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Keynesianism in the Great Recession:

Right diagnosis, Wrong cure

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ideas into movement

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Ideology provides the intellectual and moral foundations of an economic order. From the late 1970s to the first decade of the twenty-first century, neoliberalism was the dominant ideology that legitimized the institutions of global capitalism. The principal tenet of neoliberalism was that the less hampered the market, the fewer the distortions in the economy and the more efficient the allocation and distribution of resources. According to neoliberalism, intervention by the state in any form – whether directly by producing goods or regulating the private sector's own production and distribution of goods, or indirectly through fiscal or monetary policy – was the source of distortions or barriers to the efficient allocation of resources.

Neoliberalism in retreat

In finance, the two key pillars of neoliberal ideology were the *efficient market hypothesis* and the *rational expectations hypothesis*. Efficient market hypothesis held that without government-induced distortions, financial markets are efficient since they reflect all information made available to market participants at any given time. It also maintained that all stocks are perfectly priced according to their inherent investment properties – knowledge of which all market participants possess equally and act on as rational individuals maximizing their self-interest. Markets thus move towards equilibrium or stability where supply and demand for assets are perfectly matched.[1] Rational expectations hypothesis provided the theoretical basis for the efficient market hypothesis with its assumption that 'individual agents in the economy – be they individuals or businesses – operate on the basis of rational assessments of how the future economy will develop'.[2]

These two theories collapsed with the onset of the global financial crisis in 2007-2008, when financial market players collectively lost faith in market valuations, panicked, and engaged in 'irrational' herd behaviour, bringing down not only the financial market but also the whole economy. This led to a discrediting of neoliberalism in general. Robert Lucas, one of the key proponents of the rational expectations hypothesis, probably best expressed the crisis of neoliberal theory when he paraphrased a well-known adage about atheism to say: 'Everyone is a Keynesian in a foxhole.'[3] This was the same Lucas who, in 1996, told a journalist: 'One cannot find good, under-40 economists who identify themselves as Keynesian ... people don't take Keynesian theorizing seriously anymore: the audience start to whisper or giggle to one another.'[4]

Neoliberals never denied a crisis could take place, but they were convinced that if one did, it would be the result of government intervention in the economy. However, with the cut backs in government regulation of the financial sector that had taken place during the 25 years since the Reagan era, it was difficult for neoliberals to blame government for the financial crisis that broke out in 2008. Despite this, they were not short of prescriptions for dealing with the crisis – as bequeathed to them by neoliberal pioneers such as Friedrich Hayek or Ludwig Von Mises of the so-called Austrian School. Deficit and debt reduction was their answer. One Nordic Central Bank official had this pithy summary of Hayek's approach:

'According to Hayek, measures should be focused on the underlying challenges, such as public debt, that had created the crisis. In Hayek's opinion, higher public debt would inevitably end up funding unproductive investments and consumption in the public sector, which would lead to low growth. Instead, government budgets should be brought into balance and regulations hampering economic activity should be removed. In Hayek's view, this would, over time, provide the basis for healthy, self-driven economic growth, even if the measures taken might deepen the crisis in the short term.'[5]

This 'purging of past excesses' approach, with its acknowledgment that it would be accompanied by high economic and social costs, was a suggestion no-one wanted to hear in a collapsing economy. What most wanted to hear was the Keynesian solution that had been discredited more than two decades before, during the 'stagflation' crisis of the 1970s and early 1980s: massive government counter-cyclical action in the form of either a fiscal stimulus or an expansive monetary policy.

Most economists of all stripes did not anticipate the severity of the financial crisis. Whatever schools of thought they belonged to, most appeared to believe that the 'great moderation' (the achievement of stable growth, with the elimination of deep recession and high inflation) was not about to end so drastically and dramatically. Ironically, except perhaps for those who had taken seriously the work of Hyman Minsky (who was largely ignored by established economics during his lifetime), few Keynesians appeared to notice that the United States (US) economy had been propped up by what political economist Colin Crouch called a 'privatized Keynesianism', wherein government and business were keeping consumers afloat with massive debt.[6] When the crisis began, however, Keynesianism was in the best position to explain it, along with Marxism. And with Marxist economists relegated the intellectual periphery, Keynesians or neo-Keynesians were also best positioned with the tools to manage the crisis. Intellectual leaders of this school included Paul Krugman, Joseph Stiglitz and Robert Shiller, who had drilled holes in neoliberal theory and practice before the crash. What united them was their skepticism about unfettered market forces, respect for the role of irrationality and imperfect information in the decisions of economic actors, fear that effective demand was being gutted by rising inequality, and advocacy of decisive government intervention to correct market failures.

Keynesianism can be said to have made a vigorous comeback over the past few years. Indeed, it has supplanted the neoliberal orthodoxy. It has come up with an explanation of the financial crisis based on Keynes' concept of 'liquidity preference'. It has deployed, with some success, the fiscal and monetary bazooka it rushed to the economic battle front. It has had a strong rationale for tougher regulation of finance and a set of solid prescriptions for doing so.

Despite all this, however, Keynesianism's impact on policy-making has been limited and, in the case of financial reform, minimal. The aim of this paper is to shed light on this paradox.

Keynesianism returns

The strength of Keynesianism (or neo-Keynesianism) lies in the conceptual toolkit and macroeconomic tools it provides for dealing with a crisis. For most Keynesians, analysis of financial crises begins with Keynes' theory of money.

Keynes' theory rests on the distinctions he makes between the different functions of money in a capitalist economy. Money's most fundamental function is to serve as medium of exchange. Money is also capital, and as such it is a factor that, in the form of credit extended to the entrepreneur, serves as investment to get production going. Money in the form of credit is essential to what is called the real economy. For production to begin, there must be credit advanced to the entrepreneur, which is repaid after what is produced is sold.

But money is also a store of value, and this role of money is what disrupts what would otherwise be a smooth circuit of credit from the creditor, to the entrepreneur who transforms it into capital, and back to the creditor as repayment with interest. During times of great uncertainty, the providers of credit may prefer to keep their wealth in liquid or monetary form, instead of lending this as capital to be invested in production. It is this contradiction between money as capital in the process of production and money as a store of value that its owners want to hold on to – Keynes' famous 'liquidity preference' – that leads capitalism to instability rather than to equilibrium, as posited by neoclassical theory. Finance, in short, can become independent of the needs and dynamics of the real economy. As Massimo Amato and Lucca Fantacci put it:

'… the institution of money as a store of value makes it possible for saving to be entirely unconnected with concrete goods and to take place rather through the constant and indefinite accumulation of abstract purchasing power, in the precise sense of power being independent of the fact of being concretely exerted – so independent as to jeopardize the very possibility of its being exerted. It is the institution of money as liquidity, of which its function as a store of value constitutes one of the fundamental pillars, that makes crises of liquidity possible.'[7]

Uncertainty plays a big role in capitalism. In real economic processes, there is always uncertainty – it is only the degree of uncertainty that varies. Uncertainty creates the contradiction at the heart of money, its competing uses as a capital and as a store of value. The concrete expression of this contradiction is the interest rate. As Keynes put it: 'The possession of actual money lulls our disquietude and the premium which we require to make us part with money is the measure of our disquietude.'[8] Another way he expressed this was: "The interest rate is the premium which has to be offered to induce people to hold wealth in some other form than hoarded money."[9]

How uncertainty affects the degree of liquidity preference and impacts on the entrepreneurial investment activity that sustains the production process was underlined by Bill Lucarelli:

'… money as a store of value depresses effective demand and delays the activation of idle resources. This only creates further uncertainty and postpones potential demand for goods and services. Entrepreneurs encounter problems in relation to their respective formation of future expectations and the timing of their investment expenditure…Under the conditions of unutilized excess capacity and rising unemployment, the state of uncertainty merely postpones planned investment and influences the expectations of wealth holders to hold their assets in a more liquid form.'

Thus, high liquidity preference 'will tend to divert real resources from being employed in the sphere of productive investment and leads inevitably to the existence of involuntary unemployment'.[10]

But creditors' options include more than just high liquidity when investment in production does not produce attractive rates of return. For Keynes there were two types of transactions associated with credit: credit used to purchase current goods and services in the process of production; and credit involving 'speculative transactions in capital goods and commodities' that 'bear no definite relation to the rate of current production'.[11] As Adair Turner noted, Keynes here saw a 'potential disconnect' between credit as investment for production and credit for speculation.[12]Not only does the latter contribute less to GDP growth, it can also spiral out of control, generating a financial crisis and a finance-induced recession in the real economy.

Keynes, then, saw money not as a passive element simply serving as a medium of exchange in the real economy or credit that is transformed into capital to get production going. '[M]oney and finance condition the real economy, not the other way around', as one commentator puts it, rather exaggeratedly.[13] Indeed, as Keynes himself put it: '... money plays a part of its own and affects the motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or the short, without knowledge of the behavior of money between the first state and the last'.[14] Money and, more comprehensively, the financial system, actively shape the dynamics of capitalism, and they respond less to rationality than to what Keynes called 'animal spirits'. The systemic instability stemming from speculative capital and animal spirits was posited in an interesting way by Keynes:

'Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic ...'.[15]

In short, finance capital was the fly in the ointment of capitalism.

Minsky and his 'moment'

Hyman Minsky took Keynes' insight into the dynamic behaviour of money and finance to paint a picture of capitalism as a system intrinsically geared toward instability and crisis rather than one that tended towards equilibrium. Keynes' propositions in his General Theory, Minsky pointed out:

'... center around the disequilibrating forces that operate in financial markets. These disequilibrating forces directly affect the valuation of capital assets relative to the price of current output, and this price ratio, along with financial conditions, determines investment activity ... Once financial considerations are integrated into the investment decision, it is evident that capitalism as we know it is endogenously unstable ... Contradictions and tensions associated with the accumulation of wealth come to the forefront of the analysis. Instability becomes normal rather than abnormal.'[16]

Minsky used Keynes' distinction (and conflict) between money as capital and money as a store of value to explore the reality behind the seemingly smooth-functioning of the economy idealized by orthodox economics. The seeds of crisis are already in the 'boom', and, as Keynes' and Minsky's followers put it, lay even insuch long periods of normalcy as the so-called 'great moderation'. Minsky said: 'The fundamental instability of capitalism is upward. After functioning well for a time, a capitalist economy develops a tendency to explode, to become "euphoric".'[17]

In the neoclassical view, finance – or money – is a mechanism that passively reflects exchanges at the level of production and circulation in the real economy. For Keynes, finance and monetary flows and transactions were active processes that impacted on real economic processes. For

Minsky, the key problem of orthodox theory was that it did not allow ‘activities that take place in Wall Street to have any impact upon the coordination or non-coordination of the economy’.[18] In fact, financial processes achieved a dynamic of their own that began to destabilize the process of production. As the holders of money put a premium on extracting the highest value for their investments, banks and other financial agents begin to compete feverishly to create financial products that would deliver the highest monetary returns. Thus, ‘financial innovation therefore tends to induce capital gains, increase investment, and increase profits: the economy will try to expand beyond any tranquil full-employment “state”.’[19]

As the profit rates in industry become less attractive relative to finance, more and more money is devoted to extracting higher returns in ever more complex financial products. Corporations themselves begin to borrow to engage in financial speculation, depending less on retained earnings as capital, increasing their leverage and thus their profits if they make the ‘right’ financial bets.

Detailing Minsky’s dynamic picture of the processes unleashed by speculation, one commentator wrote:

‘The economy therefore tends towards disequilibrium as these destabilizing financial forces assume ever more speculative forms. Asset price inflation during the peak of the boom will generate an increase in investment and consumption through the various channels of income and cash flows. When the price of capital assets exceeds the price of current output, excess investment is channeled into rising equity markets, which also encourages investors to increase their leverage. An implicit capital gain is realized, which merely serves to attract more investment. In other words, the rise in the price of capital assets relative to the price of current output could set in train quite perverse wealth effects, which amplify increases in consumption and investment.’[20]

The critical moment comes when there is widespread realization that the asset price bubble is about to burst and there is a ‘rush towards liquidity and riskless assets’ before the value of financial assets collapse. That is the so-called ‘Minsky moment’.

The crisis of profitability and stagnation

Finance played a central role in the ongoing economic crisis, in that financial speculation instead of the productive process became the driving force of the economy, eventually destabilizing it. This essentially is what is meant by ‘financialization’. The dynamics of financialization, however, cannot be fully understood without exploring what triggered it. Here is where the Keynesian focus on macroeconomic trends and dynamics must be supplemented by a critical analysis of capitalism as a system driven forward by class conflict.

The origins of the Great Recession, as it is now called, lie in the crisis that overtook western capitalism in the late 1960s and 1970s. That crisis marked the end of what the French called *Les Trente Glorieuses* (or ‘The 30 Glorious Years’) from 1945 to 1975, when fiscal and monetary intervention, applied in a counter-cyclical Keynesian way, seemed to have eliminated the swings between frenzied booms and deep busts of capitalism, the most cataclysmic of which was the Great Depression.

Stagflation (the coexistence of stagnation or low growth and high inflation that was not supposed to occur under the Keynesian 'Philip's curve'), squeezed the advanced capitalist economies, translating into a crisis of profitability. Stagflation was, however, a symptom of two related, profound developments in advanced capitalist economies. One was the problem overproduction or over-accumulation. The other was the flaring up of the struggle between capital and labour over the fruits of the production process.

The crisis of overproduction had its roots in the swift and successful economic reconstruction of Germany and Japan and the rapid growth of industrializing economies such as Brazil, Taiwan and South Korea. This added tremendous new productive capacity and increased global competition, while income inequality within countries and between countries limited the growth of purchasing power and effective demand. This classic crisis of overproduction – or underconsumption, to use Paul Sweezy's formulation – led to a decline in profitability. This in turn resulted in the fraying of the class compromise between labour and capital that had been institutionalized in Keynesian economics, as capital and labour struggled over the diminishing profits yielded by the production process.

Indeed, the coexistence or direct correlation of stagnation and inflation was a symptom of the class struggle: a well organized labour force made it difficult for capital to get rid of workers and forced it to grant them relatively high wages and benefits packages. A pithy description of this process is provided by Radhika Desai:

'Western capitalism arrived at industrial maturity … and could enjoy the 'golden age' of growth thanks only to the state-organized expansion of working class consumption made more urgent by the loss of colonies. It could only last as long as productivity increases permitted wages to rise without eating into profits. As soon as that limit was reached, further expansion of working class consumption proved intolerable.'[21]

The crisis of profitability was eventually resolved by the adoption of neoliberal measures, but a necessary condition for the adoption of these measures was the political defeat of the working class. The most dramatic manifestations of this debacle were the defeat of striking air traffic controllers in the US by Ronald Reagan in 1982 and Margaret Thatcher's crushing of the miners' strike in Britain. As Paul Mason argues, although it has become commonplace to think that the triumph of globalization and neoliberalism was inevitable, it was not. It was predicated on labour's political defeat:

'Neoliberalism was designed and implemented by visionary politicians: Pinochet in Chile; Thatcher and her ultra-conservative circle in Britain; Reagan and the Cold Warriors who brought him to power. They'd faced massive resistance from organized labour and they had enough. In response, these pioneers of neoliberalism drew a conclusion that has shaped our age: that a modern economy cannot coexist with an organized working class. Consequently, they resolved to smash labour's collective bargaining power, traditions, and social cohesion completely.'[22]

While traditional conservatives or liberals sought to co-opt the working class, Mason argues that what the neoliberals wanted was its 'atomization':

'Because today's generation sees only the outcome of neoliberalism, it is easy to miss the fact that this goal – the destruction of labour's bargaining power – was the essence of the entire project: it was a means to all the other ends. Neoliberalism's guiding principle is not free markets, nor fiscal discipline, nor sound money, nor privatization and offshoring – not even globalization. All these things were byproducts or weapons of its main endeavour: to remove organized labour from the equation.'[23]

With organized labour defeated, global capitalism sought to resolve its crisis of profitability by doing away with the Keynesian or social democratic arrangements that had been the concrete expression of the social compromise with labour, and reshaping the economic and social landscape.

Escape routes from stagnation

There were, broadly, three escape routes from the crisis of the 1970s.

The first was neoliberal restructuring or removal of government barriers to the operation of market forces. In the global North, this involved breaking up unions that were accused of distorting labour markets; deregulation; privatization or reprivatization of government enterprises; and trade liberalization. In the global South, similar measures were adopted, along with the radical dismantling of the state as the leading agent of economic development.

The second escape route was globalization, the most striking manifestations of which were the elimination of barriers to trade, investment, and capital flows. The World Trade Organization was created to break down such barriers, especially in developing countries. The International Monetary Fund was harnessed to force capital account liberalization in the South, in other words the elimination and liberalizing of rules on entry and exit of foreign capital, particularly portfolio investment. Transnational corporations shifted their operations to cheap labour areas in the South from the US and Europe.

The third escape route was financialization, or the increasing use of the financial system not as an intermediary between savers and investors, but as a mechanism to produce profit that would otherwise come from the production process. Using Marxian terms, this was a case squeezing 'value' from value already created in the production process.

Capitalism is incredibly contrary, so that what might appear as a solution in fact deepens the same problem or creates new problems.

Neoliberal restructuring

The aim of neoliberal restructuring or structural adjustment, the first escape route, was to invigorate capital accumulation in two ways: first, by removing state constraints on the growth, use and flow of capital and wealth; and second, by redistributing income from the poor and middle classes to the rich on the theory that the rich would then be motivated to invest and reignite economic growth.

The problem with this formula was that in redistributing income to the rich, it gutted the incomes of the poor and middle classes, thus restricting demand, while not necessarily inducing the rich to invest more in production. In fact, it could be more profitable to invest in speculation.

In the three decades prior to the crash of 2008, the wages of the typical American hardly increased, and actually dropped in the 2000s, as a result of neoliberal policies. A big part of the problem was the elimination of high-paying manufacturing jobs – an estimated 8 million of which vanished in the US between June 1979 and December 2009. One report describes the grim process of deindustrialization: 'Long before the banking collapse of 2008, such important US industries as machine tools, consumer electronics, auto parts, appliances, furniture, telecommunications equipment, and many others that had once dominated the global marketplace suffered their own economic collapse.'[24] Traditional manufacturing jobs were outsourced, and so were high-tech and high-tech related jobs that had been expected to make up for them. Apple's case is paradigmatic. According to the one report:

'Apple employs 43,000 in the United States and 20,000 overseas, a small fraction of the over 400,000 American workers at General Motors in the 1950s, or the hundreds of thousands at General Electric in the 1980s. Many more people work for Apple's contractors: an additional 700,000 people engineer, build, and assemble iPads, iPhones, and Apple's other products. But almost none of them work in the United States. Instead, they work for foreign companies in Asia, Europe, and elsewhere, at factories that almost all electronics engineers rely upon to build their wares.'[25]

In relation to growth, neoliberal restructuring (which was generalized in the North and South during the 1980s and 1990s) had a poor record: global growth averaged 1.4 per cent in the 1980s and 1.1 per cent in the 1990s, whereas it averaged 3.5 per cent in the 1960s and 2.4 per cent in the 1970s, when state interventionist policies were dominant. Neoliberal restructuring could not shake off stagnation.

Globalization

The problem with globalization, the second escape route from stagnation, was that while it reduced the costs of labour, with the substitution of cheap labour in the global South for relatively costly labour in the global North, it also exacerbated the problem of overproduction or underconsumption. There was a lot of productive capacity added in places like China but it was not matched by a significant corresponding rise in effective demand. True, some 1.7 billion new workers were estimated to have joined the labour force between 1980 and 2010,[26] but as Andrew Farlow points out:

'Those being employed in places like China were being paid a small proportion of the value they produced. The corporates that employed them were saving a high proportion of what they were generating. Hence those being employed were not contributing much to the global aggregate demand that would absorb what they produced. Meanwhile, the shift in production also put downward pressure on wages in richer countries, amongst those who might ordinarily have been thought of as the source of demand for the output … As firms chased insufficient demand, it seemed that one solution was for them to cut costs even more and further shift their activities offshore.'[27]

In their drive to regain profitability, US industry coupled offshoring activities with massive investment in labour-saving technology and information technology. As Deepankar Basu and Ramaa Vasudevan write:

'The pervasive adoption and growth of information technology would have almost certainly played an important role in shaping the particular evolution in the nineties when capital productivity showed an upward trend. New forms of managerial control and organization, including just-in-time and lean production systems have been deployed to enforce increases in labour productivity since the 1980s. The phenomena of 'speed-up' and stretching of work have enabled the extraction of larger productivity gains per worker hour as evidenced by the faster growth of labour productivity after 1982. People have been working harder and faster. Information technology has facilitated the process. It enables greater surveillance and control of the worker, and also rationalization of production to "computerize" and automate certain tasks.'[28]

Offshoring production to take advantage of cheap labour and eliminating jobs through labour-saving technology regained a measure of profitability for capital but it also deepened the crisis of overproduction. Labour productivity rose by 7 per cent a year in the late 1990s and early years of the 21st century, but wages plummeted and millions of manufacturing jobs were lost. Supply kept outstripping effective demand, with the result that by the end of the 1990s – with excess capacity in almost every industry – the gap between productive capacity and sales was the largest it had been since the Great Depression.[29]

The impact of overproduction on the rate of profit did not manifest itself immediately,[30] but in the 10-year period before the Great Recession there was a marked decline in the productivity of capital, which foreshadowed the coming profitability crisis – a prospect underlined by the 'dot.com' recession of 2001-2002. One way of staving this off was to intensify even more the exploitation of the working class by promoting regressive income distribution measures.[31] There were, however, limits to this without provoking social instability. Another attractive course was to increase income from investment in the financial sector, where profits dwarfed those that could be derived from industry: though it accounted for only 8 per cent of GDP, finance raked in 30 per cent of the profits, with some analysts saying the actual figure was 50 per cent.[32] As we shall see, for capital, financialization provided the solution both to averting social instability and shoring up profitability.

The financialization option

Against a backdrop of uncertainty in relation to the productive process, capital sought ever greater rates of return by increasingly concentrating on speculation rather than production. Along lines sketched out by Keynes and Minsky, the financial sector began to move relatively independently of the production process, bringing increasing instability to the whole system. This situation was insightfully observed by Marx in a remarkable passage that could be said to anticipate 20th and 21st century developments:

'[To the possessor of money capital] the process of production appears merely as an unavoidable intermediate link, as a necessary evil for the sake of money-making. All nations with a capitalist mode of production are therefore seized periodically by a feverish attempt to make money without the intervention of the process of production.'[33]

The profitability of finance stemmed from four developments. First was the abolition, during the Clinton administration, of the Glass-Steagall Act (1933) that had served as a firewall between commercial or retail banking and investment banking. This abolition was the result of tremendous pressure from the big banks who felt left out of the boom in trading. Second was the expansive monetary policy promoted by the US Federal Reserve to counter the downturn following the piercing of the dot.com bubble in the first years of the new century. Third was government and business' move to shore up effective demand by substituting household indebtedness for real wage increases. Fourth was the lifting of capital controls on the international flow of finance capital, following the post-war era of financial repression. These developments together produced a speculative boom in the housing and stock markets, and fed on each other to accelerate an economic nose-dive during the 'bust' period that was to follow.

Eliminating the Glass-Steagall Act, 1933

The Glass-Steagall Act was perhaps the greatest factor in the relative stability of the financial sector until the late 1990s. It had been passed in the midst of the Great Depression, which had been blamed by many on the unrestricted speculative activities of the banks. The law separated commercial from investment banking on the grounds that conflicts of interest could develop if institutions that were granting credit were also investing or using credit. The law made retail banking predictable and unexciting, though not unprofitable.

Over time, however, the commercial banks began to feel disadvantaged in relation to the investment banks, which were developing all sorts of financial innovations that were translating into high profits. The commercial banks' lobbying resulted in the Gramm-Leach Act of 1999, which repealed the Glass-Steagall Act and 'paved the way for financial *supermarkets* – one-stop money shops taking deposits, making loans, providing advice, underwriting and trading securities, managing investments and providing insurance'.[34] Banking no longer consisted of just taking deposits from people at a low rate of interest and lending to households, consumers and firms at a higher rate of interest, in the classical economic textbook model. It had become an increasingly torrid investment activity chasing higher and higher profits. Bryan Dorgan, one of eight senators who voted against the bill noted, presciently in hindsight, that 'this bill will, in my judgement, raise the likelihood of future massive taxpayer bailouts'.[35]

Monetary Keynesianism

Speculative activity in the late 1990s focused on high-tech stocks. This created the dot.com bubble through demand for shares in high-tech corporations (including start-ups) that was rooted in a belief in the endless profitability of these investments. With the collapse of the bubble and the subsequent recession, Alan Greenspan, chairman of the Federal Reserve, reduced the federal funds rate (the Federal Reserve's main policy instrument) from 6.5 per cent to 1 per cent – a 42-year record low – in a Herculean effort to counteract the strong recessive trends.

Greenspan's countercyclical monetary policy did indeed pull the US out of recession, with families spending on new homes, cars, home renovations and vacations, and it sent stock prices tonew heights.Greenspan talked about 'irrational exuberance' as an extraordinary wave of consumer spending and financial speculation fueled the recovery, owing partly to his expansive Keynesian monetarism. The cost of this, however, was the build-up of another bubble: this time in housing and real estate.

Credit creation as class pacification

Greenspan's monetary stimulus would probably have been less effective had credit not been made easily available to the middle and working classes by government and the banks. Easy credit was a way of substituting for the share in the national income that capital had clawed back from labour via wage cuts and wage repression, and other neoliberal measures. This was necessary not only to counter economic crisis but to promote political stability. As Robert Alpert put it:

'Easy credit didn't just prevent Americans from seeing inequality. It also helped obscure the fundamental ways in which a good swath of the public lost out under globalization ... Under normal circumstances, the pain and dislocations caused by globalization would have triggered a massive backlash against the free trade regime embraced by both political parties ...Yet easy credit helped salve the wounds of downwardly mobile Americans and silence dissent. Sure, the plants may be closed and the jobs shipped to China. But with adjustable rate mortgages at rock bottom rates and Home Depot offering no payments for a year on new kitchens, the good times could go on.'[36]

Mortgage credit was the principal mechanism for creating effective demand in what political economist Colin Crouch called 'privatized Keynesianism'.[37] Cheap credit was initially made available to low-income groups via the mortgage finance giants Freddie Mac and Fannie Mae, two government-supported enterprises (GSEs). Then the private sector joined the party. As Raghuram Rajan wrote: 'After all, they could do the math and they understood that the political compulsions behind government actions would not disappear quickly. With agency support, subprime mortgages would be liquid, and low-cost housing would increase in price. Low risk and high return – what more could the private sector desire?'[38]

Most of the debt was unsecured. Indeed it was important to understate risk, perform no due diligence and throw responsibility to the winds if the consumer demand that was the basis of both profitability and political stability were to be maintained. As Crouch put it, that was the only way in which privatized Keynesianism could have the same counter-cyclical stimulant effect as state-directed, demand-management Keynesianism, since 'prudential borrowing against specified collateral would not have helped the moderate-income groups who had to keep spending despite the insecurity of their labour market positions'. The illusion of prolonged, widespread unsecured debt that had little risk was in turn made possible through innovations in financial engineering, 'innovations which for a long time had seemed to be an excellent example of how, left to themselves, market actors find creative solutions'.[39]

In 1990, US mortgage debt totalled $2.4 trillion. By 2000 it had risen to $4.8 trillion, and by 2004 it reached $7.8 trillion; by 2006, $9.8 trillion; and by 2007, $10.5 trillion. In addition, between 2000 and 2008 the amount of revolving debt held by consumers increased by nearly 50 per cent – from $675 billion to $976 billion. Outstanding student loans rose from $200 billion in 2000 to over $800 billion by 2010 – a stunning 400 per cent increase. As Alpert noted, 'Never in history had individuals – in any country or at any time – borrowed so much money so quickly'.[40]

Liberalizing global capital flows

Finally, as noted earlier, a key factor contributing to the financialization frenzy was the lifting of controls on global financial capital flows that had made the post-war period one of financial repression. This capital account liberalization took place against a backdrop of global monetary turmoil, including: a 'haemorrhaging' of dollars from the US to finance the war in Vietnam; an offshore financial centre evolving in London as a result of this outpouring of dollars and becoming a source of funds for investors; and the end of the Bretton Woods system of fixed currency values, giving way to floating values and creating opportunities for making money from currency arbitrage.

This liberalization led to intense speculative activity globally as investors, aided by information technology, chased after profits in the rise in value of stocks, bonds and derivatives in different markets, leading to investment saturation, and to collapse. Not surprisingly there have been around 12 major international financial crises since the early 1980s, followed by recessions. These recessions triggered by banking crises were more severe than normal, real-economy recessions.[41] Perhaps the most severe after the Great Recession was the Asian financial crisis of 1998 to 2001, which saw $100 billion in speculative funds flow into Asia from 1994 to 1997, finding their way to real estate and causing over-investment in this sector. This sparked a 'rush for the exits' that brought about the collapse of, and recession in, key Asian economies, including South Korea, Thailand, Indonesia and the Philippines.

The Asian financial crisis was a key factor in the growth of the US speculative bubble that burst in 2007-2008. When the Asian economies were destabilized by the panicky exit of foreign investors and the opportunistic actions of currency speculators – which together drastically weakened their currencies, leading to more expensive imports and an inability to service foreign debts – they were forced to go to the IMF. In turn, the IMF forced them to undertake contractionary policies that led to tremendous suffering.

Asian technocrats said 'never again', and to protect themselves from future speculative attacks they geared up their export machines to earn dollars, mainly from goods sold in developed countries, the biggest of which was the US. Many of these dollars were then bought by Asian central banks with domestic currency. This fulfilled two objectives. First, it prevented the appreciation of the local currency, thus keeping Asian countries' exports competitive in world markets. Second, it allowed central banks to build up their reserves to support their currencies with a 'big bazooka' and deter future speculative attacks.

East Asian reserves – excluding Japan's – went from less than $100 billion in 2000 to more than $4 trillion in 2007. The central banks did not, however, keep all of these reserves in a state of hibernation – after all, banks must use money to make money. A large part was recycled back to developed economies through the purchase of assets such as mortgage-backed securities from the private sector in the US, or US Treasury bills.

The total issuance of private sector securities in the US and Europe reached some $3 trillion in 2007. Close to half of this amount was purchased by foreign actors, principally emerging market central banking institutions from East Asia. As Atif Mian and Amir Sufi note:

'From 1990 to 2001, central banks bought around $100 billion annually. From 2001 to 2006, the rate of reserve accumulation just about *sextupled*. This led to a breathtaking jump in demand for new safe assets, and foreign central banks heaped money into US Treasuries. As foreign central banks built up their dollar war chests, money poured into the US economy. In theory, this flow did not have to end disastrously.'[42]

But it did end disastrously, largely because so much of it ended up being re-lent to private financial institutions that used it to create the credit that financed US consumer spending, particularly in housing.

Calling attention to the role of Asian savings in the US financial crisis is not to endorse former Federal Reserve Chairman Ben Bernanke's theory that it was the 'savings glut' in East Asia making its way to 'savings deficit' countries such as the US that was the central cause of the crisis. The US economy was not a passive receptacle for the Asian funds. They were being pulled in by the dynamics of the financialized US economy and the interventionist foreign policy of the US government. Former World Bank economist Justin Lin said Bernanke had the causal relationship wrong:

'The combination in the United States of financial deregulation (starting in the 1980s, which allowed higher leverage, and low interest rates (following the bursting of the housing bubble in 2001) led to a large increase in liquidity, which fed the housing bubble. The wealth effect from the housing bubble and innovative financial instruments supported excessive household consumption. The consumption surge and the fiscal deficits needed to finance the wars in Iraq and Afghanistan generated large US trade deficits and global imbalances. The United States was able to maintain these severe imbalances for as long as it did because of the dollar's reserve currency status.'[43]

In any event, the massive inflow of Asian funds interacted with US banking liberalization, the Federal Reserve's expansive monetary policy, and the effort to prop up consumer demand through credit rather than wage rises. The result was a volatile brew that fueled the subprime bubble. From the beginning of the bubble to the feeding frenzy that pushed it ever upward to its bursting, to the recession that brought the economy to a standstill, the process unfolded in the way Minsky predicted.

Creating and inflating the bubble

The main mechanism through which credit was pumped into the system involved mortgages made to middle- and lower-class households – a great many of them representing credit risks that in normal times banks would have refused. Thus the term 'subprime crisis'. Subprime and other mortgages served as the basis of the speculative bubble that grew in the 2001-2007 period because they were transformed into securities that financial institutions, both US and foreign, bought in large quantities in the belief that they were relatively risk free and could only appreciate in value. Complementing and interacting with the frenzied trade in mortgage-based securities was credit going to corporate players that invested in stocks as well as in new instruments called 'derivatives', which came to also be regarded as risk free, thanks to the alchemy of financial engineering. The combination of very low interest rates on money borrowed from the Federal Reserve and the government, and the seemingly unlimited supply of foreign money from China and the other East Asian countries that found its way to the private sector either directly or through official conduits, led to the idea that 'relatively risk-free' speculation was where large profits were to be made, rather than in the productive sector.

Getting leverage became the name of the game, meaning limiting one's equity while using large amounts of borrowed money to make huge profits on a trade, from which the relatively low interest could later be paid. Nailing down huge profits through highly leveraged deals increased the valuation of a company, meaning the value of shares escalated. Thus, raising 'shareholder value' became the Holy Grail sought by market players, leading them to make bigger and bigger bets with borrowed money, fortified with the belief that even if trades did not go the way they expected, losses would be minimal in a bull market that seemed to be endless. In brief, these were the dynamics of the bubble economy that inflated rapidly, then burst in 2007-2008.

The subprime mortgage implosion

As noted earlier, housing became a fertile field for speculation owing to the banks taking advantage of US government programmes to provide affordable housing to low-income groups. While the process of securitization of mortgages began with the GSEs, it was kept under control through underwriting standards; but when the private sector entered the scene, things got out of control. While the GSE's Fannie Mae and Freddie Mac catered mainly to mortgages that met conventional lending standards, the new private sector lenders went after subprime borrowers, thanks to the wonders of financial engineering.[44]

The wondrous formula went as follows: private lenders entering the scene borrowed the 'originate to distribute' model pioneered by Fannie Mae and Freddie Mac, which bought conforming mortgages from conforming or creditworthy individuals from banks that originated the mortgage, and paid for them by pooling the mortgages together and selling them as securities to financial institutions and other investors. What this model of securitization meant was that the originating bank no longer had to hold the mortgage until it was fully paid. Indeed, there was an incentive to sell the mortgage immediately to intermediary institutions and get the profit up front.

What the non-GSE private securities specialists did was to create a market for non-prime mortgages through financial engineering devised to assure investors that buying the securities was almost risk free. Through pooling and tranching, prime and subprime mortgages were combined into 'safe' securities and sold to investors. These came to be known as collateralized debt obligations, or CDOs. This process of 'slicing and dicing' securities into lower risk and higher risk tranches based on the mortgage holder's ability pay quickly got out of hand. As two specialists on derivatives note:

'While securitization itself was a legitimate operation, further securitization (through CDOs) was probably not. When securitized mortgage loans were further securitized into CDOs with different risk categories, it resulted in a massive secondary market in these complex derivative securities. In some cases, there were CDOs which consisted of parcels of other CDOs (known as "CDO squared"). This led to a situation where the ultimate risk-bearer could often not be identified. In reality, there was no safe category any more in these instruments that were securitized multiple times over. Further, in effect, a mountain of leverage had been built on the original home mortgage; a progressively smaller and weaker foundation of equity supported a huge securitization superstructure.'[45]

Moreover, since they had an incentive to get rid of mortgages immediately and make their money upfront, originators became lax in their standards of lending and indeed many deliberately passed off subprime borrowers as prime borrowers. Fraud was widespread. The idea was to make a sale quickly, get your money upfront and make a tidy profit, while foisting the risk on others down the line – the hundreds of thousands of institutions and individual investors that bought the mortgage-tied securities. This was called 'spreading the risk', and it was actually seen as a good thing because it lightened the balance sheet of financial institutions, enabling them to engage in other lending activities. Keynes caught the essence of this behaviour when he wrote: 'The actual, private object of the most skilled investor is "to bet the gun,' as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half crown to the other fellow.'[46]

With such perverse incentives promoted by the 'originate and distribute' model, lenders piled into poor neighbourhoods, aggressively hooking poor residents into contracting mortgages. The consequences are detailed by Atif Mian and Amir Sufi:

'The expansion of credit to more and more borrowers who were likely to default ended disastrously. Lenders flooded low-credit neighborhoods with credit, despite no evidence of better income prospects. Investors buying the Mortage Backed Securities (MBS) fueling this expansion made simple mistakes in their models, and the arrangers of securitization pools exploited these mistakes. Fraudulent practices infected private-label securitization, and credit-rating agencies were either unaware of what was going on or were happy to look the other way ... Eager to create and sell profitable securities, lenders extended credit to so many marginal borrowers that they reached a point at which they lent to borrowers so credit-unworthy that they defaulted immediately after the loan originated. Once the defaults began to rise, the entire game unraveled, and levered losses kicked in.'[47]

It is estimated that during the Great Recession, housing prices fell by $5.5 trillion, or by over a third of the US GDP of $14 trillion. The main victims were low-income households that had been aggressively baited into borrowing, though a significant number of middle class and even upper middle class households registered losses. The impact went beyond households, however. With trillions of dollars' worth of toxic assets purchased by investors, a virus was injected into the global financial network, driving financial institutions, corporations and individual investors to bankruptcy, among the most prominent being Lehman Brothers, Bear Sterns, the British bank Northern Rock, the Swiss Bank UBS, and the German Bank IKB Deutsche Industriebank. Alan Greenspan himself provided the best description for the virus-like spread of securities based on subprime mortgages: 'The roots of this crisis are global and geopolitical … the actual trigger is securitized American subprime mortgages which became toxic and essentially proliferated around the world.'[48]

Derivatives drive the crisis

Greenspan noted, however, that had it not been subprime-based securities, 'something else would have triggered it'.[49] He probably had in mind derivatives, which were the other big contributor to the crisis. Because of their role, the financial guru Warren Buffet labeled derivatives 'weapons of mass destruction'. Derivatives are financial products that are not the assets themselves but are priced on the likely movement of these assets. One buys or sells derivatives depending on one's sense of the likely direction of the underlying asset, making or losing money on this 'bet'. The best known derivative to emerge during the financial crisis was the 'credit default swap' (CDS), which was actually a form of insurance that was termed a 'swap' to avoid the federal regulation to which other forms of insurance were subject. CDSs were originally contracts that credit default obligation (CDO) holders took to insure themselves against losses in case their CDOs turned sour in the event of a downturn in the real estate market. However, since CDSs, being outside government regulation, did not require an insurable interest, speculators bought CDSs in the expectation that growing risks of default would raise the price of the CDSs they purchased, and they could make a neat profit from the sale. As two derivatives specialists put it,

'Many institutions acquired CDS on the secondary market as investments without any interest in the original credit. If so much money is at stake on a disaster happening (credit default), then perhaps there is a perverse incentive to make the risk materialize rather than prevent it from happening. Thus, there is moral hazard written all over the credit default swap industry.'[50]

Not surprisingly, the market in CDSs exploded, as speculators took out CDSs not only on CDOs but on price movements of different commodities, as well as on risks such as crop failures or natural disasters such as climate change. Such bets on credit defaults made up, prior to 2007, a $45 trillion market that was entirely unregulated. It amounted to more than five times the total of the US government bond market.

When the subprime bubble exploded and investors and speculators rushed to convert their CDSs into cash to make up for their losses, the American International Group (AIG) was felled by its massive exposure in CDO insurance. AIG lost billions of dollars on these swaps, and it was Washington's fear that its bankruptcy would infect the whole CDS market and cause it to implode – bringing the whole financial system with it – that made Washington go to its rescue after it allowed Lehman Brothers to collapse in the fateful fall of 2008.

The trade in derivatives was completely unregulated, taking place in what was called a 'shadow banking system' where most trades were done 'over the counter' (OTC), meaning there was no public record of these exchanges, which would have existed had they taken place in official exchanges. Further, these transactions were not entered into the balance sheets of many of the corporations engaging in trades, but into ‘special purpose vehicles’ (SPVs) set up to avoid regulation and taking advantage of loopholes in the law. SPVs allowed banks to present healthy balance sheets when in fact their SPVs showed losses in trades. Once a bank was rumoured to have a liquidity or solvency problem, however, market players ripped apart the fiction of SPVs, and held the parent bank accountable for paying back credit it had extended to its subsidiaries, as they did to Lehman Brothers and other big Wall Street institutions during the panic of 2008.

Financial ‘tail’ wags industrial ‘dog’

Financialization reshaped the corporate landscape, and perhaps the most telling evidence of this was how corporate stalwarts in industry were transformed into organizations where the financial tail ended up wagging the industrial dog. General Electric exemplified this transformation. One of the US’s most successful industrial corporations, GE found its profits shrinking amidst the fragile state of US industry in the late 1980s and 1990s. A conglomerate, its mature industrial businesses were not growing and its profits were not expanding as desired, to the disappointment of shareholders who believed in the new doctrine of the financial era: constantly rising share value was a good indication of good management. To counteract poor performance of its traditional industrial units, GE set up a financial arm, GE Capital, to aggressively play the financial markets, diverting earnings from its old industrial units to it. By the early 2000s GE was ‘leveraged around 10 times; $10 of borrowings, much of it short term, for every $1 share of capital’.[51] It also went on a buying spree of financial businesses, from whose investment and trading operations the conglomerate was eventually drawing half of its growth earnings. Industrial operations were subordinated to financial operations, and the aim of financial operations was to constantly enhance its return on equity, earnings and share price. Eventually, GE became extremely fragile, and the advent of the financial crisis in 2008 revealed just how overextended and indebted it was, leading to a corporate meltdown. This was not surprising since meeting financial targets had replaced production of goods as the prime corporate concern.[52]

GE and many other industrial corporations were in the vortex of a speculative frenzy, where the Wall Street financial establishment was calling the shots. The irrationality of the bubble was evident in the fact that the total volume of traded derivative financial instruments came to $740 trillion, compared to the world GDP of $70 trillion. The most common derivatives were mortgage-backed securities, CDOs and CDS, though there were more exotic varieties. $640 trillion of these were traded over the counter, meaning there was little transparency, little indication of how healthy these derivatives were, and little knowledge of how many were owned by whom. Not surprisingly, credit ratings agencies failed to price these instruments properly, often taking the word of investment banks that created them and the financial institutions that bought them as to the value of these instruments and the health of their holders.

Fear of the 'unknowns'

With so many unknowns, when news of widespread subprime mortgage failures spread in 2007, panic quickly followed, leading to radical downgrading of all mortgage-backed securities, and, by contagion, almost all other derivative products too. Not knowing each other's toxic securities holdings, lending between banks practically halted. The rating agencies that had been caught napping at the wheel sprang to life, 'downgrading hundreds of issues of securities and thus accelerating the crisis'.[53]

So exposed were the top financial institutions to toxic and downgraded securities that the federal government had to undertake the massive rescue operations in 2008-2009, which injected direct investments in preferred and common stock to the tune of billions of dollars. Others, such as Paul Krugman, urged nationalization. The banks were considered 'too big to fail', and with this rationale, some $20 billion was invested in Bank of America and another $20 billion in Citigroup. The banks were saved, but households were left to fend for themselves.

Impact of the crisis

As the bubble economy burst, the financial system froze, with interbank lending grinding to a halt along with bank lending to corporations on overnight, fortnightly, short-term or long-term bases. The impact on the real economy was devastating. Governments in the US and Europe went into motion – not to prevent or mitigate spreading unemployment, but to save the big banks that had brought on the crisis, on the assumption that failure on their part would trigger the collapse of the real economy.

The Great Recession was the biggest economic disaster to hit the US since the Great Depression. Unemployment rose from under 5 per cent in 2007 to 10 per cent in 2010 and around 8.6 million jobs were lost between March 2007 and October 2009. More than six years later, in 2015, the number of unemployed was still about two million above the 6.7 million unemployed at the start of the recession in 2007.[54]While employment started to rise in December 2009, it nevertheless took until 2014 to reach the pre-crisis peak of 138 million employed workers.[55] Moreover, the fall in the unemployment rate was driven less by improved labour market conditions than by a falling participation rate, as discouraged workers withdrew from the labour force.

As far as growth was concerned, the recovery was tepid, with average GDP growth barely 2 per cent per annum between 2011 and 2013 – less than half the pace of typical post-World War II expansion.[56]In terms of inequality, the statistics were clear: 95% of income gains from 2009 to 2012 went to the top 1%; median income was $4,000 lower in 2014 than in 2000; concentration of financial assets increased after 2009, with the four largest banks owning assets that came to nearly 50% of GDP. An Economic Policy Institute study summed up the trends: '[T]he gains of the top 1 percent have vastly outpaced the gains for the bottom 99 percent as the economy has recovered.'[57] At the individual and household level, the economic consequences of being laid off were devastating, with one study finding that workers laid off during recessions "lose on average three full years of lifetime income potential'.[58] One estimate showed that the income of the US would have been $2 trillion higher had there been no crisis, or $17,000 per household.[59]

More than four million homes were foreclosed.[60] Lower income homeowners – the main victims of aggressive mortgage sharks – suffered most. Since they were highly leveraged, meaning their debt to equity ratio was quite high, their net worth plunged from $30,000 to almost zero between 2007 and 2010. This decline in net worth, according to Mian and Sufi, 'completely erased the gains from 1992 to 2007'.[61]

Keynesianism to the rescue

The unfolding of the crisis brought Keynesian economics to the forefront, with neoliberalism beating a hasty retreat in the immediate aftermath of the crisis. Keynesian economists, in particular those in the Minsky stream, had correctly anticipated the crisis, but even they were probably surprised by its severity. But it was not the correctness of their financial analysis for which their expertise was sought – but rather for the policy tools they offered for dealing with the unfolding crisis. As noted earlier, the neoliberal par excellence Robert Lucas said, 'everyone is a Keynesian in a foxhole'.

Even before Obama won the 2008 election, George W Bush's administration had discarded the hands-off approach to the financial sector and brought recalcitrant proponents of the free-market in Congress to endorse the massive rescue of the banks via the $700 billion Troubled Assets Rescue Program, which was set up to purchase the toxic securities of the top commercial and investment banks under the doctrine that the banks were 'too big to fail'. This was in addition to the Federal Reserve's infusion of credit via 'special purpose vehicles' to two troubled financial players, Bear Sterns and the American International Group (AIG). Government action also forced two investment banks, Goldman Sachs and Morgan Stanley, to convert themselves into holding companies of the big banks.

But Keynesianism's rise to prominence really took place during the Obama presidency. Government fiscal intervention and regulation of the banks were seen by the incoming administration and its advisers as the central instruments in stabilizing an unraveling system.

Failure on the fiscal front

'Stimulus' was the byword of 2009, with governments in the North running deficits of up to 10 per cent of their Gross Domestic Product to counteract the economic downturn. The Group of 20 (G20), meeting in Pittsburgh in September 2009, appeared to give the imprimatur to a new era of fiscal activism by urging the adoption and maintenance of stimulus programmes as the key solution to the crisis.

Another key G20 resolution was the creation of a new regulatory framework for the financial sector at both the national and international level. While everyone agreed on financial reform, the devil was in the detail, with some governments favoring the banning of derivatives and the imposition of some kind of financial transactions tax, and some (like the US) not willing to go that far.

The move on the fiscal front was, however, disappointing. Christina Romer, the head of Barack Obama's Council of Economic Advisors, estimated that it would take a $1.8 trillion to reverse the recession. Obama approved only less than half, or $787 billion, supported by the more conservative members of his economic team, leaving Romer isolated. Relatively speaking, this package was smaller than the $585 billion stimulus the Chinese government injected into its own economy. For many Keynesians like Richard Koo, the US had only to look to Japan for an example of the importance of massive fiscal stimulus. Despite much scepticism in policy and academic circles, noted Koo, the 140 trillion yen spent by the Japanese government to counter the country's Great Recession in the 1990s prevented economic collapse:

'In reality, it was only because the government increased fiscal expenditures to the extent it did that the nation's standard of living did not plummet. Indeed, it is nothing less than a miracle that Japan's GDP remained at above peak bubble-era levels despite the loss of 1,500 trillion yen in national wealth and corporate demand equal to 20 per cent of GDP, and it was government spending that made this miracle possible.'[62]

What makes President Obama's restraint even less understandable is that the neoliberals were still in disarray, with a number of their leading lights supporting Obama's stimulus spending. One was Nobel Prize laureate Robert Lucas, unofficial dean of US neoliberalism. Another was John Cochrane, also a University of Chicago neoliberal luminary, who stated his position in a way that Paul Krugman would have approved:

'Let's be clear what this issue is not about. Governments *should* run deficits in recessions, and pay off the resulting debt in good times. Tax revenues fall temporarily in recessions. Governments should borrow (or dip into savings), to keep spending relatively steady. Moreover, many of the things government spends money on, like helping the unfortunate, naturally rise in recessions, justifying even larger deficits. Recessions are also a good time to build needed infrastructure or engage in other good investments, properly funded by borrowing. For all these reasons, it is good economics to see deficits in recessions – and surpluses in booms …We can argue whether the overall level of spending is too high; whether particular kinds of recession-related spending are useful or not; whether particular infrastructure really is needed; and we certainly face a structural deficit problem. But those are not the issue either.'[63]

Obama's apparent motive in halving Romer's proposed stimulus was not economic but political: to signal to the right in Congress that he was someone with whom they could talk business. According to Krugman and other Keynesians, this Solomonian decision may have prevented the economy from tanking but it prolonged the stagnation, with GDP growth not rising above 2.25 per cent and unemployment not going below 7 per cent from 2009 to 2013.[64]

The limits of monetary policy

With the Obama administration unwilling to put into effect an aggressive stimulus programme for fear of triggering a neoliberal backlash, the one Keynesian mechanism that was left to stop the downward spiral was an expansive monetary policy. Here, the Federal Reserve under Ben Bernanke did act aggressively, radically bringing down the rate at which banks could borrow – from 2.5 per cent to effectively zero. A wide range of channels opened to pump liquidity into the economy and radically raise effective demand. Say Atif Mian and Amir Sufi:

'The Fed also expanded the definition of who could borrow and what classified as acceptable collateral. An entire alphabet soup of new programs was initiated. There was the $150 billion Term Auction Facility (TAF); $50 billion in swap lines for foreign central banks; the $200 billion Term Securities Lending Facility (TSLF); the $20 billion Primary Dealer Credit Facility (PDCF); the $700 billion Commercial Paper Funding Facility (CPFF); and the $1 trillion Term Asset-Backed Securities Loan Facility (TALF).'[65]

The biggest and longest-lasting Federal Reserve programme was the Large Scale Asset Purchase (LSAP) Program – informally known as 'quantitative easing'. This involved the Federal Reserve buying long-term assets from the banks, including agency debt, mortgage-backed securities, and long-term treasuries. This programme was massive, with the Federal Reserve's balance sheet leaping from $800 billion in 2007 to $3.3 trillion by 2013.[66] The idea was these purchases would enable the banks to make loans to companies and households who would then spend, add to aggregate demand, and jump-start the economy.

The slow pace of recovery and continuing high unemployment showed that this second-best Keynesian method for overcoming recession was disappointing in its results, though it did not trigger the inflation that the hardline neoliberals and neoliberal press (such as the Wall Street Journal) predicted. Again, there was a Keynesian explanation for this, and this time it was not the size of the programme. Drawing from his experience in Japan during the 1990s, Richard Koo explained this by saying that the response of indebted corporations and households would be to pay off their debts or 'deleverage' rather than contracting new debt.

'The private sector began paying down debt after the debt-financed asset bubble collapsed, leaving only debt in its wake. This was both responsible and correct behavior for individual businesses and households, but as a result of their actions the economy as a whole experienced what are known as fallacy-of-composition problems. A fallacy of composition refers to a situation in which behavior that is correct for individuals or companies has undesirable consequences when everyone engages in it.'[67]

This means that when corporations stop borrowing money (even at zero interest rates) because they are deleveraging, funds supplied to financial institutions by the central bank remain stuck within the financial system. The same disappointing results that met expansive monetary policy in Japan in the 1990s also greeted the dramatic expansion of the monetary base post-Lehman in the US. The key implication here, writes Koo, is that 'the effectiveness of monetary policy diminishes dramatically as the private sector switches from maximizing profit to minimizing debt'.[68]

In the US, the infusion of money by the Federal Reserve into the banks or 'bank reserves' rose from under one trillion dollars in 2009 to three trillion in 2013, while currency in circulation – reflecting money released by the banks through loans to corporations and households – rose only from 500 billion dollars to less than 1 trillion.

Far more effective in the Keynesian view is monetary stimulus that puts as much money – as directly as possible – into the hands of households that have a significant propensity to spend, meaning poor households. Atif Mian and Amir Sufi say, perhaps exaggeratedly, that:

‘A better approach would [have been] to allow central banks to directly inject cash into the economy, bypassing the banking system altogether. The most extreme image that comes to mind is the chairman of the Federal Reserve authorizing helicopter drops of cash. The idea of directly injecting cash into the economy may at first seem crazy, but reputable economists and commentators have suggested exactly such a policy during severe economic downturns. Ben Bernanke, only a few years before he was chairman of the Fed, suggested helicopter drops for Japanese central bankers in the 1990s, earning the nickname “Helicopter Ben”. *Financial Times* columnist Martin Wolf wrote in February 2013 that “the view that it is never right to respond to a financial crisis with monetary financing of a consciously expanded fiscal deficit – helicopter money, in brief – is wrong. It simply has to be in the tool kit. Willem Buiter used rigorous modeling to show that such helicopter drops would in fact help an economy trapped at the zero lower bound nominal interest rates. It would be best if the helicopters targeted indebted areas of the country to drop cash.’[69]

The banking reform that wasn’t

The most dismal failure of the Keynesian effort, however, occurred in the area of financial reform.

When the financial crisis broke, there was one thing on which there was a virtual national consensus, and this was urgent reform of the financial system so the crisis would not happen again. There were widespread expectations that with Barack Obama taking over as president in the depths of the crisis and the Democrats winning control of the House and Senate, banking reform was just around the corner. The new president captured the mood of the country when he warned Wall Street: ‘My administration is the only thing that stands between you and the pitchforks’.[70]

Reform of the US financial system was not just the concern of Keynesian and progressive economists. Many economists and policy-makers of a strong free market bent were, in fact, also supporters of tough penalties and robust rules for the big banks. What is amazing is that despite a common front uniting the vast majority of the public, economic policy-makers and economists, practically no real reforms have seen the light of day nearly nine years after the outbreak of the financial crisis.

The first reason is that – excluding outright fraudsters such as Bernie Madoff, whose criminal wrongdoing began way before the crisis – no Wall Street senior executives have been jailed for the myriad white-collar crimes involved in the mortgage-backed securities and derivatives business, including ‘well documented illegal acts, such as authorizing document forging, misleading investors, and obstructing justice’.[71] Failure to prosecute people at the top has contributed to a continuing lack of accountability among top executives, resulting in scandals such as the recent Wells Fargo fraud involving bank personnel creating false accounts in unwitting customers’ names.

Next, there’s the question of executive pay. Despite opprobrium visited on AIG officials for pocketing bailout money from the government in 2009, executive pay has remained relatively unrestrained. Caps on the pay of top executives of the banks that were bailed out while they were indebted to government was one of the reasons that they rushed to pay back the government. This way, they were able to take advantage of tax loopholes like the CEO bonus based on ‘performance’. This loophole, as many have noted, had been one of the reasons for the irresponsible executive behaviour that led to the crisis. With the loophole ban lifted, 'Between 2010 and 2015, the top executives at the 20 leading US banks pocketed nearly $800 million in stock-based "performance" pay–before the value of their company's stock had returned to pre-crisis levels. In other words, with shareholders who had held on to their stock still in the red, executives were reaping massive rewards that their banks could then deduct off their taxes.'[72]

Interestingly, the biggest beneficiary of the bonus was John Stumpf, CEO of Wells Fargo, who received tax-deductible bonus pay between 2012 and 2015 to the tune of $155 million.[73] As noted above, Wells Fargo is the focus of the most recent Wall Street scandal, which has resulted in Stumpf's resignation.

Nationalization of troubled banks such as Citi and Bank of America (BofA), which were propped up by over $800 billion from the government at the start of the financial crisis, was one of the measures in the toolkit of Keynesians like Paul Krugman and Joseph Stiglitz. As Krugman put it:

'To end their zombiehood, the banks need more capital. But they can't raise more capital from private investors. So the government has to supply the necessary funds … But here's the thing: the funds needed to bring these banks fully back to life would greatly exceed what they're currently worth. Citi and BofA have a combined market value of less than $30 billion, and even that value is mainly if not entirely based on the hope that stockholders will get a piece of a government handout. And if it's basically putting up all the money, the government should get ownership in return.'[74]

Again, economic rationality was not the reason the Obama administration took a different route to that chosen by other governments in Europe. It was ideology. The Obama administration, said White House spokesman Robert Gibbs, believes 'that a privately held banking system is the correct way to go'.[75] Bank nationalization, even temporary nationalization, was said to be 'anathema to large segments of the American public, not to mention to the banking lobby'.[76] In any event, what eventually resulted was the government charade of giving the banks 'stress tests' in order to declare them healthy – even if some of them were insolvent or bordered on insolvency – so they could raise the capital that would bring them back to good health. As Barry Eichengreen writes:

'A less happy interpretation is that the Good Housekeeping Seal of Approval conferred by the tests was tantamount to a colossal government guarantee. The nineteen biggest banks received special attention. Treasury asserted that they were solvent. Nine of them, starting with Goldman Sachs and JP Morgan Chase, required no additional capital. Citigroup, Bank of America, and eight of their less pristine competitors would be adequately capitalized if their raised only an additional $75 billion of capital, or so the government averred. If they then got into trouble, it stood to reason that this would be due to events not of their own making, and that the authorities, having attested to their soundness, would bail them out.'[77]

The total cost to taxpayers of bailing out the banks in 2008 and 2009 came to $2.2 trillion – $900 billion through the US Treasury and $1.3 trillion through the Federal Reserve. The paradoxical result is that the big banks have become even bigger and more profitable, and have continued to engage in many of the practices that led the financial crisis. Derivatives trading that violated federal law led to JP Morgan paying $920 million in fines in 2013, and the bank continues to be the object of wide-ranging criminal charges that it misrepresented the quality of the mortgages it was packaging into bonds and selling to investors. Wells Fargo, for its part, has admitted to creating millions of false accounts in unwitting clients' names. Meanwhile, CEOs of the two corporations, Jamie Dimon of JP Morgan and John Stumpf of Wells Fargo, received pay packages totaling $27 million and $19 million respectively in 2015.[78] Given these developments, it is hard to argue that nationalization was not the better option.

Keynesian economists and policy-makers also favoured having the financial institutions bear part of the cost of the subprime crisis, instead of laying them at the doors of bankrupt homeowners. This would have involved the government forcing banks to forgive the mortgages of indebted homeowners, and making the banks take the hit. The rationale for sharing the financial consequences of the housing crisis was that since both homeowners and creditors were responsible in driving the housing boom, it was only fair to have a 'more even distribution of losses between debtors and creditors ...'[79]

Such an arrangement would also make macroeconomic sense, because the lack of effective demand could be partly addressed by reducing the indebtedness of households in trouble. Indeed, top economists who met President Obama and Vice President Joe Biden said that Obama 'could have significantly accelerated the slow economic recovery if he had better addressed the overhang of debt mortgage debt left when housing prices collapsed'.[80]

The problem again was again ideological: that the banks had to be saved at all costs – and that having them bear part of the cost of the mess they created by forcing them to write down mortgages would have harmed their recovery. In the measured judgment of Atif Mian and Amir Sufi:

'When a financial crisis erupts, lawmakers and regulators must address problems in the banking system. They must work to prevent runs and preserve liquidity. But policy makers have gone further, behaving as if the preservation of the bank creditor and shareholder value is the only goal. The bank-lending view has become so powerful that efforts to help homeowners are immediately seen in an unfavorable light. This is unacceptable. The dramatic loss in wealth of indebted home owners is the key driver of severe recessions. Saving the banks won't save the economy. Instead, bolstering the economy by attacking the levered-losses problem directly would save the banks.'[81]

Ideological predisposition was very pronounced among economists, who ignored the fact that the banks were no longer in severe stress after the bailout of 2008 and 2009. 'The bank lending view,' according to Mian and Sufi, 'enjoys tremendous support among some in the economics profession, and they help lodge it in the public discourse of policies in severe recessions. The entire discourse becomes focused on the banking crisis, and potential solutions to the household-debt crisis are ignored.'[82] In fact, not only was the plight of households ignored; the administration deliberately sabotaged the passage of measures to assist them:

'[A] policy that implied large losses for the lenders would have undermined Treasury's strategy for rehabilitating the financial system, which was based on the banks' earning their way back to health. Secretary Geithner opposed any form of intervention that meant losses for the banks. The Senate was quietly told that that bankruptcy reform was not a priority of the Treasury, and legislation aimed at revising the [law] died a quick death.'[83]

Of course, ideological predilection was greased by money. Research by Mian and Sufi found that 'campaign contributions by financial firms led congressional representatives to be more likely to vote for bank bailout legislation … Some members of Congress desperate to get campaign funds have clearly been bought off by the financial industry'.[84]

Another badly needed reform was to have banks increase their equity relative to the debt, thus decreasing the leverage and their willingness to take risks that had contributed to the financial crisis. And when banks get distressed, the more equity they have makes them less susceptible to insolvency. Moreover, as Anat Admati and Martin Heilwig point out:

'If solvency risk is reduced, the likelihood of liquidity problems and runs is also reduced because depositors and other creditors are less nervous about their money. Moreover, beyond the bank's own ability to absorb losses without becoming distressed, the fraction of assets that a bank may have to sell after losses in order to recover its equity is smaller if it has more equity. Therefore, the contagion caused through asset sales and interconnectedness is weaker when banks have more equity. Increasing banks' ability to absorb losses through equity thus attacks fragility most effectively and in multiple ways.'[85]

When the financial crisis began in 2007, the equity of some major financial institutions was 2 to 3 per cent of their assets, and these thin safety margins had a critical role in bringing about the crisis. The Basel I and II Accords that government bank regulators put together to regulate capital did little to prevent the crisis. Basel III, which regulators agreed after the outbreak of the crisis, failed to address the basic problem that banks can easily 'game' the regulation, with the agreement still permitting banks' equity to be as low as 3 per cent of their total assets.[86] 'The weakness of Basel III,' note Anat Admati and Martin Hellwig, 'was the result of an intense lobbying campaign mounted by the bankers against any major change in regulation. This campaign has continued since. By now even the full implementation of Basel III is in doubt.'[87]

The most ambitious effort at financial reform was the so-called Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Authored by Senator Christopher Dodd and Representative Barney Frank, this piece of legislation came to 848 pages, which, as one authority has noted, '… easily surpasses the 32 pages of the Federal Reserve Act of 1913 and the 37 pages of the Glass-Steagall Act of 1933, the earlier major pieces of banking legislation'.[88]

Upon its being signed into law, President Obama said: 'The American people will never be asked again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts. Period.'[89] It is fair to say, however, that this monumental and exceedingly complex and detailed law gave birth to a mouse. On this, both the right and the left agreed.

One of the main objectives of the law was to eliminate moral hazard, especially that which came under the rubric of too-big-to-fail institutions. Yet, by declaring that every banking organization worth more than $50 billion was 'systemically important', assure the big banks that they were too big to fail was exactly what the legislation did. As Peter Wallison and Cornelius Hurley asserted, 'Prior to the financial crisis, the policy option of government intervening was called "constructive ambiguity". It provided creditors with just enough uncertainty to keep the biggest banks from being subsidized. But the financial crisis and the Dodd-Frank response have turned government intervention into a perceived entitlement.'[90]

Given their central role in triggering the financial crisis, there was a strong call for the banning or very strict control of derivatives. Dodd-Frank did nothing of the sort. Instead, it permitted investment banks 'to create innovative (toxic) derivative products (such as "CDO-cube" or synthetic CDs) that defy analysis by ratings agencies as well as by investors, with no required approval by the Securities and Exchange Commission or the new Consumer Financial Protection Bureau within the Federal Reserve as long as the products are sold only to professional investors.'[91] It left out regulation of cross-border derivatives trading, a process that has contributed to the crisis. Even the minimum demand of the reformers that derivatives trading must take place on electronic exchanges where they could be better monitored and put on public record did not make it.

Following the financial crisis, there were calls to bring back the separation of retail banking and investment banking as laid out in the Glass-Steagall Act, the abolition of which during the Clinton administration had led the banks to engage in risky trades in search of high profits. This was not taken up by Dodd-Frank. Instead, the final version of the legislation adopted what came to be known as the Volcker Rule, which, in its original formulation, would have banned banks from engaging in proprietary trading or using depositors' money to trade on the banks' own accounts; from owning or investing in a hedge fund or private equity fund; and set limits on the liabilities that the largest banks could hold. In fact, the Volcker Rule was watered down, so that rather than banning proprietary trading, banks could still invest up to 3 per cent of their equity in speculative trading. How the banks could twist the weak version of the Volcker Rule that became law was illustrated by the $6.2 billion lost by JP Morgan in speculative trading by an agent known as "London Whale" in 2012. The Bank initially claimed this was within the parameters of the Volcker Rule but the bank eventually admitted violating securities laws and agreed to pay fines of more than $1 billion.[92]

Why Keynesianism failed

Banking reform in the US was a case of the regulated capturing the regulators. In spite of their severe crisis of legitimacy, the financial elite was able to resist reform. Despite a national consensus for radical reform of banking, Keynesian reforms were stopped dead in their tracks.

Finance capital and its allies were able to wage skilled defensive warfare from their entrenched positions in the US economic and political power structure. This structural power had developed over the nearly 30 years of neoliberal hegemony, wherein the balance of power in government-business relations had shifted decisively in the direction of business.

The first thing the deployment of this 'structural power' by the banks achieved was to get the government to rescue them from the financial mess they themselves had created. The banks flatly refused Washington's pressure on them to mount a collective defense with their own resources. The banks simply told government that they were responsible only for their own balance sheets and not for dealing with any systemic threat. This is what Cornelia Woll so aptly called the 'power of inaction', or the power to influence developments by not acting.[93] Even when Lehman Brothers was about to go under in the fall of 2008, the banks did not budge. Revealing the banks' sense of their strong bargaining position vis-à-vis government, Merrill Lynch CEO John Thain remarked that in hindsight the only thing he regretted in the tense days of negotiations leading up to the collapse of Lehman Brothers was that the bankers did not 'grab [the government representatives] and shake them to say that they can't let this happen'.[94] It was up to government to come up with the resources to save the banks and save the system, not the banks themselves.

The banks calculated right. The Bush administration pressured Congress to approve the $787 billion Troubled Assets Program (TARP) and used this to recapitalize the banks, with the dividend for the government shares so low that Vikram Pandit, CEO of Citigroup, the most troubled Wall Street giant, exclaimed, 'This is really cheap capital.'[95] Accepting the banks' implicit position that 'they were too big to fail', Treasury and Federal Reserve funds that went to the banks through various conduits either as capital for recapitalization or as guarantees eventually came to $3 trillion.

Government action – and taxpayers' money – saved the day, but the banks also calculated right that, despite pressures from Keynesian economists like Paul Krugman and Joseph Stiglitz, nationalization was out of the question since it was 'not the American way'. So generous (or intimidated) was Washington that what should have been standard operating procedure – the firing of top management and the shake-up of the board of what were essentially insolvent institutions – was not even seriously considered.

To the power of inaction must, however, be added the power of action – the second element of the banks structural power. As shown in the various cases cited above – the debates over burden sharing between the banks and indebted homeowners, bank equity levels, Dodd-Frank – Wall Street deployed massive lobbying and cash to accompany it. Indicative of the bank's lobbying firepower was the $344 million the industry spent lobbying the US Congress in the first nine months of 2009, when legislators were taking up financial reform. Senator Chris Dodd, the chairman of the Senate Banking Committee, alone received $2.8 million in contributions from Wall Street in 2007-2008. The result of the lobbying offensive was summed up by Cornell University's Jonathan Kirshner:

'[The] Dodd-Frank regulatory reforms, and provisions such as the Volcker Rule, designed to restrict the types of risky investments that banks would be allowed to engage in, have ... been watered down (or at least waterboarded into submission) by a cascade of exceptions, exemptions, qualifications, and vague language ... And what few teeth remain are utterly dependent for application on the (very suspect) will of regulators.'[96]

The third element of the structural power of the banks was ideological – the sharing of its perspectives with key government personnel about the centrality of finance, about how the good health of the financial system was key to the good health of the whole economy, including the government. Some analysts called this the 'bank-lending' point of view. Others called it the Wall Street–Washington connection. Cornelia Woll characterizes this as 'productive power', the joint production of world views, meanings and interpretations that emerge from shared perspectives.[97] The perspective in question developed from the thorough discrediting of government interventionist approaches (not least through the stagflation of the 1970s and 1980s) and their yielding primacy to the supposed superior efficacy of private sector initiatives. It was a central part of the neoliberal revolution. Through education and close interaction, regulators and bankers had come to internalize the common dictum that finance, to do its work successfully, must be governed with a 'light touch'. By the late 1990s, according to Simon Johnson and James Kwak, this process had created a Washington elite worldview 'that what was good for Wall Street was good for America'.[98]

Neoliberalism may have gone on the defensive with the financial crisis, but it was not without influence within the Obama administration, especially in the years 2009 to 2012, when the administration was forging its strategy to deal with the fallout from the financial crisis. The new regime's core economic technocrats had a healthy respect for Wall Street, notably Treasury Secretary Tim Geithner and Council of Economic Advisors' head Larry Summers. Both had served as close associates of Robert Rubin, who had successive incarnations as co-chairman of Goldman Sachs, Bill Clinton's Treasury chief, and chairman and senior counsellor of Citigroup. More than anyone else, Rubin has, over the last two decades, symbolized the Wall Street–Washington connection that had dismantled the New Deal controls on finance capital and paved the way for the 2008 implosion. Over a period of nearly 20 years, Wall Street had consolidated its control over the US Treasury Department, and the appointment of individuals that had served in Goldman Sachs (the most aggressive investment bank on Wall Street) to high positions became the most visible display of the structural power of finance capital. Robert Rubin and George W. Bush's Secretary of the Treasury, Hank Paulson, were merely the tip of the Goldman Sachs iceberg at the centre of Washington politics.

Wall Street was afforded an opportunity to make an ideological counter-offensive when the financial crisis entered its second phase, which was dominated by Greece's sovereign debt crisis. During the debate on the fiscal stimulus, which would involve the government going into deficit spending and increasing the national debt, and even as they enjoyed tremendous monetary support from the Federal Reserve and the Treasury, the banks and their Republican allies in Congress were able to change the narrative from one of 'irresponsible banks' to one of 'the profligate state'. Greece was painted as the future of the US. In the words of one Wall Street economist:

'As federal and state debt mounts up, the US credit rating will continue to be downgraded, and investors will become reluctant to hold US bonds without receiving much higher interest rates. As in Greece, high interest rates on government debt will drive federal and state governments into insolvency, or the Federal Reserve will have to print money to buy government bonds and hyperinflation will result. Calamity would result, either way.[99]

Wall Street's hijacking of the crisis discourse and shifting the blame for the continuing slowdown on government convinced some sectors of the population that it was the Obama administration's pallid Keynesian policies that were responsible for the continuing stagnation, and this contributed to putting it on the defensive and going slow on bank reform. Cornelia Woll's conclusion is that: 'For the administration and Congress, the main lesson from the financial crisis in 2008 and 2009 was that they had only very limited means to pressure the financial industry into behavior that appeared urgently necessary for the survival of the entire sector and the economy as a whole.'[100]

The structural power of Wall Street certainly contributed to making Obama less aggressive in pushing banking reform and taking state action that would decisively end the recession. But Woll's analysis is too deterministic an explanation for failure. The presidency is a very powerful position, and from 2009 to 2011, the Democrats also controlled the House and the Senate, which put them in a position of pushing decisive measures for recovery. Moreover, no other office can compare in terms of mobilizing the citizenry in support of reform. In other words, if power could be productive on the side of Wall Street, it could also be productive on the side of the administration. Here, the contrast between Obama and Franklin Delano Roosevelt is stark.

Whereas Roosevelt used the presidency as a bully pulpit to rally the population, setting in motion the massive organizing drive of labour that became a key pillar of the New Deal, Obama adopted a technocratic approach that demobilized the base that had carried him to the White House and instead kowtowed to the Wall Street-biased prescriptions of the conservative wing of his economic team. This pallid, pragmatic Keynesianism was precisely what people were not looking for in period of deep uncertainty and crisis.

Building a mass base for reform would, of course, have necessitated an inspiring comprehensive alternative vision to the discredited neoliberal one. Perhaps it was precisely articulating such an agenda that Obama, with his pragmatic instincts, feared, for it could run out of his control. But such are the risks that must be taken by serious reformers. The opportunity that presented itself and the way it was wasted is well described by Barry Eichengreen:

'An administration and a president convinced of the merits of a larger stimulus would have campaigned for it. Obama could have invested the political capital he possessed as a result of his recent electoral victory. He could have appealed to GOP senators from swing states like Maine and Pennsylvania. Going over the heads of Congress, he could have appealed to the public. But Obama's instinct was to weight the options, not to campaign for his program. It was to compromise, not confront.'[101]

The derailment of progressive Keynesianism by Obama's conservative, technocratic Keynesianism resulted in a protracted recovery, continuing high unemployment, millions of foreclosed or bankrupt households fending for themselves, and more scandals in a Wall Street where nothing had changed. Obama did not pay for this tragic outcome in 2012, but Hillary Clinton did in 2016.

The political consequences of economic failure

If one certainty emerged in the 2016 elections it was that Hilary Clinton's unexpected defeat stemmed from her loss of four 'Rust Belt' states: Wisconsin, Michigan and Pennsylvania (which had previously been Democratic strongholds), and Ohio, a swing state that had twice supported Barack Obama.

The 64 Electoral College votes of those states, most of which hadn't even been considered battlegrounds, put Donald Trump over the line. Trump's numbers, it is now clear, were produced by a combination of an enthusiastic turnout of the Republican base; his picking up significant numbers of traditionally Democratic voters; and large numbers of Democrats staying home.

But this wasn't a defeat by default. On the economic issues that motivate many of these voters, Trump had a message: the economic recovery was a mirage, people were hurt by the Democrats' policies, and they had more pain to look forward to should the Democrats retain control of the White House.

The problem for Clinton was that the opportunistic message of this demagogue rang true to the middle class and working class voters in these states, even if the messenger himself was quite flawed. These four states reflected, on the ground, the worst consequences of the interlocking problems of high unemployment and deindustrialization that had stalked the whole country for over two decades as a result of the flight of industrial corporations to Asia and elsewhere. Combined with the financial collapse of 2007-2008 and the widespread foreclosure of the homes of millions of middle class and poor people who had been enticed by the banks to go into massive debt, the region was becoming a powder keg of resentment.

True, these working class voters going over to Trump or boycotting the polls were mainly white. But then these were the same people that placed their faith in Obama in 2008, when they favored him by large margin over Republican John McCain. And they stuck with him in 2012, though his margins of victory were for the most part narrower. By 2016, however, they'd had enough, and they would no longer buy the Democrats' blaming George W. Bush for the continuing stagnation of the economy. Clinton bore the brunt of their backlash, since she made the strategic mistake of running on Obama's legacy–which, to the voters, was one of failing to deliver the economic relief and return to prosperity that he had promised eight years earlier, when he took over (from Bush) a country falling into a deep recession.

Failed policies have massive political consequences.[102]

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This paper focuses on the dynamics of the United States' economy during the current global economic crisis, and is the first part of a broader study on global finance, conducted under the auspices of the Transnational Institute (TNI) and the Center for Southeast Asian Studies (CSEAS), Kyoto University. Three forthcoming parts of the study are provisionally entitled: *Europe's Financial Crisis: a crisis of European integration*; *China: its role in the global financial crisis;* and *Finance in a Post-Capitalist World: the struggle for an alternative global financial architecture*.

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