BRITAIN & OVERSEAS

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

Autumn 2011 Vol. 41, No. 3

Editor: Jim Bourlet

The articles published in this journal do not necessarily reflect the views of The Economic Research Council

Published quarterly by

The Economic Research Council

Tel: 020 7340 6016

www.ercouncil.org

Price: U.K. £35 Australia $60 Canada $50 New Zealand $60 U.S.A. $50 Japan ¥5,000

ISNN 0045-2866

MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. Annual subscription ranges from £20 to £70, with student discounts available. For more details, please go to www.ercouncil.org/join.php

Contributions to *Britain and Overseas* should be submitted to the editor, Mr Jim Bourlet, (jbourlet@hotmail.co.uk) in either hard-copy or electronic format.

Books for review should be sent to the Economic Research Council, 55 Tufton Street, London SW1P 3QL.

POLITICAL ECONOMY AND THE CRISIS

Extracts from a talk given by Steve Baker MP to members of the Economic Research Council on Tuesday 28th June 2011

Political Economy

I think economics should become political economy and that morality should be an intrinsic part of our thinking about economics. Political economy is not just about production, exchange and consumption apart from the State. It is a system of social cooperation, mediated by money, affected by a range of other things in such fields as sociology, political science, anthropology and psychology.

It seems to me mistaken to regard political economy as a positive applied science. Contrast it, for example, with ballistics. If you want to predict the trajectory of a shell and you know the inclination of the gun and muzzle velocity, you could very accurately predict that trajectory. You would not get two experts publishing an article, one arguing for one trajectory and one arguing for another. That is what you see in economics so there is something fundamentally different between a positive applied science such as physics and the study of the interaction of human beings which is economics. In contrast to physics, in economics it is impossible to collect the information which is dispersed in the minds of many, many people, information that is subjective, practical, tacit and non-verbal. Much such information is not yet discovered or created, and very often, intervention prevents you from discovering that information. Clever techniques in the use of statistics may give the impression of overcoming these factors but the validity of the results should questioned.

And political economy in contrast to economics involves public choice theory. The State spends around half of GDP – it is an enormous player in society. When we look, for example, at high-speed rail, the situation could be a classic example of public choice theory – dispersed costs with concentrated benefits. You can see the lobbying groups separating. In favour of high speed rail are such as opponents of the third runway at Heathrow and those who genuinely believe that a high speed railway line will regenerate the north; whilst against we find those with concentrated costs. But since those with dispersed costs and benefits cannot lobby, they need to be taken into account through public choice theory.

Let me also say that political economy involves morality (as well as jurisprudence, theology and logic) if we wish to produce flourishing human beings. Adam Smith's 'The Theory of Moral Sentiments' was a key part of his understanding of political economy.

Political Philosophy

My next consideration in looking at the crisis is to say that classical liberalism is the most robust political economy but we should be coherent and consistent in the way we apply it, both to infrastructure and to money and banking.

Hayek discussed three political economy positions: Communism and Socialism (a kind of 'left'), Fascism and Conservative interventionism (a kind of 'right') and classical liberalism (in the centre). I like to think of my politics as extreme centre. In this crisis it is obviously ridiculous to move towards communism and yet, when the students were rioting over tuition fees, there were communist flags on Parliament Square and even Marxist speakers playing to the crowd. I'm afraid that there is a risk that as unemployment rises, interest rates go up and lives get worse, people could turn towards authoritarian doctrines. But we know that state ownership of the means of production simply isn't acceptable and central planning doesn't work.

Socialist and conservative interventionists come in various guises. Some socialists believe in some state ownership of the means of production whilst others believe that everything should be private except for the system of money. Conservatism with a small 'c' is merely the avoidance of change. None of these are sound or sufficient answers to the present crisis.

So for me, if we are to have a consistent system of thinking about political economics, we should start looking at how to apply liberal political economy to every aspect of our society. I have found that the Austrian School of economics offers important insights in guiding these developments. One such insight is to challenge the often held view of 'individualism' as a selfish foolish obsession with oneself. In fact, quite independently of state institutions we see individuals cooperating with others in a rich dynamic tapestry of relationships, which is society. Another insight is to recognise that this 'society' is a dynamic process, not a static set of relationships. We should not therefore assume away life itself, which is the choices that people make, the actions they take to pursue their goals.

We should be able to talk about profit; we must reclaim profit. Provided an action doesn't enjoy state privileges, surely profit is a measure of the value you've created for other people in their opinion. So far from saying that profit is amoral, profit actually – provided it doesn't exploit state privileges – should be a moral and positive thing. And markets are a vital part because only with markets can one know prices and make rational decisions. Another insight from the Austrian School that I'll mention is the 'agony of interventionism', this constant application of one intervention after another. We agonise about youth unemployment but yet we persist in a commitment to the minimum wage. We really have to decide if we want to support human flourishing, what is the best way of producing maximum utility.

Political Finance

The nation's financial history of the last one hundred years has been dominated by the inexorable growth of the state as a proportion of GDP from around 10 to 15% a hundred years ago to about a half today. Such high levels of expenditure have to be paid for from taxation, borrowing and currency debasement, so let's look at each of those. In 1960 taxation as a fraction of GDP hit 40% for the first time, then fell back a bit, but since 1970 has remained around that much. Since government expenditure is around 50% and taxation is around 40% of GDP the government (and many governments around the world are in a similar position) borrows to finance the difference. Some projections show some countries national debt rising to five or even eight times their GDP by 2040. The Bank for International Settlements says that by 2040 the UK will be spending a quarter of GDP on debt interest. Such a situation would be clearly catastrophic and so the only way out – historically the way throughout the 20th century – is through currency debasement.

Now the reason that I've put this to you is that it seems to me that the history of the last one hundred years is the adoption on interventionist ideas, the belief that society could be managed, the discovery of practical limits on taxation, and so then governments are paying for their intervention by borrowing and debasing money – through increasing the money supply. This creates distortions in capital allocation and goes a long way towards explaining boombust cycles. An important commentary on this is Jesus Huerta de Soto's Money Bank Credit and Economic Cycles written in 1998 in Spanish, and translated and published in English in 2005.

And the Central Bank

So where next for banking? The arguments are frustrating. I've heard some economists say that fractional-reserve deposit-taking is a product of the market; I've heard free-market economists say it's a product of the state. I've heard one notable economist say that central banking is an evolutionary product of the market and yet others will say that central banking is undoubtedly a product of the state. These arguments are conducted with a ferocity that only comes with full intellectual commitment. This is frustrating if you believe, as I do, that the central challenge of our time is to review our monetary arrangements. In the end really, I agree with Sir Mervyn King: 'Of all the many ways of organizing banking, the worst is the one we have today', which is something Mervyn King said in his lecture 'Banking: From Bagehot to Basel, and Back Again', his Second Bagehot Lecture at the Buttonwood Gathering, on 25th October last year. I've got a quote here from Bagehot which I'd like to share with you. It's from the end of his book Lombard Street, which he concludes by saying 'We must therefore I think have recourse to feeble and humble palliatives such as I have suggested; with good sense, good judgment and good care I have no doubt that they may be enough, but I have written in vain if I require to say now that the problem is delicate, the solution is varying and difficult and the result is inestimable to us all.' Essentially, in this conclusion, he is really criticising the monetary arrangements of his time but suggesting that there is no point in trying to promote profound reform to the monetary system. Many would now challenge this apparent complacency. In the end, looking at the crisis, I personally am an optimist but I am cautious because the debate is changing, it's shifting. We are all here today having a conversation – and who knows where it will lead …

UNTIL WE RETURN

By Stewart Newton

One ship sails East, and another West,
By the self-same winds that blow.
'Tis the set of sails, and not the gales
That tells the way we go.

Ella Wheeler Wilcox, *Poems of Progress* (1911)

Everyone knows that the 2008 crisis/credit crunch in the developed world was caused by too much debt and greed.

However there has been limited discussion as to how and why the US, with its Puritan origins, top mathematical brains in finance, squads of MBAs from the best business schools, great wealth and power, got into such a mess.

These questions and their answers are important in helping assess how the economic issues we are facing are likely to be resolved.

The Commercial Success of the Puritans

The USA, despite its materialism, is still a religious country. In an excellent book, 'The Puritan Gift', the Hopper brothers describe why the Puritans emigrated, what characteristics underpinned their success and why the US is in its present weakened state. Their conclusion is that it is down to poor management and a failure to continue with some simple but basic rules which were critical in the economic success of the Puritan communities.

Across the Atlantic in England, the Quakers, based on the Puritan ethos and led by Fox in the mid seventeenth century, had evolved after much persecution into a small but very powerful economic group by the nineteenth century.

At the peak of English economic power, they had built businesses which controlled some 75% of the steel industry, and many household names including Barclays, Lloyds Bank, Reckitt & Colman, Clarks Shoes, Cadbury's, Fry's and Rowntrees to name but a few.

What were the reasons for their commercial success?

1. The underlying philosophy was to make Heaven on Earth e.g. to allow the interests of society to override those of oneself. This set the standard. Behaviour was reviewed by the local society, and deemed breaches were discussed and reviewed.
2. The underlying philosophy meant one had to be honest and have integrity. In nineteenth century England business ethical standards and treatment of staff were both poor. For example, lead filings, which were substantially cheaper than cocoa, were often added to chocolate as a filler as both were a similar colour. Not surprisingly, there were serious health issues. A good example of maximising short term profits irrespective of the longer term consequences. The fact that the Quaker companies did not do this enabled them to establish strong market positions based on brand and quality.
3. As a group, they looked after each other provided you stayed within the rules. Going bankrupt usually meant you were expelled from the Society, so there was a big incentive to seek help early, be cautious and succeed. Often there was fierce competition e.g. the chocolate companies. This culture of tough competition was overridden if the wider society was at risk.
4. While the philosophy encouraged the making of money, the purpose was not to maximise one's own wealth but to build a business for the good of society. Hence for example, hardly any Quakers got involved in arms manufacture and Quakers had a deserved reputation for looking after their staff e.g. Cadbury's village at Bourneville.

The Rake's Progress

One has to start at some date and, for this note, 1980 has been chosen. At that time Volcker was Chairman of the Federal Reserve. Faced with high and rising inflation he decided to stand his ground. He raised interest rates sharply. Rates reached a peak of 20% in March 1980 and Volcker made it clear that they would go higher if necessary to get inflation under control. Such action required courage and much unpopularity, yet his remuneration was never great. He showed many attributes which the Founding Fathers would have appreciated. Yet even at the height of his power Volcker was out-gunned by the Wall Street lobby. He was therefore not able to impose the necessary culture.

Another key factor in the build-up to the 2008 crisis was the evolution in law of what is referred to as 'the agency approach' to the corporate governance challenge of aligning the interests of shareholders and management in quoted corporations. This established the primary or sole purpose of corporations as being to maximise shareholder returns within the confines of the law. Thus corporate managers and boards in the US are *legally required* to place the interests of shareholders ahead of those of debt holders, labour, the environment and society. This is totally at odds with the Puritan ethic of encouraging individuals to act in the interests of society before their own.

Volcker was followed as Chairman of the Fed by Greenspan and Bernanke, both philosophically committed to keeping the party going rather than 'taking away the punch bowl'. Given the sound base that Volcker had created, it was possible for the party to go on a long time. In such an environment, attitudes and cultures changed. Greed rather than fear dominated and there were few constraints and controls. Regulatory controls and banking capital ratios were relaxed. Worse, inappropriate activity was encouraged by flawed risk management techniques. Debt was encouraged by the tax system in preference to equity.

Moreover, it was assumed, relying on investment history, that diversification would protect investors. Hence significant risk was incurred on the basis the overall risks taken were small. The toxic combination listed above encouraged reckless borrowing and lending.

Inevitably, this less disciplined environment of greed enabled the rich, CEOs, senior management and the finance industry to grab a much bigger piece of the economic pie. In 1970, the typical chief executive of a large company was paid 25 times the average wage – not far from the multiple of 20 that Pierpont Morgan, the New York financier, had recommended a hundred years earlier. By 2006, this figure had risen to 475! (By comparison, the ratio for Japanese chief executives was 11 and 12 for German.) In addition, tax changes increasingly favoured the wealthy.

As a consequence of this re-allocation of wealth, the middle and especially lower income groups have seen their standards of living come under great pressure. It is not surprising therefore, that it has proved difficult for the US, a consumer-led society, to achieve sustainably higher levels of growth.

In summary:

> … the phenomenal growth of finance capital that has come to define capitalism over the past 30 years was accompanied by policies that

> favoured financial market deregulation, a diminution of workers' rights and organized labour power, weakened antitrust enforcement, and corporate governance rules that placed the rights of shareholders ahead of those of all other corporate and societal constituencies. The growing dominance of finance in the world economy was an essential factor in the displacement of productive investment by speculation that culminated in the financial crisis of 2008. Finance became its own *raison d'etre*, and instead of providing credit to fund capital expansion and economic growth, the financial sector's function became to expand itself.
>
> (Lewitt: '*The Death of Capital – How Creative Policy Can Restore Stability*').

Against this background a 'Minsky moment', when overindebted investors are forced to sell good assets due to cash flow problems, was virtually inevitable. Like most such crises, no one could judge the catalyst or the timing.

Reaction

The reaction of Bernanke, the Federal Reserve Chairman, and other Federal governors to the credit crisis was to print huge amounts of money and move much of the toxic debt in the finance sector on to the Government books. Thus the debt became the responsibility of the tax payer.

Given the circumstances, there were few choices. However, these actions have not solved the problem, just 're-arranged the deckchairs', and bought some time for issues to be addressed. Already the weakest e.g. Ireland, Greece are experiencing Sovereign debt issues.

Reactions of Governments to the problems have and will vary dependent on the circumstances and the attitude of the populace. For example, in the UK, the Government is beginning to address the problems but is meeting growing resistance from entrenched public sector employees.

In the US, the Wall Street lobby still has powerful influence, and they will slow or stop many of the radical changes that are needed. This in turn will make it difficult to find a global solution to financial regulation and standards. In addition, there is a major divide in the US between the Republicans, who wish to cut taxes to get the economy going, and the Democrats, who are more focused on protecting the benefits of weaker members of society and raising taxes.

Europe is essentially trying to achieve an impossible balance between

Germany, who has made itself more and more efficient over the last decade, and other less disciplined members.

In the slow growing, developed world, central bankers are keeping interest rates artificially low to force investors into higher risk assets and to help creditors and the banking system. This is a dangerous policy and is not sustainable indefinitely. It is only possible because the developing world is prepared to fund the developed world. Should this change, then clearly there would be major issues for the developed world.

At some stage we could well drift into another crisis, the consequences of which are difficult to assess.

Possible Outcomes

The problems we face are deep-rooted and took many years to evolve. In countries like the US and UK, satisfactory solutions will be difficult to achieve given the level of indebtedness and Government deficits, the significant widening of the disparity in income and wealth in democracies, the prioritisation of self over society and, with growth in the welfare state, the decline in the percentage taking personal responsibility. In the Puritan society, the individual had a responsibility to society and the society had a responsibility to the individual. For many in the UK, only the second part is relevant.

It may be possible for countries such as the UK to take sufficient action to create time and successfully to address the issues nationally. There are signs that some in the US are moving back to their Puritan roots but the pace and number so doing is unlikely to be sufficient or fast enough. History is against such an outcome as significant change is usually only possible through crisis.

The problem for investors is that, in the present environment of considerable debt, weak governments and areas of conflict, it is difficult to judge if, when and where a serious crisis will emerge. The political changes in the Middle East and events surrounding *News International* highlight the impact of the internet and social networks and the power they have given to the people to change behaviour of even the most powerful.

It is important to understand that some countries (e.g. Singapore, Canada, Norway) and some companies (strong, well managed, multinational groups with a good culture) are much better placed to ride out any storms and emerge even stronger. In Singapore, for example, there is a clear sense of personal responsibility. Cab drivers in Singapore are proud to tell you that if one kills someone while drunk driving, the driver is executed.

Many countries in Asia, in particular, are taking on the Puritan mantle, and this is often reflected in their attitude to education and work. Not surprisingly therefore, growth is being driven by Asia.

What should the investor do in such circumstances?

Firstly, accept we are living in a very uncertain world and that we are in the middle of one of history's great financial experiments, led by the Federal Reserve.

Secondly, accept that there is likely to be continued volatility of assets. The financial uncertainty will be compounded by political issues and history shows that economic stress causes political problems. There are likely to be conflicts between countries and amongst societies.

Thirdly, think hard about one's risk profile and be honest with oneself. Changing one's risk profile after a significant move in markets is often an expensive reaction.

In such times it is helpful to think in real terms, not indices, over a period of time, suitable to one's circumstances, say over a rolling 5 years.

In his book 'The Great Reflation', J. Anthony Boeckh describes the alternatives available to investors and the risks attached to each type of major asset class.

He has a bias towards equities, as do I, but in this uncertain and volatile world, even the best businesses may be unexpectedly hit and many of the weakest will undoubtedly perish.

Hence even if one has an equity bias, having some spread of assets with a different risk profile may well be appropriate. Moreover, if one cannot find attractive, quality risk assets to fit one's risk profile at sensible values, it is better to remain in cash or quality bonds, despite the present meagre yields, rather than lose capital.

There are times in investment, as in football, when good defence is more important than trying to score goals.

SHEER INCREDULITY

By Kishore Mahbubani

The demand for global leadership has never been greater. The world is truly lost in trying to find a way out of the current crisis. America is imploding. Europe is crumbling. London is burning. The Arab Spring has lost direction. China and India remain internally preoccupied. If ever there were a moment for a global leader to step up, this is it. So why is no leader emerging?

First, the world has changed structurally, yet our systems for managing global affairs have not adapted. In the past, when the billions of citizens of planet earth lived in separated countries, it was like having an ocean of separate boats. Hence, the postwar order created rules to ensure that the boats did not collide; it created rules for cooperation.

Up until now, this arrangement has worked well. World War III did not follow World Wars I and II. But today the world's seven billion citizens no longer live in separate boats. They live in more than 190 cabins on the same boat. Each cabin has a government to manage its affairs. And the boat as a whole moves along without a captain or a crew. The world is adrift.

The G-20 was set up to provide global leadership at the height of the latest financial crisis. The group came together in London in early 2009 to save the global economy. However, as soon as the crisis receded, the G-20 leaders retreated into their cabins again. To make matters worse, some nations have become unmanageable. Just look at the United States.

The best candidate for global leader is, of course, Barack Obama. No leader gets as much global press coverage as Obama does. But he has no time to save the world. This summer a tiny group of crazy Tea Party congressmen held him, the United States and the world hostage.

In the next 14 months, Obama will only focus on his reelection. The world will not matter. Sadly, no European leader seems ready to fill this vacuum. Nor is there a Chinese or Indian leader willing to step up. Our global boat will continue to drift in the coming months.

The second reason no global leader has emerged: the geopolitics of the world are running at cross purposes with the geoeconomics of the world. Geoeconomics requires consensus; countries coming together. In geopolitics, we are experiencing the greatest power shifts we have seen in centuries. Power is shifting from West to East. All this creates deep insecurity in the established powers. They want to cling on to privileges acquired from previous days of glory.

Only this can explain the rush by Europe to reclaim the headship of International Monetary Fund when Dominique Strauss-Kahn stepped down. No one doubts that Christine Lagarde is a competent administrator. But is it wise for Europe to cling on to old privileges when power is shifting? And is it wise to choose a non-economist to run the most important economics organization at a time of economic turmoil? A secure Europe may have ceded power graciously. An insecure Europe clings to privileges.

Third, political leadership is always preceded by intellectual leadership. For several decades, the Western intelligentsia provided this intellectual leadership. Indeed, they used to happily lecture the world on what should be done. Today, they are clearly lost.

As an Asian, I used to be regularly lectured by Westerners on the inability of Asians to slay their sacred cows. Today, the Western intelligentsia seems equally afraid to attack their own sacred cows. Surely, after the damage done by the Tea Party episode, an obvious question to ask is: Have democracies become dysfunctional? Have special interest groups distorted the global agenda? Should some of them be disbanded?

Sadly, the parameters of intellectual discourse in the West have become narrower and narrower. Short-term political fights take precedence over long term strategic decisions. Only one phrase captures the current Asian perception of the West: sheer incredulity.

How could the best preachers on political courage and economic discipline in the world display none of it when the hour came?

In short, we are not going to get any great global leadership soon. And if we continue to drift, we will at least know why.

Kishore Mahbubani, dean of the Lee Kuan Yew School of Public Policy, National University of Singapore, is working on a book about global governance and leadership.

DISCREDITING DEMOCRACY

Damon de Laszlo

Everywhere you look gloom is in fashion. The glass is half-empty in the West. While none of the problems are insurmountable, comparisons are being made with 2008, but there is very little relevance in this comparison. The present situation can be summed up as follows:

Europe has been in structural treaty problems for a number of years and so far the European constitution has made it difficult to address the core issues of the individual European governments' financial deceit. France and Germany both broke the borrowing rules some years ago. At the other extreme, Greece was accepted into the Monetary Union even though it clearly did not comply with the rules from its published government accounts which subsequently were shown to be falsified with some possible connivance of Brussels. Today, it is generally accepted that Greece will have to default, however politically the leaders of France and Germany don't want to be seen to accept reality in the fear that they may be blamed for the default and the potential damage to their own banking systems.

This dance has been going on for nearly two years and is very unnerving, both to the public and to European business managers. The financial uncertainty created by the political paralysis causes long term business decisions to be put on hold and also encourages excessive private saving.

The crisis in the banking sector caused by the failure of banks to mark-to-market their holdings of Europe's sovereign debt will be resolved in the fairly near term, hopefully by the political leaders, failing that by a disorderly default and a full blown banking crisis. The separate problem facing Europe is the fixed exchange rate that means the Mediterranean countries have become very uncompetitive compared to their northern neighbours and they cannot devalue. Relatively low inflation, pay freezes and massive loss of jobs is the only way to drive down their costs; a horrendously difficult political and socially painful process.

The black swan events of 2008 – the unknown unknowns which led to the freezing of the banking system around the world, and the subsequent freezing of world trade bears little resemblance to what one can only describe as the white swans, or known unknowns in the European system.

By contrast the USA's problems are much more recent and created by the paralysis in Congress during the July and August budget debates. The childish and partisan debates in Congress turned into a T.V. soap, broadcast across the Nation. This meant that the nascent recovery that was well under way stalled as business and the general public started to realise that their Government could actually shut itself down and default.

The economy stalled and the numbers are appearing in the statistics. They are, however, not nearly as bad as many of the predictions, but what has changed most is the mood and perception of forecasters. The predictions of the pundits have gone from underestimating the high growth, a phenomenon of the first half, to downgrading everything in the second half, which adds to the general feeling of nervousness and uncertainty. The numbers that are currently coming out only show a lowering of growth expectation, but it's difficult to remember that things are better than they were a year ago. The flames of uncertainly are being further fanned by huge volatility across all markets.

The vast amounts of cash that have been pumped into the system, added to the computer driven 'high frequency trading' is causing unheard of volatility, further unnerving those that have to take serious decisions on investment.

It is ironic that the US President is focussing his ire on the European crisis, when his own back yard is in a state of self inflicted government economic chaos. Political ineptitude in the West is having a serious long term impact on the respect for democracy. The public distrust of politicians both in Europe and USA is causing enormous problems for the democratic system. This disenchantment and distrust is leading to people voting for wacky parties: in Germany we see the rise of the Pirate Party and in the USA the Tea Party. The members of these parties tend to be way outside the normal political spectrum and seem to be largely made up of people who have very little concept of the role or responsibility of Government.

The good news is the problems of the noughties ('00s) fall into the category of white swans; Western business is gradually seeing its way through the problems of economic mismanagement and regulatory incompetence.

Gradually, the excessive debt built up in the system is being absorbed. Hopefully, the current political tensions will make the West's politicians address their responsibilities – this is a big hope – and show some leadership. There is underneath this no reason why economic stability and slow and steady growth cannot continue. I suspect by the end of the year, and probably one or two more economic earthquakes, there will be a realisation that the system isn't broken and the economies will stabilise. The longer term worry is the reputational damage that the West is suffering in the Middle and Far East. The governments of the rest of the world are showing, with some justification, more and more disdain, which will end in disrespect for western democracy and values.

THE TRIFFIN DILEMMA TODAY

By Adam Baldwin

Clearly, since 2008 our global financial markets have indicated that confidence in the US dollar as the global reserve currency has declined, leading many to question the position of the US dollar as the global reserve currency. Many now speculate that the ever-rising US current account deficit has risen to unsustainable levels. This is not the first time in which our current global currency system has been questioned, and it will doubtless not be the last. Crucially however, is it even possible for any one currency to efficiently serve as the global reserve currency? Was the US dollar doomed from the start? Would it have been different with any other currency?

Proposed by Robert Triffin in the 1960s, the 'Triffin Dilemma' emphasises that when a currency serves simultaneously as both a national currency and also as a global reserve currency, a fundamental incompatibility exists between short-term domestic objectives and long-term global economic aims. In his 1960 warning to the US congress, Triffin outlined that the issuing nation of the global reserve currency has no choice but to run a persistent current account deficit in order to supply the global economy with sufficient currency in order to fulfil demands for foreign exchange reserves. Triffin warned that whilst such a deficit would bring with it excess global liquidity, which would risk sparking inflation, failure to do so would risk the global economy falling into a contractionary spiral. Thus, somewhat ironically, the ever increasing demand for the 'safe' assets of the global reserve currency issuing nation eventually leads to such high levels of debt that in time the very confidence that forms the original basis of the reserve asset status of that nation is eroded.

This tension between monetary policy at a national and global level is reflected in imbalances in the balance of payments, most specifically the current account. Whilst certain objectives require an outflow of dollars from the host country, others require an inflow. Such inflows and outflows cannot occur simultaneously.

In essence, has the US dollar's *exorbitant privilege*[1] of being the key supplier of the global reserve currency led to an ever-increasing level of demand for US$ that has caused an erosion of the very confidence upon which the original premise was built?

Triffin's solution to the dilemma was to create new sources of liquidity through issuing more IMF drawing rights that are not liable for any one country. The creation of new reserve units would allow the US to reduce its balance of payments deficit without compromising global economic expansion. Whilst serious discussions regarding a reduction of the global reliance upon the US dollar was politically unfeasible at the time, in light of recent events its contentiousness may have been alleviated.

On 23rd March 2009, the Governor of the Bank of China, Dr Zhou Xiaochan, re-instated the Triffin Dilemma back onto both the political and academic world stage. 'Issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries' demand for reserve currencies …' Xiaochan stated, '… they may either fail to adequately meet the demand of a growing global economy for liquidity as they try to ease inflation pressures at home, or create excess liquidity in the global markets by overly stimulating domestic demand. The Triffin Dilemma, i.e., the issuing countries of reserve currencies cannot maintain the value of the reserve currencies while providing liquidity to the world, still exists.'[2]

1 i.e. the unique advantage of a reliance upon one country as a key supplier of global reserve assets.

2 *Reform the International Monetary System*, essay by governor of Bank of China, 23rd April 2009.

WHAT WENT WRONG WITH ECONOMICS

By Michael Reiss. Goldhurst Press 2011 p/b

Subtitled 'The flawed assumptions that led economists astray' this book contains loads of ideas, perceptions and good sense. It is a book based on issues where the tools of economics can help in developing public policies issues like banking, usury, income distribution, pension policy, land ownership, and the national debt. The prose is that of the intelligent layman rather than the mathematical obfuscation of the modern economist and one wonders just where such an approach fits in? One answer is that this in the style of economics past rather than economics today – it is as if one is reading a modern version of David Hume or Adam Smith – or even Karl Marx. Such writers were broad brush, concerned with policies rather than intellectual econo-castles and saw economics as a development in philosophy a concern to promote moral and public values. So Reiss is in good company though he has yet to compose a 'theory of moral sentiments'!

Of course this book – this conversational polemic – can be easily enough criticised. In the early chapters there seems an urge to entertain – to grab our attention with a 'wow' factor using the skills of a conjuror. Conjurers hold our attention through a series of steps diverting our gaze when they make that crucial little mis-move which allows the rabbit to be found in the hat. Thus in discussing money creation he notes that money is only created when a bank's credit worthy customers offer to be in debt. It is the customer that 'creates' the money rather than the responding bank but in Reiss's account it is the banks that are the guilty initiators of money creation. This leads him to claim that if all a bank's depositors asked for their money back, the bank could not pay them (page 27) which is simply not the case if their credit worthy customers are given the time to repay their loans. The chapter on 'supply and demand' (Ch 3) shows a misunderstanding of the proper definition of a good or service traded. Chapter 4 deals with savings but seems to lose sight of the fact that savings must end up equalling investment – a subject well dealt with in any number of macro-economic text-books.

Some chapters are interesting, accurate and stimulating but others remind one of a little book called '101 unuseless Japanese inventions'[1] – ideas that appear good initially but have to be discarded on second thoughts. Thus the chapters on redistributing land ownership ignore issues of incentives, stewardship and history. His proposals might be interesting if one could start all over again but, in the context of where we actually are, would amount to unacceptable confiscation.

But such criticisms are for the reader to supply. The more important point is to ask whether this book answers to the title question 'what went wrong with economics?'. There are three main ways in which economics as

---

1 Kenji Kawakami 101 Unuseless Japanese Inventions Published by Harper Collins 1995

a subject has, of late 'gone wrong'. One is that it has become mathematical to the point of being utterly unrealistic. The second is that it remains based on a 1930s understanding of human motivations and the third is that theoretical economics has become almost totally separated from the study of economic history. Reiss fails to cover the first and second points but makes a great contribution towards correcting the third. And if re-uniting economics with real events looks a bit like returning to the economics of earlier work then we should cheer Reiss on and gladly read his attempt to make sense of our world.

J.B.

BACK FROM THE BRINK

By Alistair Darling, published by Atlantic Books, 2011

Alistair Darling in this book shows little recognition of the origins of the world financial crisis. On page 140, he seems to think that it is the banks' lack of capital which is the main fault without recognising that this lack of capital arose from a high level of defaulting debtors. Was this high level of defaulting debtors entirely due to poor judgment on the part of the banks' executives, or was there some overriding hidden cause, hidden apparently from the Bank of England, the FSA and the Treasury, let alone the politicians? For the initial cause we have to look to the land of the defaulting debtor, the USA, particularly the two institutions Fannie Mae and Freddie Mac which were designed to guarantee mortgages from subprime loans without the financial resources to achieve this, so that guaranteed defaulting debts accumulated in their balance sheets. Ever resourceful, the United States devised a way of dealing with this known as securitization where investments could be sorted according to yields and redemption dates. Securitization may be fine for investments which have yields and redemption dates, but the defaulting debtors held by Fannie Mae and Freddie had lost these strengths years ago. But not to worry, the world's bankers and insurance companies were still keen buyers motivated by the misleading ratings and by abstruse probability theory. Darling seems naive about the conservatorship of Fannie Mae and Freddie Mac in September 2008. This was not on old Labour type of nationalisation but a credit event which activitated credit default swaps to be decided by the International Swaps and Derivatives Association which Alistair Darling like Gordon Brown before him fails to mention. Darling (page 15) seems to think that insuring against defaulting debtors is a good idea which he had apparently encouraged in the early years of the Labour Government 1997–1998. He fails to recognise that this meant an inability to value debtors which was the main problem in 2007–2008. Darling's book clearly shows that for international financial problems, an international financial awareness is essential. We may not expect this from politicians but it is vital at the Treasury and at the Bank of England and also from professional economists.

Peter L. Griffiths

THE STRANGE NON-DEATH OF NEOLIBERALISM

By Colin Crouch, Polity Press 2011 p/b £14.99, h/b £50.00

Your reviewer found this book very prominently displayed in *The Economist's Bookshop* at *The London School of Economics*, billed as a 'best seller' for students and with a title based (as the author acknowledges) on George Dangerfield's 1936 classic *The Strange Death of Liberal England*. So what are LSE students reading these days?

In the book one is treated to an intellectual *Tour de Force*, the condensed notes of a complete lecture series. As such it is hard to summarise but we start with a description of the early post-war period – of pre-globalisation with strong nation states running mixed economies where those industries left in private ownership were (mostly) composed of smallish firms. This happy shire was then upset, we learn, by the neoliberalism of Hayek and Friedman, of the Chicago school and the politics of Thatcher and Reagan. Neoliberalism's belief in 'market forces' has had us privatising state run industries, globalising trade and undermining social cohesion. Life based on greed and power based on corporate influence is now everywhere about us – in banker's absurd bonuses, in Enron collapses, in dishonest Arther Anderson style accountancy and in wars imbued with commercial gains. Thus the 'neoliberal project' has, in the author's view, clearly failed – but will not die.

Crouch begins by attacking the credentials of market mechanisms. We read about the unrealistic assumptions underlying faith in markets (or at least of that unfortunately named concept 'perfect competition') and we are treated to a lengthy analysis of 'market failures'; failures which then justify government intervention. We are told that the growth of personal borrowing, since this supplements government borrowing in stimulating aggregate demand, has become 'privatised Keynesianism'. Economic growth now seems to depend on 'consumer confidence' – that is, more and more personal indebtedness through the use of credit cards and mortgages.

Meanwhile, public decision-making is limited by the mobility of companies, tax exiles and workers, whilst at the same time big companies have great powers, not just to lobby public decision makers, but to control them through campaign contributions and threaten them with no-cooperation of various kinds. We now, Crouch says, have four great political forces – government, market, the press and corporations. Although there are some glimmers of hope – governments sometimes defy lobbying (as in banning smoking), the market sometimes works in the public interest (as in bringing down the costs of telecommunications), the press sometimes undertakes truly independent investigative journalism, and corporations sometimes appear to sincerely embrace their 'corporate social responsibilities', the outlook, nonetheless, is for an essentially pseudo-democratic, corporation dominated, world order.

Perhaps the first observation to be made about this thesis is that it is hardly new. Opponents of capitalism never gave up their crusade just because Marx turned out to be wrong about the inevitability of monopoly – and they were little concerned with Communism's disaster in practice. Revisionist Marxism has a distinguished record. Think, for example of the 1960's book '*Monopoly Capital* by Paul A Sweezy and Paul M Baran – or even of J K Galbraith's *The New Corporate State*. *The Strange Non-Death of Neoliberalism* is a worthy modernised and updated successor for the neo-Marxist book-shelf.

A problem with this *genre* is a failure to distinguish between the concept of 'corporatism' and the concept of 'liberal-pluralism'. Both philosophies are based on the observation that groups exist in society which in practice largely dominate political life. Indeed, common sense tells us that anyone who turns up at the Palace of Westminster to lobby their MP is much more likely to do so on behalf of others of like concern rather than just on behalf of themself. Instead of society consisting of separate atomised individuals (the *individualistic* philosophy of the Physiocrats) or as an organic collectivity (as in Plato's *Republic*), we have groups of all kinds representing interests – trade unions representing their member workers, companies representing their shareholders, organisations such as *Which?* magazine representing some consumers, trade associations representing industries, and pressure groups of all kinds. The issue is how to relate 'groups' to the 'state'. Under the philosophy of corporatism this is seen as based on power – the state is just an alliance of the more powerful groups, existing to enable them to exploit the weaker groups. Under the philosophy of liberal-pluralism the relationship is based on law – the state is the referee in the game of politics rather than the captain of the stronger side. Liberal-pluralists follow the ideas Jefferson, Smith, Mill and Hayek and call for laws equally applicable to all, more competition in the market place and a limited role for intervention and expenditure. Corporatists scoff at all this as naive and call for ever greater limitations on the actions of groups – and ultimately for the collectivist agenda – the (hopefully) benign big state. *The Strange Non-Death of Neoliberalism* views the world through the red-tinted glasses of a corporatist prism and the conclusions of the book are thus obvious from its premise – though nuanced by the frustrations of neoliberalism's evident successes.

This blinkered, if brilliant, account misses the opportunity to discuss more interesting concerns. To start with, there is little said about the inefficiency of state provision, the impossibility of measuring it, and the near impossibility of raising the quality as well as the efficiency of state provision to private sector standards. This is a real and debilitating issue which should not be dodged in the name of values and ideology. Then there is indeed a problem of corporations becoming large and powerful without seeming to be accountable to their (mostly passive) shareholders. A possible solution lies in empowering shareholders by having an internationally agreed rule that 'retained earnings' be prohibited so that *all* net profits are distributed each year to shareholders – who would then be invited to return all or part of their dividends to their companies for further investment if they so wished. In contrast Crouch would have us demand more state and persuasion interference with management. A yet further example is his failure to recognise changing human behaviour as a response to any given set of incentives. We simply no longer live in a world where only the needy seek government housing, where the overwhelming aspirations are for two parent families, where trade unions represent half the working population or where education is the guarantee of a job. The world moves on and liberalism rather than corporatism has the greater flexibility to move with change.

Fritz Schumacher, with his enthralling little book *Small is Beautiful* argued in the first chapter in favour of what he called 'Buddhist economics', – a delightfully attractive proposed world in which we should all care for each other in unselfish and disinterested ways; in contrast to the greed and indulgence of our world today. This, of course would be wonderful and seemed so plausible – but there was a trick if you thought about it. Schumacher was comparing one world 'in theory' with another 'in practice'. This logical fallacy runs deep through *The Strange Non-Death of Neoliberalism*, however convincing a read it appears to be.

Most worrying however, is the inadequacy of description of the concept 'neo-liberalism' itself. There is little apart from the author's own version – and the index and 'further reading' give almost no guidance for disinterestedly exploring what it might mean. We have one or two lines mentioning Hayek and a couple more mentioning Friedman (references to Galbraith and to Marx are a little longer) but there is total silence on the huge intellectual output of pro-market solution advocacy institutions – in America such as the Atlas Foundation or the Fraser Institute or in the UK, the Institute for Economic Affairs and the Adam Smith Institute, for example. It would seem that Crouch wants the students – for example at the LSE – to see just his version of our world and remain in the dark about the arguments in detail, case by case, in favour of liberal courses of action. Thus this book needs to be seen as a work of persuasion, perhaps tending towards propaganda, rather than an account of serious academic worth. It amounts to an intellectual challenge to be used in the seminar room. Good luck to those LSE students!

J.B.

BOOMBUSTOLOGY

By Vikram Mansharamani, published by Wiley 2011 h/b

Cheer up – it has all happened before – and will happen again soon! This entertaining but closely argued serious analysis of booms and busts is subtitled 'Spotting financial bubbles before they burst'. If you once read and enjoyed 'Mania, Panics and Crashes: A History of Financial Crises' by Charles P Kindelberger and Robert Aliber, this is the can't-miss sequel.

The scope of analysis from this Yale University lecturer provides a lesson in methodology alone – a process of taking events, trends, anecdotal material and theory, and building them into what he calls 'The Five-Lens Approach' to recognising a bubble in progress. These five lenses are headed microeconomics, macroeconomics, psychology, politics and biology. Each of these leads one to systematically identify clues. Have we reached the stage where amateurs are investing? Has government made monetary policy errors? Is there over confidence and feelings that 'it is different this time'?

Mansharamani then treats us to five delightfully crafted chapters – historical case studies of Tulipmania, The Great Depression, The Japanese Boom and Bust, The Asian Financial Crisis and The US Housing Boom. Each of these is presented as an exercise in applying The Five-Lens Approach. It is very interesting, rather familiar and well explained with snippets of new information, clear perception and amusing asides. A useful revision course and great bed time reading.

But the real purpose of this book, the market justification for its publication, the inspiration for both author and publisher comes in the final pre conclusions chapter headed 'Boombustology in Action: Is China Next?' The author is suitably cautious saying (page 218) 'As an East Asian Studies major who once spoke Chinese well and worked at the U.S. Embassy in Beijing, it is with great trepidation that I proceed with this chapter'. He then presents 20 pages of jaw-dropping bar charts, graphs, cartoons, information and analysis (did you know that 20% of Chinese steel production is used to construct more steel mills or that Chinese Investment as a percentage of GDP, a healthy enough 25% in 1990, is now nearly 50%?) which amount to an entirely convincing case that China is in a boom that must bust.

And that bust will have dramatic consequences as commodity prices fall affecting both companies and countries that supply them; and expectations of China-led consumer price inflation go into reverseg – not to mention the possible political implications for China itself. So one is lead anxiously to the big question: When? Frustratingly, Mansharamani declines to make a prediction. It could be tomorrow or it could be in a decade – or more. It seems to be the case with financial bubbles that prediction should be avoided – after all the 2008 crises came 5 years later than Peter Warburton, author the 1999 analysis 'Debt and Delusion' predicted and the Japanese bust came at least 3 years later than economist Jon Woronoff expected. China is large and tightly controlled – and as Adam Smith remarked 'there is a deal of ruin in a nation'. So we are not to know 'when' but it is at least helpful to have one's suspicions pushed towards conviction.

J.B.

LETTER

A Response to The Rescue of British Leyland *By Garel Rhys*
(B&O Vol. 41, No. 2)

A memory triggered by Garel Rhys' piece on the British Leyland rescue in the 1970s/80s is, I was sitting in a renewable energy technology conference in the mid 1970s, when one of the speakers proposed the introduction of a new decimal unit, which he proposed to call 'The Leyland'. He then went on to suggest that the total UK investment in renewable energy technology be measured in milli-leylands and individual projects funded in micro-leylands. At that point I was leading the largest of the UK wave energy research teams and was the recipient of some of those micro-leylands. So in the 1980s we did manage to be sufficiently entrepreneurial that we did introduce world-beating wind turbine blade technology and my old team is still on the Isle of Wight, employing some 200 people. It is now the global blade technology development centre of Vestas, the Danish wind turbine company. So maybe even the micro-leylands paid off.

Yours,
Jim Platts

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.