Robin Hahnel's *ABCs of Political Economy: A Modern Approach* (2002) is a good overview of radical, i.e., commonsensical, political economy. Its information and arguments are very useful for an economics idiot like me.

What Hahnel calls the macro law of supply and demand, postulated by Keynes, is that aggregate supply will follow aggregate demand if it can (if, that is, the economy isn't already producing at full capacity, in which case high demand will lead to inflation rather than an increase in production). This law explains the possibility of "downward spirals," or not-self-correcting recessions. "Keynes pointed out that weak demand for goods and services leading to downward pressure on wages and layoffs was likely to further weaken aggregate demand by reducing the buying power of the majority of consumers. He pointed out that this would in turn lead to more downward pressure on wages and more layoffs, which would reduce the demand for goods even further." Downward spiral.

The reason that few economists before Keynes acknowledged the possibility of such a downward spiral is that they had been seduced by Say's Law, which is basically the reverse of Keynes's macro law of supply and demand. It says that in the aggregate, supply creates its own demand. "Say's Law implies that there can never be insufficient demand for goods in general, and governments therefore need not concern themselves with recessions, which should cure themselves." As David Ricardo expressed it, the rationale behind Say's Law is that every dollar of goods produced generates a dollar of income or purchasing power, either through wages or profits. And while it's true that people don't spend all their income on consumption but instead save some of it, which means that consumption demand falls short of the value of goods produced, the money they save goes into banks that then lend it to businesses—*all* of it, at the equilibrium rate of interest—because if they don't lend, they can't make profits. And businesses in turn use the money to invest. So the shortfall in consumption demand is made up for by investment demand, and as a whole, aggregate demand equals aggregate supply.

The flaw in this reasoning, which Keynes pointed out, is that, "while it is true that every dollar's worth of production generates exactly a dollar's worth of income or potential purchasing power, it is not necessarily true that a dollar's worth of income always generates a dollar's worth of demand for goods and services." Aggregate demand can be greater than income if, for example, actors use *previous* savings to spend more than their current income, or if they borrow against future income. Or aggregate demand can be *less* than income because the fact that at the equilibrium rate of interest the supply of loans is equal to the demand for loans does not mean that business demand for investment goods has to be equal to household savings. After all, businesses do not use all the loans

they receive to buy investment goods (capital goods). Sometimes they buy government bonds or shares of stock in other businesses, which does not add a single dollar to demand.

"A given value of production *does* generate an equal value of income. But *when* that income gets used to demand goods and services can make a great deal of difference. If less income is used to demand goods and services in a year than were produced in that year, aggregate demand will fall short of aggregate supply and production will fall, as the macro law of supply and demand teaches. If the sum total of household, business, and government demand is greater than production during a year, production will rise (if it can), as Keynes's macro law teaches."

Hahnel's remarks on inflation and unemployment are illuminating. Cyclical unemployment results when "low aggregate demand for goods leads employers to provide fewer jobs than the number of people willing and able to work," while structural unemployment occurs when "the skills and training of people in the labor force do not match the requirements of the jobs available." Structural unemployment can be caused by changes in the international division of labor, rapid technical changes in methods of production, or educational systems that are slow to adapt to new economic conditions. If structural unemployment is the problem, policies that increase aggregate demand won't help much but instead will cause inflation, as in the 1970s. What are necessary are programs to retrain and relocate the workforce.

There are different kinds of inflation too. Demand-pull inflation tends to occur when the economy is reaching its full potential of output but demand is still increasing. So prices rise (because output can't). Cost-push inflation is when, say, employers raise prices because employees have negotiated a wage increase. So the rise in prices compensates for the wage increase.

"It is important to note that structural unemployment can exist in the presence of adequate aggregate demand for goods and services, and cost-push inflation can exist even when aggregate demand does not exceed aggregate supply." In other words, stagflation can happen. "Our Keynesian macro model does *not* help us understand how stagflation is possible." The point is that "demand-pull inflation can coexist with rising structural unemployment, and cyclical unemployment can coexist with increasing cost-push inflation. Often conflicts over distribution, changes in the international division of labor, and rapid technological changes generate significant amounts of structural unemployment and cost-push inflation to go along with the cyclical unemployment and demand-pull inflation the simple Keynesian macro model explains."

As for inflation, Hahnel debunks some myths. It is *not* bad for everyone. It means that prices are rising *on average*, at different speeds. “If the prices of the things you buy are rising faster than the prices of the things you sell”—and everyone sells something, be it labor-power or goods or whatever—“you will be ‘hurt’ by inflation. That is, your real buying power, or real income, will fall. But if the prices of the things you sell are rising faster than the prices of the things you buy, your real income will increase. So for the most part, what inflation does is rob Peters to pay Pauls. That is, inflation redistributes real income. …Inflationary redistribution is essentially determined by changes in relative bargaining power between actors in the economy.” So if corporations and the wealthy are becoming more powerful—as they have been for the last forty years—inflation will make the distribution of income more inequitable, because prices will rise faster than wages.

Sometimes inflation can be so extreme or unpredictable that it makes businesses invest less and people work less, in which case it reduces output. But that’s rare. “Most of us should think long and hard before joining corporations and the wealthy who put fighting inflation at the top of their list of problems they want the government to prioritize. The wealthy rationally fear that inflation can reduce the value of their assets. And employers have an interest in prioritizing the fight against inflation over the fight against unemployment because periodic bouts of unemployment reduce labor’s bargaining power.” It seems to me that, while inflation in the early twenty-first century isn’t good for workers—because the weakness of organized labor means that prices rise faster than wages—it could be the lesser evil if it results from large government initiatives to put more people to work, i.e., to reduce unemployment. But this point is moot, since in the neoliberal age the government, being controlled by the corporate sector, isn’t going to prioritize the fight against unemployment. Realistically, inflation nowadays is bad both for wealthy owners of assets and poorer workers.

Hahnel makes the Keynesian argument that “wage-led growth” is possible, that higher wage rates don’t have to lead to lower long-run economic growth by means of lower capital accumulation (because of a wage squeeze on profits). The reason is that higher wages mean higher aggregate demand, which stimulates greater capacity utilization. “Depressing wages and thereby consumption does leave more output available for capital accumulation, but by lowering the demand for goods and services it also decreases capacity utilization.” It could lower the rate of growth of actual GDP even while increasing the rate of growth of potential GDP.

Such ideas, put forward by Michael Kalecki and Josef Steindl long ago, provide a plausible explanation of the lower rates of economic growth in advanced economies over the past forty years. "As corporations have increased their power vis-à-vis both their employees and their customers, they have been able to drive real wages down over the past thirty years. This has prevented aggregate demand from increasing as fast as potential production and led to falling rates of capacity utilization and lower rates of economic growth." Think of the fact that Scandinavian economies had higher rates of growth than most other advanced economies for fifty years despite higher tax rates and lower rates of technological innovation. "Could it be that strong unions, high real wages, and high taxes to finance high levels of public spending are not detrimental to long-run growth at all, but quite the opposite?" At least under certain conditions, "quite the opposite" is clearly true.

Hahnel challenges the conventional wisdom regarding international trade, too. Sure, it *can* be efficient because of comparative advantage, but it can also be very inefficient. Adjustment costs, for example, can be significant—moving people and resources out of one industry and into another—and the social costs (environmental, etc.) of a country's specialization in some good are not reflected in prices, even though these costs can be considerable. They might be such that the country *shouldn't* specialize in that good, i.e., that its comparative advantage has been misidentified because of the biases and inefficiencies of the market. He also notes that "the theory of comparative advantage is usually interpreted as implying that a country should specialize even more in its traditional export products, since those would presumably be the industries in which the country enjoys a comparative advantage. But underdeveloped economies are less developed precisely because they have lower levels of productivity than other economies enjoy. If less developed economies further specialize in the sectors they have always specialized in, it may well be *less* likely that they will find ways to increase their productivity." Japan and South Korea, for instance, were smart enough not to accept their old comparative advantages but instead to *create* new ones in industries where it would be easier to achieve large productivity increases. Industries like cars and steel and then, later, electronics and computers. Productivity increases were easier in these industries than in Japan's old comparative advantage of textile production.

International trade also tends to increase global inequality. The terms of trade between countries are usually such that countries that were better off in the first place get most of whatever efficiency gains there are in trade. The main reason for this is that productive capital is more scarce globally than labor, so that relatively poor, labor-rich ("Southern") countries have to compete among themselves for the scarce machines of the capital-rich ("Northern") countries.

This gives the latter power to dictate the terms of trade, which therefore end up being disadvantageous to labor-rich countries. Also, if capital-intensive industries are characterized by a faster pace of innovation than labor-intensive industries, the terms of trade will deteriorate for Southern countries. Third, if markets are not all equally competitive but instead Northern exporters have more market power than Southern exporters—as they usually do—the terms of trade will be even worse for the latter than in competitive markets.

Trade also increases inequality *within* countries. Mainstream trade theory itself explains why, at least with regard to rich Northern countries. "According to Heckscher-Ohlin theory, countries will have a comparative advantage in goods that use inputs, or factors of production, in which the country is relatively abundant. But this means trade increases the demand for relatively abundant factors of production and decreases the demand for factors that are relatively scarce within countries. In advanced economies where the capital-labor ratio is higher than elsewhere, and therefore capital is 'relatively abundant,' Heckscher-Ohlin theory predicts that increased trade will increase the demand for capital, increasing its return, and decrease the demand for labor, depressing wages. Of course this is exactly what has occurred in the U.S., making the AFL-CIO a consistent critic of trade liberalization. In advanced economies where the ratio of skilled to unskilled labor is higher than elsewhere, Heckscher-Ohlin theory also predicts that increased trade will increase the demand for skilled labor and decrease the demand for unskilled labor and thereby increase wage differentials."

However, Heckscher-Ohlin theory can't explain rising inequality in less developed economies. In fact, it predicts the opposite: unskilled labor should get higher returns from trade because that is what those countries are relatively abundant in. The problem is that H-O theory, like all theories, is *ceteris paribus*, ignoring dynamics that in this case overpower the theory. Specifically, decades ago large amounts of land in the Third World had a sufficiently low value that billions of peasants could live on them without trouble from local economic and political elites who *now* want to use the land for valuable export crops. So peasant squatters are no longer tolerated. The "Green Revolution" of the 1960s—which made much of the rural labor force redundant in Third-World agriculture—globalization, and export-oriented agriculture have increased the value of Third-World land, so billions of peasants have been driven out of rural areas into mega-cities where they seek new labor-intensive manufacturing jobs produced by trade liberalization and international investment. But there are far fewer jobs than ex-peasants who need them, so wage rates are low, not high.

International investment, like trade, can either increase or decrease global efficiency and inequality. But it usually comes with the bad, not the good. Direct

foreign investment can be very profitable for investors, but, contrary to what mainstream economists think, that isn't necessarily because the plant and machinery are more productive in developing countries than they would have been at home. It could be, in fact usually is, because the bargaining power of Third-World workers is even less than that of their First-World counterparts. Or because governments in the developing world are so desperate to woo foreign investors that they offer large tax breaks and lower environmental standards. Similarly, international *financial* investment can lead to huge efficiency losses, for example when investors panic and sell off their currency holdings, stocks, and bonds in an "emerging market economy," which can erase all the gains that had been made over many years. The 1997 Asian financial crisis is a good example.

International investment also usually increases global inequality. "Global efficiency rises when international loans from northern economies raise productivity more in southern economies than they would have raised productivity domestically. But when capital is scarce globally, competition among southern borrowers drives interest rates on international loans up to the point where lenders capture the greater part of the efficiency gain… So even when international financial markets work smoothly and efficiently, they usually increase income inequality between countries." But when they don't work smoothly and efficiently, it's even worse. For instance, international financial crises give foreign investors the opportunity to buy up businesses at very cheap prices. Hahnel explains the "great global asset swindle" as follows: "International investors lose confidence in a third-world economy, dumping its currency, bonds, and stocks. At the insistence of the IMF, the central bank in the third-world country tightens the money supply to boost domestic interest rates to prevent further capital outflows in an unsuccessful attempt to protect the currency [i.e., to prevent it from depreciating more]. Even healthy domestic companies [as a result] can no longer obtain or afford loans, so they join the ranks of bankrupted domestic businesses available for purchase. As a precondition for receiving the IMF bailout, the government abolishes any remaining restrictions on foreign ownership of corporations, banks, and land. With a depreciated local currency and a long list of bankrupt local businesses, the economy is ready for the acquisition experts from Western multinational corporations and banks who come to the fire sale with a thick wad of almighty dollars in their pockets."

As for *efficiency*, empirical data prove that neoliberal policies have not accelerated world economic growth. Growth rates were much higher in the Bretton Woods era than they have been in the neoliberal era.

Stuff about the IMF:

> In exchange for a "bailout loan" that allows the country to pay off international loans coming due that it would otherwise have to default on, IMF "conditionality agreements" typically demand that the recipient government reduce spending and increase taxes, and the central bank reduce the money supply—in addition to demanding removal of restrictions on international trade and investment and foreign ownership. Since the economy is invariably already in recession, fiscal and monetary "austerity" further aggravate the recession. Reducing government spending and increasing taxes both decrease aggregate demand, and therefore decrease employment and production. Reducing the money supply raises interest rates, which reduces investment demand and further decreases aggregate demand, employment, and production…
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> …The IMF policies are designed to increase the probability that the country will be able to repay its international creditors, and make perfect sense once one realizes this is their goal. If the government is in danger of defaulting on its "sovereign" international debt, forcing it to turn budget deficits into surpluses provides funds for repaying its international creditors. If the private sector is in danger of default, anything that reduces imports and increases exports or increases the inflow of new international investment will provide foreign exchange needed for debt repayment. Deflationary fiscal and monetary policy reduces aggregate demand and therefore inflation, which tends to increase exports and decrease imports. By reducing aggregate demand, deflationary fiscal and monetary policy also reduces output and therefore income, which further reduces imports. Tight monetary policy raises domestic rates, which reduces the outflow of domestic financial investment and increases the inflow of new foreign financial investment, providing more foreign exchange to pay off the international creditors whose loans are coming due. Finally, since all in the country who owe foreign creditors receive their income in local currency, anything that keeps the local currency from depreciating will allow debtors to buy more dollars with their local currency, which is what they need to pay their international creditors. IMF austerity programs are well designed to turn stricken economies into more effective debt repayment machines as quickly as possible.

Incidentally, Joseph Stiglitz's bestselling *Globalization and Its Discontents* (2002) bears out Hahnel's analysis in its condemnation of the IMF, the World Bank, and the World Trade Organization. The evolution of the former two, for example, has been quite ironic. Formed after the Great Depression and World War II, they were originally Keynesian institutions fully cognizant of market failures. The

IMF's mission was to prevent another global depression, in part by lending to countries facing an economic downturn so that their level of aggregate demand could be maintained and a depression averted. The World Bank (or International Bank for Reconstruction and Development) for decades took seriously its mission of alleviating poverty by limiting itself to giving loans for projects like building roads and dams. In the late 1970s things changed. "Founded on the belief," Stiglitz says, "that there is a need for international pressure on countries to have more expansionary economic policies—such as increasing expenditures, reducing taxes, or lowering interest rates to stimulate the economy—today the IMF typically provides loans only if countries engage in policies, like *cutting* deficits, *raising* taxes, or *raising* interest rates, that lead to a *contraction* of the economy." Ironic, eh? As the global political economy has changed, so have the functions of these institutions. The World Bank has become more intertwined with the IMF than before, now giving "structural adjustment loans" to countries that accept IMF-imposed conditions. And after the fall of Communism, both institutions, though especially the IMF, guided the transition to capitalism. Badly.[1] The point is that, far from facilitating global stability, they have evolved so as to create and exacerbate instability. Because that serves the interests of the institutions whose servants they are. (It used to be that these latter institutions, particularly the financial sector, had an interest in stability; in the 1970s and 1980s, as you know, that changed, when certain regulations were dismantled and instability became wildly profitable for speculators.)

To return to Hahnel's book. International economic considerations can help explain political behavior that might otherwise seem paradoxical or stupid. Hahnel gives the example of Jimmy Carter reneging on his campaign promise to prioritize the fight against unemployment over the fight against inflation. His betrayal of this promise was partly responsible for his loss to Ronald Reagan. So why did he do it? In part because of reasons having to do with the balance of payments. In 1977 the U.S.'s trade account deficit was increasing, which put downward pressure on the value of the dollar. "What made this particularly worrisome was that Saudi Arabia was Washington's ally inside OPEC and had prevented the OPEC oil price increases [of the 1970s] from being even greater by increasing its own production and sales. Since the oil price increases were widely believed to be responsible for a substantial part of the stagflation—rising unemployment *and* rising inflation—that rocked the European and U.S. economies in the 1970s, Carter deemed it critical to persuade the Saudis not to abandon their opposition to the majority of their Arab brethren in OPEC who wanted to cut world supplies and boost oil prices even further. But the Saudis

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[1] See Naomi Klein's *The Shock Doctrine* (2007).

were asking why they should continue to trade oil for dollars if the value of the dollar was going to continue to fall—as it surely would if U.S. trade deficits continued to rise." If the dollar was going to fall further, it was better for the Saudis just to leave more oil in the ground where it could only increase in value. Now, if Carter had tried to aggressively combat unemployment this would have increased production and income but also imports, and thereby increased the trade deficit even more. So he adopted deflationary fiscal policies, which caused the trade deficit to disappear in the recession of 1980. Thus he defended the value of the dollar in order to prevent oil prices from rising even more. (The poor guy was caught in a double bind. Had he adopted expansionary policies, the Saudis would have let oil prices rise, which would have exacerbated inflation and maybe unemployment too, since high oil prices were probably partly responsible for high unemployment. So he adopted deflationary policies, which led to higher unemployment. There was no way out for him, it seems.)

Carter also "betrayed" progressives by reappointing Paul Volcker as chairman of the Fed, which he did in part to show the Saudis he was serious about shoring up the dollar. "The only way to [raise the dollar's value] quickly was to raise U.S. interest rates significantly above world levels to induce a massive inflow of finance capital on the short-run capital account to counter the trade deficit until it could be reduced."

In the penultimate chapter Hahnel demolishes Milton Friedman's apologetics for capitalism. He points out, for example, that the market isn't "free, voluntary, and non-coercive" if people come to it with different amounts of capital. In a sense, yes, employees have freely chosen to work for someone else. But they've been coerced into having to make that unpleasant decision by their relative lack of capital. It's either rent yourself out or starve.