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Keynes's Stimulus, Polanyi's Moment

The foundations of Keynes and the principles of Polanyi offer insight into crafting a new American economy

January 2009 marked not only the inauguration of a new President of the United States, but also a virtual coronation of John Maynard Keynes as the king of modern economics. For decades, the economics profession attacked Keynesianism, first for lacking a theory of inflation and then for an insufficient appreciation of individual rationality in decisions made by investors and employers. But in the past year Keynesianism has served as the inspiration for the ideas of today's most celebrated economists. From Martin Feldstein to Joseph Stiglitz, from Glen Hubbard to Paul Krugman, all major economists supported the adoption of a massive Keynesian stimulus to reverse our economic decline. Most of them support a second round of fiscal stimulus.

Keynes taught us that a fully decentralized, free market economy does not naturally gravitate to full employment. This radical conclusion comes not from the assumption of rigid labor markets, a high minimum wage, excessive union bargaining power, or the presence of distortionary taxes. It is the result of inadequate aggregate demand. Keynes detailed (and Hyman Minsky, 1986, elaborated) how endogenous and speculative financial market bubbles can bust with disastrous consequence for investment, employment, and output. And Keynes understood (as emphasized by followers like Paul Davidson, 1996) why the efficient market hypothesis so central to today's macro and financial models is of limited relevance given the non-ergodic nature (that is, unpredictable in statistical or stochastic terms) of many economic processes.[1]

Keynesianism is, thus, a useful and tested backdrop for policy making today, and Keynes himself, were he alive today, might not have been surprised at the resurgence of his ideas in policy circles. "Practical men who believe themselves to be quite exempt from any intellectual influences," Keynes wrote in the last paragraphs of his 1936 book, The General Theory of Employment, Interest, and Money, "are usually the slaves of some defunct economist."

Keynes is, by any account, more than just "some defunct economist," but the current economic challenges require a creativity of economic theory and policy making that extends beyond Keynes. Free markets have led to unprecedented and unacceptable inequality of income and wealth, imbalances in international payments, and a misallocation of resources that overemphasizes financial speculation and underemphasizes entrepreneurship, innovation and economic security. Today we face the challenge of creating a society that provides a more productive and sustainable use of resources at the same time that it should generate a greater degree of economic security for its citizens. In short, America is searching for a new social contract.

New and creative thinking will be required to build true economic security—starting with universal access to good quality education, health care, and adequate and secure retirement income—while encouraging private innovation and job creation; to re-regulate the financial markets with the aim of channeling financial institutions to do what they are designed to do in capitalism: allocate resources efficiently by providing credit for production, innovation and long-term growth; and to redesign the architecture for the management of international finance so it promotes economic growth and stability globally. What may be required is a new way of thinking, in short, a new theory of political economy.

If Keynesianism is not enough, what will constitute the next great paradigm of political economy? To begin to understand the challenges, economists and policy makers might be well advised to take advice from another mid-20th century thinker, Karl Polanyi. Polanyi's 1942 book The Great Transformation: The Political and Economic Origins of Our Time shows that industrial capitalism has exhibited a series of swings in economic and social policy from free market fundamentalism to a more regulated system in response to the excesses and detrimental social consequences of the free market phase. This "double movement" captures what capitalism today is undergoing, and, amidst the frenzy of bailouts, stimulus plans, TARPs and TALFs emerging these days, Polanyi's warnings about the nature of this "countermovement" are useful to revisit and consider as the basis for an alternative theory of political economy to replace the failed market fundamentalism espoused by economists for decades.[3]

Polanyi describes how industrial capitalism has consistently fluctuated between free-market fundamentalism and considerable government intervention. When free markets create social conditions that threaten social cohesion—massive unemployment or dangerous working conditions, for example—governments respond with a "countermovement" like the one we're witnessing today: they expand regulation of markets, strengthen social protections like anti-poverty programs and work safety regulations, and bail out failing businesses and households. Whether it was wage subsidies to avert mass poverty in England at the end of the 18th century, or the late 19th century British laws on coal mine safety and the expansion of public access to vaccinations, or 20th century America's invention of Social Security, legislators supported government intervention because the effect of free markets was unacceptable and threatened social cohesion.

In this context, Keynesianism is the easy part. Economists can faithfully rely on Keynes's 1936 text for scientific foundations and politicians can readily support more spending for unemployment and health insurance, and for the construction of roads, schools, solar panels and wireless internet access. The harder part involves the Polanyian pendulum swing we find ourselves in, since it signals the need for a new social contract and a new way of thinking about the economy. Polanyi's insights give a sense of how complex and contested this countermovement is and how much creativity and diligence its success will require. Here's a very brief synopsis:

1. Markets work best when embedded in a legitimate institutional context. Polanyi insisted that markets function because they are embedded in social and political institutions which create trust and provide norms and limits. Institutions, in Polanyi's view, extend well beyond questions of property rights and legal contracts that are the main focus of institutional economics today. Market-based freedoms (consumer choice and business investment) must be balanced with attention to other freedoms, including the provision of

such basic needs as adequate food, housing, healthcare, education, and income security. Our inability to adequately address many of these social freedoms could be said to have contributed to the current economic collapse: A study by my colleagues at the Schwartz Center for Economic Policy Analysis found that the U.S. current account deficit, sometimes attributed to Americans' consumer spending binge, was best tracked by increases in healthcare spending by Americans (Barbosa et al. 2005). To ignore these social freedoms is to reduce the likely success of market-based reforms.

2. Ad hoc solutions are often unsustainable. While the move to laissez-faire often occurs as a result of careful deregulation and political change (for example the adoption of the gold standard in 1870 or the deregulation of industry and decline of unions in the U.S. in the 1970s and 1980s), the re-regulation of capitalism often occurs under emergency conditions and in an ad hoc manner. The passage of the $700 billion TARP without clear guidelines or sufficient oversight is a perfect example of the chaotic nature of the countermove. Polanyi argues for a solution that is sustainable in order to avoid a drastic reverse counter swing of the social pendulum. Providing universal health insurance coverage that also lowers costs to business would be an example of a sustainable response to today's crisis.

3. The social contract requires democracy, accountability and justice. Despite the inaccurate but oft-trumpeted description of Obama as a socialist, today we simply don't face the deadlock between the economic and political realms that confronted many countries in the 1930s, when Polanyi eschewed the "idealist" extremes of both communism and fascism for a pragmatic approach. Polanyi insisted that democracy, accountability and justice are crucial for government legitimacy in the eyes of its citizens. Bailouts and stimulus plans must be transparent and regulations enforced. Our voting system must instill confidence. Executive compensation schemes must be more fair, especially when supported by taxpayers. International economic institutions too must be even-handed and democratic, not promoting austere monetarism for poor countries in crisis and expansionary Keynesianism in the rich ones, for example.[3]

4. Economics combines science, politics and ethics. Economists too can learn from Polanyi that models of the optimality of free markets often ignore broader social consequences of market forces. There are a series of much-heralded, new developments in economic thought today: experimental economics, behavioral economics, complexity theory and agent-based modeling, to name a few. These are all impressive technical developments. But there is very little of substance about the economy in any of these, much less a coherent vision about social relations, and in particular the connections among states, markets, firms and households—that is, about capitalism. Capitalism is a word that had until the last few months disappeared from the lexicon of economics—it is not mentioned in Gregory Mankiw's bestselling, 500-page economics principles textbook.[4] The previously unmentionable word has now resurfaced in legitimate academic and policy circles, an indication precisely of the broad questioning and rethinking currently underway.[5]

The recent return to Keynesianism is perhaps just a step on the path to a new theory of political economy that will be more rooted in institutional detail and more modest in its predictions. Economists have already begun a debate over the failure of existing economic models and the likelihood of a new paradigm.[6] Most indications are that change will be resisted. But without a new Keynes in the wings, it is hard to know exactly how the countermove will manifest itself in economic thought.

The Obama administration has shown a strong allegiance to Keynesianism as a means of creating a real "21st century economy." But the Polanyian challenge demands unparalleled imagination and accountability as we move towards a legitimate renegotiation of the social contract. Policy must aim to reverse decades-long trends of rising economic insecurity and income inequality, of speculative bubbles and their inevitable collapse, and of growing rewards for unprofitable and unethical corporate behavior. And all this must be accomplished while we encourage business to be the driver of innovation, investment and economic growth. Only by meeting this grander challenge are we likely to approach Polanyi's pragmatic goal of "freedom in a complex society." H

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Endnotes

1. *See Buiter (2009) for a similar critique of the most recent macro and financial models. Krugman (2009) also expresses doubts about the usefulness of theoretical developments in macroeconomics since Keynes and Hicks in the 1930s.*
2. *See Kozul-Wright and Rayment (2007).*
3. *Chang (2007).*
4. *This omission was noted by Heilbroner (1999) in a prescient essay entitled "The End of The Worldly Philosophy?"*
5. *See, for example, Posner (2009), Barbera (2009) and Akerloff and Shiller (2009).*
6. *See, for example, Kobayashi (2009) and recent articles in The Financial Times by De Grauwe (2009) and Skidelsky (2009).*

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