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Macroeconomic Foundations for Comparative PoliticalEconomy

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Abstract

The global financial crisis and ensuing weak growth have increased interest in macroeconomic issues within comparative political economy (CPE). CPE, particularly the dominant Varieties of Capitalism approach, has based its analyses on mainstream economics, which limits analysis of the relation between distribution and growth and neglects the role finance plays in modern economies. It overstates the stability of the capitalist growth process and understates the potential effectiveness of government interventions. Baccaro and Pontusson have suggested a post-Keynesian (PK) theory of distribution and growth as an alternative. This article generalizes their point. PK theory highlights the instability of the growth process and lends itself to an analysis of income distribution and power relations. The article identifies the analysis of financialization and financial cycles, the understanding of neoliberal growth models, and the political economy of central banks as areas where PK economics provides specific insights for CPE. It also highlights that these arguments have important implications for government policy in an era of secular stagnation with ongoing social, distributional, and economic crises.

Keywords - post-Keynesian economics, comparative political economy, growth models,financial instability

Introduction

Political economy approaches assert that economic, social, and political factors have to be analyzed in conjunction. Comparative political economy (CPE) is the field that studies differences in institutions, policies, and economic outcomes across countries. It seeks to determine why some countries have higher incomes or economic growth than others, why there are different degrees of inequality, and how these relate to dif- ferences in the institutions structuring industrial relations, financial systems, and wel- fare regimes. CPE therefore needs a theory of institutions and politics as well as a theory of how the economy works. One key question that divides economic theories iswhether growth should be understood as driven mostly by (slowly changing) supply- side factors, such as the skills of the workforce and the speed of technological prog- ress, or by the (more volatile) demand side, that is, spending decisions of firms, households, and governments. The answer to this question has far-reaching implica- tions for economic analysis and, more important, shapes the interpretation of eco- nomic crises. Are they due to exogenous, unforeseeable shocks that bring about temporary deviations from an otherwise stable growth path (as implied by most sup- ply-side theories)? Or are they the endogenous outcome of systemic forces that lead toboom-bust cycles, as non-mainstream versions of demand-side analyses suggest?

These questions matter to CPE because they are necessary to understand the eco- nomic performances of countries and to evaluate economic policies, but CPE rarely confronts them head on. Herman Mark Schwartz and Bent Tranøy argue that over the past few decades there has been a slow shift in CPE from macroeconomic approaches that emphasize economic instability and issues of political legitimacy to neoinstitu- tional approaches, in particular the Varieties of Capitalism (VoC) approach, that pre- suppose (stable) market outcomes which allow for multiple institutional equilibria.[1] This has moved CPE closer to mainstream economics with its supply-side focus and an interpretation of market economies as inherently stable. The global financial crisis and the ensuing weak growth have reignited interest in macroeconomic issues of growth, distribution, and stability and thus the question of the economic underpinning for CPE. Lucio Baccaro and Jonas Pontusson propose basing CPE on the post-Keynes- ian (PK) theory of demand regimes and use the cases of Germany, Sweden, and the United Kingdom to analyze export-led and debt-led growth models.[2] In a reply, David Hope and David Soskice argue that the more mainstream New Keynesian (NK) theory, which is based on methodological individualism, features a supply-side-determined long-run equilibrium, and regards financial crises as caused by exogenous shocks, is amore appropriate foundation.[3]

The Macroeconomics of Current Comparative PoliticalEconomy

At the inception of CPE, Andrew Shonfield had a focus on demand formation, eco- nomic stability, and political legitimacy; similarly, Peter Hall’s early work was con- cerned with demand management.[9] However, in subsequent debates CPE moved gradually in the direction of microeconomic questions and a supply-side focus. Schwartz and Tranøy trace this gradual shift and argue that it has resulted in a neglectof fallacy-of-composition problems and financial instability.[10] The culmination of thisdevelopment is the VoC approach, which regards as the core reference point for the

This article is a reply to this controversy and makes a systematic case for post-Keynesian economics (PKE) as the macroeconomic foundation for the comparative analysis of capitalisms. It argues that CPE lacks adequate macroeconomic founda- tions; it needs an analytical framework that allows an analysis of the potential insta- bility of growth in a financialized economy and the power relations that underpin inequality as well as financial relations. PKE, in contrast to NKE, offers a (Kaleckian) theory of demand regimes that allows for wage-led as well as profit-led demand regimes, partially used by Baccaro and Pontusson. Importantly, the PK theory of money and finance enables an analysis of financialization that considers

(Minskyan) financial instability. It has a focus on the demand side of growth but considers growth as path-dependent, with (Kaldorian) technological progress induced by demand pres- sures. Together this forms a basis for an analysis of growth models that is more appropriate than mainstream economics for a world characterized by distributional conflict and financial crises.

The article is at the same time highly sympathetic to and critical of Baccaro and Pontusson. I argue that PKE has more to offer than Baccaro and Pontusson realize, in particular regarding finance and financial instability. The article discusses several spe- cific areas where a PK economics approach can make contributions to CPE debates. First, the PK analysis of endogenous financial instability has implications for our understanding of financialization.[4] Second, I argue that, contrary to what Baccaro and Pontusson assert, neoliberal growth models are premised on wage-led demand regimes and that the stagnation tendencies they encounter in the face of rising inequality are compensated for by debt-driven or export-driven stimulation, both of which give rise to unstable regimes. Third, endogenous financial instability has implications for the political economy of central banks. They act as lender of last resort for private finan- cial institutions as well as governments, which gives them a distinct form of financial power. The overall PK vision of capitalist dynamics is one of an intrinsically unstable growth process, where class relations, financial instability, and government activity shape the growth path of economies.

The article is structured as follows. The first section below situates PKE and CPE within the historical development of the political economy approach. Next, recent debates on the role of macroeconomics in CPE are discussed. The sections following that discussion present NK theory and the three-equation model advocated by Hope and Soskice; set out the core features of the PK analysis of distribution, finance, and path-dependent growth; and highlight contributions of PKE to CPE on financialization and financial cycles, for the interpretation of neoliberal growth models and for the political economy of central banking. The last section concludes.

establishment of a viable variety of capitalism its ability to generate competitiveness.[11] VoC takes a firm-centric view. It analyzes firms as a set of relations: relations between firms and their employees, embodied in industrial relations and training systems; rela- tions between a firm and its owners and stakeholders (corporate governance); and relations between a firm and its financiers and competing firms. All these are shaped in part by national regulations and policies that constitute the constraints that firms face. There exist complementarities between different sets of institutions, which led VoC to distinguish liberal, coordinated, and mixed market economies. The subtitle of Hall and Soskice's influential book encapsulates the approach: the institutional foun- dations of comparative advantage. VoC offers an institutionally nuanced supply-side analysis of economic performance, centered on the concept of competitiveness that highlights the possibility of multiple institutional equilibria. Traditional concerns of Keynesian macroeconomics such as unemployment caused by demand deficiencies or crises and financial instability are not at the core of its research agenda.

In an attempt to reconstitute CPE, Baccaro and Pontusson suggest an approach that builds on the PK macroeconomic theory of demand regimes, and they develop this into an analysis of growth models that highlights the interaction between distributional changes, demand formation, and export performance. They identify Germany as an export-led growth model and the United Kingdom as consumption-led, with Sweden as an intermediate case and Italy as a case of stagnation.[12] Their growth models are "more numerous and more unstable" than those in traditional VoC analyses.[13] They conceive the growth models as underpinned by social coalitions and a hegemonic social bloc, based on sectoral interests, and they illustrate the notion with reference to coalitions around export interests. This conception is an important step away from static VoC classifications that tries to grapple with instability, but there is clear asym- metry in the depth with which export orientation is covered and an absence of an analysis of financialization and thus of the debt-led growth model.

In a reply, Hope and Soskice welcome the discussion of demand issues but argue that the modern New Keynesian mainstream economics is a more appropriate founda- tion. They specifically recommend the three-equation model, a textbook version of NKE.[14] This model is anchored in a supply-side-determined long-run equilibrium with monetary policy providing a stabilizing function. (The three-equation model will be discussed in more detail in the next section.) As much of the VoC literature does not discuss its macroeconomic underpinning, Hope and Soskice's work is welcome in that it makes explicit the implicit macroeconomic assumptions of the VoC approach. There is a basic complementarity between NKE and VoC in that both share a supply-side focus, despite different research agendas.

Demand formation plays a secondary (short-run) role; in a longer perspective only institutions and other supply-side factors such as technology matter. Issues like financial stability or the demand effects of rising inequality were sidelined until recently.

While VoC plays a strong role within CPE, there is a substantial and growing litera- ture that has moved beyond VoC. In doing so, many CPE authors take a position and ask questions very close to those of PKE, and at times they build explicitly on PKE. Colin Crouch proposes the concept of "privatized Keynesianism" to describe a regime

where private consumption (rather than government spending) is financed by credit. Colin Hay uses the term "Anglo-liberal growth model" to describe more specifically how rising asset prices and equity withdrawal give rise to a growth model based on credit creation.[15] This is very close to the PK concept of debt-driven growth to be dis- cussed later. In their discussions of the Euro crisis, Andreas Nölke and Magnus Ryner prominently feature PK contributions and specifically the juxtaposition of export- driven and debt-driven growth models and how their interaction generates systemic instability.[16] Baccaro and Pontusson's interest in PKE thus is symptomatic of a grow- ing engagement of CPE and IPE with macroeconomic issues and theories. However, these attempts are as of yet eclectic and limited in scope. They explain specific epi- sodes but do not reflect systematically on the macroeconomic foundations of CPE. Crouch and Hay explicitly analyze the UK and Anglo-Saxon experience during the pre-2008 boom and do not attempt a systematic theory of finance. My argument is that the best-developed stream within CPE, the VoC approach, is closely wedded to parts of contemporary mainstream economics, which hampers its ability to comprehend the changes brought about by financialization and thus fails to understand the instability of neoliberal varieties of capitalism. CPE needs to consider its macroeconomic foun- dations more systematically and, in particular, how it explains the economic growth process and crises.

Conclusion

CPE is the study of institutions and economic performance across countries. It requires a theory of the economy as well as a theory of politics and institutions. Much of current CPE, in particular the VoC approach, relies explicitly or implicitly on mainstream economics. This article has argued that this reliance leads to an overstatement of the stability of market systems and fails to appreciate the changes brought about by financialization, namely, the return of financial cycles. PKE is proposed as an alternative economic grounding of CPE. It offers, first, a theory of demand regimes allowing for both wage-led and profit-led growth, which has been extended to analyze debt-driven and export-driven growth models. This aspect has already been recognized by CPE research, in particular through the work of Baccaro and Pontusson. However, their approach lacks an analysis of financialization and financial instability. The PK theory of finance is based on credit-created money and a theory of endogenous financial cycles. It thus offers an enhanced understanding of the process of financialization such as the shift to financial asset transactions and the return of financial cycles. Finally, PKE is based on the concept of fundamental uncertainty and pursues a class-analytic approach that regards income distribution as the outcome of power relations. In addition, its theory of finance and central banking incorporates power relations.

The overall vision of capitalism that emerges from the PK approach is of a dynamic system in an uncertain world. The growth path is not anchored in an insti- tutional equilibrium, but rather one where growth dynamics, financial structures, power relations, institutions, and state interventions coevolve. Demand regimes may generate periods of growth as well as systemic instability. Political coalitions will form around growth models and states that stabilize an unstable economy. The growth path is temporarily stabilized by institutions and state interventions, but because these serve many purposes, in particular crystalizing power relations and enabling class compromise, they will not always be conducive to growth over longer periods. A key source of instability is the financial sector. Asset prices and credit volumes, in an uncertain world, are guided by expectations and social conventions, which will often lead to overreactions and speculative bubbles. Financial instability thus is a pervasive feature of capitalism, but it has more than merely cyclical effects. First, financial crises leave long-lasting scars on the economy because of hysteresis effects. Second, in times of acute crisis, states often intervene and thereby critically shape the distribution of the costs of recessions and the path to recovery or stagna- tion. States also mediate distributional conflicts (or reinforce social domination) and can shape the sectoral composition of the economy.

This article has emphasized the analytical contributions of PKE relative to NKE and tried to illustrate how it can help illuminate areas where CPE has deficiencies in explanation. However, what is at stake here is not merely a matter of academic ele- gance and explanatory power. Ultimately, the choice of macroeconomic theory allows us to interpret economic and social problems and thereby frame policy inter- ventions. In a time of secular stagnation with slow-growing economies, a large debt hangover, and persistent income inequality, the question is what CPE has to offer in terms of policy analysis and advice. Orthodox economic policies have arguably exacerbated these social crises, such as in the Euro crisis. While NKE offers a vision of limited but targeted intervention,[87] it remains wedded to a vision of market effi- ciency that discourages radical policies. The PK focus on financial instability, per- sistent involuntary unemployment, and the possibility of wage-led growth allows a broader set of policy proposals that may include QE for the people, growth via public development banks, job guarantee programs, substantive redistribution, and state-led innovation and decarbonization policies. In short, PK macroeconomic analysis not only offers a richer understanding of macrodynamics than NKE; it also enables CPE to develop a richer set of policy interventions.

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