-1.8%	22
2000 - 12	111,681	2003 - 7	108,231	-3.1%	31
2008 - 1	115,610	2010 - 2	106,772	-7.6%	25

Broadly speaking there exist three competing perspectives on the crisis (Palley, 2012). Perspective # 1 is the hardcore neoliberal position which can be labelled the “*government failure hypothesis*”. In the U.S. it is identified with the Republican Party and with the economics departments of Stanford University, the University of Chicago, and the University of Minnesota. Perspective # 2 is the softcore neoliberal position, which can be labeled the “*market failure hypothesis*”. It is identified with the Obama administration, the Walls Street and Silicon Valley wing of the Democratic Party, and economics departments such as those at MIT, Yale and Princeton. In Europe it is identified with “Third Way” politics. Perspective # 3 is the progressive position which is rooted in Keynesian economics and can be labeled the “*destruction of shared prosperity hypothesis*”. It is identified with the New Deal wing of the Democratic Party and the labor movement, but it has no standing

within major economics departments owing to their suppression of alternatives to economic orthodoxy.

The hardcore neoliberal government failure argument is that the crisis is rooted in the U.S. housing bubble and its bust. The claim is that the bubble was due to excessively prolonged loose monetary policy and politically motivated government intervention in the housing market aimed at increasing ownership. With regard to monetary policy, the Federal Reserve pushed interest rates too low for too long following the recession of 2001. With regard to the housing market, government intervention via the Community Reinvestment Act and Fannie Mae and Freddie Mac, drove up house prices and encouraged homeownership beyond peoples' means.

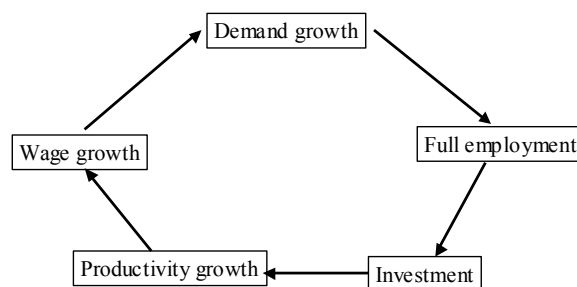
The softcore neoliberal market failure argument is that the crisis is due to inadequate financial sector regulation. First, regulators allowed excessive risk-taking by banks. Second, regulators allowed perverse incentive pay structures within banks that encouraged management to engage in "loan pushing" rather than "sound lending." Third, regulators pushed both deregulation and self-regulation too far. Together, these failures contributed to financial misallocation, including misallocation of foreign saving provided through the trade deficit, that led to financial crisis. The crisis in turn deepened an ordinary recession, transforming it into the Great Recession which could have become the second Great Depression absent the extraordinary policy interventions of 2008-09.

The Keynesian "destruction of shared prosperity" argument is that the crisis is rooted in the neoliberal economic paradigm that has guided economic policy for the past thirty years. An important feature of the argument is that, though the U.S. is the epicenter of the crisis, all countries are implicated as they all participated in the adoption of a

systemically flawed policy paradigm. That paradigm infected finance via inadequate regulation, enabling financial excess that led to the financial crisis of 2008. However, financial excess is just an element of the crisis and the full explanation is far deeper than just financial market regulatory failure.

According to the Keynesian destruction of shared prosperity hypothesis, the deep cause is generalized economic policy failure rooted in the flawed neoliberal economic paradigm that was adopted in the late 1970s and early 1980s. For the period 1945 - 1975 the U.S. economy was characterized by a “virtuous circle” Keynesian growth model built on full employment and wage growth tied to productivity growth. This model is illustrated in Figure 1 and its logic was as follows. Productivity growth drove wage growth, which in turn fuelled demand growth and created full employment. That provided an incentive for investment, which drove further productivity growth and supported higher wages. This model held in the U.S. and, subject to local modifications, it also held throughout the global economy - in Western Europe, Canada, Japan, Mexico, Brazil and Argentina.

Figure 1. The 1945 – 75 virtuous circle Keynesian growth model.

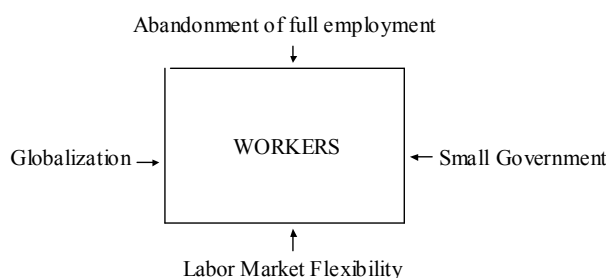


After 1980 the virtuous circle Keynesian growth model was replaced by a neoliberal growth model. The reasons for the change are a complex mix of economic,

political and sociological reasons that are beyond the scope of the current paper. The key changes wrought by the new model were: 1) abandonment of the commitment to full employment and the adoption of commitment to very low inflation; 2) severing of the link between wages and productivity growth. Together, these changes created a new economic dynamic. Before 1980, wages were the engine of U.S. demand growth. After 1980, debt and asset price inflation became the engine.

The new economic model was rooted in neoliberal economic thought. Its principal effects were to weaken the position of workers; strengthen the position of corporations; and unleash financial markets to serve the interests of financial and business elites. As illustrated in figure 2, the new model can be described as a neoliberal policy box that fences workers in and pressures them from all sides. On the left hand side, the corporate model of globalization put workers in international competition via global production networks that are supported by free trade agreements and capital mobility. On the right hand side, the “small” government agenda attacked the legitimacy of government and pushed persistently for deregulation regardless of dangers. From below, the labor market flexibility agenda attacked unions and labor market supports such as the minimum wage, unemployment benefits, employment protections, and employee rights. From above, policymakers abandoned the commitment of full employment, a development that was reflected in the rise of inflation targeting and the move toward independent central banks influenced by financial interests.

Figure 2. The neoliberal policy box.



Corporate globalization is an especially key feature. Not only did it exert downward inward pressures on economies via import competition and the threat of job off-shoring, it also provided the architecture binding economies together. Thus, globalization reconfigured global production by transferring manufacturing from the U.S. and Europe to emerging market economies. This new global division of labor was then supported by having U.S. consumers serve as the global economy's buyer of first and last resort, which explains the U.S. trade deficit and the global imbalances problem. This new global division of labor inevitably created large trade deficits that also contributed to weakening the aggregate demand (AD) generation process by causing a hemorrhage of spending on imports (Palley, 2015).

An important feature of the Keynesian hypothesis is that the neoliberal policy box was implemented on a global basis, in both the North and the South. As in the U.S., there was also a structural break in policy regime in both Europe and Latin America. In Latin America, the International Monetary Fund and World Bank played an important role as they used the economic distress created by the 1980s debt crisis to push neoliberal policy. They did so by making financial assistance conditional on adopting such policies. This

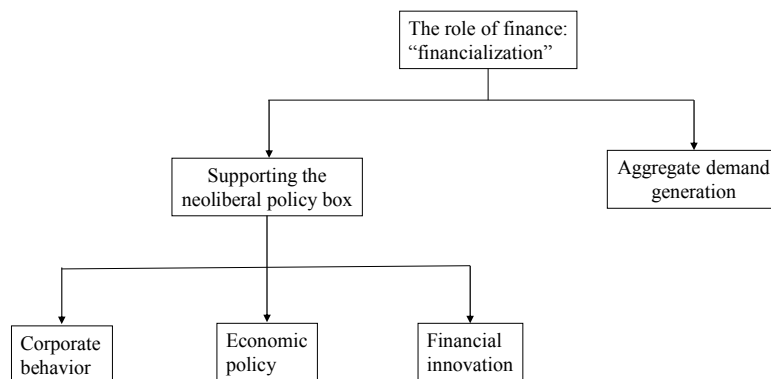
global diffusion multiplied the impact of the turn to neoliberal economic policy and it explains why the Washington Consensus enforced by the International Monetary Fund and World Bank has been so significant. It also explains why stagnation has taken on a global dimension.

III The role of finance in the neoliberal model

Owing to the extraordinarily deep and damaging nature of the financial crisis of 2008, financial market excess has been a dominant focus of explanations of the Great Recession. Within the neoliberal government failure hypothesis the excess is attributed to ill-advised government intervention and Federal Reserve interest rate policy. Within the neoliberal market failure hypothesis it is attributed to ill-advised deregulation and failure to modernize regulation. According to the Keynesian destruction of shared prosperity hypothesis neither of those interpretations grasps the true significance of finance. The government failure hypothesis is empirically unsupportable (Palley, 2012a, chapter 6), while the market failure hypothesis has some truth but also misses the true role of finance.

That role is illustrated in Figure 3 which shows that finance performed two roles in the neoliberal model. The first was to structurally support the neoliberal policy box. The second was to support the AD generation process. These dual roles are central to the process of increasing financial domination of the economy which has been termed financialization (Epstein, 2004, p.3; Krippner, 2004, 2005; Palley, 2013).

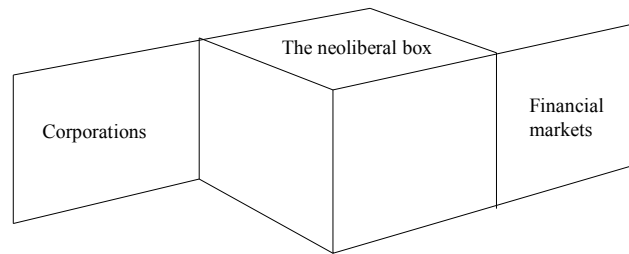
Figure 3. The role of finance in the neoliberal model.



The policy box shown in Figure 2 has four sides. A true box has six sides and a four sided structure would be prone to structural weakness. Metaphorically speaking, one role of finance is to provide support on two sides of the neoliberal policy box, as illustrated in Figure 4. Finance does this through three channels. First, financial markets have captured control of corporations via enforcement of the shareholder value maximization paradigm of corporate governance. Consequently, corporations now serve financial market interests along with the interests of top management. Second, financial markets in combination with corporations lobby politically for the neoliberal policy mix. The combination of changed corporate behavior and economic policy produces an economic matrix that puts wages under continuous pressure and raises income inequality. Third, financial innovation has facilitated and promoted financial market control of corporations via hostile take-overs, leveraged buyouts and reverse capital distributions. Financial innovation has therefore

been key for enforcing Wall Street's construction of the shareholder value maximization paradigm.

Figure 4. Lifting the lid on the neoliberal policy box.



The second vital role of finance is the support of AD. The neoliberal model gradually undermined the income and demand generation process, creating a growing structural demand gap. The role of finance was to fill that gap. Thus, within the U.S., deregulation, financial innovation, speculation, and mortgage lending fraud enabled finance to fill the demand gap by lending to consumers and by spurring asset price inflation. Financialization assisted with this process by changing credit market practices and introducing new credit instruments that made credit more easily and widely available to corporations and households. U.S. consumers in turn filled the global demand gap, along with help from U.S. and European corporations who were shifting manufacturing facilities and investment to the emerging market economies.

Three things should be emphasized. First, this AD generation role of finance was an unintended consequence and not part of a grand plan. Neoliberal economists and policymakers did not realize they were creating a demand gap, but their *laissez-faire* economic ideology triggered financial market developments that coincidentally filled the demand gap. Second, the financial process they unleashed was inevitably unstable and was always destined to hit the wall. There are limits to borrowing and limits to asset price inflation and all Ponzi schemes eventually fall apart. The problem is it is impossible to predict when they will fail. All that can be known with confidence is that it will eventually fail. Third, the process went on far longer than anyone expected, which explains why critics of neoliberalism sounded like Cassandras (Palley, 1998, Chapter 12). However, the long duration of financial excess made the collapse far deeper when it eventually happened. It has also made escaping the after-effects of the financial crisis far more difficult as the economy is now burdened by debts and destroyed credit worthiness. That has deepened the proclivity to economic stagnation.

IV Evidence

Evidence regarding the economic effects of the neoliberal model is plentiful and clear. Figure 5 shows productivity and average hourly compensation of non-supervisory workers (that is non-managerial employees who are about 80 percent of the workforce). The link with productivity growth was severed almost 40 years ago and hourly compensation has been essentially stagnant since then.

Figure 5. Productivity and real average hourly compensation of US non-supervisory workers, 1948 – 2013.

Source: Mishel, Gould and Bivens (2015).

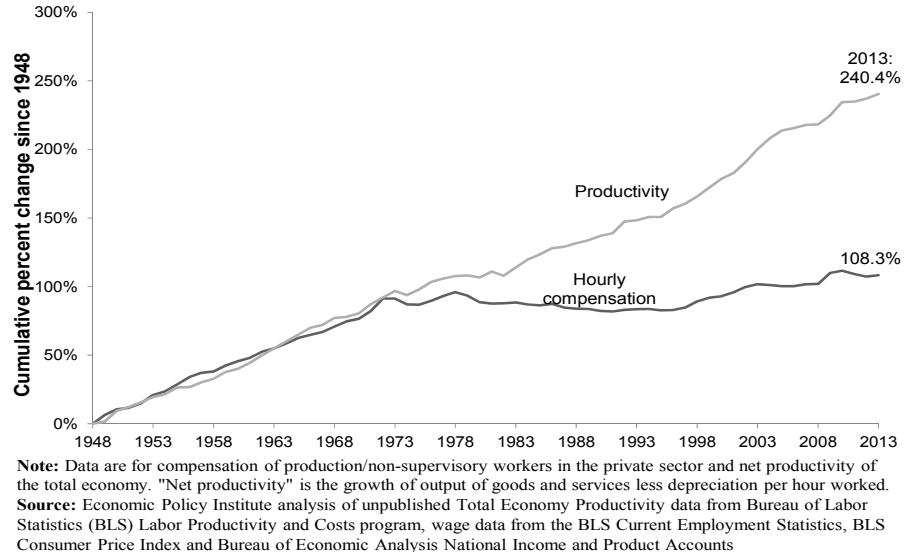


Table 3 shows data on the distribution of income growth by business cycle expansion across the wealthiest top 10 percent and bottom 90 percent of households. Over the past sixty years there has been a persistent decline in the share of income gains going to the bottom 90 percent of households ranked by wealth. However, in the period 1948 – 1979 the decline was gradual. After 1980 there is a massive structural break and the share of income gains going to the bottom 90 percent collapses. Before 1980, on average the bottom 90 percent received 66 percent of business cycle expansion income gains. After 1980, on average they receive just 8 percent.

Table 3. Distribution of income growth by business cycle expansion across the wealthiest top 10 percent and bottom 90 percent of households.

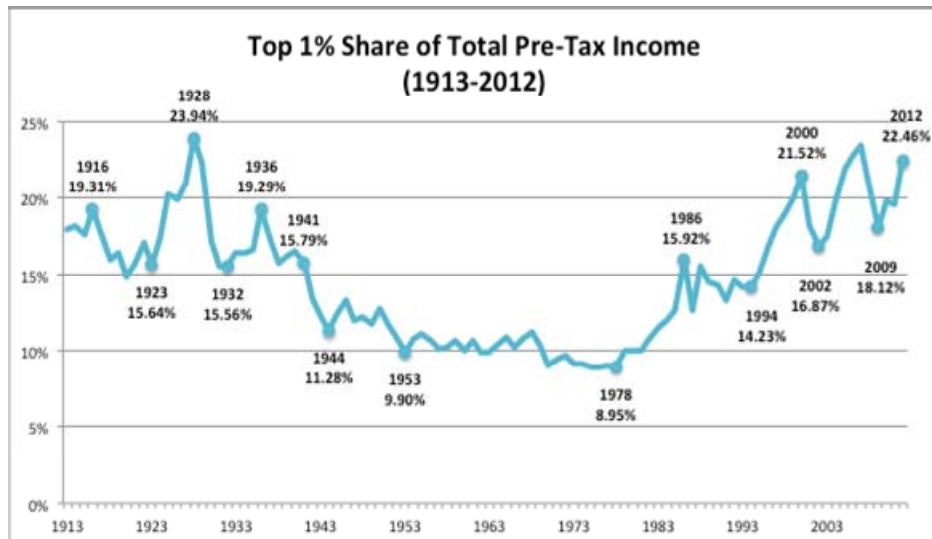
Source: Tcherneva (2014), published in *The New York Times*, September 26, 2014.

	'49- '53	'54- '57	'59- '60	'61- '69	'70- '73	'75- '79	'82- '90	'91- '00	'01- '07	'09- '12	Average Pre-1908	Average Post-1980
Top 10%	20%	28	32	33	43	45	80	73	98	116	34%	92%
Bottom 90%	80%	72	68	67	57	55	20	27	2	-16	66%	8%

Figure 6 shows the share of total pre-tax income of the top one percent of households ranked by wealth. From the mid-1930s, with the implementation of the New Deal social contract, that share fell from a high of 23.94 percent in 1928 to a low of 8.95 percent in 1978. Thereafter it has steadily risen, reaching 23.5 percent in 2007 which marked the beginning of the Great Recession. It then fell during the Great Recession owing to a recession-induced fall in profits, but has since recovered most of that decline as income distribution has worsened again during the economic recovery. In effect, during the neoliberal era the US economy has retraced its steps, reversing the improvements achieved by the New Deal and post-World War II prosperity, so that the top one percent's share of pre-tax income has returned to pre-Great Depression levels.

Figure 6. US pre-tax income share of top 1 percent.

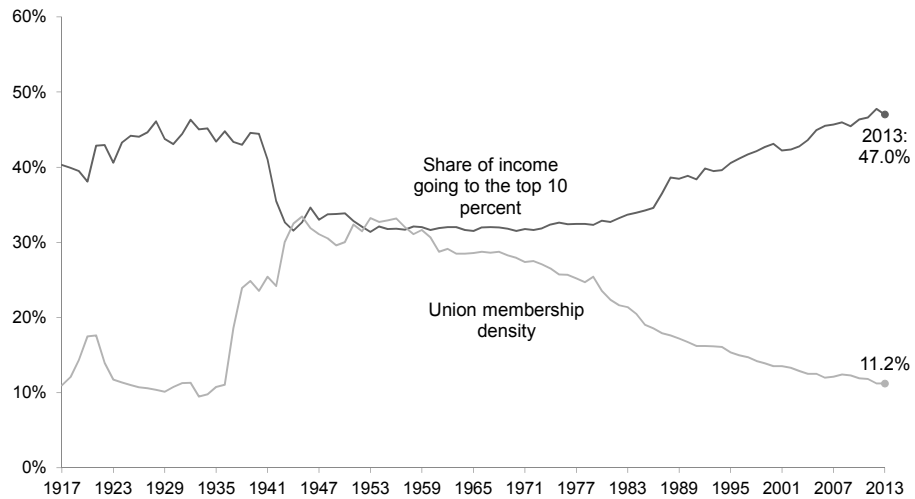
Source: <http://inequality.org/income-inequality/>. Original source: Thomas Piketty and Emanuel Saez (2003), updated at <http://emlab.edu/users/saez>.



As argued in Palley (2012a, p. 150-151) there is close relationship between union membership density (i.e. percent of employed workers that are unionized) and income distribution. This is clearly shown in Figure 7 which shows union density and the share of pre-tax income going to the top ten percent of wealthiest households. The neoliberal labor market flexibility agenda explicitly attacks unions and works to shift income to wealthier households.

Figure 7. Union membership and the share of income going to the top ten percent of wealthiest households, 1917 – 2013.

Source: Mishel, Gould and Bivens (2015).



Source: Data on union density follows the composite series found in Historical Statistics of the United States; updated to 2013 from unionstats.com. Income inequality (share of income to top 10%) from Piketty and Saez, "Income Inequality in the United States, 1913-1998, *Quarterly Journal of Economics*, 118(1), 2003, 1-39. Updated

Table 4 provides data on the evolution of the U.S. goods and services trade balance as a share of GDP by business cycle peak. Comparison across peaks controls for the effect of the business cycle. The data show through to the late 1970s U.S. trade was roughly in balance, but after 1980 it swung to massive deficit and the deficits increased each business cycle. These deficits were the inevitable product of the neoliberal model of globalization (Palley, 2015) and they undermined the AD generation process in accordance with the Keynesian hypothesis.

Table 4. The U.S. goods & services trade deficit/surplus by business cycle peaks, 1960 – 2007.

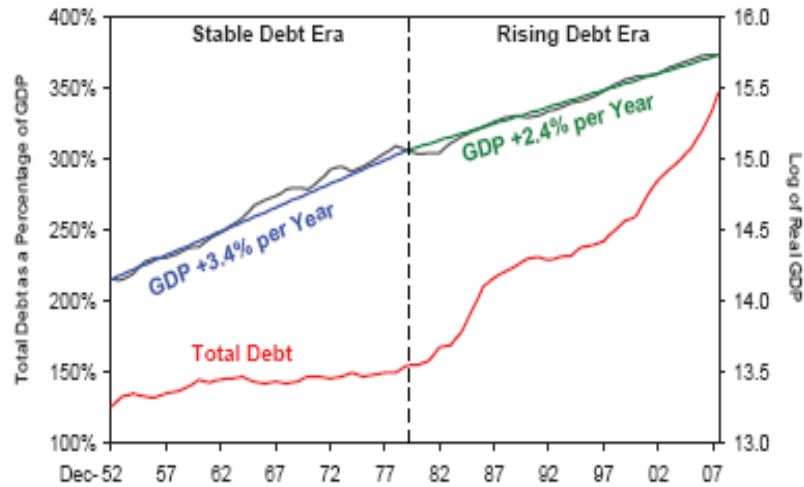
Sources: Economic Report of the President, 2009 and author's calculations.

Business cycle peak year	Trade balance (\$ millions)	GDP (\$ billions)	Trade balance/ GDP (%)
1960	3,508	526.4	0.7
1969	91	984.6	0.0
1973	1,900	1,382.7	0.1
1980	-25,500	2,789.5	-0.9
1981	-28,023	3,128.4	-0.9
1990	-111,037	5,803.1	-1.9
2001	-429,519	10,128.0	-4.2
2007	-819,373	13,807.5	-5.9

Finally, Figure 8 shows total domestic debt relative to GDP and growth. This Figure is highly supportive of the Keynesian interpretation of the role of finance. During the neoliberal era real GDP growth has actually slowed but debt growth has exploded. The reason is the neoliberal model did nothing to increase growth, but it needed faster debt growth to fill the demand gap created by the model's worsening of income distribution and creation of large trade deficits. Debt growth supported debt-financed consumer spending and it supported asset price inflation that enabled borrowing which filled the demand gap caused by the neoliberal model.

Figure 8. Total domestic debt and growth (1952-2007).

Source: Grantham, 2010.



V The debate about the causes of the crisis: why it matters

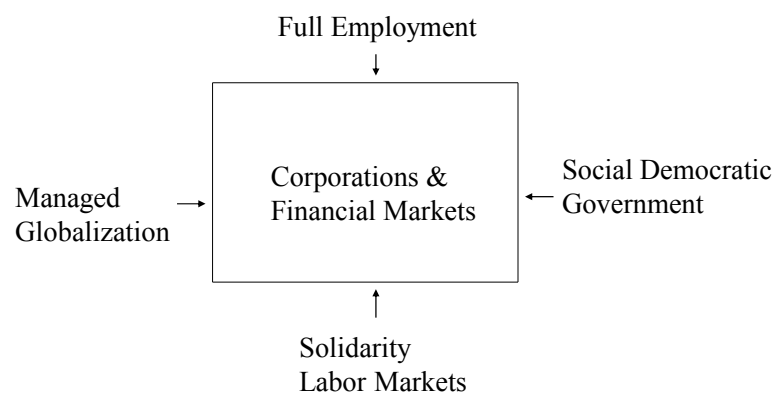
The importance of the debate about the causes of the crisis is that each perspective recommends its own different policy response. For hardcore neoliberal government failure proponents the recommended policy response is to double-down on the policies described by the neoliberal policy box and further deregulate markets; to deepen central bank independence and the commitment to low inflation via strict rules based monetary policy; and to further shrink government and impose fiscal austerity to deal with increased government debt produced by the crisis.

For softcore neoliberal market failure proponents the recommended policy response is to tighten financial regulation but continue with all other aspects of the existing neoliberal policy paradigm. That means continued support for corporate globalization, so-called labor market flexibility, low inflation targeting, and fiscal austerity in the long term.

Additionally, there is need for temporary large-scale fiscal and monetary stimulus to combat the deep recession caused by the financial crisis. However, once the economy has recovered, policy should continue with the neoliberal model.

For proponents of the destruction of shared prosperity hypothesis the policy response is fundamentally different. The fundamental need is to overthrow the neoliberal paradigm and replace it with a “structural Keynesian” paradigm. That involves repacking the policy box as illustrated in Figure 9. The critical step is to take workers out of the box and put corporations and financial markets in so that they are made to serve a broader public interest. The key elements are to replace corporate globalization with managed globalization that blocks race to the bottom trade dynamics and stabilizes global financial markets; restore a commitment to full employment; replace the neoliberal anti-government agenda with a social democratic government agenda; and replace the neoliberal labor market flexibility with a solidarity based labor market agenda. The goals are restoration of full employment and restoration of a solid link between wage and productivity growth.

Figure 9. The structural Keynesian box.



Lastly, since the neoliberal model was adopted as part of a new global economic order, there is also need to recalibrate the global economy. This is where the issue of “global rebalancing” enters and emerging market economies need to shift away from export-led growth strategies to domestic demand-led strategies. That poses huge challenges for many emerging market economies because they have configured their growth strategies around export-led growth whereby they sell to U.S. consumers.

VI From crisis to stagnation: the failure to change

Massive policy interventions, unequalled in the post-war era, stopped the Great Recession from spiraling into a second Great Depression. The domestic economic interventions included the 2008 Troubled Asset Relief Program (TARP) that bailed out the financial sector via government purchases of assets and equity from financial institutions; the 2009 American Recovery and Reinvestment Act (ARRA) that provided approximately \$800 billion of fiscal stimulus, consisting of approximately \$550 billion of government spending and \$250 billion of tax cuts; the Federal Reserve lowering its interest target to near-zero (0 - 0.25 percent); and the Federal Reserve engaging in quantitative easing (QE) transactions that involve it purchasing government and private sector securities. At the international level, in 2008 the Federal Reserve established a temporary \$620 billion foreign exchange (FX) swap facility with foreign central banks. That facility provided the global economy with dollar balances, thereby preventing a dollar liquidity shortage from triggering a wave of global default on short-term dollar loans that the financial system was unwilling to roll-over because of panic.² Additionally, there was unprecedented globally coordinated fiscal stimulus arranged via the G-20 mechanism.

² The FX swaps with foreign central banks have been criticized as being a bail-out for foreign economies. In fact, they saved the US financial system which would have been pulled down by financial collapse outside

Despite their scale, these interventions did not stop the recession from being the deepest since 1945, and nor did they stop the onset of stagnation. Table 5 shows how GDP growth has failed to recover since the end of the Great Recession, averaging just 2.1 percent for the five year period from 2010 – 2014. Furthermore, that period includes the rebound year of 2010 when the economy rebounded from its massive slump owing to the extraordinary fiscal and monetary stimulus measures that were put in place.

Table 5. U.S. GDP growth.

Source: Statistical Annex of the European Union, Autumn 2014 and author's calculations. The growth rate for 2014 is that estimated in October 2014.

1961 - 1970	1971 - 1980	1981 - 1990	1991 - 2000	2001 - 2007	2008 - 2009	2010 - 2014
4.2%	3.2%	3.3%	3.5%	2.5%	-1.6%	2.1%

Table 6 shows employment creation in the five years after the end of recessions, which provides another window on stagnation. The job creation numbers show that the neoliberal model was already slowing in the 1990s with the first episode of “jobless

the US. Many foreign banks operating in the US had acquired US assets financed with short-term dollar borrowings. When the US money market froze in 2008 they could not roll-over these loans in accordance with normal practice. That threatened massive default by these banks within the US financial system, which would have pulled down the entire global financial system. The Federal Reserve could not lend directly to these foreign banks and their governing central banks lacked adequate dollar liquidity to fill the financing gap. The solution was to lend dollars to foreign central banks, which then made dollar loans to foreign banks in need of dollar roll-over short-term financing.

recovery”. It actually ground to stagnation in the 2001 – 2007 period, but this was masked by the house price bubble and the false prosperity it created. Stagnation has persisted after the Great Recession, but the economic distress caused by the recession has finally triggered awareness of stagnation among elites economists. In a sense, the Great Recession called out the obvious, just as did the little boy in the Hans Anderson story about the emperor’s new suit.

Table 6. U.S. private sector employment creation in the five year period after the end of recessions for six business cycles with extended expansions.

Source: Bureau of labor statistics and author’s calculations. * = January 1980 the beginning of the next recession.

Recession end date	Employment at recession end date (millions)	Employment five years later (millions)	Percent growth in employment
Feb 1961	45.0	52.2	16.0%
Mar 1975	61.9	74.6*	20.5%
Nov 1982	72.8	86.1	18.3%
March 1991	90.1	99.5	10.4%
Nov 2001	109.8	115.0	4.7%
June 2009	108.4	117.1	8.0%

The persistence of stagnation after the Great Recession raises the question “why”? The answer is policy has done nothing to change the structure of the underlying neoliberal economic model. That model inevitably produces stagnation because it produces a structural demand shortage via (i) its impact on income distribution, and (ii) via its design of globalization which generates massive trade deficits, wage competition and off-shoring of jobs and investment.

In terms of the three-way contest between the government failure hypothesis, the market failure hypothesis and the destruction of shared prosperity hypothesis, the economic policy debate during the Great Recession was cast as exclusively between government failure and market failure. With the Democrats controlling the Congress and Presidency after the 2008 election, the market failure hypothesis won out and has framed policy since then. According to the hypothesis, the financial crisis caused an exceptionally deep recession that required exceptionally large monetary and fiscal stimulus to counter it and restore normalcy. Additionally, the market failure hypothesis recommends restoring and renovating financial regulation, but other than that the neoliberal paradigm is appropriate and should be deepened.

In accordance with this thinking, the in-coming Obama administration affirmed existing efforts to save the system and prevent a downward spiral by supporting the Bush administration's TARP, the Federal Reserve's first round of QE (November/December 2008) that provided market liquidity, and the Federal Reserve's FX swap agreement with foreign central banks.

Thereafter, the Obama administration worked to reflate the economy via passage of the ARRA (2009) which provided significant fiscal stimulus. With the failure to deliver a V-shaped recovery, candidate Obama became even more vocal about fiscal stimulus. However, reflecting its softcore neoliberal inclinations, the Obama administration then became much less so when it took office. Thus, the winners of the internal debate about fiscal policy in the first days of the Obama administration were those wanting more modest fiscal stimulus.³ Furthermore, its analytical frame was one of temporary stimulus with the

³ Since 2009 there has been some evolution of policy positions characterized by a shift to stronger support for fiscal stimulus. This has been especially marked in Larry Summers, who was the Obama administration's

goal of long-term fiscal consolidation, which is softcore neoliberal speak for fiscal austerity.

Seen in the above light, after the passage of ARRA (2009), the fiscal policy divide between the Obama administration and hardcore neoliberal Republicans was about the speed and conditions under which fiscal austerity should be restored. This attitude to fiscal policy reflects the dominance within the Democratic Party of “Rubinomics”, the Wall Street view associated with former Treasury Secretary Robert Rubin, that government spending and budget deficits raise real interest rates and thereby lower growth. According to that view, the US needs long-term fiscal austerity to offset Social Security and Medicare.

Side-by-side with the attempt to reflate the economy, the Obama administration also pushed for major overhaul and tightening of financial sector regulation via the Dodd-Frank Act (2010). That accorded with the market failure hypothesis’s claim about the economic crisis and Great Recession being caused by financial excess permitted by the combination of excessive deregulation, lax regulation and failure to modernize regulation.

Finally, and again in accordance with the logic of the market failure hypothesis, the Obama administration has pushed ahead with doubling-down and further entrenching the neoliberal policy box. This is most visible in its approach to globalization. In 2010, free trade agreements modelled after NAFTA were signed with South Korea, Colombia and Panama. The Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TTIP), two mega-agreements negotiated in secrecy and apparently bearing

chief economic adviser when it took office. This shift has become a way of rewriting history by erasing the memory of initial positions. That is also true of the IMF which in 2010-2011 was a robust supporter of fiscal consolidation in Europe.

similar hallmarks to prior trade agreements, are also being pushed by the Obama administration.

The Obama administration's softcore neoliberalism would have likely generated stagnation by itself, but the prospect has been further strengthened by Republicans. Thus, in accordance with their point of view, Republicans have persistently pushed the government failure hypothesis by directing the policy conversation to excessive regulation and easy monetary policy as the causes of the crisis. Consequently, they have consistently opposed strengthened financial regulation and demands for fiscal stimulus. At the same time, they have joined with softcore neoliberal Democrats regarding doubling-down on neoliberal box policies, particularly as regards trade and globalization.

Paradoxically, the failure to change the overall economic model becomes most visible by analyzing the policies of the Federal Reserve, which have changed the most dramatically via the introduction of QE. The initial round of QE (QE1) was followed by QE2 in November 2010 and QE3 in September 2012, with the Fed shifting from providing short-term emergency liquidity to buying private sector financial assets. The goal was to bid up prices of longer term bonds and other securities, thereby lowering interest rates on longer-term financing and encouraging investors to buy equities and other riskier financial assets. The Fed's reasoning was lower long-term rates would stimulate the economy, and higher financial asset prices would trigger a positive wealth effect on consumption spending. This makes clear the architecture of policy. The Obama administration was to provide fiscal stimulus to jump start the economy; the Fed would use QE to blow air back into the asset price bubble; the Dodd-Frank Act (2010) would stabilize financial markets; and globalization would be deepened by further NAFTA-styled international agreements.

This is a near-identical model to that which failed so disastrously. Consequently, stagnation is the logical prognosis.

VII Déjà vu all over again: back to the 1990s but with a weaker economy

The exclusion of the destruction of shared prosperity hypothesis, combined with the joint triumph of the market failure and government failure hypotheses, means the underlying economic model that produced the Great Recession remains essentially unchanged. That failure to change explains stagnation. It also explains why current conditions smack of “déjà vu all over again” with the US economy in 2014-15 appearing to have returned to conditions reminiscent of the mid-1990s. Just as the 1990s failed to deliver durable prosperity, so too current optimistic conditions will prove unsustainable absent deeper change.

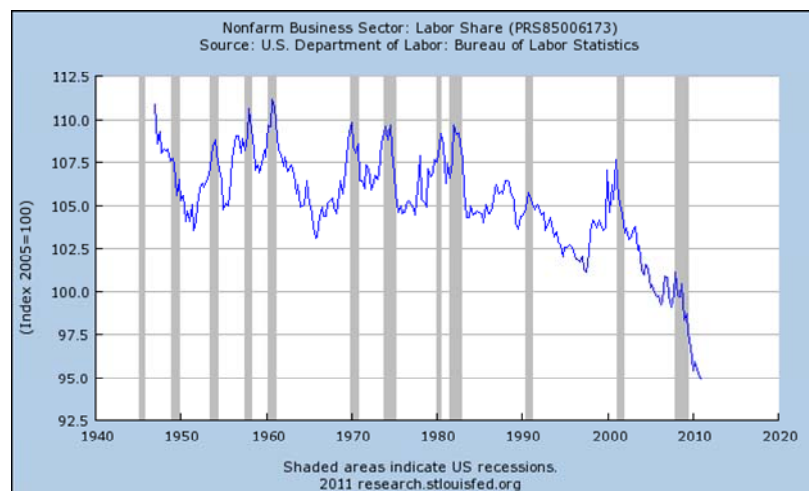
The déjà vu similarities are evident in the large US trade deficit that has started to again deteriorate rapidly; a return of the over-valued dollar problem that promises to further increase the trade deficit and divert jobs and investment away from the US economy; a return to reliance on asset price inflation and house price increases to grow consumer demand and construction; a return of declining budget deficits owing to continued policy disposition toward fiscal austerity; a return of the contradiction that has the Federal Reserve tighten monetary policy when economic strength triggers rising prices and wages that bump against the ceiling of the Fed’s self-imposed 2 percent inflation target; and renewal of the push for neoliberal trade agreements.

All of these features mean both policy context and policy design look a lot like the mid-1990s. The Obama administration saved the system but did not change it. Consequently, the economy is destined to repeat the patterns of the 1990s and 2000s.

However, the US economy has also experienced almost twenty more years of neoliberalism which has left its economic body in worse health than the 1990s. That means the likelihood of delivering another bubble-based boom is low and stagnation tendencies will likely reassert themselves after a shorter and weaker period of expansion.

This structurally weakened state of the US economy is evident in the further worsening of income inequality that has occurred during the Great Recession and subsequent slow recovery. As shown in Figure 10, national income data show that the labor share has continued to fall during this period, hitting new post-war lows. Furthermore, earlier, Table 3 showed how the top ten percent of wealthiest households garnered 116 percent of the income gains during the recovery period 2009-12, implying that the bottom 90 percent had negative income growth during this period.

Figure 10. Labor share of US non-farm business GDP (%), 1945 - 2011.



Source: Economist's View, June 16, 2011. Labor share consists of wages, salaries and pension benefits of non-supervisory workers.

This worsening of income distribution has multiple negative implications that promote stagnation via direct and indirect effects. With regard to direct effects, worsened income distribution shifts income from poorer low saving households to richer high saving households. That shift reduces consumption spending and aggregate demand. With regard to indirect effects, by lowering the incomes of poorer households which tend to be borrowers, it reduces their borrowing capacity which in turn reduces credit expansion via consumer and mortgage borrowing. This indirect effect helps explain why credit and mortgage growth have been sluggish despite much lower interest rates. QE aimed to stimulate household borrowing, but continued worsening of income distribution has undermined middle class households' ability to do so. Furthermore, at the start of the recovery in 2009 households already had more debt that was accumulated over the period 2000 – 2007 than they did in the 1990s. That combination of further worsened income distribution and increased debt makes the possibility of another 1990s-style extended debt-driven expansion unlikely.

A second problem is the macroeconomic restraining effects of the Dodd-Frank Act (2010) financial sector reforms and increased regulation. These measures were necessary to limit the scope and space for financial excess that was a threat to the economy's stability. However, the neoliberal economic model needs asset price inflation and borrowing to fill the demand gap created by worsened income distribution, the trade deficit and fiscal austerity. Ironically, the Dodd-Frank reforms of the financial sector limit the financial system's capacity to generate asset price inflation and borrowing to fill that gap. That is another difference from the 1980s and 1990s when the system was being deregulated to facilitate this demand filling mechanism (see Palley, 2012, Chapter 5). This is another

reason why the system is less capable of generating another credit bubble to drive economic expansion.

Lastly, weakness in the global economy resulting from the spread of the export-led growth model (Palley, 2012b) promises to weaken demand for exports by US firms; increase the intensity of import competition as foreign firms try to capture an increased share of the US market to compensate for weakness in their own domestic markets; and increase the grinding downward pressure on US wages via global wage competition as unemployment threat compel workers to accept lower wages.

These adverse developments combine with and amplify the existing structural drags inherent to the neoliberal model (i.e. wage stagnation, deteriorated income distribution, proclivity to fiscal austerity, trade deficits, global wage competition, job and investment off-shoring, etc.). The 1990s boom proved unsustainable despite more favorable conditions. Worsened current conditions suggest any new expansion will again prove unsustainable, will peter out in stagnation, and will be much weaker and of shorter duration.

These tendencies are already visible. Table 7 shows the contributions to GDP growth from different sources for the period 2008 - 2014. Having been positive in the period 2008-2010 because of ARRA, government spending has begun to contract and become a drag on growth. The collapse of imports during the Great Recession helped strengthen growth by lowering the trade deficit, but as the economy and the dollar have strengthened that impetus has fallen and reversed. Investment spending has made a positive contribution but the contribution has been weaker than in the 1990s. The one strengthening area is consumption spending, but the past two business cycles (1991-2001, 2001 – 2007) have shown that alone is not sustainable.

Table 7. Contributions to percent change in real GDP.

Source: Bureau of Economic Analysis, GDP Report, Table 1.1.2.

	2008	2009	2010	2011	2012	2013	2014
1. Government consumption & investment spending	0.54	0.64	0.02	-0.65	-0.30	-0.39	-0.03
2. Net exports of goods & services	1.11	1.19	-0.46	-0.02	0.04	0.22	-0.22
3. Gross private investment spending	-1.71	-3.52	1.66	0.73	1.33	0.76	0.95
4. Consumption spending	-0.23	-1.08	1.32	1.55	1.25	1.64	1.72
GDP growth (= 1 + 2 + 3 + 4)	-0.3%	-2.8%	2.5%	1.6%	2.3%	2.2%	2.4%

VIII Conclusion: stagnation rather than another financial crisis

The great Recession has been followed by stagnation which is likely to endure. That is because of failure to change the structure of the underlying economic policy model. Policy saved the model but did not change it. The policy mix constituting the neoliberal model failed in the 1990s and 2000s under more favorable conditions (i.e. less debt hangover, less destroyed consumer credit-worthiness, financial innovation that was beginning and had room to grow, and equity and house prices that were at a lower base with more room for increases, etc.). That suggests the model is destined to fail again.

However, this time it is less likely the expansion will end in a financial crisis because the resolution of the last crisis compelled the financial sector to massively strengthen its balance sheet. Instead, the expansion is likely to end with a stock market correction and evaporation of growth, but that may take a couple of years to play out. That said, there are two scenarios which may end in financial crisis. The first is if the

euro implodes as a result of exit of economically depressed and politically stressed member country exit. The second is if the Federal Reserve continues to pump up financial asset prices and the economy eventually hits an inflation threshold that triggers higher interest rates, which could then trigger an asset price melt-down.

Stagnation without financial crisis seems the most likely outcome for the US economy. The neoliberal economic model is unchanged and exhausted. That is symbolically paralleled by the political system in which the 2016 presidential election may well be between Hilary Clinton and Jeb Bush. One is the wife of former President Bill Clinton, while the other is the brother of former President George W. Bush. Together, Presidents Clinton and Bush presided over the entrenchment and implosion of neoliberal model. Paralleling the economy, U.S. politics also smacks of déjà vu all over again.

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