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

Autumn 2004 Vol. 34, No. 3

Perma-bulls, Perma-bears and Bear-Bulls. This time it's different 3
The Decline of the Public Service Ethos 17
Research Study No 20, 'Family Structure and Economic Outcomes' 23
The Politics of 'Political Economy' 24
Adventure Capitalist 32

BRIAN READING – THEODORE DALRYMPLE – ROBERT McGARVEY

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
7 St James's Square, London SW1Y 4JU
Tel: 020 7439 0271
www.ercouncil.org

Price: U.K. £15 Australia $35 Canada $35 New Zealand $45 U.S.A. $25 Japan ¥4,000
ISNN 0045-2866

President Lord Biffen
Chairman Damon de Laszlo

Vice-Presidents Tim Congdon
Russell Lewis
Brian Reading

Hon. Secretary Jim Bourlet

Executive Secretary Professor Peter Davison

MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. The minimum annual subscription for individual members is £25 for full members, £15 for Associate members, and Student members £10.

Corporate membership is open to all companies and other bodies, minimum annual subscription £55 (Educational institutions £40) in respect of which they may send up to six nominees to any of the Council's discussion meetings and lectures.

Executive Committee

Damon de Laszlo (Chairman)
Tony Baron
Jim Bourlet
Peter Davison
Peter L. Griffiths
Dan Lewis
Robert McGarvey
Dulcibel McKenzie
Christopher Meakin
John Mills
Alan B. Parker
John T. Warburton

PERMA-BULLS, PERMA-BEARS AND BEAR-BULLS. THIS TIME IT'S DIFFERENT

By Brian Reading

Economic forecasters always disagree. If they did not there would not be so many of them. If one were always right (and none are) nobody would listen to anyone else. Disagreement is greatest at cyclical turning points and so are forecasting errors. Today, as 2004 draws to its close, the forecasting horizon has moved on to 2005–06. A turning point has already been reached. Most major economies – except the UK – suffered mild technical recessions (two or more successive quarters in which GDP contracted) between mid-2000 and mid-2002. Timing differed from country to country and indeed some recessions have since been revised away. There followed a period of strong above-trend growth to the first quarter of 2004, led by the US, China and – you have to believe this – Japan. Yes, the Japanese average growth rate in the two years to the first quarter was 3.8% a year. In the second quarter American and Japanese growth slowed sharply although Euroland's and the UK's bucked up. The forecasting debate now ranges between optimistic and pessimistic extremes.

Super-optimists, sometimes called 'perma-bulls' by their opponents, expect a soft landing on sustainable trend growth. They expect the recovery to continue uninterrupted for several more years during which inflation remains modest. Perhaps here it will be helpful to some readers to explain the concept of 'trend GDP growth' otherwise known as 'potential growth'. There is theoretically a potential GDP *level* at which an economy is not too hot and not too cold. If the actual GDP level equals its potential level, inflation neither accelerates nor slows down. When actual GDP differs from potential, there is said to be an 'output gap'. If GDP is above potential the output gap is positive and inflation accelerates, if below the gap is negative and inflation slows down. But the potential GDP level *grows* over time. This is the result of labour force growth (or decline) and productivity growth. Although potential GDP level cannot be directly measured, unlike unemployment or inflation, it can be estimated and so can its growth rate. This is what is called 'trend growth'. The point that the perma-bulls are making is that GDP in major economies is now close to potential. Gaps were negative during the 2000–02 recessions, generating fears of deflation and falling prices. But the subsequent growth spurt has largely eliminated negative gaps and inflation is now moderate. So a soft landing on trend

GDP growth rates would allow the recovery to continue at a measured pace into the foreseeable future. In other words, the death of the business cycle. Trend growth rate estimates differ. But most put America's at around 3% a year, the UK at perhaps $2\frac{1}{2}$%, Euroland's at around 2% with Germany and Italy (where labour supply is falling) between 1% and $1\frac{1}{2}$%. Japan also comes in at around 1% to $1\frac{1}{2}$% for the same reason. Estimates for rapidly developing economies such as China and India are more difficult as both have large pools of under-utilised labour.

Super-pessimists expect hard landings in the US and China and a global recession in 2005–06 during which the spectre of deflation returns. They get called 'perma-bears'. The middle ground is occupied by forecasters who project a mild mid-decade recession as in the 1980s and 1990s. It could be so mild that growth merely drops for a while below trend without ever actually going negative for two successive quarters. The recession is needed to prevent over-heating and rising inflation. But it is only a pause for breath, followed by a second, longer and stronger recovery phase. Perhaps they should be labelled 'bear-bulls'.

The perma-bulls seem to imagine that major economies are now so well balanced and well managed that, to change the metaphor, they can gently slow down to the 30 miles per hour limit when leaving the motorway and entering a town. Needless to say, Alan Greenspan at the US Fed is again the perma-bulls' cheer-leader. Many forecasters working for financial institutions, central banks, international organisations and national governments have a vested interest in optimism. They cannot be blamed for this. If major commercial banks (see *The Economist's* monthly poll of forecasters) the Fed, the OECD, ECB, Bank of Japan or Peoples Bank of China preached doom and gloom their forecasts could easily become self-fulfilling prophesies. But their case is manifestly unsound. Major domestic and international financial imbalances exist following policy bubble-bungles. The business cycle is alive and kicking.

The arguments between bear-bulls and perma-bears merit serious consideration. I confess to being a perma-bear, but have great respect for the views of my friends – such as Anatole Kaletsky – who are bear-bulls. So here I will put the arguments on both sides without claiming I am right and they are wrong. We shall see. But knowing where we differ allows observers quickly to see the denouement as the plot unfolds. A word of warning is however necessary. Some protagonists in this debate misuse the latest indicator series and new data. They select and emphasise only those supporting their own projections. My aim here is to present you with two

different pictures from the lid of the jigsaw box. As each new piece is turned face-up one must examine where it fits in and not disregard those that don't fit. If too many don't fit the picture is wrong and must be changed. Alan Greenspan is particularly guilty of selective advocacy. He pleads a preconceived case to justify Fed policy. Markets can also be selective to the Nth degree. Just now the flavour of the month is US payroll employment data. In Britain it used to be monthly trade figures or unemployment.

Decade Comparisons

There are crude versions and credible versions of the arguments on both sides. The bear-bull's crude argument is to use experience during the 1980s and 1990s as the template for the 2000s. All three decades began with recessions, severe in the early 1980s and 1990s owing to oil price hikes. Initial recoveries were temporarily interrupted by policy tightening in mid-decade following a mild acceleration in inflation. Bear-bulls are effectively saying 'This time is the same.' They decry those of us who say 'This time it's different'. They point to precedents like the 'new economy' and Wall Street bubble, where many wrongly argued 'This time it's different'. But remember, these were the super-optimists who often had a vested interest in their forecasts being believed.

The perma-bulls reply is that every decade is different. The 1950s were dominated by European and Japanese post-war reconstruction and a world dollar shortage (effectively over by 1958). The 1960s saw a dollar glut emerge owing to the US policy of guns and butter – the Vietnam War and Great Society. The inflationary 1970s were dominated by the collapse in Bretton Woods fixed exchange rates and oil price shocks. In the 1980s monetarists defeated Keynesians and full employment was abandoned in the fight against inflation. The 1990s saw the end of the cold war, collapse of communism, disintegration of the Soviet Union, German reunification, the Maastricht Treaty and post-bubble Japanese stagnation. These changes never took place discretely at the beginning of each decade. The phases merged into each other. But the decades were all different.

The 'noughties', as the decade from 2000 is called, is certain to be different. The collapse of communism and the opening up of China have expanded the market economy by a quantum jump never before experienced. Asia has become a major league player to rival the US. Big economies are launched into catch-up growth, massively more important

than their tiny Asian tiger predecessors. During the 19th century the global centre of economic gravity passed from Asia to Europe with the industrial revolution (in 1820 China accounted for 40% of world GDP). During the 20th century it crossed the Atlantic to America. During the 21st century it is certain to cross the Pacific back to Asia. Global capital flows took off during the 1990s, returning the world to its late 19th century openness. Euroland has its single currency and the EU has expanded to include ten new members – 20% more people but only 5% more GDP. Japan is pulling out of its decade in the doldrums. To suppose that the future will simply be a replica of the recent past is to sit facing backwards in a rowing boat, paddling into the future firmly believing you are going where you have just been. At the crude level the bear-bulls lose the argument hands down. This time will be different. But that does not necessarily mean the perma-bears' version of the future is right. Both can be wrong.

The Perma-bears' Case

The argument must now be conducted at a serious level. Here it is worth starting with the perma-bears' case first then considering the bear-bulls' criticisms. The case for a US and Chinese synchronised hard landing leading to a global recession has three elements. (China is shorthand for Asia/China as China is the dominant player.) The domestic causes of hard landings differ – put simply Americans save too little and Chinese invest too much. But the behaviour of each is only possible because of the opposite behaviour of the other. The third element in the argument is the linkage between them.

(i) US Sectoral Imbalances

For the US 'this time it's different' is obviously true. The booms in the late 1970s and 1980s *burnt out in excess demand*, overheating and accelerating inflation. The recessions in the early 1980s and 1990s *followed policy tightening*. The boom in the late 1990s *froze out in excess supply*, falling prices and squeezed profits. The recession *was despite policy easing*, which is why it was so mild. The early 1980s' and 1990s' recessions helped to correct sector financial imbalances, the early 2000s' policy easing postponed their correction. (A sector financial balance is the difference between its savings and investment spending – or between total spending and total income. If it is in deficit it must borrow and run up debts. If it is in surplus it must

lend and acquire assets. The sectors are households, business, public and overseas, foreigners.) Before the Wall Street bubble burst in early 2000, both the household and business sectors were running historically large financial deficits. The public sector was running an unusual budget surplus and the overseas sector (current account with sign reversed) was also running a surplus.

When the bubble burst the business sector set about increasing profitability, reducing debt and restoring balance sheet health. The fall in share prices demanded no less. This involved restructuring to eliminate excess capacity by closing redundant plant, outsourcing production, raising productivity by firing workers and cutting back harshly on new investment. But while restructuring by an individual company can restore its own profitability, it is a fallacy of composition to suppose that restructuring can, of itself, restore the entire business sector's profitability. The greater part of an improvement in any company's profitability is at the expense of other companies' sales and households' incomes. The household sector is particularly squeezed by falling incomes and consumer spending suffers. The result is a tit-for-tat deflationary spiral. The more businesses struggle to cut costs, investment and employment, the more households cut back on consumption. It is a no win situation which results in a severe recession unless the public and/or overseas sectors take the strain.

Policy easing prevented a severe US post-bubble recession. Tax cuts and public spending hikes turned the budget surplus into a large deficit, supporting the growth in households' disposable incomes. Ultra cheap and plentiful credit prevented household savings from returning to normal levels. Restructuring improved business finances at the expense of the public sector's. Meanwhile the unprecedented household financial deficit, building up debt, continued and even increased. When the Wall Street bubble burst the Fed inflated a property price and borrowing bubble. Domestic demand continued to rise faster than GDP and the current account deficit increased, offsetting part of the domestic impact of stimulus from fiscal and monetary easing. Cheap money also leaked abroad, especially to Asia, of which more anon. It's different this time: unlike the mid-1980s and 1990s the US is still suffering major financial imbalances – too little household savings coupled with large public sector and current account deficits.

In round numbers, the household deficit in early 2004 was 3% of GDP matched by a 3% business sector surplus to leave the private sector in balance. The public sector's 5% of GDP deficit was matched by the overseas sector's 5% surplus (current account deficit with sign reversed). The long

run average (the norm) is a 2% household surplus, a 1% business deficit, a 2% public deficit and a 1% current account deficit. During any period in which financial balances depart from their norms there is an unusual build up of debts and of assets. In the following period balances overshoot their norms in the opposite direction to restore balance sheet equilibrium. In the bubble years the US business sector swung into unusually large deficit. This is now being corrected by an unusually large surplus. But the household sector's balance sheet remains stressed. The situation is complicated. Household debts are at record levels relative to incomes, but thanks to artificially low interest rates the cost of servicing debt is not unusually high. Similarly, household wealth has substantially increased with the rise in asset prices, so that net wealth (assets less liabilities) has increased. But these facts conceal an important distinction. Financial liabilities are fixed in nominal terms, the value of property varies with asset prices which can and do go down as well as up. Interest rates must also rise from current artificially low levels and are doing so. As the burden of servicing debt rises, asset prices fall and net wealth diminishes. Saving and lending becomes the order of the day instead of borrowing and spending.

In order to restore equilibrium to household balance sheet the sector's surplus must overshoot its 2% norm – as it has done on similar occasions in the past. If it were to swing to 4% of GDP (not unprecedented) the shift would amount to 7% points of GDP subtracting an equal amount from demand. Business balance sheet health has not been fully restored. Its financial surplus could be reduced, but there is no way it could swing 7% points to a deficit of 4% of GDP. Wall Street would crash again. Equally the public sector 5% deficit could not rise to 7% or 8% of GDP without causing the bond market to implode.

Household savings are bound to rise as the Fed pushes artificially low interest rates up toward neutral levels. (The reason why the Fed must increase interest rates is explained later.) Markets expect to see Fed funds at around 3½% by end-2004. If the housing bubble consequently bursts, a sharp correction in the household sector's financial balance can be expected. In this event the above analysis clearly implies that the US is bound to suffer a hard landing unless the current account deficit dramatically diminishes. Unless export-led growth sustains business investment and profits, the collapse in consumer spending will be fatal. There are only two ways in which a current account balance can improve. First, with unchanged shares in export markets and unchanged import penetration, export markets must grow faster than the domestic market. Secondly improved

competitiveness must lead to increased shares in export markets and reduced import penetration. As relative inflation rates differ only marginally, big changes in increased competitiveness only come from exchange rate depreciation. So if the US is to avoid recession in 2005–06, Asia must boom and/or the dollar depreciate substantially.

As already argued, the US is in danger of a hard landing because it saves too little. The different reason why China is in danger of a hard landing is because it invests (and saves) too much. The result is global over-capacity in manufactures. China is tackling hot-spot inflation by administrative action. This is a blunt instrument. It can have no significant impact if state banks, state companies and provincial governments ignore or more usually get round Beijing directives. For example, hundreds of golf courses were being constructed or planned. Beijing ordered all new projects to be put on ice and they were. Golf courses were locally re-designated peoples' parks, to which the ban did not apply, and work continued. But Beijing is the 'Queen of Hearts' and 'off with their heads' stops such pranks. Administrative guidance then becomes like a stick pushed into the spokes of a bicycle's front wheel – a disastrously effective braking system. The beauty of administrative action, however, is the ease with which it can be reversed.

(ii) The Investment Decelerator Effect in China

The serious argument for a Chinese hard landing comes from textbook economics course 101 – the investment accelerator theory. The growth in investment is a function of the change in the rate of growth (second derivative) in demand. This needs to be spelt out for non-economists. Take a factory with a capital stock of 20 machines worth $100m and an annual output is 100,000 units worth $50m. The capital stock is worth twice a year's output. Suppose that one machine wears out every year and has to be replaced (depreciation 5% a year). Then if demand remains constant at 100,000 units, gross investment is one machine $5m and net investment is zero. Now suppose demand rises to 110,000 units. A further two machines will be needed. Gross investment will be three machines costing $15m, an increase in investment spending of 200%. Next year demand rises to 120,000 units. Again three machines must be purchased. But investment remains at $15m, zero growth. The following year demand remains at 120,000 units. No further additions to the number of machines are needed and gross investment falls to the one replacement machine. The fall in investment spending is 67%.

Chinese GDP statistics are undoubtedly suspect. But taken at face value, in broad numbers growth in 2003 was 10%, capital investment rose by 25% and its share of GDP rose from 35% to 40%. (Exact numbers do not change this argument.) On these figures and ignoring multiplier implications gross investment contributed nearly 9% points to the 10% rise in GDP. Unless demand growth accelerates, investment growth must slow down sharply and even become negative. Investment growth of say 10% in 2004 would add only 4% points to GDP. As China is already experiencing over-capacity at the manufacturing end of the chain and planned investment is absurdly excessive – every competitor expecting to grab an impossibly large share of continually rapidly growing demand (car sales rose 40% in 2003) any slowdown in demand has a catastrophic impact on investment. So high an investment/GDP ratio is incompatible with stable growth.

(iii) The Effect of Financial Outsourcing Off-shore in the New Dollar Area

This leads to the third stage in the perma-bear case. The first was to show that Americans save too little and will save more. The second was to argue that the Chinese invest too much and will invest less. This final step is to explain that Americans have only been able to save too little because the Chinese invest too much and *vice versa.* They are two drunks who can only stand up by leaning against one another.

This time it's different. During the late 1990s the 'new dollar area' emerged. This is the Bretton Woods Mark 2, a system of fixed or semi-fixed dollar exchange rates amongst a group of countries holding dollars as their reserve currency. The new dollar area has the US at its core. There is an 'inner area' of countries whose currencies are pegged to the dollar – China, Hong Kong, Malaysia and several Gulf States such as Saudi Arabia, Kuwait and the UAE. The 'outer area' comprises countries whose currencies are managed against the dollar – quasi-fixed. This includes Japan, India, South Korea, Thailand, Taiwan, Indonesia, Singapore and Russia. In 2003 the new dollar area accounted for more than half the world's current dollar GDP.

Unlike Bretton Woods the new dollar area was not created by an international conference and treaties. It was not of America's making. It simply evolved. The story begins during the early 1990s' recession. Global capital flows to Asia and China exploded. Indeed Asian growth slowed down only briefly. It was an OECD rather than a global recession. Yet the flow of capital to Asia defied textbook theory. Mature, rich, advanced and

ageing industrial countries are supposed to generate excess savings. The high cost of labour relative to capital means that at the margin they exhaust all their limited profitable investment opportunities. Young, poor, rapidly developing countries generate inadequate savings so that profitable investment opportunities due to their low cost of labour cannot be fully exploited. Capital therefore flows from developed to developing countries, enabling the former to sell their excess products (usually capital goods) and run current account surpluses. This was Britain's story in the mid 19th century, though later the story changed.

Today capital flows up-hill, from the US with inadequate savings to Asia with surplus savings. Net national saving (the balance between domestic savings and investment) is measured by current account balances. A country with excess net national savings has a current account surplus. A country with negative net national savings runs a deficit. The US has been in current account deficit for some decades and Asian countries regularly run surpluses. Yet since the early 1990s private capital has flowed from the US to Asia. The US lends what it has not got and Asia borrows what it does not need. Why so? The secret lies in the efficiency of domestic financial intermediation – the banks and financial markets that transfer funds from savers and lenders to borrowers and spenders. An efficient competitive system allocates capital where it is most profitably employed (never perfectly) and does so with small margins between returns to lenders and costs to borrowers. An inefficient system pays miserable returns to lenders and either charges exorbitant rates to borrowers or misallocates capital cheaply to state enterprises or political buddies – crony capitalism. Profitable investment is starved of funds or crowded out by the high cost of borrowing. The moment exchange controls are relaxed an appetising margin emerges for foreign financial intermediaries. They can exploit a wide gap between domestic lending and borrowing rates. The result, as with call centres and computer programming in India, is financial outsourcing off-shore.

In the 1990s Asian financial intermediation was outsourced to the US and UK. A surrogate banking and market system developed which recycled domestic savings to domestic borrowers off-shore. As a current account surplus country cannot be a net borrower, private capital inflows have to be its own savings recycled off-shore. Since Asian countries initially ran current account surpluses the sudden surge in private capital inflows could be handled in two ways. Either the currency could be allowed to appreciate or intervention could hold it down. The result was the same. Appreciation pushes current accounts into deficits due to changes in competitiveness.

Fixed nominal exchange rates through intervention lead to domestic credit growth, overheating and real exchange rate appreciation and hence current account deficits. Trade balances change glacially, capital flows can reverse at the drop of a statistic. Worse still the pre-Asian crisis capital inflows were skewed towards banking loans. Thai and Korean companies, for example, found they could borrow cheaper US dollars abroad than expensive baht or won at home. This meant that the borrower took the currency risk, while the lender took the default risk. As current account deficits assumed alarming proportions, capital inflows ceased or reversed. Currency reserves were run down dramatically. This only exacerbated the problem. Fears of depreciation escalated. Hence the Asian 1997 crisis.

China and to a great extent Taiwan escaped. China's borrowing was overwhelmingly foreign direct investment in which the lender takes the currency and default risk. Thailand, Korea, Malaysia, Indonesia and the Philippines were hard hit. They were caught on the horns of a dilemma. Raising domestic interest rates to defend currencies bankrupts domestic borrowers. Allowing currencies to fall bankrupts dollar borrowers. In the event they were impaled by both, resulting in severe recessions. It was the Asian crisis, followed shortly by Russian default plus the US Long Term Credit Management hedge fund collapse (LTCM) that set the Federal Reserve Board chairman, Alan Greenspan, on a course (from which he has never since deviated) which led to some calling him 'Sir Bubbles'. Instead of continuing to resist Wall Street's 'irrational exuberance' he eased back to become the 'new economy's' cheer leader. In fairness he was an internationalist set on preventing systemic failure in Asia and Russia (and at home with LTCM) causing global recession. The Fed became the world's lender of last resort.

The Asian crisis led currencies to be pegged or managed against the dollar. The intention was to prevent excessive appreciation and so avoid a repetition of the Asian crisis. The result, as so often with government policy, was the opposite. The birth of the new dollar area made the dollar artificially dear abroad and the Chinese yuan artificially cheap. Then came the Wall Street crash. To prevent a severe US recession Sir Bubbles Greenspan made the dollar artificially cheap at home, reducing interest rates to 1%, far below their neutral level. So the dollar exchange rate was held artificially high for half the world, with the floating euro a cherry pip popped upwards, and credit in the US became artificially cheap and plentiful. Intervention to stabilise rates in money and exchange markets inevitably destabilises other markets. Artificially cheap and plentiful money at home

depressed household savings and boosted consumer spending leading to domestic demand growth in excess of GDP growth. The result was the deterioration in the US current account deficit. Artificially cheap Asian currencies led to US private capital outflows exceeding inflows. So the balance of current and private capital flows from the US became massively negative. Without the new dollar area, the dollar would have crashed. Instead intervention to support it led to a vast increase in Asian and Japanese dollar reserves.

A chicken-and-egg situation followed. The Asian and Japanese governments borrowed domestic savings or printed money to finance their increased dollar reserves. They lent their dollars to the US government financing its budget deficit. This prevented long term interest rates from rising sharply as the budget deficit increased and also prevented the dollar from crashing. The US cheap money borrowing binge would not have been possible without the rise in foreign official dollar reserves. But the money made its way back into Asian and Japanese pockets in US product and asset purchases. Remember no country can be a net foreign borrower if it has a current account surplus. Credit expansion and dollar inflows caused Chinese investment and GDP to boom. While cheap money in the US caused consumption and GDP to boom. The new dollar area spawned a global boom, synchronised soaring.

There is a more sinister side to this story. Cheap and plentiful dollars led to leveraged speculation by American hedge funds and banks proprietary trading desks. It was cheap to short the dollar in the hope that China would revalue the yuan and Japan be forced to let the yen soar. China plays were also popular, buying into Australian and New Zealand dollars or primary producing companies whose main exports were to China. It was cheap to go long on commodities themselves expecting price hikes. It was cheap to ride the steep US interest rate yield curve, borrowing short to buy longer dated Treasury bills. Even when interest rate differentials were small, leveraged speculation produced significant returns. Moreover the appetite for returns amongst banks and hedge funds was enormous as stock markets appeared to be going no where but sideways and volatility had sunk to a low ebb. Much of this leveraged speculation was encouraged by unsound estimates of the risks involved. There are VAR measures for 'value at risk' (VAR) which are estimated using recent historical data for price volatility. When volatility declines VAR does too and leveraged positions can 'safely' be increased supposedly ensuring enhanced returns. But where everyone uses VAR guidelines this decreases volatility and artificially inflates prices.

It is estimated that the present level of leveraged speculation is unprecedented, even higher than in the doomed days of the Bretton Woods fixed exchange rate system. The lesson from the MTCM debacle, resulting from rocket scientists' risk miscalculation, has not been learnt. Speculation drove up oil and commodity prices beyond realistic levels. It held down US Treasury bill rates. It put upward pressure on the yuan and yen, increasing official intervention to support the dollar, boosting credit and GDP growth. It was the bubbles on the top of the freshly poured glass of new dollar area champagne. Value at risk cannot be assessed looking backwards. Volatility is measured by the ebb and flow of fans arriving at a football match. When it ends everyone wants to leave at the same time. All artificial prices are suddenly reversed and systemic failure becomes a serious possibility.

The synchronised boom was bound to end in tears. On the one hand it led to world commodity and oil price increases, exacerbated by leveraged speculation. Admittedly the geopolitical risk premium partly explains sky-high oil prices. National inflation would either accelerate, necessitating policy tightening, or lack of pricing power would squeeze profits. Either way the boom had to falter. Either US interest rates must rise to their neutral level and have begun to do so, or the artificially dear dollar must be allowed to fall. Rule out the latter. Japan is not overheating. China may be. But it will only use yuan appreciation as a last resort measure to tackle inflation. Meanwhile, as argued above, administrative action and/or the dynamics of the investment accelerator will ensure cooling. No other country will want to appreciate against the dollar if China does not. Rising US interest rates will deflate borrowing and speculative bubbles and the result will be synchronised Sino-US sinking. All the forces explaining the synchronised boom will go into reverse.

That is the perma-bears' case.

The Bear-bulls' Case

(i) Gradual Adjustment in the US

The bear-bulls ignore or minimise financial imbalances and speculative excesses. They see just gradual adjustment. The argument for the US is partly monetarist. Money is mostly bank deposits and bank loans create deposits. As an article of faith, money growth drives GDP growth. Banks have been extremely profitable and have ample reserves to expand loans. After the Wall Street bubble burst US non-financial companies stopped

borrowing from banks. Restructuring allows them to reduce bank debt. Money supply growth would have faltered unless loans to households and government were increased. The supply of loans was there and demand was created by artificially low interest rates and the budget deficit. Rising interest rates are now causing lending to households to slow down. Fiscal consolidation is more likely than further easing. But companies have returned as borrowers. As consumer demand falters, corporate investment will take up the running, driving the economy forward. Indeed it is normal for consumer demand to lead a recovery and investment later to recover as idle capacity diminishes.

The argument above, based on sector financial balances, throws doubt on investment booming when consumer and public spending stalls. Unless booming Asia and dollar depreciation lead to export-led growth, investment is bound also to stall. The problem is when? The Fed watches prospects for domestic demand extremely closely and is flexible. It has embarked on a measured return of interest rates to their neutral level. But if the economy falters it will be quick to halt or reverse interest rate increases. The notion that the Fed funds rate will rise to $3^1/_2$% by end-2005 seems absurd. It surely could not do so without bursting the housing bubble. Although most US mortgages are still at fixed rates, which reduces the impact of rising rates on mortgage defaults with negative equity, higher rates still curb re-mortgaging to cut monthly payments and home equity withdrawals. Consumer spending need not collapse to produce a recession, it simply needs to slow sharply.

(ii) Continued Expansion in China

Again the answer lies in Asia driven by China. Here the bear-bulls have their strongest case. China is still overwhelmingly a command economy. Over-investment is concentrated at the finished manufacturing end and in residential and commercial construction. Further back in the production chain there are acute shortages and bottlenecks – energy, transportation, docks and infrastructure generally. Inflation, apart from a few hot spots, is not a serious problem. Food price increases are partly to blame for rising prices and this year's promisingly good harvest will make things better. The regime's existence depends upon domestic tranquillity that can only be achieved through rapid growth and the creation of millions of new jobs each year as urbanisation accelerates. It cannot afford a recession. Through state banks and state companies, co-operating with foreign enterprise and

capital, it can switch on major infrastructure projects to keep the economy galloping along. Beijing already seems to be reacting rapidly to the danger of a hard landing.

Command economy China has major advantages over democratic countries like New Zealand. Here a Resource Management Act means any project, major or minor, is subject to years of expensive delay as all interest groups must be heard. It is NIMBY in the extreme, with the national interest unrepresented. Costly project failures have produced a potential energy crisis and Auckland transport is a mess. Planning consent failures are admittedly few because companies are deterred from embarking on projects likely to be costly failures. China can totally ignore local protests.

So, 'Watch this Space'

The bear-bulls and perma-bears have good cases. Partly it is a matter of timing. Bear-bull soft landings in the US and China merely postpone the fundamental correction of imbalances which perma-bears fear. In the short term, 2005–06, the bear-bulls could be right. Even both could be wrong. The two protagonists argue 'soft-soft' versus 'hard-hard'. This leaves out the possibilities of 'hard, soft' (US, China) or 'soft, hard'. The last possibility seems remote in the extreme given US 'soft' depends on China 'soft'. But 'hard, soft' is a serious possibility.

Over the last few months I have been considering the consequences for currencies, markets and interest rates on the 'hard, hard' scenario. It would require another long article to spell these out. But I have more work to do looking at the other possible scenarios. This will keep me busy while the plot unfolds. Perhaps in a year's time I might be allowed to write a sequel entitled 'This time it's the same in that I was wrong again'.

THE DECLINE OF THE PUBLIC SERVICE ETHOS

A talk given by Theodore Dalrymple, Psychiatrist, Prison Doctor and Columnist for The Spectator, to members of the Economic Research Council on Wednesday 12th May, 2004

My subject tonight is 'the decline in the public service ethos' and I don't want to start by imagining that there was a golden age when public servants thought only of the public good and absolutely nothing else. After all, Dickens wrote about the circumlocution office a hundred and fifty years ago and in my vacations as a student I used to be a hospital porter and I can remember the other hospital porters saying to me 'Oh good you've come again, which means that three of us don't have to do any work now'. Nevertheless I think there has been change in the public service. For example amongst teachers – I think most of us would acknowledge that teachers not very long ago used routinely to perform services that were outside their official duties. I can tell you that this is no longer so, and I think that there are good reasons why this should be so. When I started as a doctor I was on duty one night out of two and this was an unpleasant thing to do because one would be woken at all times of the night. But one thing that compensated us slightly, in the hospitals in which we worked, was that we doctors were treated as something slightly special, we were not just 'shift workers'. For example we had a 'little nest' in which a woman (usually a widow actually who enjoyed looking after doctors) used to cook us very good meals. Now this was a very small thing and must have cost very little money for the hospitals but it did actually have a great effect on our morale. That kind of thing has all been dispensed with and what we have instead is the European Working Time Directive which turns doctors into shift workers and this has actually a very deleterious effect both on the standards of clinical practice and on morale. The idea of a 'team' in a hospital has been destroyed completely by this. We are now just 'passing the parcel'. The British people will in the end suffer a great deal – they will suffer the seventh rate medical care which I'm afraid has been developing in this country for a long time.

We are now under the direction of managers – in our Casualty Department for example we have managers whose main concern is that nobody should remain in the Casualty Department for more than four hours and they are actually directing doctors what to do with patients, irrespective of the clinical need. It is managers who are now sometimes

deciding what is done with patients, not the doctors. And this as you can imagine – especially if you've met the managers – is not very good for doctors' morale.

Now I'm not going to discuss whether the NHS should exist at all, whether Health Services should be arranged privately or as a public service. The fact is that they are arranged as a public service and what I'm going to say I think applies to all public services.

There are really only a few possible motives to make people work – I mean there is fundamentally the carrot, there's the stick, and I suppose you could call it the moral incentive – the glory, for example, of your institution. The stick can't be applied to individuals very much, it can only be applied to the institution through managers. What happens is that managers are given some kind of target which they then have to pass down. But actually nothing happens to you if you as an individual if you don't meet that target (you don't get sacked for it). So the stick isn't very good except for creating a very unpleasant atmosphere in which stupid people have predominance over the intelligent ones. There's the carrot of course, and this is money. But money is not given to doctors as individuals but given to managers who achieve their targets, principally by using bogus statistics. I'll quote here a letter that my wife received (she's also a consultant in a hospital) when she was contesting one of the policies of her hospital. The Chief Executive started with these memorable words: 'The first duty of a National Health Service Trust is to balance its books …' so now you know. It doesn't matter what happens so long as the books are balanced.

There is a slight carrot for doctors who work in hospitals and that is the 'distinction awards'. In the not distant past these were awarded to consultants by a committee of other consultants who rewarded what they thought were outstanding efforts by their colleagues. Now of course there was an element to this of 'Buggins turn' and that kind of, I suppose you might call it corruption, but it is now decided almost wholly by managers and what managers look for is compliance to their dictates. Incidentally when hospital consultants are now appointed to their positions the doctors on the appointment committee have only a very minor say. They are perhaps three out of eleven members of the board appointing the consultant, which means that they are not very important. All this leads to de-professionalisation.

Now our complicity in dishonesty is not merely desired, it is now compulsory – we must lie, cheat, all the time or in fact a lot of the time. For example, we must now have an annual appraisal. Amongst the questions

we must answer is 'What do you have to say about your integrity?' I asked the person who asked me this who is a doctor, 'Answer me two questions "What kind of person would answer such a question?" and "What kind of person would ask it?"' The whole purpose of this question is to make sure that you are complicit in what I believe to be the corruption and criminality of the British public service and I don't think this (and I stand corrected by people who belong to other professions) I don't think this is unique to medicine.

So it isn't really altogether surprising that 75% of senior doctors in this country wish to retire early because they do not wish to go through thirty years of education and training to be treated like 'clerks' – and I think this is happening in all the public services. I think it is happening in education – where the criterion of success is, to put it crudely 'bums on seats'. We have Stalinist growth statistics (Pig Iron – I remember my father having been a communist and I always remember the production of Pig Iron – ever rising. I never really understood what Pig Iron was for. But all I can say is that by the end of Stalin's time they were producing a hell of a lot of it!

I teach on a Masters Course in Toxicology and about half of the students are drawn from abroad and I can tell you that the University for which I work is selling degrees – there is absolutely no question of this, and it is required to do so for financial reasons. Many of the students can barely speak English; it is not possible for them to have accumulated enough knowledge within a year to be worthy of a Post Graduate Degree. We not only see this inflation in the granting of Degrees, we see it in the grades at school, so that in this country now (it is my belief, but again I might stand corrected) we are no longer even capable of running a public examination system due to the changes that we have seen in the public service.

I believe also that law is being bureaucratised; I see it myself with the Crown Prosecution Service of which I cannot possibly speak lowly enough (*laughter*). It seems to me that its function is partly to make up evidence and partly to persecute quite obviously innocent people. Well, that's an exaggeration but it really is extremely poorly organised and run. I see it in my prison – I can give an example of the decline in any willingness or any belief in the possibility even of public service ethos. Not all that long ago I used to charge for my services by the hour. If I left the prison and it was two minutes after an hour had passed I didn't charge for the two minutes, I thought it was wrong to do so. Then they insisted that I fill in a time sheet and now if I'm a tenth of a second after the hour I charge to the full hour as in fact I am entitled to do by the regulations.

I can't forebear from telling you also that after (well actually six months after the events in New York) I received a form, which everyone in the prison service received. I had been working in the prison for fourteen years, but they said that they needed to see my qualifications. Obviously my ministrations hadn't convinced them so they wanted to see the paper qualifications. But I also had a security form to fill in –'Are you involved in terrorist activity?' (*laughter*) 'Yes or No?' Well of course this is not unique to this country. When you go into America I think you probably remember that you have to say that you are not involved, and have never been involved in genocide. But I think this gives an insight into the kind of bureaucratic mind that is now pullulating in Britain.

How have we got there? I think I must say that Mrs Thatcher has quite a lot to answer for – I think she mistrusted private, or non-centralised interest groups – that is to say professions. She thought that professions were conspiracies against the laity. In fact she was rather like Bernard Shaw. And of course there is always an element of truth in that – there is a kind of self defence of doctors and we do tend to stick together and so on and so forth. But it's certainly not the only aspect of professionalisation and I don't think it's the predominant one, certainly in my one. I don't believe it was true of the university teachers either or the school teachers; I don't think it was true of the police; it was not true of the prison officers. In fact the only place where I know a public service ethos actually survives is in the British prison service – where men are quite willing, in my experience, to do far more than their duty.

The idea that we should get value for money of course seems a very good idea and no doubt there have always been wasters. But in saying 'we're not getting value for money' what we got was managerialism – the idea that what we needed was control of our time; itemisation of what we were doing; more information and so on. As if these things were costless! Then we had for a time an internal market – but it was a market without any consumers except bureaucrats who were made to stand in for consumers. I don't think they did a very good job and I'm afraid that the situation has escalated – I was talking to an old consultant who had just retired from my hospital (a most marvellous man I might say of a type I don't think we are likely to see again) who said 'When I came to this hospital we had eighteen hundred beds and three administrators. Now we have three beds and eighteen hundred administrators.' We are like the Bolivian Navy – many admirals but no ships! Or even shores.

So there's been a relentless increase in bureaucracy and all attempts to

reduce it will now increase it. And the information gathering that goes on is not to obtain information, it is to terrorise the staff. I can give a good example of this – it's absurd, but it's a good example. One day I arrived at an Outpatients Clinic and I was asked to barcode the patients in. I found a barcoding machine on my desk and I was asked to barcode the patients if they came into my room. And I said 'Well if that's what you want I'll do it' So the patients came in and they presented me with their barcode (actually they were wearing a barcode), I barcoded them and I thought maybe it hadn't worked), so some of them I barcoded again, and it was only later that I discovered that the alleged purpose (not the real purpose because the alleged purpose in our organisations is never the real purpose, or very rarely the real purpose) was to see whether I was seeing the patients on time and how long I spent with each of them. Well, unfortunately my patients fell into a bi-model distribution – there were those whom I saw for a fifth of a second because I barcoded them twice, and there are those according to the information who are still in the Outpatients Department. Needless to say none of this aroused the curiosity of the people who had asked me to do this. They didn't come to explain to me that I had done it wrong – as far as they're concerned I'm sure they just analysed the data as presented to them and then threw it away somewhere.

Last year in the NHS we had a 17.6% increase in managers alone and if you look in the Health Service Journal you see what these jobs actually consist of and this is where the government has 'created jobs' as they call it. Everyone is a 'facilitator/co-ordinator' – if you saw an advertisement for neuro-surgeon you wouldn't have to know any neuro-surgery to know roughly speaking what a neuro-surgeon did, what kind of thing he did. I can assure you that if you look in the Health Service Journal, look in the thousands and thousands of job available, it would convey no meaning whatsoever to you – you wouldn't know if I said to you 'What does this person do next Monday morning when he goes to work?', you wouldn't have the faintest clue. Not the faintest. And we have for example recently at a cost I suppose to the Health Service of about £40,000 if you include the other costs, we have recently appointed in our hospital something called a 'director of diversity'.

Our hospital recently (during the St Patrick's Day Parade) was giving out packets of sweets to people in the street to raise the profile of the hospital in the City. It is the only hospital in the City to which about a quarter of the people in the City can go if they are ill – we don't need a high profile, it's just a hospital you go to when you are ill or when you're injured and

when the ambulance takes you there. But this is the kind of thing on which we spend a great deal of money. We used to have a little publication called The Prescriber's Journal, it was an excellent publication used by all doctors. It had authoritative and completely uncorrupt reviews of medications – this was suppressed by the Dept. of Health on the ground that there were other publications doing the same thing, which was not true. Instead they put out a glossy newspaper which was actually a propaganda machine – containing no information of any use to anybody – and then that too was suppressed! And the reason for this was that the advice given in the Prescriber's Journal could potentially conflict with that given by the National Institute for Clinical Excellence. Incidentally the original title of the whole organisation was to be National Institute for Clinical 'Evidence' but was changed to 'Excellence' because in this wonderful new world of ours we can **all** be excellent.

In my hospital 100% bed occupancy is never taken as a sign that possibly we have under-capacity. The fact that we could have one bed that was occupied all the time would not mean to a manager that we did not have enough beds. They are demanding swift throughput of patients and I know from experience that quite large numbers of people are being discharged far too quickly in a very cruel fashion, especially the old. It will not be long I believe before elderly patients will be denied treatment on the grounds that its not economic to give them treatment.

We have proxy measures which are either bad or misleading. If you have a centralised system that gathers statistics, what you get is organised lying and I believe that this is what has happened throughout the British public service. In fact I know it's happened in all the services that I've seen. So we now live in an atmosphere in which lying is compulsory; bureaucratic interference is ever increasing; proxy or inaccurate measures are constantly being used; uniformity and mediocrity are being enforced; and we have a situation in which people who are intelligent and who have some form of integrity are actively prevented from taking any part in public administration merely by virtue of a kind of language that is used by bureaucrats. No person can advance in the bureaucracy without using this language and no person of integrity would consent to use it and therefore I think we have a situation which is worse than mere financial corruption. We also have a form of financial corruption in which people are made redundant and then come back very shortly afterwards as consultants to the organisation from which they were made redundant with quite large redundancy packages. This is something that did not exist

when I started in the National Health Service twenty-five or more years ago.

So my conclusions are that if a public service is to work, and we are going to have to have a public service, it cannot rely on the stick and carrot. Attempts at reward are inherently corrupt and corrupting. Morale is very necessary – we need institutional pride and so forth and I would remind you that a hospital in this City that was 850 years old is going to be closed down by the government. What greater example of Philistinism and stupidity could you have than that? People taking a very short term view, a hospital that was loved by its staff and loved by all the people, universally loved, by the people whom it served.

I believe that a public service must be very small if it is not to consist entirely of careerists, and just as you can't have a law abiding society that relies only on Draconian enforcement of law (you have to have some kind of internalisation of the morality behind the law for it to work), so I believe that a public service also needs a public service ethos. I regret to say that I think it has been lost and I am not at all sure how we go about recovering it.

RESEARCH STUDY NO 20 BY PATRICIA MORGAN FAMILY STRUCTURE AND ECONOMIC OUTCOMES

For the past thirty years, at least, the idea the married two-parent family as the social norm has been unpopular (much of this shift in progressive fashion has come about by default) with progressive policy makers, as well as intellectually unfashionable. Marriage, it has been argued, oppresses women, reinforces 'patriarchy' and stifles individual choice. Imposing social norms is authoritarian, as well as artificial. Privileging heterosexual marriage discriminates against homosexuals. Children are 'just as well off' in single parent or alternative families.

Such notions have underpinned the 'sexual revolution' of the late twentieth century. They start with classical liberal arguments in favour of tolerance and civil rights but move towards a value-free consumerism or free-market of relationships. The defence of 'family values' has become associated with moral conservatism or fundamentalist bigotry; this right-wing backlash harms families because it is prejudiced and extreme.

Patricia Morgan's new paper *Family Structure and Economic Outcomes* cuts through the misleading propaganda of the amoral left and the moralistic right. It shows that far from 'empowering' women, children or men, family instability and breakdown limit choice and perpetuate social exclusion. The sexual revolution is the brainchild of an affluent middle class, but its main victims are the poorest citizens – and their children. Tackling social exclusion and promoting genuine equality of opportunity (including racial and sexual equality) requires a rethink of social and fiscal policy and a presumption in favour of the two-parent family and marriage.

This groundbreaking paper places family values back in the political mainstream. In showing the link between family breakdown and poverty, it appeals to ethical socialists as much as thoughtful conservatives and genuine liberals. With statistics and rational argument, Patricia Morgan cuts through decades of sentimental rhetoric and inaccurate reporting. *Family Structure and Economic Outcomes* is a defence of individual freedom and genuine choice against an increasingly irresponsible political elite.

THE POLITICS OF 'POLITICAL ECONOMY'
A Century of Retreat and the Way Forward

By Robert McGarvey

The Marxist Challenge

One of Karl Marx's most enduring legacies has been to label capitalism as a system of endless struggles and exploitation: '*The modern bourgeois society that has sprouted from the ruins of feudal society has not done away with class antagonisms. It has but established new classes, new conditions of oppression, new forms of struggle in place of the old ones.*'[1] Paradoxically the collapse of communism has not resolved this challenge. On the contrary it has unmasked a troubling reality: western economists remain unable and/or unwilling to seriously engage Marxism in this central – and still resonate – critique of capitalism.

1 *The Communist Manifesto*, Karl Marx, Friedrich Engels 1848, Oxford University Press 1992, page 3

In many ways western economic thought has been in full retreat from Marxism for over a century, and to this day remains defensive on any notion of a theory of history.

Karl Marx began his attack on capitalism somewhat curiously by heaping praise on the productive power of capitalism and accepting (selectively) the work of classical liberals Adam Smith and David Ricardo. He particularly appreciated their labour theory of value: '*But the price of a commodity, and therefore also of labour, is equal to its cost of production*'.[2] The classical notion that the price of a commodity was equivalent to the amount of labour expended in its production was in many ways the heart of the Marxist critique. If true it made the case that capitalism was (is) inherently exploitative of workers. During the 19th century the Marxist challenge was difficult to dispute, particularly as it became obvious to all that wealth was concentrating in the hands of capitalists who, according to prevailing economic theory, were deemed to play no part in its creation.

The Failure of Economic Thought

Marx, exploiting this serious flaw in classical economic thought, put forward a dynamic, class-dominated theory of historical realism to explain the seemingly endemic inequality and conflict in capitalist society. It's now clear that Marx was a better critic of liberalism and early capitalism than a visionary of the future. However, communism's collapse has in no way diminished the strength or logic of the Marxist critique, it endures unabated in the minds of capitalism's many critics. The reasons for this lie in the failure of modern economic theory to engage in the debate, to meet the challenges presented by Marx and his dynamic theory of history.

Capitalism is Dynamic, but Economic Thought is Flawed

Although capitalism was (and remains) demonstrably dynamic, economic theory in both its classical and neoclassical forms continues to struggle with the concept of change. Classical economic theory assumed an essentially static model of capitalism, and when confronted by the scarcity of raw materials, qualified labour, market demand and economic opportunities, postulated a dark and seemingly contradictory theory, 'the law of diminishing returns'. The law of diminishing returns postulates that

2 *The Communist Manifesto*, Karl Marx, Friedrich Engels 1848, Oxford University Press 1992, page 10

because of scarcity and other limitations capital must in theory become less profitable over time (hence the 'dismal science'). This issue obviously presented a serious problem for economic theory. John Stuart Mill attempted to resolve the law of diminishing returns, but his efforts were never entirely satisfactory. He eventually came to the position that diminishing returns could, under ideal circumstances, lead to a kind of blissful equilibrium, something he referred to as the 'Stationary State': *'The increase in wealth must sometime come to an end and society must enter upon a stationary condition.'*[3]

Ironic as it may seem mainstream modern economists seem to have even less interest in dynamics. According to economic historian Eric (Lord) Roll: *'the central problem of (modern) economic inquiry becomes the explanation of the exchange process or, more particularly, the explanation of the formation of price.*[4] In neoclassicism markets are assumed over time to facilitate equilibrium, bringing the forces of demand and supply into balance with one another. According to Alfred Marshall in his *Principals of Economics,* market equilibrium is relatively stable, the system tending to return to equilibrium even if that equilibrium is disturbed, as it invariably is from time to time.[5]

Growth, improvement and progress in economics, where it occurs at all, can only really be explained through improvements in productivity – measured in output per unit of labour input. Productivity growth is seen even to this day as the singular source of rising standards of living and overall economic well-being. Indeed many economists believe there is no more important consideration in the long run health of an economy than growth in productivity.[6]

The Retreat to a Narrow Focus

Little wonder then that John Stuart Mill and other 19th century liberals working in the classical tradition were engaged in an uphill battle to square Utilitarian ethics and classical economic theory with growing labour

---

3 J.S. Mill, *The Principals of Political Economy,* first published 1848, Penguin Classics 1985. Chapter VI, page 111

4 Lord Roll, *A History of Economic Thought*, Faber & Faber, London 1938, reprinted 1987. p. 370

5 Book 5, chapter 3, *Principles of Economics*, Alfred Marshall, First published 1890, Revised 1920

6 *Productivity and American Leadership*, **The Long View,** 1989, William J. Baumol, Sue Anne Blackman, and Edward N. Wolff

discontent and the socialist movement. In these confusing – literally explosive – circumstances there must have been, according to Lord Roll, a secret desire amongst economists to simply side-step the theoretical challenge of Marxism through changing the nature of the economic debate.[7]

The Marginalist Revolution of the 1870s provided just such an opportunity. The marginal utility theories of Jevons, Walras et al did provide a sound theoretical rationale for entrepreneurial gain within the capitalist system, blunting an important source of socialist criticism. However, the Marginalist Revolution also reduced the scope of modern economic analysis considerably. By drawing a fence around the exchange process - forevermore the 'legitimate' area of economic inquiry – modern neoclassical economics retreated into a narrow, quantifiable definition of economics, where the questions of inequality and class conflict held no theoretical relevance[8]. And although economists gained much greater mathematical certainty and theoretical consistency in adopting neoclassical principles the Marginalist Revolution placed significant limits on the boundaries of economic study, stifling inquiry of those economic inputs that lay outside the narrow confines of the exchange mechanism.

The Sources of Capitalist Dynamism

Marx on the other hand, operating in a much larger theoretical universe, saw the bigger picture. Even he, a severe critic of capitalism, could see that the changing relations of property and the continuous revolution in the 'means of production' were significant engines of growth in the capitalist system. '*The bourgeoisie cannot exist without constantly revolutionizing the instruments of production, and thereby the relations of production, and with them the whole relations of society.*'[9] In addition Marx could see that capitalism was a global revolution, '*The bourgeoisie, by the rapid improvement of all instruments of production, by the immensely facilitated means of communication, draws all, even the most barbarian,*

7 Lord Roll, *A History of Economic Thought*, Faber & Faber, London 1938, reprinted 1987. p. 372/3.

8 Of course Macro-economics deals with the larger questions of public policy such as how the private and public sectors operate, the institutional framework of economics, production, finance, taxes, government controls, etc, however it does so from the vantage point of the market, strengthened by its logic and precision, but also confined by its limitations.

9 *The Communist Manifesto*, Karl Marx, Friedrich Engels 1848, Oxford University Press 1992, page 6

nations into civilization.'[10] Capitalism has proven to be as dynamic as Marx predicted and given the state of 21st century capitalism, there's no doubt of its global impact. What is it about capitalism that drives growth and change and more importantly to economic theory what economic elements facilitate this dynamism?

Revolutionizing the 'Means of Production'

So, what was Marx trying to say? He clearly viewed capitalism as dynamic. In his mind the mechanism of change was obvious, capitalism was constantly revolutionizing the *means of production*. But what exactly does that mean?

Marx, viewing the Industrial Revolution up close, was able to observe the dramatic impact that technological innovation had on capitalist development. Revolutionary innovation was occurring across the board, in steam power, production techniques, and in systems of human organization. These innovations lie behind the incredible productive power of the 'factory' system. Certainly technological innovation drove vastly more complex divisions of labour, and specializations of function in early capitalism, factors which contributed to the explosive industrial growth in the 19th century.

However the '*means of production*' are more than simply technology. Innovation or indeed technological leadership has seldom – in itself – automatically led to capitalist growth. China provides an interesting historical example. Although the Chinese at various times in their history have enjoyed a clear technological superiority over the rest of the world (inventing gunpowder, printing presses and iron ore production centuries prior to their Western counterparts) they were not able to exploit these technological advantages within their historical system of centralized political/economic control. Chinese economic growth has, until very recently, been stymied by historic limitations on the rights of individual ownership and the absence of appropriate property forms necessary to exploit the opportunities and create sustainable asset wealth.

The institutions of ownership and property are vital to capitalism, but more importantly they represent two of the principal sources of dynamism in the capitalist system. Seen from a large enough historical perspective property is not simply a static institutional fact; it is a dynamic continuum fuelling economic growth and change. The real revolution in the '*means of*

---

10 *The Communist Manifesto*, Karl Marx, Friedrich Engels 1848, Oxford University Press 1992, page 7

production' lies in the historic capacity of the capitalist system to expand the property matrix, increasing the quantity and quality of economic assets available to the economy.

This expansive process is amply demonstrated in Western economic history. During the roughly 1000-year feudal period (5th to 15th centuries) of Western civilization property *per se* was limited in its definition and very restricted. Feudal economic life, such as it was, revolved around rural agriculture in a system that the nobility and the priestly class dominated. There were very few identifiable economic assets during this period. Apart from coin and a few trading ships, landed property was the principal economic asset. The control of landed property, society's principal economic asset, was solidly in the hands of the aristocratic 'few'.

All this, as Marx observed, began to change in Northern Europe in the 16th century. Capitalism began to stir; trade and commerce began their inexorable rise. During this mercantilist period, capitalism grew in large measure through the creation of trading houses and, more formally, royal chartered companies; the East India Company and the Hudson's Bay Company are two examples. These trading houses and royal chartered monopolies represented new forms of economic property and, eventually, significant assets to the founding members. In the more successful enterprises asset wealth accumulated in large amounts, developing over the period into a considerable economic and political force.

By late 18th century Britain was leading the world into a new 'industrial' form of capitalism. The industrial age in England really hit full stride in the mid 19th century when steam power and the railway networks became widely accessible and affordable for local manufacturers. This new production and distribution infrastructure allowed industrialists to produce their goods in mass quantities and get them to market at a profit on a regular basis. In other words steam power and railways, by linking factories to customers and a stream of future earnings, created collateral value in industrial assets. This revolution, creating entirely new classes of bankable assets in 'industrial plant' and 'inventory', was a critical foundational reform that triggered and sustained economic growth in the industrial age.

Economic assets have undergone an extraordinary metamorphosis over the centuries. The expansion in the property matrix during the Commercial and Industrial Revolutions added significantly to the property inventory, increasing the quality and quantity of economic 'vessels' within which the productive elements (capital, labour and innovation) could be combined to create value. And as history has shown economic growth throughout the

capitalist world during this era has been extraordinary - unprecedented in historical terms.

The Widening Estate of Ownership

One of Karl Marx's most significant failings lay in his inability to recognise the true progressive nature of ownership. Marx rightly understood that capitalism was founded on the principle of private ownership. He certainly made no secret of his distaste for the (then) newly won ownership rights of the bourgeoisie. Indeed his solution to what he saw as the abuses of private ownership of property was to advocate its abolition: '*They (the proletariat) have nothing of their own to secure and to fortify; their mission is to destroy all previous securities for, and insurances of, individual property*[11]. As a result of misunderstanding the importance of ownership and historic trends in the overall structure of ownership, Marx sent communism on a retrogressive path.

It is the popular desire for individualised ownership and the political repercussions of that desire that have helped drive capitalism forward over the centuries, and allowed – somewhat imperfectly – the capitalist system to evolve while maintaining its social legitimacy.

Capitalism's essential character is rooted in the social origins of property and the deeply political qualities of ownership. Ownership is exercised at different levels in capitalist society. The most obvious level at which ownership exists is at the legal level. This is the level at which most individuals experience ownership, where individual entitlement to property is established. But ownership is also exercised at the political level. This is the level where the rules of ownership are established by society. Anyone who owns a house knows that legal title attaches great value, but the rules that govern home ownership are made at the political level, local councils, regional and state levels of government. What is true of houses is true of ownership of all economic assets as a general rule.

Ownership's social character and the necessity to protect asset value politically is the central reason why the advance of democracy has been so important to the evolution of capitalism. In a very real sense, the security in assets is a function of the degree to which those who own property have their interests represented in the rule-making process at the political level. Democracies often change the rules of ownership of certain forms of

---

11 *The Communist Manifesto*, Karl Marx, Friedrich Engels, 1848, Oxford University Press 1992, page 14

property to advance the public interest, (i.e. eminent domain) but in a functioning democracy, changes affecting assets should involve the interests of property owners (through their representatives) in the decision-making process.

In Britain the widening in the estate of legal ownership of various economic assets led (or was led by) a dynamic political reform process. The political reform process in England began in earnest in 1832 when Lord Grey, with the somewhat reluctant support of King William IV, secured passage of the first Reform Bill through parliament, widening the political franchise to include the property-owning middle classes. This political empowerment consolidated the 'ownership' position of the industrial middle classes, securing their growing asset wealth by granting them effective control over the rule-making process. As the centuries progressed additional incremental changes in political representation continued, most notably the 1867 Reform Act, Lloyd George's 1918 People's Act and a variety of minority rights legislation up to the present day.

Capitalism has progressed in Western history through revolutionising and expanding the forms of property, as well as widening the structure of ownership in society. Naturally, these dynamic forces have had a profound impact on long-term growth in the economy, for as you increase the absolute number and total proportion of 'owners' in the economy the opportunities to add value to an ever-expanding matrix of economic assets can lead, when optimised, to a geometric expansion in market activity and economic growth. As a consequence the dynamics of ownership and property have been major drivers behind the growth, development and overall social acceptability of capitalism.

The Challenge Ahead for Economic Theory

The need to expand the area of analysis in economics is more than simply an academic exercise; the inadequacies of a tightly-configured market-centric approach are legion. A variety of modern issue areas are demanding attention, including the problem of externalities, something Samuel Brittan referred to as the '*spillover effect from many activities (such as private motoring), pollution or unregulated urban development – in other words, costs and benefits imposed on others, which are not taken into account in an unregulated market*'[12].

12 *What's Wrong with Economics?*, Samuel Brittan: Chapter 21 of Economic Consequences of Democracy, Gower, 1977, 1988

This is not to ignore perhaps the world's most troubling issues in political economy, the colossal problems surrounding globalisation including the very dangerous question of Chinese political reform, and the stumbling efforts of many developing countries, including the former Soviet Union, to develop a capitalist economy in any sort of civil society[13]. The challenges of the modern world need economic solutions, they require economists to participate, and to contribute meaningfully.

As Marx foretold, capitalism continuously revolutionises the *means of production*; it continues to do so today. Recently the capitalist system has begun to undergo a further metamorphosis of the property matrix incorporating another new class of assets, a new engine of capitalist growth, founded in intangible 'knowledge'. This revolutionary new class of assets will not only contribute significantly to economic growth in future, but will also, as industrialisation before it, '*change thereby the relations of production, and with them the whole relations of society*'[14]. Understanding these revolutionary changes does not preclude a more rigorous mathematical approach to economics, it does however demand a larger subject area with much greater historical insight and practical application than neoclassicism, presently constituted, can deliver.

---

13 *The Creation of a Civil Economy in Russia, The Need for Mercantilism* Tony Baron & Robert McGarvey, an ERC Discussion Paper, 1993. In this Paper McGarvey and Baron argue that a successful transformation from a command economy to capitalism must include a staged approach, slowly widening the estate of ownership in order to build the underlying ethics, patterns of behavior and the civil institutions to support a liberal capitalist system.

14 *The Communist Manifesto*, Karl Marx, Friedrich Engels, 1848, Oxford University Press 1992, page 6

ADVENTURE CAPITALIST – THE ULTIMATE INVESTOR'S ROAD TRIP

By Jim Rogers.
Published by Wiley 2003 Price £14.99

Driving 150,000 miles during three years, middle-aged Americans Jim and Paige Rogers explored over a hundred countries. This book entertainingly

recounts their thoughts and experiences, focused on a good old down-to-earth and market-economy assessment of each country's economic prospects as a place to invest. I doubt if any member of the Economic Research Council can read this book without fantasising their own trip on the same lines!

A word of warning. Although the book is entitled 'Adventure Capitalist' it is not about 'Venture Capitalism'. Jim Rogers is not out to fund new and untried ideas in small businesses but rather to assess a country's overall situation and then (perhaps) buy shares in a leading bank or a major existing company. The book is not a source of bright new ideas but is a valuable evaluation of existing institutions and businesses.

This book is however 'recommended reading'. It holds one's attention and many a section sent this reviewer happily to sleep looking forward to another episode on another day. Where the commentary concerned countries I know well or subjects I think I understand – perhaps Japan or the Euro, the book was credible so I have confidence overall. And this American writes good English – not the sort that grates or boasts or seeks to pretentiously impress or bore. Enjoyable.

There is a lot of useful advice and lots of points one might pick for discussion but for this edition of 'Britain and Overseas' it seems worth including a little of Roger's comment, which comes at the end of the book when he returns to the US, on Alan Greenspan. Extracts from pages 331 to 333 run as follows:

> Greenspan … the family cocker spaniel … has a long history of failure. In 1974, he was head of the Council of Economic Advisors. The country was in the early days of inflation. Greenspan's solution to inflation was to give out little WIN buttons, for Whip Inflation Now. And, of course, during his tenure, inflation went totally out of control. Whatever he tried failed miserably. He went back to work in the private sector, from which he lobbied heavily to get the job as chairman of the Federal Reserve.
>
> Almost immediately after he got the job came the panic of '87 … Cut to 1998 and Long-Term Capital Management, a major fund that got into terrible trouble, losing billions of dollars. Its collapse was going to have an effect on a lot of Wall Street firms. The investment firms went crying to Greenspan. Instead of letting the company go under and clearing out the system, as bear markets have done for centuries, Greenspan panicked and put a lot of money into the system,

bailing out his friends. That easy money is one of the things that led to the absolute worst of the mania, the bubble that has now burst with such devastating effect.

In 2001 Greenspan panicked again. That year, the Central Bank of the United States printed more money on a percentage basis than it had ever printed in the history of the republic. Greenspan has been relentlessly pumping money into the economy. At the same time, fiscal policy has been loose … President Bush has been spending as fast as Greenspan can print … 'Well,' Americans say to themselves, 'things are not so bad after all.' How long do you suppose that will last? The Maestro has now perpetrated a housing and consumption bubble by driving down interest rates. Bubbles always end badly, and even more people will be hurt when this one bursts.

The idea of central banks and central bankers as gods who can weave magic is a phenomenon of only the last decade in the West. Never before have they enjoyed the exalted status they enjoy now, where everyone knows the name of the head of the Central Bank in the United States or the name of the Chairman of the Bank of England. This too will pass. If things get bad enough soon enough, we may abolish the Federal Reserve before it collapses. The United States has had three central banks in its history. The first two failed. This one will undoubtedly fail, too.

Alan Greenspan and Federal Reserve Governor Ben Bernanke have officially stated that the Federal Reserve will do everything it can to prevent prices declining in the United States. To prevent deflation, they will print as much money as is necessary and will pump money into the system by buying Treasury bills, bonds, 'real estate, gold mines – any asset,' whatever is necessary to drive prices higher. Anyone who thinks there will be deflation does not understand twenty-first-century central banking. There may well be a deflationary collapse later, but before that happens the government will print money until the world runs out of trees.'

Council members can go on to read more – and Rogers makes a good case for the claim that US inflation figures misrepresent reality but to go into that is beyond the scope of this brief review.

J.B.

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.

APPLICATION FORM

To the Honorary Secretary
Economic Research Council
7 St James's Square
LONDON SW1Y 4JU

Date ....

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

This application is for
(delete those non-applicable)

Individual membership (£25 per year)
Corporate membership (£55 per year)
Associate membership (£15 per year)
Student membership (£10 per year)
Educational Institutions (£40 per year)

NAME ....
(*If Corporate membership, give name of individual to whom correspondence should be addressed*)

NAME OF ORGANISATION ....
(*if Corporate*)
ADDRESS ....
....
....

PROFESSION OR BUSINESS ....
REMITTANCE HEREWITH ....
SIGNATURE OF APPLICANT ....
NAME OF PROPOSER (*in block letters*) ....
SIGNATURE OF PROPOSER ....