America's flawed paradigm: macroeconomic causes of the financial crisis and great recession

Original Paper | Published: 14 December 2010

Volume 38, pages 3–17, (2011) Cite this article

Empirica

Aims and scope →

Submit manuscript →

Thomas Palley [1]

Abstract

This paper traces the roots of the financial crisis and Great Recession to a flawed U.S. macroeconomic paradigm that was adopted around 1980 with the triumph of neoliberal economics. One flaw concerns the growth model. A second flaw concerns the model of global economic engagement that created a triple economic hemorrhage of spending on imports, manufacturing job losses, and off-shoring of investment. The new growth model hollowed out the economy and relied on growing debt and asset price inflation. As the process deepened the economy needed ever larger bubbles to grow. Financial deregulation and excess kept the model going longer than expected, but it meant the economy experienced a financial crash and deeper collapse when the contradictions finally surfaced. The

United States needs a new economic paradigm and a new growth model, but as yet this challenge has received little attention from policymakers or economists.

Notes

1. This flawed paradigm is described in detail my 1998 book, *Plenty of Nothing:*

The Downsizing of the American Dream and the Case for Structural Keynesianism, that predicted the U.S. economy would run into the type of problems it is now experiencing.

2. The Treaty of Detroit refers to the pattern of wage bargains established by the United Auto workers, under the leadership of Walter Reuther, with the Big Three U.S. automakers (General Motors, Ford, and Chrysler) in the 1950s.

3. The 1950s are an exception to this rule owing to the Korean War (June 1950–July 1953), which ratcheted up manufacturing employment above trend and was followed by a reduction of employment once the war ended.

4. Palley (1998) analyzes in detail how economic policy has impacted income distribution, unemployment, and growth. The metaphor of a box is attributable to Ron Blackwell of the AFL-CIO. There is a deeper political economy behind the neo-liberal box that has been termed “financialization” (Epstein 2001; Palley 2008). The policy agenda embedded in the box is driven by financial markets and corporations who are now joined at the hip, with corporations pursuing a narrow financial agenda aimed at benefiting top management and financial elites.

5. This is clearly evident in China which has been marked by rising income inequality and a sharp decline in the consumption to GDP ratio (International Monetary Fund 2006).

6. The fall in nominal interest rates explains why the debt service ratio rose more slowly than the debt to GDP ratio.

7. S&P/Case-Shiller index data is only available from 1987.

8. This means the crisis is not a pure “Minsky” crisis. Minsky saw crises as the

result of endogenous financial instability that developed over years. However, the current crisis is a crisis of the neoliberal paradigm. That paradigm fostered financial instability as a way of sustaining itself. Consequently, when the crisis hit it took on the appearance of a classic Minsky crisis but its real roots lie in the neoliberal model. For a more extensive discussion of this issue see Palley (2010).

9. PNTR refers to the establishment of “permanent normal trading relations” with China whereby China was granted most favored nation trading status. That means China was given the same trading status as other most favored nations with regard to tariffs and other trade restrictions. PNTR in turn opened the way for China to join the World Trade Organization.

10. The policies promoted by Treasury secretaries Robert Rubin and Lawrence Summers reflected the dominant economic paradigm. As such, Rubin and Summers had the support of the majority of the U.S. political establishment, the IMF and the World Bank, Washington’s premier think tanks, and the economics profession.

11. The strong dollar policy was also politically popular, constituting a form of exchange rate populism. Boosting the value of the dollar increased the purchasing power of U.S. consumers at a time when their wages were under downward pressure due to the neoliberal model. Households were under pressure from globalization, yet at the same time they were being given incentives to embrace it. This is one reason why neoliberalism has been so hard to tackle politically.

12. The Clinton administration celebrated the 1990s as a “fabulous decade” that they attributed to economic policy (see Blinder and Yellen 2001). To the extent there was concern in the Clinton administration about manufacturing, it was about the hardships for workers regarding job dislocations. Additionally, there was political concern that produced some sweet talk (i.e., invitations to policy consultations) aimed at placating trade unions. However,

there was no concern that these outcomes were due to flawed international economic policy. Not only did this policy failure contribute to eventual disastrous economic outcomes, it may well have cost Vice President Al Gore the 2000 presidential election. The Clinton administration's economic advisers may have downplayed the significance of manufacturing job loss but blue-collar voters in Ohio did not.

13. The first episode was from 1991–1995.

14. For a more extensive discussion of the meaning and significance of full employment see Palley (2007).

References

Bivens J, Irons J (2008) A feeble recovery: "The fundamental economic weaknesses of the 2001–07 expansion", EPI Briefing Paper No. 214, Washington, DC: Economic Policy Institute, December

Blinder AS, Yellen J (2001) The fabulous decade: macroeconomic lessons from the 1990s, New York Century Foundation

Bronfenbrenner, K,(2000) Uneasy terrain: the impact of capital mobility on workers, wages, and union organizing,. Report prepared for the United States Trade Deficit Review Commission, Washington, DC, September

Bronfenbrenner K, Luce S (2004) The changing nature of corporate global restructuring: the impact of production shifts on jobs in the U.S., China, and around the globe, report prepared for the U.S.-China Economic and Security Review Commission, Washington, DC October

Epstein G (2001) “Financialization, rentier interests, and central bank policy”, manuscript, Department of Economics. University of Massachusetts, Amherst December

Google Scholar

Friedman M (1968) The role of monetary policy. American Economic Review 58:1–17

Google Scholar

Greider W (2001)“A new giant sucking sound,” The Nation, December 13,

International Monetary Fund (2006) “People’s Republic of China: Staff Report for the 2006 Article IV Consultation,” Washington, DC

Michel L Bernstein J, Shierholz H (2009) The state of working america 2008/2009 Ithaca, NY: ILR Press

Minsky HP (1993) “The financial instability hypothesis,” Working paper No. 74, The Jerome Levy Economics Institute of Bard College, New York, 1992 and published in Arestis P. and Sawyer M. (eds), Handbook of Radical Political Economy, Aldershot: Edward Elgar

OECD Observer “China ahead in foreign direct investment,” No. 237, May 2003

Palley TI (1998) Plenty of nothing: the downsizing of the American dream and the case for structural keynesianism, Princeton: Princeton University Press

Palley TI (2005) The questionable legacy of Alan Greenspan. Challenge, 48–6 , 17–31

Palley TI (2008a) “Financialization: what it is and why it matters,” in Finance-led capitalism: macroeconomic effects of changes in the financial sector, ed. Eckhard Hein Torsten Niechoj Peter Spahn, and Achim Truger, Marburg, Germany: Metroplis-Verlag, 2008 and working paper 04/2008, IMK Macroeconomic Policy Institute, Dusseldorf, Germany

Palley TI (2007) “Seeking full employment again: Challenging the wall street paradigm” challenge 50 : 14–50

Palley TI (2010) “The limits of Minsky’s financial instability hypothesis as an explanation of the crisis,” Monthly Review, 28–43

Author information

Authors and Affiliations

New America Foundation, Washington, DC, USA

Thomas Palley

Corresponding author

Correspondence to Thomas Palley.

Additional information

This is a revised and shortened version of a paper titled “America’s Exhausted Paradigm: Macroeconomic Causes of the Financial Crisis and Great Recession” that was produced for the New America Foundation, Washington, D.C., July, 2009. My thanks to the New America Foundation for their financial support and permission to use this material. All errors and omissions are mine.

Rights and permissions

Reprints and permissions

About this article

Cite this article

Palley, T. America's flawed paradigm: macroeconomic causes of the financial crisis and great recession. *Empirica* **38**, 3–17 (2011). https://doi.org/10.1007/s10663-010-9142-3

Published
14 December 2010

Issue Date
February 2011

DOI
https://doi.org/10.1007/s10663-010-9142-3

Keywords

Great recession
Financial crisis
Neoliberalism

JEL Classification

E3
N1
N12

Publish with us

Track your research