Neoliberalism and Its Discontents

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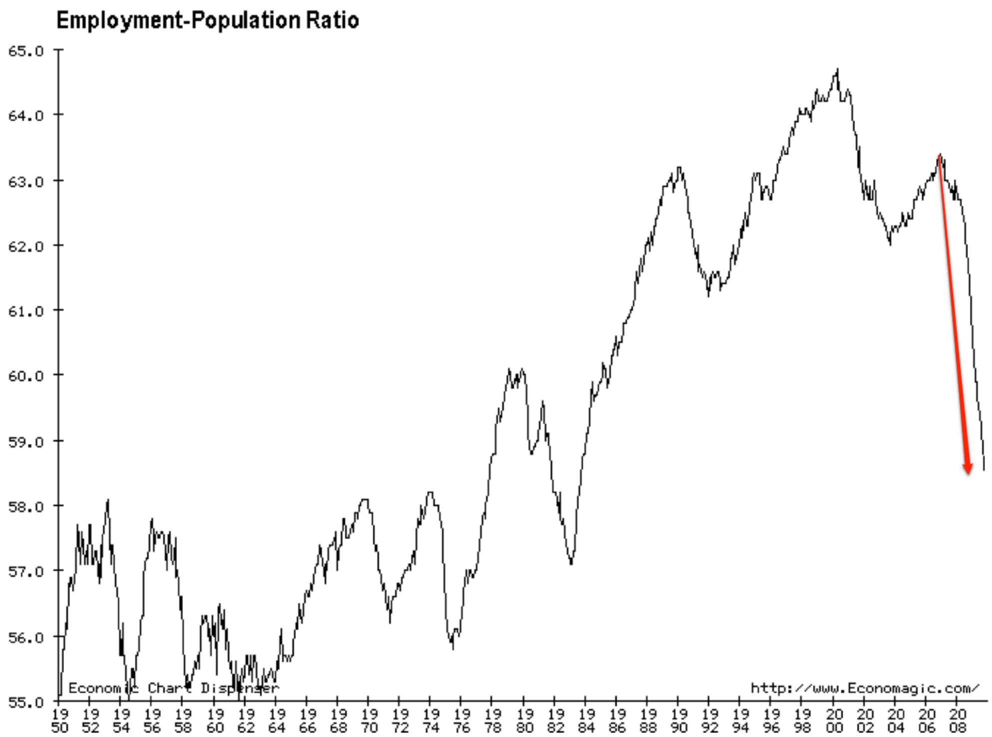
I. Introduction: The Situation Today

In the United States today, the labor market is still in free fall: although production and demand are now growing, it is still the case that fewer North Americans are at work each season than in the last, and that the share of potential North American workers who have jobs continues to drop.

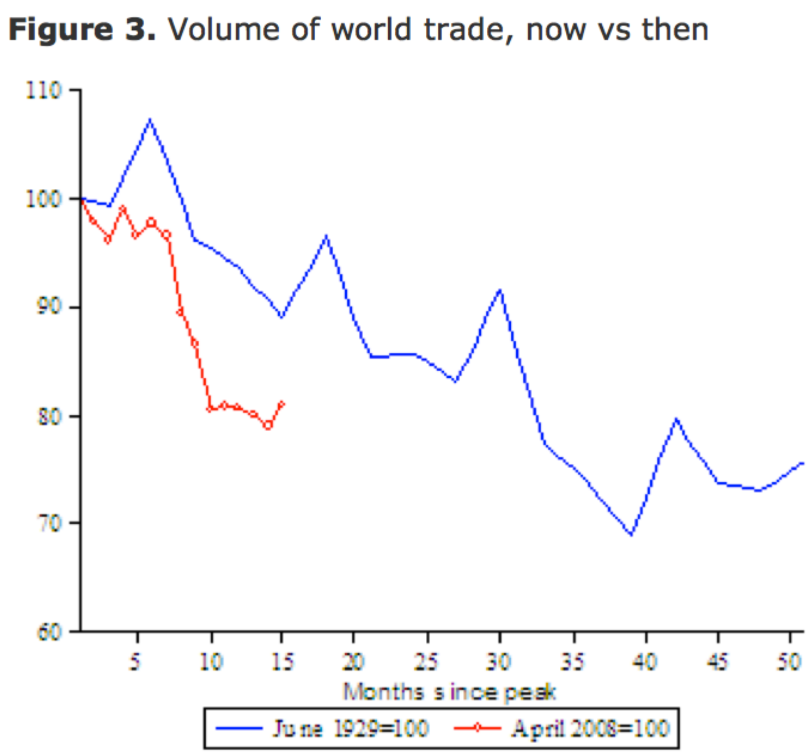
In the United States, the Employment-to-Population Ratio Is in Free Fall



America's employment-to-population ratio—the fraction of those sixteen and over who say that they have jobs when the Current Population Survey interviewers knock on their doors—is in free fall. In a week and a half we are likely to learn that the United States's seasonally-adjusted employment-to-population ratio hit 58.3%, down from 63.4% at its most recent 2007 business-cycle peak an down from its all-time high of more than 64% during the dot-com boom of a decade ago.

In the world, the volume of international trade has collapsed at a pace three times as fast as during the slide into the Great Depression—and although we see signs of a revival in trade volumes, there were signs of revival in trade volumes at several points during the slide into the Great Depression of the 1930s as well.

In the World, the Volume of Trade Has Collapsed



What the world economy is now going through is its third great purely-economic shock of the past century: the Great Depression; the Great

Inflation, that is the oil-shock ridden decade that began in 1973 with the Yom Kippur Arab-Israeli War and ended with the Latin American debt crisis of 1982; and now today. Of these three, the first was by far the greatest and most destructive—that is to say, we hope and have some reason to hope that it will still be classified as the greatest and most destructive after all this is over. Nevertheless, for my purposes tonight I want to focus on the similarities rather than the differences. In all three cases:

- A purely economic—not political-military, not political-social—shock interrupts the march of industrial prosperity and carries not just unlucky individual economies but the global economy as a whole into a relatively-long period of considerable distress.

- The shock comes out of the blue: in advance, even as the storm clouds gathered, mainstream economists and policymakers were congratulating each other and patting themselves on the back about how the global economy was now well-governed, and how the episodes of macreconomic distress that had afflicted industrial economies were now a thing of the past.

- The aftermath of the shock saw a great rethinking of the relationship between state and market: individuals held to their previous positions, but the center of intellectual gravity around the world and the burden of proof on political advocates shifted—in the case of the Great Depression from confidence in the gold standard and *laissez-faire* to a belief in Keynesian macroeconomic management and government control or influence over the "commanding heights" of the economy; in the case of the Great Inflation from post-WWII "social democracy" to what we now call "neoliberalism," a belief that on balance we should presume that we should trust state less because of government failure and trust market more because market failures were overrated and overstressed; and in the case of today, whatever we eventually decide to call this episode, a shift away from "neoliberalism" to something else that we cannot yet quite see.

My task this evening, as I understand it, is to try to put what is now going on both in the world economy and in thought about the world economy into its proper perspective, so that we can better understand what is happening to us even if we cannot—certainly not individually and to a distressing extent not even collectively—control what is happening to us. Tonight I hope to weave back and forth in subject, from the economy to thought about the economy and back again; and back and forth in time, from today as far back as 1825 and as far forward as 2050.

Counting this introduction, my talk will have seven sections. The second will jump back in time to cover the past three decades, surveying the doctrine of "neoliberalism" as it was constructed by the politicians who followed Thatcher and Reagan, by the economists and central bankers with their bad consciences about the distressing inflation and the disturbingly-large numbers of "white elephant" state-built, state-run, and state-subsidized development projects during the first post-World War II generation, and by the international technocrats of the IMF and the World Bank—its promises, its partial successes, and its failures. The third part will jump further back in time to the era of the Great Depression and World War II and trade forward the Keynesian "commanding heights" social-democratic doctrine that proceeded it, not in the sense that any of these doctrines commanded a consensus but rather that they were "hegemonic" in the sense of Italian political philosopher Antonio Gramsci: that they were presumed to be true unless special and strenuous arguments were made to overcome them in a particular case.

Section four will consider the ruling secret, the *arcane imperii* of neoliberalism: that even when the state was not trusted, central bankers were. There was always one area and one set of issues where the neoliberal logic that said that the state was too large and a less-regulated market could do better did not apply. That area was central banking, and it was the forgetting of that principle in the late 1990s that opened us up to our current crisis. It will jump all the way back in time to 1825 to analyze why the central banking exception existed—and why it had always existed since the beginning of industrial society: belief in a market economy always went only so far, and it was only when the avid worshippers of market economies forgot its limits, as they did at the end of the 1920s and in the middle of the 2000s, that their systems of thought and policy fell into trouble.

Section V will do a little of old-fashioned macroeconomics. It will explain why the central-banking exception always existed, why even thinkers as attached to economic libertarianism as Milton Friedman always held back and in their footnotes and asterisks always called for aggressive government intervention to control finance and financial markets when necessary.

The sixth section will then apply the old-fashioned macroeconomics to give my view on what should be done now—both at the level of the world economy as a whole, and at the level of individual countries like Brazil that do not control but cannot escape: that are bound to this particular wheel of karma with distressingly little freedom of action.

And the seventh section will speculate on what the likely "hegemonic" configuration of global political economy will be that will emerge from our current crisis.

II. The Neoliberal Promise, 1980-2009

The neoliberal promise was that relatively small state sectors (or at least sectors smaller than had been the case in 1980) and a relatively light government regulatory hand over all industries would produce a rich and growing world—a world that would grow faster than the world had in the 1970s and probably the 1950s and 1960s as well. Moreover, the neoliberal promise was that a world and nations run according to its principles would be an economically stable world as well. Large episodes of macroeconomic distress had, its advocates argued, origins in mistakes of monetary policy: central banks that did not understand their duty to keep the nominal flow of spending from collapsing (as Milton Friedman diagnosed the Great Depression) but that also did not understand their duty to keep the nominal flow of spending from exploding, or could not perform their duty because they served governments that spent and did not tax, and hence left no course but large-scale money printing and runaway inflation.

Where did this neoliberal view of the relation between state and market come from?

On the political side, it came from the electoral victories of Margaret Thatcher in Britain and Ronald Reagan in the United States of America. Thatcher in 1979. Margaret Thatcher ran for election on the slogan that "labor isn't working," which had a three-fold meaning: (i) that Britain's Labor Party was not a competent party of government; (ii) that British unemployment after six years of Labor Party rule was unacceptably high; and (iii) that the large state- and state-owned sectors of social-democratic Britain had produced a culture in which work effort and work quality in everything state-run were low and falling because nobody cared. Ronald Reagan in the United States ran on slogan: "The scariest words in the world are 'I'm from the government and I'm here to help you…'", meaning that government was bound to be too tied up with red tape to accomplish anything.

Many of my left-wing friends attribute Thatcher's and Reagan's election and reelection victories to pure luck: that Britain's Labor Party in 1979 was split into factions each of which would rather see the Conservatives win an election than see the members of the other faction take office, and the wave of British nationalism that followed the decision of the Argentinian generals that they should stop throwing people out of helicopters into the South Atlantic for a while and instead mobilize the population behind the government by a war over the Islas Malvinas; that President Carter's helicopters crashed in the desert rather than rescuing the hostages from the U.S. embassy in Iran and then that the recession of 1982 ended just in time for the bounceback to convince U.S. voters that it was "morning in America" when Reagan ran for reelection. But there was more to it than that. The decade of high inflation and then deep recession, albeit not as deep as this one, sapped confidence in the old social democratic political-economic order. And many on the center and the left accepted the neoliberal critique that post-World War II North Atlantic social democracy had overstressed the value of government in compensating for market failures and underestimated the mgnitude and consequences of government failures. The decade of the Great Inflation led them to accept the right-wing three-fold critique of social democracy as vulnerable to:

- Corruption
- Rent-seeking
- Inertia

As indeed they are. Corruption: looking at the past half-decade of the United States's attempt to rebuild Iraq, it is hard to escape being impressed by how much money the Halliburton Corporation extracted from the U.S. government by how little work—and not because the U.S. contract overseers and advisers on the ground were especially venial or easily bribed but simply because everyone knew that Vice President Richard Cheney had previously been president of Halliburton, and these were his friends. Inertia: some R$650 billion a year is spent by the United States military today on forces that have no rationale other than to wage a large-scale conventional and nuclear war against that aggressive expansionist superpower that is the Soviet Union, and have little potential use in any other foreseeable conflict. Rent-seeking: the United States today spends twice as much on health care as any other country and has life expectancy shorter than that of countries spending only one-quarter as much, yet reforming American health care to get more health for the money runs into politically-powerful and well-entrenched interest groups at every turn.

Outside the narrow world of the North Atlantic these three critiques of post-World War II-era social democracy were reinforced by two others: Argentina's Raul Prebisch argued for a much stronger government hand was called for than social democracy allowed lest countries that were primarily exporters of resource-based products find that their terms of trade collapsed as rapidly as their export volumes could grow, and thus that the international division of labor benefitted the North Atlantic much more than it benefitted anybody else. Brazil's Fernando Cardoso argued that perhaps the tight-knit, stable, and mature political democracies of the North Atlantic could tolerate the rent-seeking, corruption, and inertia diseases of state-guided social-democratic development but that the weaker states of the global south with their weaker political and civil societies could not, and that alternative roads were necessary—not that either of them thought that neoliberalism as we have known it for the past three decades was necessarily an improvement.

The neoliberals promised to do better in dealing with these three modes of government failure. First, a smaller state is less vulnerable to government corruption—and private corruption can be limited by a state that is much closer to the "night watchman" of nineteenth-century thought than by a state that is powerfully involved in economic development. And a smaller state is much less vulnerable to rent-seeking.

The major benefit, however, was to come from the overcoming of inertia. Private enterprises must meet a market test that government-run, -owned, and –subsidized enterprises with their soft budget constraints as outlined by Janos Kornai do not. And change had benefits not just in overcoming inertia and ossification. Change maximizes contact, and contact—especially across national boundaries—makes successful transmission of technology and organization more likely. The free flow of goods and capital was supposed to maximize market discipline over corporations (which could have management entrench and ossify as completely as any government) and over governments as well.

There is a point to this. Three years ago Nestor Kirchner sought short-term political advantage by severely restricting beef exports from Argentina. Today and for some years in the future there are, as a result fewer cows and cow-related jobs in Argentina and more in Rio Grande do Sul. Brazil's bureaucrats can look with pride on the industrial success of Embraer. But they are quiet about the much more expensive attempt to produce a Brazilian minicomputer industry.

But the neoliberal promises had not all turned out well even before the current crisis. In the United States, the neoliberal era has been one of extraordinary increases in income inequality. And with the exception of the Clinton years of the 1990s—during which policies took a step or two back to the left—economic growth had been unimpressive even before the recent collapse. Elsewhere it was the countries like Mexico under Salinas de Gortari and Zedillo Ponce de Leon and Argentina under Menem and de la Rua that strained the most to satisfy the neoliberal policy checklists that turned out to have the most fragile prosperity.

III. Keynesian Social Democracy, 1945-1980

In truth, the neoliberal cure was not an especially well-designed treatment for the diseases of social democracy in the 1970s. From one perspective the speed with which it attained intellectual hegemony was surprising. Had not the post-World War II years in the North Atlantic been the "thirty glorious years" in which economic growth was faster than it had ever been before? Was not that episode of economic growth one of extraordinarily egalitarian growth in the North Atlantic? Had not a number of countries—Japan, the four East Asian dragons, and southern Europe—joined the exclusive formerly North Atlantic plus Australasia core of the world economy? (Although those were also the years in which Venezuela, Chile, Argentina, Uruguay, and southern Africa lost what claim they had to economic-core status.) It is true that there was little or no catch-up of the periphery to the core in the post-World War II generation, but outside of Africa and the communist world economic growth was also faster than it had been before—albeit unequal as opposed to the egalitarian growth in the North Atlantic. Why should a bad decade of oil shocks, inflation, and debt crises lead to the intellectual overthrow of a political-economic model that had served the world better than any of its predecessors?

I believe that there are three reasons. First, the critique of social democracy—as overly prone to corruption, rent-seeking, and inertia—was already on the shelf. It did not have to be thought up when the crisis hit. These arguments had been made for decades, back to Friedrich Hayek's *Road to Serfdom* and before. Second, social democracy did not have the ever-shifting balance between state and market correct: it did spend too much time discoursing on how the government could correct for market failures and too little time focusing on what governance mechanisms would minimize the government failures associated with a larger and a stronger state.

The third, however, is the most important. It is that voters and thinkers have short memories, that "what have you done for me lately?" is always the question of the day, and that political-economic systems do not keep their legitimacy if they produce even half a decade of income stagnation, mass unemployment, or gross instability. After all, social democracy was an off-the-shelf alternative to the gold standard *laissez-faire* political economy of the pre-1929 years. It was not thought-up during the Great Depression. And it was not even a terribly adequate answer to the problems of the Great Depression—as the persistence of the Great Depression until and into World War II showed.

IV. The Central Banking Exception

But even during the heyday of neoliberalism one and only one branch of government was exempt from its "shrink the state" logic. Central bankers and their cousins in international agencies grew in staff, power, authority and in insulation from normal politics. They became philosopher-princes of a sort, responsible for price stability, economic growth, and high employment.

Where did this special exemption to the normal rules of neoliberalism come from?

To understand that, we have to turn away from modern economic theory back to economic history and the history of economic thought—to what has happened in the past when we have found the economy wedged in similar situations, and to what models frameworks economists in the past set forth that they found useful in thinking about policy issues even though their models and frameworks do not meet today's methodological canons of technical rigor.

So let's get into the WABAC machine and head back to 1825 in London, back to the first industrial business cycle, and the very first attempt to stem an industrial business cycle by government action.

English Novelist E.M. Forster's Great Aunt Marianne

English novelist E.M. Forster wrote a biography of his great-aunt Marianne, who had a ringside seat at the financial crisis of 1825. Her brother Henry, in his twenties, was through his family connections one of five partners in the bank of Pole, Thornton and company. Pole, Thornton's annual normal earnings were as large a share of the British economy then as R$700M would be today. Young Henry had no previous banking experience, and had been in the banking industry for only seven months when the crisis hit. At t this point you should be dividing R$700 million a year by five and meditating on the value of choosing the right parents.

Now let us turn the microphone over to Marianne Thornton:

> Battersea Rise, 7th December 1825
>
> PRIVATE AND CONFIDENTIAL
>
> Dearest Mrs. H.M.,
>
> There is just now a great pressure in the mercantile world, in the consequence of the breaking of so many of these scheming stock company bubbles…

Can you say "irrational exuberance"?

> …and Free had been inexcusably imprudent in not keeping more cash in the House…

Can you say "excessively leveraged"?

> but relying on that credit in them which had never been shaken, and which would enable them to borrow whenever they pleased...

Can you say “able to adjust his portfolio by trading at or very close to recent market prices whenever they pleased”?

> [Free, however,] was not however particularly uneasy till last Thursday and Friday…. On Saturday however—that dreadful Saturday I shall never forget—the run increased to a frightful degree, everybody came in to take out their balance, no one brought any in; one old steady customer, who had usually £30,000 there, drew it out without, as is usual, giving any warning…

Think “nine months’ normal earnings of the bank with not five minutes’ notice”:

> and in order to pay it the House was left literally empty.... Such a moment of peril completely turned [managing partner] Free's head; he insisted on proclaiming themselves bankrupts at once, and raved and self-accused himself…. Old Scott cried like a child of five years old, but could suggest nothing. Pole and Down were both out of town. Henry saw it all lay upon him.... [H]e found that during the next hour they would have to pay thirty-three thousand [pounds], and they should receive only twelve thousand. This was certain destruction, and he walked out, resolved to try one last resource…

Seven months working in the banking industry, in his twenties, wandering the streets of London’s financial district, with nothing to offer in collateral, at 4 PM on a Saturday afternoon, looking to borrow cash. He found some:

> John Smith declared… he would apply to the Bank of England for them. Henry had little hope from this, for the Bank had never been known to do such a thing in the annals of Banking…. [T]he next morning at [AM Sunday]…. [A]ll the Bank of England directors who were in town.... John Smith began by saying that the failure of this House [of Pole, Thornton] would occasion so much ruin that he should really regard it as a national misfortune…

Can you say “too big to fail”?

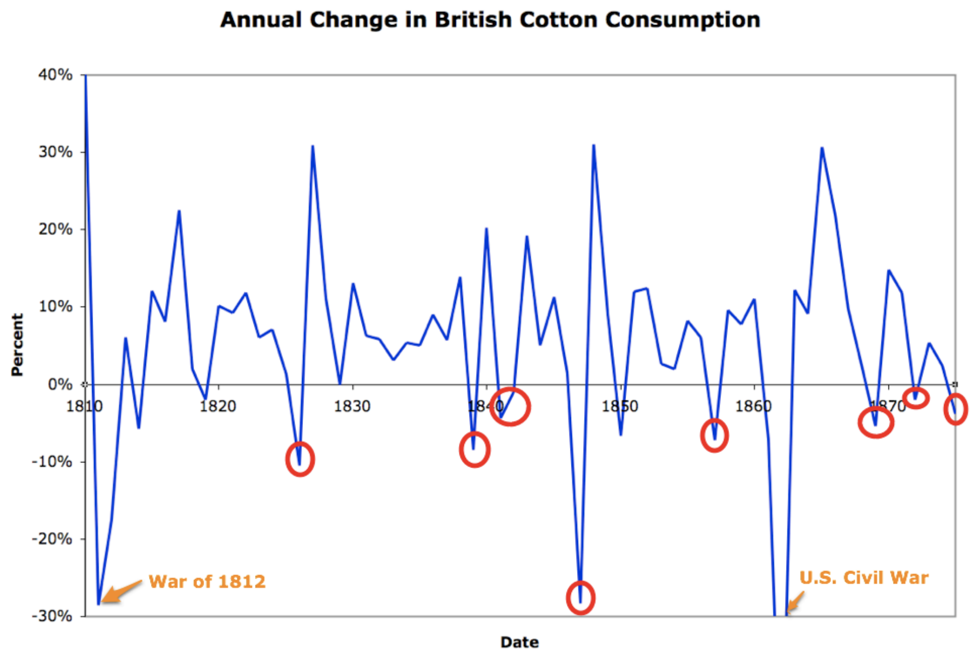
And here something happened that neither John Smith, nor Henry, nor Marianne Thornton could have counted on. Lord Liverpool—Robert Banks Jenkinson, Second Earl of Liverpool, First Lord of the Treasury—had already gone to the Governor of the Bank of England, Cornelius Buller, and asked him to do something about the situation: otherwise, Lord Liverpool feared, there would be great misery in the cities of Manchester and Birmingham and London as people in manufacturing industry rendered unemployed by the financial crisis and their families starved on the streets. For the first time, you see, you had a large manufacturing sector—people who could not just go back to the farm if their employers could not borrow. And the financial crisis rolling forward was creating a situation in which no business could borrow to expand or even to fund its day-to-day operations on terms that made such profitable.

Hence after Henry Thornton made his presentation, Governor Cornelius Buller:

> turned to Henry and said, 'I think you give your word the House is solvent?' Henry said he could.... 'Well then', said the Governor and the Deputy Governor of the Bank, 'you shall have four hundred thousand pounds by eight tomorrow morning, which will I think float you'. Henry said he could scarcely believe what he had heard.… He was off again in the dark on Monday morning to the Bank of England, where he found the Governor and Deputy Governor who for the sake of secrecy had no clerks there, and they began counting out the Bills for him.... [T]he rumours that the Bank of England had taken them under its wing soon spread, and people brought back money as fast as they had taken it out on Saturday...

1825 is the first time the financial system was large enough and integrated enough with the nascent industrial economy for a financial crisis to threaten large-scale unemployment. It was the first time the crisis called forth aggressive public action to support and sustain market prices and market liquidity—by two guys in the Bank of England counting out banknotes and sending them out in a cart down Threadneedle Street (in violation of the Bank of England’s charter, I must say); by TARP and TALF and ARRA and a host of other alphabet-soup vehicles today.

Did It Work?



Did it work? Did the Bank of England's intervention help the British economy's manufacturing sector avoid a deep depression? We believe so: British cotton use in 1826 was only 12% below its 1825 level, and 1827 saw a 30% rise, after which British manufacturing resumed its growth in the Industrial Revolution.

By the way, Henry Thornton lied about the solvency of Pole, Thornton and company: the Bank of England got some but not all of its money back. His cool behavior in the crisis, however, meant that the crash of Pole, Thornton did not mean the end of his banking career. Nathan Meyer Rothschild, then the richest man in the world, and others were impressed and willing to fund and back his projects thereafter.

Manias, Panics, and Crashes

My old teacher Charlie Kindleberger, author of the wonderful *Manias, Panics, and Crashes,* would say that today's story is the same. The process starts when for some reason asset prices get way out of whack and rise to unsustainable levels. Sometimes the culprit is lousy internal controls in financial firms that over-reward subordinates for taking risk; sometimes it is government guarantees; sometimes it is the selection of the market as a long run of good fortune leaves the financial market dominated by cockeyed unrealistic overoptimists. These produce a substantial runup in financial asset prices. But the runup is unsustainable—in its late stages at least, people are holding assets at high prices for no reason other than they expect someone else to buy those assets for an even higher price in the future.

Thus the crash comes.

When the crash comes the risk tolerance of the market collapses. Everybody knows that there are immense unrealized losses in financial assets. Nobody is sure that they know where those unrealized losses are. To buy or even to hold risky assets in such a situation is a recipe for financial disaster.

That nobody is sure where the losses lie, and thus as a result that every single private-sector investment has become risky, is absolutely key to the process. Four times as much money was lost in 1999 and 2000 by enthusiastic investors overwhelmed by irrational exuberance investing in the companies of the dot-com bubble as was lost making mortgages that will not be repaid on houses newly built in the desert between Los Angeles and Albuquerque. But the venture capitalists of 2000 had raised their money by offering investors shares in their funds, so when the crash came nobody feared that there would be a chain of bankruptcies. By contrast, the Bear Stearnses and the Lehman Brothers and the WaMus and the Citigroups had bet on subprime mortgages with money that they had borrowed—and so not only did the market's appetite for holding risky assets fall but a great many assets that had been thought to be of minimal risk turned out to be of substantial risk indeed. Thus the dot-com crash of

2000 generated no fears of a collapse of the financial system. The much smaller subprime crash of 2007 did.

Thus the crash is followed by a flight to safety as investors all at once try to shift their portfolios out of risky and into safe assets. The prices of private bonds fall. By contrast, the prices of safe bonds—in this case U.S. Treasury securities—rise as a result of the great financial "flight to safety." It is certainly true that this panic is by economists' canons "irrational." There is a lot of money to be made by buying when everyone else is panicked and selling. There are, however, three problems with doing so:

First, if you are investing not your own but your customers' or borrowed money, you have to identify the bottom: buying before the bottom is a much quicker road to total bankruptcy as your customers or your creditors demand that you repay even though you know very well that if only you an hang on until the market recovers from panic you will make a fortune.

Second, we are herd animals: East African Plains Apes who like to do things in groups: "Let's all go to the waterhole!" "Let's go eat Mgongo nuts!" Stubborn individualists who insisted on going to eat Mgongo nuts when everyone else in the pack headed for the waterhole ran into hungry leopards and did not contribute their genes to our current population. If everyone else is panicking, then you are unlikely to be able to avoid panicking as well.

Third, finance is boring unless you are by nature a gambler. And if you are a gambler than you have to pay to that propensity the appropriate toll. You will gamble on anything—on whether Lindys sells more cheesecake or strudel, or on whether when you tap a sealed deck of cards fresh from the factory the jack of hearts will jump up and squirt cider in your ear. Even if you have a good fundamental long-run position that you should lock up and leave alone until its securities reach maturity, the kind of people who can do that are not the kinds of people who take jobs on Wall Street.

Financial markets have had manias, panics, and crashes caused not by outside shocks or forces but by their own spontaneous psychological-economic dynamics for at least three centuries now. Deal with it.

But why is this any more the concern of those of us not immediately involved and working in global finance than are Brad Pitt and Angelina Jolie? Movie stars have more interesting private lives, smarter and funnier people writing the lines for their press appearances, and are much, much prettier to look at than are Lloyd Blankfein or Tim Geithner.

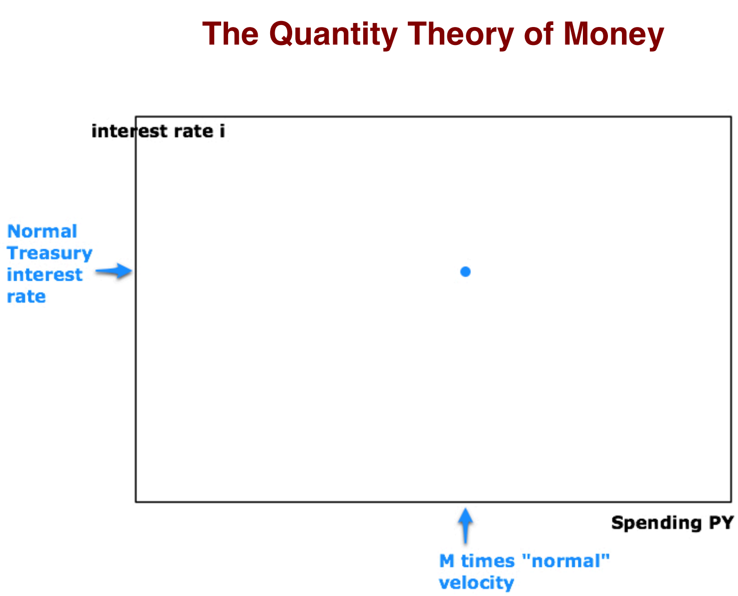
It matters because ever since 1825 finance has been at the center of our economy. We have a price mechanism at its core: prices serve as semaphore flags: they send us signals as to what we ought to be doing in our work lives—what firms and occupations should grow, and what ones should shrink. A financial panic deranges the price mechanism: all of a sudden the prices that the financial sector is sending to the real economy are signaling the real economy to shut down. We may believe in a market economy—neoliberals certainly do—but we do not believe that the market should be allowed to set prices when the prices it sets tell businesses that they should create mass unemployment—like now. Something needs to be done to correct or compensate for this derangement.

V. Old-Fashioned Macroeconomics

Why a financial crisis exercises such a deranging effect on the macroeconomic functioning of the price mechanism is a question that was settled about seventy years ago by what was then cutting-edge technically-sophisticated economic theory. So sharpen your pencils.

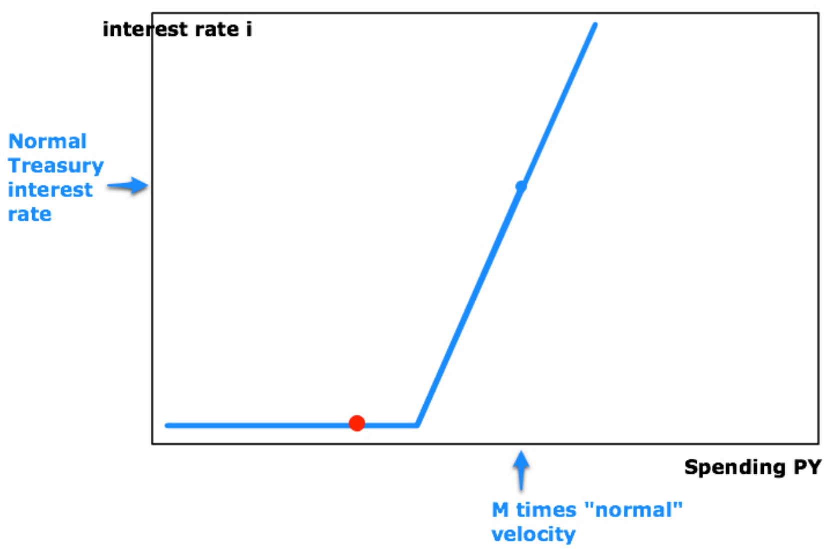
There is, in practically all economies since the predecessors of Croesus of Lydia came up with the idea of coins perhaps 2700 years ago, a special commodity called "money": things that are valued not because you can eat them or be pleased by looking at them or use them to keep your scalp free from lice or to keep yourself reasonably dry through a Portland winter but valued only because other people will value them in turn. Money in your pocket is useless. Money is useful only when you spend it. Money in your pocket should be held in some other form that is either directly useful to you or at least earns you some interest.

So the more money—cash, checking account balances, PayPal balances, reserve deposits at the Federal Reserve—you have, the more you are going to want to spend. You aren't going to want to spend it all today: you might well find something tomorrow that you would like to buy more than the things you see today. But under normal circumstances the speed at which people spend their money—the "velocity" or money, as Yale's Irving Fisher called it—will be at some normal level. Thus if you know how much cash money in all of its paper and electronic forms there is the economy and if you know the institutional setup and technology of banking that tells you how long checks take to clear, et cetera, then you know how much spending there will be—and combine how much spending there is with what the level of prices is and you can calculate what inflation-adjusted sales—aggregate demand—will be, and thus production, and thus employment, This is the quantity theory of money.



Now consider what happens when the interest rates on Treasury bills aren't normal. Treasury bills are very close to cash money in lots of ways. The government prints dollar bills, the government prints Treasury bills, holding both is thus subject to the same set of risks. And when you are deciding whether to hold your wealth in bills or cash you don't have to worry at that margin about other sources of risk—markets for private securities dry up and become illiquid, companies default, companies are reorganized in ways that leave you with title to an empty debt-burdened shell, and so forth. So the interest rate on Treasury bills is a very good measure of the "opportunity cost" of holding cash. Each dollar bill in my pocket or in my checking account could be in a money market account invested in Treasuries instead—and there is would (most of the time) be earning interest.

The Liquidity Trap



This means that when interest rates on T-bills are not normal but are high then it is expensive to hold cash money: you are losing a lot of interest for each dollar in your pocket. They are burning holes in it. So you have an incentive to rearrange your spending plans: hold each dollar in cash for a shorter time before you spend it. Aggregate up all the decisions as to how to change their spending plans people make when T-bill interest rates go up and their cash starts burning holes in their pockets, and you will see that rising T-bill rates go along with higher spending conditional on the quantity of money in the economy.

Now consider the reverse: what happens when T-bill interest rates are very low—like now. Now there is no incentive to economize on your cash holdings. You could move your cash into T-bills, but what's the point: T-bills aren't paying any interest. You could move your cash into other private investments, but they are very risky right now—and your tolerance for risk is very low. This is the "liquidity trap": whenever interest rates are very, very low, the normal relationship between the quantity of money and the level of spending breaks. The level of spending could be any of a whole bunch of things—as in the liquidity trap diagram. And guess where the economy is right now.

This is why we care: when financial panic reaches a stage in which T-bill interest rates are pushed down to zero, then we run the risk of a big depression if one consequence of that is a collapse of the normal relationship between the amount of cash in the economy and the level of the flow of spending. That's what we fear. That's what we have. The shrp reduction in interest rates on safe short-term assets generates a steep fall in the velocity of money: households and businesses everywhere hoard and do not spend their cash. And this fall in monetary velocity reduces spending and demand, and brings on recession, excess capacity, and high unemployment.

The neoliberals, especially under Alan Greenspan, had forgotten this danger, and had adopted a policy of deregulation in financial markets as well as in the rest of the economy: in financial markets as elsewhere, the ruling principal was to lighten the regulatory hand of the government on private institutions and let them innovate. There would be episodes of irrational exuberance and those rich people who become irrationally exuberant would in the end lose lots of money. But central bankers would have the power and the skill to keep financial turmoil limited and, especially, to keep financial turmoil from spilling over to the non-financial economy in the form of substantial output declines, large amounts of idle production capacity, and mass unemployment.

As of 2003 this bet appeared a good one: 1982, 1987, 1990, 1994, 1997, 1998, 2000, and 2001 had seen financial crises. But all had been successfully contained and managed so as not to spill out and endanger the entire global economy. As of today this bet does not appear to have been a good one.

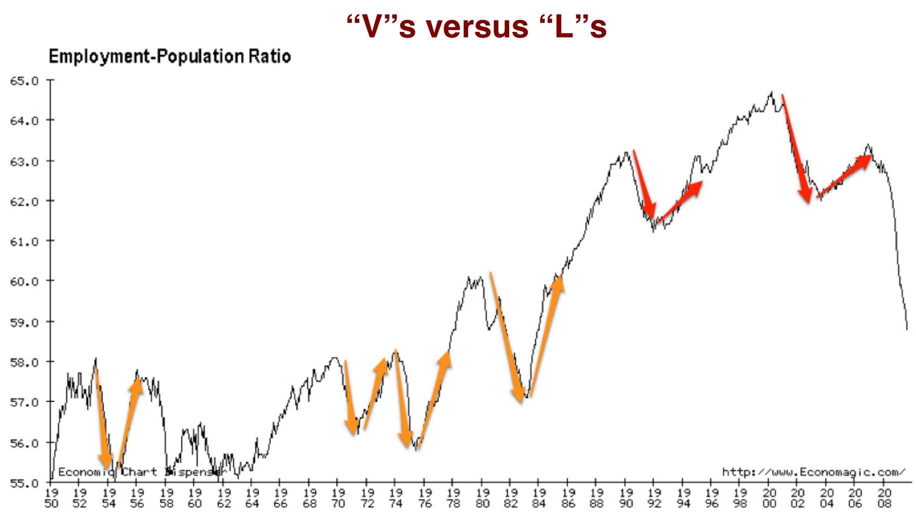
Treasury Assistant Secretary and then Federal Reserve Chair William McChesney Martin said, famously, that the purpose of the Federal Reserve was to take away the punchbowl before the party got going. His successor's successor's successor's successor Alan Greenspan begged to differ: the Federal Reserve, Alan Greenspan thought, should—as long as there was no threat of an inflationary spiral in *consumer* prices—be willing to spike the punchbowl with the grain alcohol of 1% federal funds rates, because it can serve as a designated driver to make sure that everyone gets home.

Four years ago I was a reluctant but convinced neoliberal: one of those hooting at Raghuram Rajan at the Federal Reserve's Jackson Hole conference when he argued that financial innovation and sophistication had exposed us to aggregate risks we did not understand and that global central banks might not be able to manage. (The only person at the conference I recall speaking up in strong support of Raghuram was Brazil's own Armenio Fraga.) Today—can you say "agonizing reappraisal"?

VI. "V"s versus "L"s

Very few people today expect a rapid return of the world economy to normal levels of unemployment, of capacity utilization, and of the employment-to-population ratio. Today's forecasts are of global real GDP growth of 4% a year going forward, but that is not enough to materially reduce unemployment.

The reason for the slow recovery is, I think, clear. Recessions arise when asset prices crash, and when as a result businesses find it unprofitable to raise capital to expand capacity or even to continue operations at the previous scale. The substantial post-World War II recessions before 1990 were all produced by Federal Reserve decisions to raise interest rates to fight inflation, decisions that produce correlated falls in all asset prices from Treasuries to equities and real estate and beyond. And when those policies are reversed—when the Federal Reserve decides it has done enough or gone to far and reverses its high interest rate policies—all asset prices rise together in a correlated fashion, non-financial businesses find they can raise capital on more-or-less normal terms again, and we have a "V."



That hasn't happened since the start of the 1990s. Since the start of the 1990s, recessions have typically seen a negative correlation between returns on U.S. Treasury bonds—in the first, short-term, and in the second and third episodes, all—and returns on other asset classes. The configuration of asset prices wheels as the prime mover is not inflationfighting on the part of the central bank but instead a fall in risk tolerance on the part of the private market. And risk tolerance does not spring back to normal immediately after the recession trough is reached. And so asset prices do not recover as rapidly as they do when the prime impetus behind the recovery is the Federal Reserve lowering interest rates. And so we get an L more than a V. That's what we got in the Great Depression. That's what Japan got in the 1990s. That's what we got to some extent in the early 1990s and to a greater extent in the early 2000s. And it looks like that is what we are getting now.

The example I like to use at this point is that of the very sharp Professor Robert Lucas of the University of Chicago, who gave an interview to Tom Keene of Bloomberg news at the end of March 2009. In it he said two things. First:

> LUCAS: Our economy's got a remarkable ability to return to its long term growth trend. And for most of the depressions we've had or recessions, the return has been quick. Two or three, four years...

Second:

> LUCAS: [T]here is no question that fear is what this liquidity crisis is. I mean the reason I got into money [with my portfolio] is that I got afraid to leave my pension fund in other securities. So I'm sitting there with a portfolio full of zero-yield stuff just because I'm afraid to do anything else. I think there are millions of people like me…
>
> KEENE: What will be the signal for Robert Lucas to go back into the markets?…
>
> LUCAS: I don't know. Robert Rubin made a joke about that in the first session today. Nobody knows...

You will note an inconsistency here. Recovery in four years would seem to imply equity market values 50% higher than they are today. And holding your money in cash is not all that safe either: the scenarios I can envision in which equities do not increase in real value over the next four years are all scenarios in which inflation has eaten away much value of debt. So what is Lucas doing holding his portfolio in cash? He, and millions of others around the globe, have panicked. And he is not thinking with the rational economic-forecasting part of his brain but rather with the dig-a-hole-and-hide part of his brain.

My guess is that the salience of the 2000 and now 2007-2009 market crashes—the ones in which the structure of asset prices wheel, as the prices of U.S. Treasuries (and the dollar) rise while the prices of all other assets fall, and fall the more the more risky they are perceived to be—will be high for a generation. And so risk tolerance will be low.

This means that the world's private investment market will recovery slowly, and thus that we will get not a V but an L as far as the global recovery is concerned.

This also means—unless economic policymakers around the globe wish to see only a very, very slow recovery of unemployment from its current elevated levels—that the world's governments should be doing more.

What can a country like Brazil do? Relatively little. The global level of output and demand is set elsewhere. Decoupling from the world economy takes a long time to accomplish and reverse, and is a bad long-run bet in any case: in at least 2/3 of decades you want to be tied in rather than decoupled from the world's international division of labor.
Attempting to keep the faulty price signals that financial markets are sending from causing too much disruption and damage is the best that a non-core government can do.

VII. The Next Political Economy

We can already see that political economy, thought about the economy, will undergo a big shift in the aftermath of this crisis like the shifts it underwent in the aftermath of the Great Depression and the Great Inflation. The presumption that market failures are less dire and serious than government failures is gone. The presumption that central banks have the tools and skills to insulate financial distress from spilling over to the economy as a whole is gone. The presumption that unregulated or loosely-regulated financial innovation and experimentation has benefits that are clearly bigger than its costs is gone as well.

What will replace these presumptions? Back in the 1930s social democracy already existed as a doctrine that could be pulled off the shelf and plugged in to replace gold standard-style *laissez faire*. And back in the 1980s the neoliberal critique of social democracy had been building for quite a while.

And here I am going to have to break my contract as speaker with you, my audience. I do not know what the next "hegemonic" form of political economy will be. What is likely is that one large country or set of country will adopt policies that work less badly than the others—and that in the aftermath of the crisis those who designed or motivated those policies will spread their gospel around the world, and it will be picked up by others. But which?

Germany is pursuing relatively "orthodox" neoliberal policies—plus large-scale work sharing. East Asia is pursuing tighter financial regulation and aggressive but old-fashioned Keynesian fiscal measures. Nine months ago I would have said that the United States was pursuing (a) aggressive banking recapitalization plus (b) a reregulation of financial markets along lines suggested by a psychological behavioral-finance theory of investor animal spirits and psychological biases, but the financial reform effort in America appears to be running onto the rocks of interest-group politics and the political inertia of the arcane and sclerotic system of government that the United States has. Japan continues to follow the cautious policies that produced a decade of stagnation in the 1990s and early 2000s.

It is not yet clear which countries' policies will be most successful, or will be most convincingly defined in retrospect as having been successful.

And so it is not clear what will be our next global system of political economy.

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