Tomorrow's Capitalism

Global Dimensions of the Financial Crisis

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Global Dimensions of the Financial Crisis

Introduction

All analyses of the current crisis have been incomplete. They deal with symptoms, not causes. There has been a focus on financial sector institutions and regulation, on the operation of monetary policy and on alleged policy errors. These things were important in shaping the way that the crisis evolved but they are not at its root. The truth is that the world and its economy have changed in ways that are likely to lead to periodic instability. The changes have not been recognised and assimilated in the practice of monetary policy or in the way that politicians regard the economy.

Controls on the international movement of capital were generally lifted in the 1970s and 1980s. Together with the collapse of communism, which released millions of workers into the capitalist world economy, capital liberalisation effectively recreated a global 'reserve army of labour'. As widely noted, that development contributed to a rise in the share of profits in world GDP, and in the GDP of most individual countries, and a decline in the share of wage income. What was not widely noted is that such a development easily leads either to over-investment by businesses or a shortfall of aggregate demand. When wages lag, consumer spending can only keep up with output through a continuing expansion of consumer debt. These tendencies are at the heart of the present crisis.

The post-war era

The period from the end of the second world war to the early 1970s was one of full employment in the capitalist world and, in Europe and Japan at least, rapid growth. Capital controls were very general and remained in place even as trade in goods and services was progressively liberalised. International trade grew rapidly. There was a general confidence that full employment could be maintained by the techniques 'discovered' in the Keynesian revolution. By using fiscal and monetary policy government, it was thought, could ensure that the slump conditions of the inter-war years would never be repeated.

The Bretton Woods system had ordained fixed, or rather adjustable-peg, exchange rates. Given limitations on the international movement of capital, pegs were threatened mainly by trade imbalances. Since that implied limits on the size of trade deficits, countries' rates of investment were largely limited by domestic rates of saving.

The nemesis of the system was inflation. The Polish economist Michael Kalecki, who anticipated much of the Keynesian revolution in his own writings, identified the difficulty in maintaining full employment. There would be a problem of incipient inflation as workers pushed for higher wages and these were passed on in prices. His conclusion was that governments would engineer periodic bouts of unemployment to maintain discipline and keep wage inflation under control – in other words deliberately reintroduce a synthetic trade cycle. Some countries evolved corporatist procedures, like incomes policies or centralised wage bargaining, to make the process less painful but inflation widely began to creep higher through the 1960s. Differential inflation rates, with the United States a relatively high-inflation offender, led to the break-down of the fixed exchange rate system in 1971 and generalised floating of currencies in 1973.

The system was unsuited to dealing easily with terms of trade shocks whereby the price of a country's imports rose relative to its export prices. Such a shock inevitably reduces national income and would be likely to trigger a battle over whether profits or wages bore the brunt of the reduction. Such a battle over income shares would typically take the form of an aggravated wage-price spiral.

The oil price surges of the 1970s were exactly such a terms of trade shock that affected all Western countries. The first shock was caused by the action of Arab states after the Yom Kippur war of 1973, when they suspended oil deliveries for political reasons. The demonstration of their power, however, strengthened the OPEC oil cartel and prices were driven higher. This led to stagflation, a rise in both inflation and unemployment. There was much glib talk about stagflation undermining Keynesian economics but, on a theoretical level, it presented no difficulties for Keynesian or indeed competing theories. It was simply the consequence of the deterioration in the terms of trade which, in Kalecki's terms, meant a political recession had to be endured to restore wage discipline.

Countries often tried to counter the effects of unemployment after the first oil shock with counter-cyclical fiscal policy but after the fall of the Shah of Iran led to the second oil shock in 1980 and inflation soared again, the iron entered the soul. Almost all countries voted in governments that followed restrictive policies, driving up unemployment until inflation fell, ultimately sharply. Although nothing that happened would have surprised Kalecki in the least, the experience led to a change in the dominant view of how to manage the economy. There was an increasing acceptance of a theory of inflation that held there was only one rate of unemployment consistent with stable inflation and, if monetary policy tried to maintain any other rate, inflation would accelerate or decelerate without limit. The promoters of this theory also believed that the market system would generally be stable at that natural unemployment rate and so policy should simply concentrate on controlling inflation.

By and large, central banks have continued to act as if that world of the early 1980s was the one that still existed – right up to the current crisis. They perceived their role as contesting wage-price inflation by a policy of targeting inflation, letting real activity look after itself.

The era of free capital flows

In the early 1980s, the world began to change. Before then nearly all post-War recessions had been triggered by a burst of inflation and a policy response. After 1980, however, there were several more or less serious recessions around the world and only one of them was preceded by a serious rise in wage inflation – in the UK at the end of the 1980s. All others were caused by a different mechanism entirely, to which theorists, governments and central banks have been blind.

Governments around the world abolished exchange controls in the liberalising wave of the 1980s and allowed capital to flow freely to wherever it could find the highest profit. This political opening-up changed the balance of forces and made labour unions weaker relative to capital. This began to be reflected in factor income shares – the relative shares of profits and wages. The share of wages in GDP had been stable during the period from 1945 to 1980 in some countries, such as the United States, or had risen in other countries, such as the UK. Now that process went into reverse. In virtually all countries the wage share began to fall and the profit share to rise.

Many attributed this development to 'globalisation' – the tendency for production to become footloose. Fearing protectionism, some economists tried to claim it was a consequence of changes in the nature of technical progress that was substituting capital and skilled labour for unskilled labour but that looks like special pleading. Technical progress did have the effect of allowing more services to be traded internationally. The falling price of communications meant call centres for the UK could be opened in India and the radiologist studying X-rays of patients in Boston could be in Bangalore. A wider range of jobs were thereby subjected to international competition. But technical progress has been present since the industrial revolution; it was a factor but the key new element was the political decision to free capital.

These developments went into overdrive after 1990 with the collapse of communism and the Soviet Union and the subsequent liberalisation of the economic model in China, India and other large less-developed economies. This did indeed recreate what Marx called the reserve army of labour on a global scale. The potential growth rate of the global economy was raised and a period of rapid, inflation-free growth ensued, for which the current institutions of monetary policy – independent central banks, inflation targeting and so on – took credit. Another consequence was a sharp further rise in the share of profit in global GDP.

Since Keynes had become unfashionable, and Marx unmentionable, no one thought to ask what the effect of this changing income distribution would be. As Marx or Kalecki could have predicted, the first consequence of rising profit shares was a rising investment share. This first became evident in Asia where rapidly growing economies, benefiting from foreign investment, saw profits and investment rise to very high proportions of GDP. To this day investment in China is over 40 per cent of GDP.

Japan was the first to show where this could lead. In the 1980s the Japanese economy grew by 4 per cent a year in real terms and its profit share was as high as 40 per cent, compared with 20 per cent or less in the West. As the economy boomed the stock market and property prices soared. Asset prices got to such a crazy level that stocks were selling at 100 times earnings and the land occupied by the Imperial Palace in Tokyo was worth more at current prices and exchange rates than the entire state of California. Meanwhile, there was no retail price inflation at all and the Bank of Japan was undisturbed.

In 1990, the stock market crashed and activity and prices began to fall. Falling prices – deflation – made debt burdens worse and a persistent recession ensued. The Japanese government began to run larger and larger deficits, increasing public spending to try to keep the economy out of a slump. Nothing like the 1930s crash happened but annual growth fell from 4 per cent to around 1 per cent, and the public sector deficit became a permanent feature of the economy.

Other Asian countries flirted with the same fate. Their investment-driven boom ended in 1997 with a succession of foreign exchange crises and stock market crashes. Under pressure from the International Monetary Fund, they followed policies of austerity and devaluation. Since the rest of the world continued to grow, these policies enabled them eventually to export their way out of trouble and get back to growth. For that to be possible, however, demand had to continue growing strongly in the West.

Flaws in the global model

Here was the central problem with the globalised system. If profits and output (GDP) rise persistently faster than wages, who will buy the output? If the answer is that increasingly profitable businesses will invest more and more, investment will also rise as a share of GDP. As both Marx and Kalecki knew, that will ultimately lead to excess capacity and the probability of a deflationary slump. An incipient effective demand problem, in the language of the Keynesians, is averted for a time but ultimately shows up in a problem of 'the realisation of capital' in the language of the Marxists.

So it proved. Although investment in the more developed countries never reached the levels of the Asian countries, it began to rise. In the 1990s the share of business investment in the GDP of the United States rose from some 9 per cent to some 14 per cent. (Since the US did not save more, this extra investment involved borrowing from abroad and hence a large current account deficit.) Much of this investment was in computers and it was accompanied by a tremendous rise in the equity market, particularly in stocks that had any connection with information technology. Shares changed hands at prices hundreds of times not earnings

but sales. By the turn of the millennium, however, the over-investment had become evident and the stock market fell, embarking on a three-year decline. The economy fell into recession in the United States and elsewhere.

Unlike Japan, however, the United States experienced only a shallow and short-lived recession. Nothing fateful seemed to have happened. We come now to the new mechanism whereby the globalised system evaded for a while longer its incipient problem of insufficient effective demand. First, however, let us pay a visit to Hyman Minsky, another renegade economist ignored in the academies and largely forgotten.

It had begun to dawn on the more observant commentators that the fluctuations in economic activity since 1980 were different from those prior to that date. They were not obviously triggered by policy error (though some idealists can be counted on to explain why the Government is responsible for anything that goes wrong); they were not preceded by wage-price spirals nor were they triggered by terms of trade shocks. The US had suffered a recession in the early 1990s following a crisis in its savings and loans institutions. Then there was the dot.com bubble, an old-fashioned investment boom and bust of the type that had not been seen in the West since the 1920s, though it was a feature of the economic history of the nineteenth century. What the Japanese, Asian and these two American recessions all had in common was a boom in asset prices which went along with an investment boom in a debt-fuelled bubble that eventually popped.

Minsky had predicted this sort of development, claiming it was the inevitable pattern in a capitalist economy with liberalised financial markets. His basic thesis was that success breeds excess. As the economy grows and profits are made, institutions become aware that more money can be made if they borrow to gear up their investments. Leverage, or gearing, the ratio of debt to equity, therefore rises inexorably so long as the economy is doing well. Institutions pass from being hedgers, when their liabilities can be covered by their assets, to being speculators who cannot cover their liabilities but can service them from income. As the good times continue to roll, some pass from being speculators to playing a Ponzi game, in which they can only service their liabilities by raising more debt. The system is then vulnerable to the smallest setback. A small hesitation in the path of rising asset values forces sales that trigger an asset price collapse. Widespread bankruptcies and dislocation ensue.

It sounds like an utterly prescient description of the current crisis. Yet Minsky was writing long before the invention of Centralised Debt Obligations, Credit Default Swaps and the growth of the US sub-prime mortgage market. The precise mechanisms of folly differ every time but this sort of folly is a recurrent feature of the system, he believed.

The current crisis

In 2001, the United States appeared to have weathered the bursting of the dot.com bubble with the mildest of recessions. The reason was a development unforeseen by Marx or Kalecki. Excess capacity meant US companies would not continue to invest as they had in the 1990s. The whole of Asia was tightening its belt and growing by saving and exporting. Households and consumers in the West were not earning enough to take up the slack. But if they could be induced to borrow, they could buy the things they otherwise could not afford. Growth could continue. In the nineteenth century no one would have considered lending to workers so they could maintain aggregate demand, because they would not have been considered credit-worthy. But in the late twentieth and early twenty-first centuries workers often had assets, and the most important of these were their houses.

For various reasons, house prices have been rising for half a century in many economies, particularly in the English-speaking countries where owner-occupation has become a general

individual and political aspiration. Such a long period of rising prices, as Minsky knew, was sure to create the expectation of indefinite further increase. When interest rates were cut to ameliorate the recession of 2000 and 2001, they triggered a boom in borrowing to fuel house purchase in numerous countries around the globe. House prices rose, so household balance sheets appeared to be perfectly sound; debts increased rapidly but so did assets. Thus household debt in the UK rose from 90 per cent to 180 per cent of annual household income, with only slightly less extreme developments in the US, Spain, Australia, Denmark, New Zealand and Ireland. In few countries was there no rise in household debt as a proportion of GDP and even those countries shared, via international trade, in the boom facilitated by the rise of consumer debt.

Eventually, of course, this process had to reach a limit. When house prices reached levels that even the most imaginative exercise in misplaced ingenuity could not justify, they would be likely to falter. Those who had taken on too much debt would have to sell or be foreclosed. Prices would tumble. It was indeed a classic Minsky process, which ended in taking down the banks and other financial institutions that had borrowed and lent too much money on an inadequate asset base.

The first instinct of many commentators and central bankers was denial. The system was self-regulating. The Government should keep out. By interfering it would create moral hazard and prevent a healthy cleansing of the system. However, the 1930s were too stark a warning of what would happen should the banking credit system be allowed to implode. Denial turned to reluctant acceptance of massive state bail-out.

Then began the search for scapegoats. Initially, the monetary authorities were blamed. The then-chairman of the US Federal Reserve, Alan Greenspan, kept interest rates too low after 2002, it was asserted, triggering the housing bubble. But some remembered that Greenspan in raising policy rates had been unable to drive up the 10-year bond yield, the rate that most affected the housing market. Blame was redirected to the Chinese and other Asian central banks who matched US credit creation by buying up all the dollars that flooded into their economy as the US and other Western consumers supported their industry. They bought the dollars, creating credit in domestic currency and reinvested the dollars in US Treasury bonds, holding their prices up and keeping their yields low. They were as much to blame as Greenspan and the US Federal Reserve.

The real cause of the current crisis

Marx observed that all business cycles appear to be credit cycles but credit is the symptom, not the cause. That is perhaps too polar a view but it contains some truth. The underlying problem facing the world economy is an incipient problem of defective demand caused by profits outstripping wages in a world of global excess labour. That is not bound to lead to a business cycle in the deterministic way that Marx thought but it is highly likely to do so. The problem has been made worse because an important region of the world, Asia, which suffered an early example of an investment boom and bust, was able to emerge by beggar-my-neighbour policies of domestic deflation and devaluation. Those policies can work for one country or region but not for the system as a whole. The Asian countries, however, learned a mercantilist lesson that they had to keep exchange rates down and maintain an export surplus in order to grow without risk. Such policies encouraged continued excess investment in production for export and threw an even greater burden on the West for maintaining effective demand.

It is easy to blame Western central banks for maintaining too loose policies after 2002 but it is now forgotten that at that time there was a widespread fear of deflation. That fear was not

entirely misplaced. In the wake of the dot.com bust, a prolonged global recession could have eventuated there and then, if consumer borrowing had not come to the rescue. The Minskyesque nature of financial markets, and the dominant ideology which refused to recognise that nature, meant consumer borrowing and house price inflation were allowed to explode. The boom ended with a bang but the alternative was a whimper; global growth could not be sustained by ever rising consumer indebtedness anyway.

What should happen next?

It should now be evident that we do not live in a world of capital controls where a domestic wage-price spiral should be the sole objective of central bank attention. They have to pay attention to asset prices. It should also be clear that in a globalised world economy there is a need for someone to pay attention to the rate of credit creation globally. Mechanisms like the old IMF or Organisation for Economic Cooperation and Development consultation committees need to be revitalised so pressure can be brought to bear on important countries whose policies are unbalanced enough to destabilise the world economy. China and others, for example need to use foreign exchange reserves to mobilise domestic resources to meet latent domestic demands, not try to subsidise exports.

International agreements on financial regulation and capital taxation are also urgently required. If capital is free to chase the cheapest or most efficient labour around the world it should not also be free to chase tax concessions, inducing a race to the bottom in capital taxation. Indeed governments should resolve to shift more of the burden of taxation to capital to offset the effect of a rising pre-tax profit share. That is impossible for one country but can be done by international agreement and concerted action.

The capitalist system remains the only one that we know that has resulted in general and sustained rises in living standards. But to preserve it, and to preserve it in an international form that offers hope to the poor of the world, requires state intervention and, what is yet more difficult to achieve, extensive consultation and cooperation among states. The alternative is repeated crises leading to political and economic upheavals.

The institutions of Bretton Woods, including the IMF, were designed in 1944 for an era of international policy coordination but that era is long passed and the world economy is now very different. During the period of liberalisation from 1980 onwards, these institutions became increasingly marginal as policy cooperation in macroeconomics declined and private finance expanded to take on many of their functions. Now, with the crisis in private finance and an urgent need for renewed international policy cooperation, the institutions must be revamped.

Politically, that will be more than difficult to do. The original IMF was the result of the hegemony of the United States, the dominant economy in a war-ravaged world, with input from the United Kingdom, then the world's third largest economy. Now the institutions can only be reconstructed by international agreement involving a dozen or so substantial players and success requires that hitherto dominant countries dilute or sacrifice their leading roles.

If your taste in humour is black, there has been something amusing about watching economists, pundits and special pleaders denying the role of macroeconomic stabilisation, never mind international cooperation and insisting on the dismantling of the few remaining barriers to systematic instability. They have extolled deregulation and flexibility and wished to foster even more comprehensive uncertainty in people's working lives. They asserted the impossibility of any scheme to equalise income distribution 'in

one country'. This looked clever in the boom but becomes politically unsustainable in the bust. Voting is still organised on national lines and, one way or another, nationalism will reassert itself as the only political force, given the demise of socialism, able to deliver people from instability. We shall have to recreate the habit of cooperation and mechanisms to achieve it more effectively than those that existed in the third quarter of the twentieth century. It is to be devoutly hoped we do so without passing through the horrors of the first half of that century.