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Thomas I. Palley[1]

Inequality, the Financial Crisis and Stagnation: Competing Stories and Why They Matter

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Keywords: Income inequality, financial crisis, stagnation, economic theory.

JEL refs: E00, E02, E10, E20, E24.

[1] Thomas I. Palley, Senior Economic Policy Adviser, AFL-CIO, mail@thomaspalley.com

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Thomas I. Palley
Senior Economic Policy Adviser, AFL-CIO
mail@thomaspalley.com

Abstract

This paper examines several mainstream explanations of the financial crisis and stagnation and the role they attribute to income inequality. Those explanations are contrasted with a structural Keynesian explanation. The role of income inequality differs substantially, giving rise to different policy recommendations. That highlights the critical importance of economic theory. Theory shapes the way we understand the world, thereby shaping how we respond to it. The theoretical narrative we adopt therefore implicitly shapes policy. That observation applies forcefully to the issue of income inequality, the financial crisis and stagnation, making it critical we get the story right.

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1. Introduction: economics, economists and inequality

Economists have always been interested in income inequality for sociological, political and egalitarian policy reasons. However, recently, the character of that interest has changed and there seems to be a realization that income inequality may matter for macroeconomic efficiency by impacting unemployment and growth. This idea has long-standing in the Keynesian economic tradition and there is an extensive theoretical, empirical and policy literature on it.[2] Now, there are indications it is also seeping into the mainstream of the economics profession.

[1] This paper was originally presented at the *European Dialogue 2015* forum organized by the Hans Bőckler Foundation and held in Brussels, Belgium on April 16-17, 2015.

[2] The Keynesian approach is based on the neo-Kaleckian growth model pioneered by Rowthorn (1982) and refined by Bhaduri and Marglin (1990) to include a distinction between wage-led and profit-led growth. Stockhammer (2011) provides a survey of this literature. Palley (2011) provides a policy framework for implementing wage-led growth.

In the past, mainstream interest was exclusively focused on empirically documenting inequality. In the 2000s, the mainstream began to discuss the “causes” of increased inequality. And now, in the wake of the financial crisis and emergence of stagnation, that interest has changed further and begun to consider the role of inequality in causing the crisis and stagnation. This paper examines several mainstream explanations of the financial crisis and stagnation and the role attributed to income distribution and income inequality. Those explanations are then contrasted with a structural Keynesian explanation. The role played by income inequality is substantially different in each explanation, giving rise to different policy recommendations.

These features illustrate the importance of economic theory. Theory shapes the way we understand the world, thereby shaping how we respond to it. The theoretical narrative we adopt thereby implicitly shapes policy. That general observation applies to the issue of income inequality, the financial crisis and stagnation. That makes it critical we get the story right.

2. *Fault Lines*: Rajan (2010)

Rajan (2010) was an early contributor to the new wave of thinking attributing a role for inequality in the financial crisis. According to him, increased income inequality in the US prompted a populist political response focused on making homeownership more affordable. This involved government interventions in the housing finance market which encouraged homeownership beyond people’s means and spurred a credit-driven house price bubble. When the bubble eventually burst in 2006, the supporting financial structure came crashing down.

There are three features to note about this story. First, Rajan’s claim that the financial crisis of 2008 was caused by government intervention in the housing market is empirically implausible (Palley, 2012, chapter 6). These interventions had been in place for decades. The Community Reinvestment Act was passed in 1977, and the Federal National Mortgage

Association (FNMA or Fannie Mae) was founded in 1938 as part of the New Deal. Sub-prime loans, which triggered the crisis, were originated by private lenders and Fannie Mae only started buying them and facilitating their issuance towards the very end of the bubble. Lastly, the price bubble impacted commercial real estate equally strongly but commercial real estate was not subject to any of these government interventions.

Second, according to Rajan the labor market was working efficiently and income distribution was neither a micro nor a macroeconomic problem. Instead, income inequality was economically justified by technological developments that had increased returns to skilled labor and lowered returns to unskilled labor, and it was only a problem because it spurred politically motivated flawed policy. Thus, though raising the issue of income inequality, Rajan departs fundamentally from reasoning that holds income inequality generates aggregate demand problems and is the result of unequal bargaining power in labor markets. Absent careful attention, it is very easy to misattribute this argument to Rajan, when it is in fact completely absent in his book.

Third, Rajan's book lacks any implications about stagnation. Recently, to explain stagnation, he has argued (Rajan and Ramcharan, 2015) that the after-effects of economic crises associated with high leverage are especially long. That puts him in the company of Reinhart and Rogoff (2009), but their empirical claim of lengthy recessions after financial crises has been challenged by Christina and David Romer (2015). The latter find that when financial distress is categorized on a relatively fine scale rather than being treated as a 0-1 variable, "output declines following financial crises in modern advanced countries are highly variable, on average only moderate, and often temporary."

3. *Inequality, leverage and crises*: Kumhof & Rancière (2010)

A second contribution to the debate about the role of income inequality in the crisis comes from Kumhof and Rancière (2010). Their explanation is a mix of Keynesian demand side theory and classical supply-side theory. The argument is worsening income distribution, caused by declining union bargaining power, led to a persistent surge in borrowing as workers tried to maintain their living standards. That rendered the economy fragile to a financial sector shock.

However, closer inspection shows the story is much less Keynesian than it appears. First, the economy is a full employment economy both before and after the crisis so the distribution of income is not a concern for full employment.

Second, the role of income distribution is to drive borrowing that causes financial fragility. That means their explanation of the crisis is really one of financial market failure in the form of excessive lending that renders the economy vulnerable to shocks. Absent excessive lending, deteriorating income distribution is not a problem except for ethical reasons.

Third, the model has difficulty explaining the size of output reduction caused by the financial crisis and why stagnation set in after the Great Recession. Kumhof and Rancière's explanation is to assume the financial crisis destroyed 10 percent of the capital stock, which is implausible.

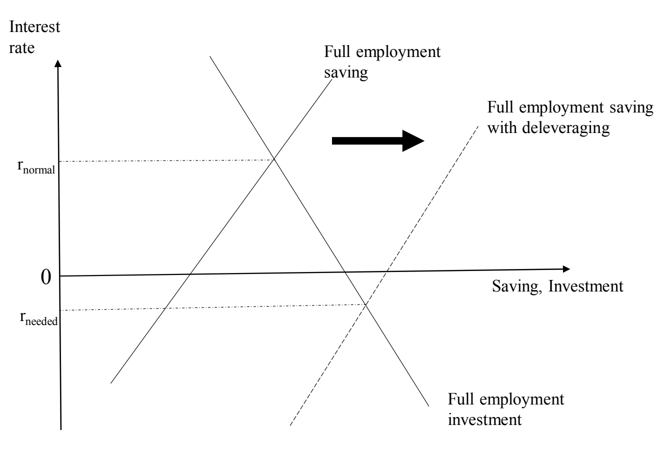
3. *Debt, deleveraging, and the liquidity trap*: Eggertsson & Krugman (2012)

A third account of stagnation is the set of explanations associated with the zero lower bound (ZLB) nominal interest rate trap. The originator of this frame of thinking is Paul Krugman (1998) who originally developed it to explain Japan's stagnation after the collapse of its asset price bubble in 1991. Now, Eggertsson and Krugman (2012) have elaborated the story to try and make it explain the stagnation that has followed the US financial crisis of 2008.

The precursor story to stagnation is that a financial bubble drove excessive borrowing and leverage in the US economy. When the bubble burst in 2007/8, the economy experienced a financial crisis and a deep recession. It also prompted a wave of deleveraging as borrowers shifted to rebuilding their balance sheets. That deleveraging increased saving which the economy has been unable to absorb because of the ZLB. The resulting excess saving has reduced aggregate demand, thereby causing stagnation.

The Krugman-Eggertsson story of stagnation is described in Figure 1. The crux of the story is the claim that interest rates are determined in the loanable funds market by the supply of saving and investment demand. The interest rate adjusts to ensure full employment saving equals full employment investment. Deleveraging increases saving and causes an outward shift of the full employment saving supply schedule so that equalizing full employment saving and investment needs a negative real interest rate. However, owing to the ZLB the nominal interest rate cannot go negative. Consequently, there is an excess supply of saving which causes a contraction of income and employment.

Figure 1. The Eggertsson – Krugman deleveraging explanation of stagnation.



The policy solution is two-fold. First, run large budget deficits so that the public sector deficit absorbs the excess private sector saving. Second, encourage inflation expectations so that the expected real interest rate goes negative even if the market nominal interest rate is trapped at zero.

There are multiple features of the ZLB story that are problematic. At the most general level, the ZLB story of stagnation rests on a loanable funds theory of interest rates in which the interest rate is determined by the supply of saving and the demand for investment. That approach to the theory of interest rates was discredited long ago by Keynes (1936) in his *General Theory*.

Second, the ZLB story of stagnation attributes too much significance to interest rates as both the source of the problem and as a means of solving the employment and instability problems of a capitalist economy. The claim is a three percent negative real interest rate would increase AD so as to restore full employment. However, real interest rates were negative in the 1970s and that did not solve the employment problems of that era. Today, a three percent negative interest rate would likely trigger a renewed financial bubble that would crash even harder once real interest rates eventually started to reverse upwards. That inconsistency suggests that there is a deeper problem in the economy that the Eggertsson – Krugman (2012) ZLB story fails to identify.

Third, the deleveraging story of excess saving and demand shortage is unconvincing. In fact, as shown in Table 1, US non-financial business debt has been increasing quite fast since 2011. US household debt also shrank little during the Great recession and it too has been increasing since 2012. Furthermore, a significant part of the reduction in household debt likely came from default and debt write-offs, which likely increases aggregate demand and reduces saving by relieving debtors of their obligations.

Table 1. Growth of US household and non-financial business debt (%).
Source: Financial Accounts of the United States, Federal Reserve, Fourth Quarter 2014.

	2008	2009	2010	2011	2012	2013	2014
Households	1.1	0.0	-1.1	-0.2	1.5	1.5	2.9
Business	5.8	-4.3	-0.9	3.0	4.8	5.1	5.9

Fourth, the Eggertsson – Krugman (2012) explanation of stagnation actually attributes no role for income inequality. Income distribution can be added to the story by assuming higher income households have a higher propensity to save.[3] In that case, a shift in income distribution toward higher income households would increase full employment saving. In terms of Figure 1, it would have an identical effect as deleveraging and would shift the full employment saving function right. However, even though this adds income distribution effects to the Eggertsson – Krugman model, it does not resolve the other criticisms of the model regarding the economic logic and significance of ZLB reasoning. There is need to add income distribution to explain stagnation, but it must be added to another story.

4. The economic significance of inequality for stagnation

In addition to introducing the ZLB as an explanation of stagnation, Krugman has persistently contested the economic significance of inequality for explaining stagnation:

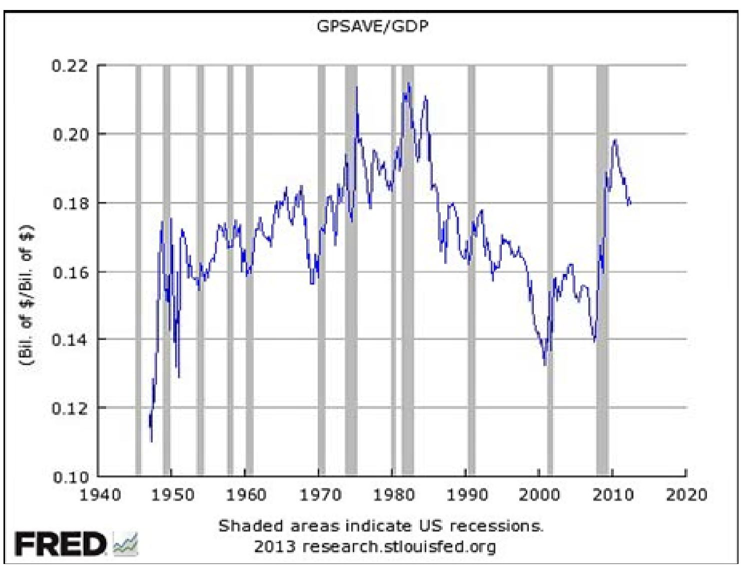
[3] Palley (2010) provides a comprehensive theoretical justification for differences in the propensity to consume by debtor and creditor households. The theory is consistent with all the established stylized facts of consumption spending including the findings that the long-run aggregate propensity to consume exceeds the short-run propensity (Kuznets,1946); the cross-section observation that higher income households have a higher propensity to save (Carroll, 2000); and the cross-section observation that the variance of household income exceeds the variance of household consumption (Krueger and Perri, 2002).

> "Joe Stiglitz has an Opinionator piece arguing that inequality is a big factor in our slow recovery. Joe is an insanely great economist, so everything he says should be taken seriously. And given my political views and general concerns about inequality, I'd like to agree. But – you knew there was a "but" coming – I've thought about these issues a lot, and haven't been able to persuade myself that this particular morality tale is true (Krugman, 2013a)."

The essence of Krugman's rejection of inequality's economic significance is the fact that US private saving as a share of GDP decreased in the years prior to the financial crisis despite the fact inequality was increasing. As shown in Figure 2, the saving rate declined significantly after 1980 through to 2000, which supposedly proves inequality does not decrease demand:

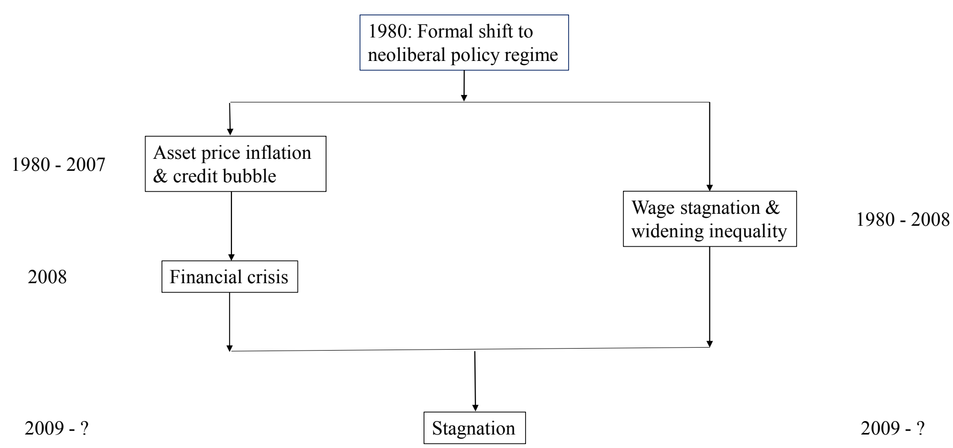
> "So look at overall private saving as a share of GDP: the trend before the crisis was down, not up – and that surge with the crisis clearly wasn't driven by a surge in inequality. So am I saying that you can have full employment based n purchases of yachts, luxury cars, and the services of personal trainers and celebrity chefs? Well, yes. You don't have to like it, but economics is not a morality play… (Krugman, 2013a)."

Figure 2. US private sector saving as a share of GDP, 1947-2012.



What's wrong with this argument that a falling saving rate shows increased income inequality does not cause demand shortage? The problem is it takes no account of other developments that were counteracting and hiding the adverse demand effects of worsening income distribution. This is illustrated in Figure 3. The neoliberal era formally began with the inauguration of President Reagan (in reality, it was already underway with President Carter who initiated the deregulation movement and appointed Paul Volcker with a mandate to crush inflation with high interest rates). The shift to neoliberal policy generated two fundamental changes. The first was an era of wage stagnation and widening income inequality. The second was an era of asset price inflation and a thirty year-long credit bubble which increased wealth, collateral, the quantity of credit, and ease of access to credit. Those financial developments fuelled spending that more than offset the negative impacts of wage stagnation, and they explain why the saving rate fell even as income inequality was rising. The credit bubble ended with the financial crisis, bringing to an end the era of outlandish borrowing. That caused the saving rate to rebound, causing demand shortage. This explanation fits the facts in both Table 1 and Figure 2, showing that saving rather than deleveraging is responsible for stagnation.

Figure 3. The evolution of the US economy in the neoliberal era, 1980 - 2015.

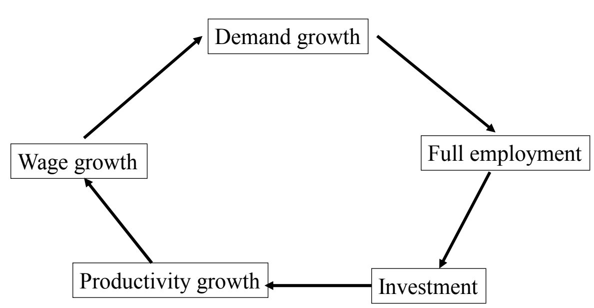


5. The structural Keynesian account of inequality and stagnation: Palley (2009, 2012)

The above argument shows that income distribution matters, but it must also be incorporated in a better macroeconomic story than that offered by ZLB proponents. This section presents a "structural Keynesian" account (Palley, 2009, 2012) of the financial crisis and stagnation – which was written long before stagnation was even a twinkle in Larry Summers' eye. That makes it rather unusual for economics as it correctly anticipated imminent developments.

The explanation runs as follows. Until the late 1970s developed country economies, including the US, could be described by a Keynesian virtuous circle growth model in which wages were the engine of demand growth. The economic logic is illustrated in Figure 4. Productivity growth drove wage growth which fuelled demand growth. That promoted full employment which provided the incentive to invest, which drove further productivity growth. Within this system, finance was characterized by a public utility model based on New Deal regulation. Its role was to (a) provide business & entrepreneurs with finance for investment; (b) provide business and households with insurance services, and (c) provide households with means of saving for future needs.

Figure 4. The 1945 – 75 virtuous circle Keynesian growth model.

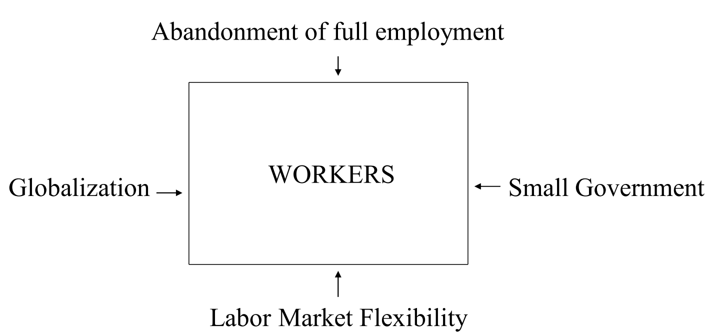


After 1980 the virtuous circle Keynesian growth model was replaced by a neoliberal growth model. The two key changes in the real economy were: 1) abandonment of the policy commitment to full employment which was replaced by a commitment to stable low inflation;

and 2) severing of the link between wages and productivity growth. Additionally, there was change in the financial sector driven by the phenomenon of “financialization” which increased the presence and power of finance within the economy. Together, these changes created a new economic model. Before 1980, wages were the engine of demand growth: after 1980, debt and asset price inflation became the engines of demand growth.

As shown in Figure 5, the new economic model can be described as a “neoliberal policy box” that fences workers in and pressures them from all sides via (1) the corporate model of globalization; (2) the small government agenda that attacks regulation and public sector activity; (3) the labor market flexibility agenda that attacks unions, worker bargaining power and worker protections; and (4) the replacement of full employment macroeconomic policy with low inflation targeting policy. With regard to the financial system, the New Deal public utility model was gutted by deregulation and subsequent financial innovations were left largely unregulated. The result was a new system characterized by growing financial instability, wage stagnation and increased income inequality.

Figure 5. The neoliberal policy box.



These wage and income developments created a growing structural demand shortage. The role of finance was to fill that gap. Financial deregulation, financial innovation, speculation, and old fashioned financial fraud enabled finance to fill the demand gap by lending to consumers and by inflating asset prices.

There are several features to note. First, having finance fill this "demand gap" was not part of a grand plan: it was an unintended consequence. Neoliberal economic policymakers did not realize they were a creating a demand gap, but their *laissez-faire* financial ideology unleashed developments that accidentally filled it. Second, the process was inevitably unstable and was always destined to implode. There are limits to borrowing and asset price inflation. Every Ponzi scheme comes apart eventually. The problem it is impossible to predict when it will end. Third, the process was of long duration. Consequently, the collapse was far deeper when it eventually happened. It also means escaping the after-effects is far more difficult because the economy is now burdened by debt and destroyed credit worthiness.

6. The role of inequality in the financial crisis and stagnation

The above structural Keynesian account of events is subtly different from popular accounts. Income inequality did not cause the financial crisis. The crisis was caused by the implosion of the asset price and credit bubbles which had been off-setting and obscuring the impact of inequality. However, once the financial bubble burst and financial markets ceased filling the demand gap created by income inequality, the demand effects of inequality came to the fore.

Viewed in that light, stagnation is the joint-product of the long-running credit bubble, the financial crisis and income inequality. The credit bubble left behind a large debt over-hang; the financial crisis destroyed the credit-worthiness of millions; and income inequality has created a "structural" demand shortage.

This diagnosis also makes clear why the medium-term prognosis remains stagnation.

That is because policy has not repaired these fundamental problems and they have actually worsened. First, the US still has a structural “demand gap” caused by deteriorated income distribution and income distribution has actually worsened since the crisis of 2008. Second, the credit bubble is over so that borrowing can no longer fill the “demand gap”. Furthermore, financial sector reforms have systemically tightened credit access. Third, the import and investment leakages associated with globalization remain unrepaired, while fiscal stimulus has turned to fiscal austerity. Consequently, despite the Federal Reserve’s zero interest rate and quantitative easing (QE) policies, the economy is beset by slower growth and overall labor market slack stands to be permanently higher. Furthermore, there is a danger that having re-inflated asset prices, the QE experiment will backfire in the form of renewed financial market turmoil.

7. The story we accept matters

The previous sections have described four different stories regarding the role of income inequality in causing the financial crisis and stagnation. Which story we accept matters enormously because the way we explain the world affects how we understand it, which in turn has major political and policy consequences.

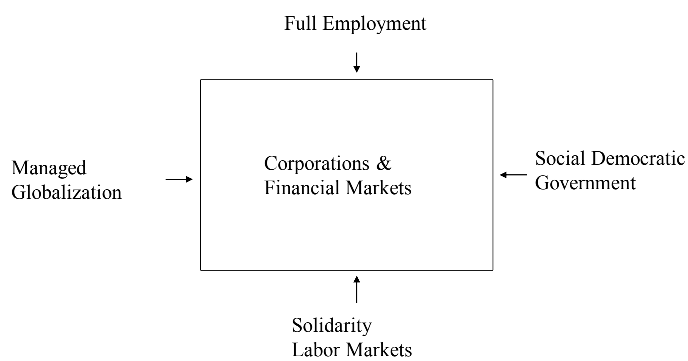
If Rajan’s (2010) story is accepted income distribution is reduced to an issue of political and ethical concern, but it is not an issue of macroeconomic concern. Furthermore, since labor markets are working as they are supposed to, there is no justification for interventions in labor markets aimed at increasing the wage share or strengthening worker bargaining power. Rather than focusing on income inequality, the economic policy response should be to repeal government interventions in housing finance and return to more orthodox monetary policy to avoid possibilities of another asset price bubble. There may also be case for some after-tax income redistribution but that is a purely ethical and political matter.

If the Kumhof and Rancière (2010) story is accepted, the cause of the crisis is financial market failure that allowed excess borrowing by worker households whose income prospects had diminished. The policy response should be to tighten financial market regulation to prevent a repeat of an unsound lending bubble. However, once again, labor markets are actually working efficiently. That means the case for income redistribution aimed at increasing the wage share is again purely ethical and political.

If the Eggertsson - Krugman (2012) ZLB deleveraging story is accepted, income distribution is again reduced to a non-economic issue. Instead, the cause of stagnation is deleveraging which is a process to be worked through. However, during this period there is a case for large budget deficits to offset excess private saving caused by deleveraging, and thereby avoid any output and employment losses caused by the ZLB obstruction to full employment. Since the labor market is efficient and not the cause of the problem, it means income distribution is again a purely ethical and political matter and there is no economic case for interventions aimed at increasing wage share.

Lastly, if the "structural Keynesian" story is accepted, income distribution is a central problem and the principal factor explaining the demand shortage that is the cause stagnation. The solution is to replace the neoliberal policy framework with a "structural Keynesianism" framework. Metaphorically speaking, policymakers needs to repack the box, take workers out, and put corporations and financial markets in. As illustrated in Figure 6, that requires replacing corporate globalization with managed globalization; restoring macroeconomic policy commitment to full employment; replacing the anti-government agenda with a social democratic agenda that supports and funds public investment, provision of public services and regulation (including financial markets); and replacing neoliberal labor market flexibility with solidarity based labor markets in which workers have greater bargaining power and receive an increased wage share.

Figure 6. Repack the box.



8. Inequality and economic policy failure as cause of stagnation

Thus far, the focus has been on the economic role of inequality in generating stagnation. Political economy provides another channel of impact by having inequality affect economic policy. Indeed, Krugman (2013b) argues that political economy has been the main channel. His argument is increased inequality increased the political power of the wealthy who favored policies of fiscal austerity that caused stagnation:

> "In my view, however, the really crucial role of inequality in economic calamity has been political. In the years before the crisis there was a remarkable bipartisan consensus in Washington in favor of financial deregulation – a consensus justified by neither theory nor history. When crisis struck, there was a rush to rescue the banks. But as soon as that was done, a new consensus emerged, one that involved turning away from job creation and focusing on the alleged threat from budget deficits…. Surveys of the very wealthy have, however, shown that they – unlike the general public – consider budget deficits a crucial issue and favor big cuts in safety-net programs. And sure enough, those priorities took over our political discourse (Krugman, 2013b)."

According to Krugman, stagnation is the result of failure to use fiscal policy to offset deleveraging, and that policy failure can be attributed to the political effects of increased income inequality.

There are several important points to note. First, this political economy argument is fully consistent with the structural Keynesian hypothesis. Indeed, Palley (2012, p.205-7) explicitly argues that power and wealth have shaped economic ideas that have pushed neoliberal policy. Increased income inequality has only further strengthened that shaping.

Second, albeit unintentionally, Krugman's political economy argument gets to the heart of the economic debate. For Krugman, there is nothing "structurally" wrong with the economy. It is in a process of deleveraging that needs to be worked through, and fiscal stimulus can help work through that process faster and with less pain. In contrast, the structural Keynesian hypothesis roots stagnation in the flawed structure of the economy. The adoption of fiscal austerity has definitely aggravated stagnation, but it is not the deep cause.

Third, the idea that economic policy is the cause of stagnation is common to both Krugman's view and the structural Keynesian view. However, as with the debate over the economic impact of income inequality, it is important to get the story straight regarding the role of economic policy. For Krugman (2013b), the policy failure is the turn to fiscal austerity after 2009. That contrasts with the structural Keynesian hypothesis which traces the policy failure back to the late 1970s and the shift to neoliberal policies. That is a very different story with very different policy implications. It shows, once again, the importance of getting the story right.

9. Conclusion: gattopardo economics again

There are three major conclusions. First, the four stories above have superficial similarities in their mention of either "income distribution" or "demand shortage", but they are actually fundamentally different. If readers do not have their wits about them, it is easy to miss those fundamental differences.

That potential for confusion is increased by the fact that different stories can lead to overlapping policy recommendations. For instance, Krugman's ZLB story recommends using fiscal stimulus, as does the structural Keynesian story. However, the two stories are fundamentally different in their explanation of the roots of the financial crisis and stagnation. That raises a critical issue. It is not enough to find points of policy agreement: there is also need to get the story about the economy right. A wrong story misleads policy makers and the public regarding how to think about the economy; encourages an incomplete policy response; and sets up future analytical and policy disagreements that are politically damaging.

Second, there is a great danger of "gattopardo economics" (Palley, 2013), which is change that leaves economics unchanged. For thirty years, progressive Keynesians have argued for the macroeconomic significance of income distribution. Now, mainstream economists are picking up on this issue. The gattopardo danger is that they will incorporate it into their stories in ways that strip income distribution of its critical significance for macroeconomic efficiency, thereby cannibalizing the case for policy interventions to reduce income inequality.

Third, the paper described four stories. Three of them are widely cited and known. They are taught in graduate schools and discussed by the IMF and central banks. The fourth (the structural Keynesian story) is consigned to a black hole. It is not because of lack of evidence or logic. In fact, its logic and evidence are superior. Instead, it is because of the "power of interests" that ensure only certain ideas make it into the classroom and on to the stage of public debate. Those interests include the wealthy, but they also include the economics profession which is structured like a club and only gives voice to the ideas of existing club members.

These conclusions carry an important practical implication. Given the vital significance of "getting the story right", progressive political action aimed at policy change must be accompanied by vigorous efforts to change the mainstream economic story. Absent that, progressives are unlikely to win the political debate about policies and economic arrangements necessary for shared prosperity and the good society.

That failure is visible in political developments since the financial crisis of 2008. The failure to change the story has seen economic policy significantly revert to pre-crisis tropes, including fiscal austerity, labor market flexibility and more corporate globalization. Only monetary policy remains in a different mode, but it too threatens to revert to pre-crisis mode at the first whiff of inflation. As for electoral politics, in the US the Republican Party has made large political gains; in the UK the Conservative Party has trounced the Labor Party; and in Germany the conservative Christian Democrats have trounced the Social Democrats. In part, these political developments reflect the failure to get the story right and offer electorates a clearly defined alternative structural Keynesian narrative.

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