Accountancy Business and the Public Interest, Vol. 7, No. 2, 2008

*The Twilight of Neo-Liberalism?

by

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***Paper presented to Chartist AGM - April 2008**

‘’Economically this country (the UK) is strong …’’ Chris Wearmouth (*Beyond Blair* - 2006 - page 8.)

‘’ … the Anglo-American economies are bloated property/credit bubbles waiting to burst, which they will.’’ Frank Lee (Ibid., page 66)

Introduction

What a difference 18 months makes! The present convulsions on the world’s financial markets – by some estimates the worst crisis since 1929 - rather puts a dent in Gordon Brown’s fatuous ‘end-of-boom-and-bust’ claim. The eclipse of Northern Rock and the considerably larger US Investment bank, Bear Stearns, are the first major casualties in the current financial blow-out: be certain that more will follow. We are, I believe, now in an interregnum period which comes at the critical point of a banking and credit crisis and its impingement on the real economy. At the present time there is a sort of phoney-war interlude between a financial and economic emergency. Employment is holding up and businesses are still functioning as usual; the term ‘crisis’ seems a touch hyperbolic in these circumstances. Staying with the war analogy there are no big battles and nobody seems to be getting killed (well not many anyway, apart from the two aforementioned banks). But just, we are still in the early stages of the great market ‘correction’, however, and unemployment and business failures are not called ‘lagging indicators’ for nothing. Lagging indicators are late changes which make their appearance after the overall economy has changed; examples include labour costs, business spending, the unemployment rate and deflation or inflation.

What happened?

But how exactly did we get to this point and how will the present situation unfold? The origins have been almost 40 years in the making and can be traced back to the dissolution of the Bretton Woods system, and the stagflationary crisis of the 1970s. I have written exhaustively on these topics – see *Beyond Blair* and elsewhere - and have no intention of repeating myself.

Suffice it to say that the ascendancy of neo-liberalism which began in the late 20th century swept all before it and became established as the new conventional wisdom – even on the left. (Hence the quote at the beginning of this paper.) The long bull-market which began at this time was occasioned by the coming to power of Reagan and Thatcher and was based upon 18th and 19th century theories of economic liberalism (hence 'neo-liberalism'). Central to this doctrine was the view that the best economic and welfare outcomes would be served by the unfettered market and price mechanism. It was claimed that left to their own devices free-markets, and free-trade, would maximise output, minimise costs, and result in optimum welfare gains and general equilibrium. This is the sort of rubbish that is still taught at A-level and degree level economics. The logical implication of this is that the nearer you could run an economy upon textbook liberal lines the better. Liberal economic theory was itself predicated on a timeless set of economic models and concepts without a shred of empirical evidence to substantiate the various hypotheses. It was a methodology which had more in common with speculative philosophy and theology rather than science and rigorous empirical analysis.

However, in the real-world of actually existing capitalism, markets were imperfect, competition was restricted, prices and wages tended to be 'sticky' and market failures were endemic. Market structures were dominated by oligopolies with the textbook competitive sector marginalised. Moreover, e*conomic liberalism just didn't work.* And as a matter of fact it never could. Socialists are mistaken when the claim the moral high ground for socialism, but reluctantly concede that rip-roaring capitalism is somehow more 'efficient'. This is not a concession we should ever have made. As John Maynard Keynes once said in this regard: ''Decadent … but individualistic capitalism … is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous – and it does not deliver the goods.'' (*The Yale Review* – 1933)During the inter-war period critics such as Keynes, Polanyi and even austere Austrian theorists such as Schumpeter, all duly pronounced the death of liberal economics; the stake through the heart was finally driven home with the New Deal and Roosevelt's reforms in the USA.

The crisis period of the 1970s, however, was to bare witness to a revival in fortunes of the previously defunct and archaic doctrines of free-markets. Like some Hammer horror movie, the interred, semi-mummfied corpse of liberal economics (in the shape of Christopher Lee qua Dracula) got the taste of human blood and went on the rampage once again. Behold the Beast has arisen!

Thus although it could be said without any equivocation that the theories of economic liberalism were/are an academic and intellectual disgrace, pure bunkum, they did have one selling point: that is, to serve as an ideological rationale for monied interests – particularly financial-rentier interests. In terms of policy instruments derived from the general theories of neo-liberalism these consisted of the holy trinity of liberalisation-deregulation-globalisation.

Although the period since the neo-liberal counter-revolution has generally been one of strong growth and full employment (particularly in the Anglo-Saxon world) it would be a mistake to discount events such as the 1987 stock market meltdown, the 1998 East Asian financial and economic crisis, and the bursting of the dot.com bubble of 2001. Also bear in mind the high levels of inflation and unemployment in the early 80s together with the house price bubble which burst in the early 90s. But all these crises tended to be localised and were ridden out in the fullness of time.

In every previous financial emergency involving a potential meltdown in equity markets, the US Federal Reserve Board ‘The Fed’ lowered interest rates, flooded the markets with money and kept these interest rates low as a matter of policy. This policy became known as the ‘Greenspan put’. Alan Greenspan, the then chairman of the Fed would, through banking intermediaries, increase liquidity in the markets ensure that corporations and consumers would borrow and spend more to keep economic growth going. This borrow and spend economy became the economic model with which Blair, and more importantly Brown became infatuated. And it seemed to work. Year on year steady and even above trend growth, low inflation, full(ish) employment. The Holy Grail of positive growth and low inflation had apparently been achieved; the stop-go economy had transfigured into the go-go economy.

At this stage in the proceedings the various wiseacres, mountebanks, charlatans and plain ignoramuses entered the scene. The nearest thing to a Blairite intellectual – Anthony Giddens – spouted on about the need for social democracy to adapt to the age of globalization; Charles Leadbetter, argued that it was possible in our ‘lightweight economy’ to live on air, and various other semi-literate assorted riff-raff of right *and* left were to prattle on about the boundless opportunities afforded to us by globalization and the need to modernise and become competitive. Leading the dawn chorus of course was New Labour with its end-of-boom-and-bust tripe. The two know-nothing, grand dames of the *Guardian* newspaper qua new labour propagandists duly announced the achievement of ‘a recession-proof economy’ (Polly Toynbee) and ‘a well run economy’ (Jacqueline Ashley). And as can be seen our own publication was not immune from this particular ideological virus.

Unfortunately, however, spending, borrowing and debt peonage does not – *horribile dictu* - lead to prosperity; such practises result in an entirely opposite outcome. Mr Micawber was, as it happens, absolutely correct in his assessment. It is incredible that we need to point out that economic prosperity is a function of wage growth, saving and investment, as was the case in the post-war period circa 1950-70. In the Anglo-Saxon world in particular the great bull market of the late 20th and early 21st centuries was based upon stagnant wage growth, high levels of debt and leverage, and high unsustainable levels of consumption.

From Boom to Bubble

For economic growth to occur their must be 1. Sufficient productive capacity in the economy, and 2. sufficient monetary demand to bring forth increases in supply. In a period of healthy growth in the mid 20th century when wages grew at approximately the same rate as productivity there occurred high output growth but no bubbles, simply because rising worker salaries precluded a sharp rise in profits. However, high profit growth is the prerequisite for the type of equity bubble and share-price mania which characterised the 1980/2000 period in equity markets. This type of explosion in share prices cannot take place even in a booming economy if wages rise in sync with profitability.

The share of wages in total national income – particularly in the Anglo-Saxon world – had to be reduced, and it was. In the UK the richest 10% of the population increased their share of the nation's marketable wealth (excluding housing) from 57% in 1976 to 71% in 2003. The figures for the US are even starker. This meant an increase in the profitability of companies and this was in turn reflected in the rising value of shares and the consequent stock exchange booms. However, since wages were in relative terms falling or stagnant, demand would fall and the economy would enter a downturn due to the increasing deficit in aggregate demand. The solution – albeit short-term – was to plug the gap in aggregate demand caused by the fall in wages by the issue of debt.

''When wages trailed productivity, demand grew slowly, so debt soared to preserve the demand-supply balance. Output also grew slowly but profits grew sharply, so the bubble arose, lingered for a while, but crashed in the end. Thus some decades saw the rise of bubbles, only because wages failed to keep up with productivity and the resulting demand deficiency had to be filled up by gobs of new debt.'' (Greenspan's Fraud – Ravi Batra – p.143 – 2005).

The pre-condition for driving down wages as a percentage of national income was of course a political offensive against the working class, particularly the organised working class. The pivotal moment in the US was probably the defeat of the air traffic controllers and in the UK the defeat of the miners in the 1984/85 strike. Secondly globalization meant that wage levels in developed countries were now exposed to competition from low wage economies such as China and India. Offshoring and outsourcing became another weapon in the hands of the monied interests. In connection with this there was also large scale immigration – legal and illegal – which recruited foreign labour at lower costs than domestic labour and so had the effect of creating what is now a low-wage economy.

In the meantime with the deregulation of credit and money markets, and artificially low interest rates a relentless infusion of liquidity was being injected into the markets. Boom time had arrived. But the boom was beginning to look ominously like a bubble as property, equity and derivatives markets headed for the stratosphere. In the Anglo-Saxon economies in particular property bubbles were beginning to assume monstrous proportions (this was also the case in Ireland, Australia and Spain). All of these countries were also in the grip of deteriorating trade deficits. But, hey, according to the *Guardian* no-one was worried about deficits on current account any more. The American Vice President, Dick Cheney, had declared that 'deficits don't matter.' Debt apparently did not matter either. End of argument. The breathtaking stupidity of such comments served to reveal the abject lack of understanding of even the most basic economic laws among the political, business and media elites.

The Return of Boom and Bust

Of course the whole thing was bound to go pear-shaped and it has. While consumers kept on borrowing and spending and banks were happy to keep on supplying debt to these customers the bubble would continue to inflate. This would have the effect of driving up asset values – notably house prices – which in turn would enable householders to borrow further against an appreciating asset. This Mortgage Equity Withdrawal, i.e., using your house as an ATM, apparently suited everyone at the time. Moreover, those previously considered a bad credit risk were now invited to the party. Mortgages were unwisely extended to this group (known in the trade as the sub-prime borrowers) in the ludicrous belief that house prices always went up and that this new group would be able to service their mortgage repayments. This mortgage to far was to be the Achilles Hell of the credit boom. The sub-prime borrowers, known in the trade as NINJAS – No Job, No Income, No Assets – began, surprise, surprise, to default. This was bad enough in itself, but what made matters worse was the fact that these mortgages had been sliced up, repackaged as new debt instruments, Collateralised Debt Obligations, (CDOs) Mortgage Backed Securities, (MBSs)and various other derivatives, and then sold on to other financial institutions such as Investment Banks, Commercial banks. Hedge Funds, and pension funds around the world. Thus through this process these toxic sub-prime loans had migrated like malignant cancer cells to all corners of the world's financial system.

The sub-prime default has been the de(b)tonator for the present financial crisis. The massive credit bubble was an unsustainable house of cards (sorry about the mixed metaphor) which was just waiting for one exogenous shock to bring it tumbling down. Since central banks would not act to rein in the excesses of the borrowing spree – this being politically impossible – the markets did it instead. Pop went the weasel!

At the present time the post-bubble, credit crunch means that having had their fingers badly burned, banks and other financial institutions are very wary about lending money either to consumers or to each other. No-one knows for sure the level of bad debts that are held by would-be borrowers. Having already lost a packet the banks are in no mood for any further largesse, and it has become clear that a number are actually insolvent. Credit to consumers is now being strictly rationed also: credit will be more difficult to get, and the service payments will undoubtedly be higher. It seems obvious that the market is correcting. Northern Rock and Bear Stearns were basically insolvent and have been effectively nationalised in the sense that the respective governments have taken on the liabilities of these defunct institutions. But for political reasons the bubble must go on.

Central Bank Interventions

Of crucial importance in determining the outcome of the present crisis is the reaction of central banks around the world. In the US the Fed under the tutelage of Ben Bernanke has continued with the monetary policy of Greenspan. This has involved injecting enormous amounts of liquidity into the financial sector and underwriting the losses of failing financial institutions such as Bear Stearns. These policies are designed to restore confidence to the financial sector and in doing so prevent recession. The results so far have been patchy to say the least. Moreover, the downside of this policy of lowering interest rates has led to a collapse of the dollar on world markets. In 2002 the Euro was worth 90 cents, it is now worth $1.60. In addition gold, which at the time of writing *Beyond Blair* was $500 per ounce; it has now breached £1000 per ounce. A falling dollar – which remember is the world's principal reserve currency - means inflation, and the monetary authorities around the world have openly admitted this. In Europe the response to the crisis has been more measured, with inflation being a more important consideration but the strategy seems broadly the same.

Injecting liquidity to solve a problem that was caused by excess liquidity in the first place seems a strange way of going about things, but unfortunately it is all that central banks seem to know. Whilst these measures might serve to mitigate the financial crisis in the short run they do not and cannot address the longer term and apparently intractable problems of debt and the plummeting housing market. In addition such policies have costs and dangers of their own. Like the treatment of cancer with chemo-therapy the cure can sometimes be worse than the disease. There are no easy policy options, no magic panaceas. As Milton Freidman once said 'There is no such thing as a free lunch.' Further it should not be assumed that central banks have limitless amounts of capital at their disposal to bail-out distressed financial institutions. In the case of the Fed its '' … current … policy is clearly inflationary. While not directly increasing the liabilities of the US government (yet) the Fed only has about £700 billion in Treasury bills it can lend out for 28 days at a time (or longer as it sees fit). The recent promise to lend up to £200 billion as of March 27 eats into the $700 billion…

If the current liquidity crisis spreads beyond Bear Stearns, the Fed will be compelled to make all of its £700 billion bond assets exchangeable to distressed firms. It has said as much in accepting a ''broad range of collateral'' it is willing to accept in exchange for short-term funds. Once the Fed depletes or exhausts its inventory of Treasury bills it can swap for illiquid assets, what does it do?

It has to go out and buy more Treasury bills on the open market. And to do that it WILL (emphasis in original – FL) create new cash, which is definitely inflationary.'' (*The Daily Reckoning* – March 2008).

In the same vein another commenter has opined that:

'' The Fed is doing everything it can to stave off disaster, but frankly, it is not rich enough. With assets of about $800 billion, having instituted $400 billion of rescue programs in the last week plus unspecified intervention with Bear Stearns, it is pretty nearly tapped out. It does of course have available a further source of liquidity, the Federal printing press. With inflation already moving at a brisk trot, use of that source will replace an incipient recession with a deeper and highly inflationary recession.'' (Martin Hutchinson – www.prudentbear.com – 17 March 2008)

Similarly Alastair Darling has committed the Treasury to guarantee to cover every depositor in UK banks should they become insolvent. In light of the fact that the cost of doing this for a relatively small banking concern – Northern Rock – is now estimated at £100 billion it is difficult to see how he could honour this particular pledge.

Moreover, with US short term interest rates having been reduced to 2.25 percent that is to say below the rate of inflation, the ongoing war on savers – a permanent feature of the boom/bubble years - continues apace. If and when interest rates reach 0 or 1% and the economy does not respond then it's game over. We have reached what Keynes termed the liquidity trap. That is to say that the monetary authorities have shot their bolt and there is nothing further that monetary stimulus can do to revive the economy. We would be in a deflationary environment with falling prices, spare capacity, excess saving and negative growth. This could last for decades, as was most recently the case in Japan after the 1989 crash.

Conclusions:

Sticking my neck out I would say that the present situation looks fundamentally different to run-of-the-mill downturns which we have experienced since the end of the Bretton Woods epoch. Most stock market downturns were quickly overcome and equities continued their long upward ascent. Similarly faltering growth and property prices were quickly reversed by use of proactive monetary policy (debt issue to you and me).Furthermore the more serious financial and economic blowouts occurred in the third world and/or emerging markets, so they don't count.

This time, however, we have a humdinger of a financial blow-out right at the heart of the global system. A blow-out which has been decades in the making. Anglo-American finance capital is experiencing a fundamental and systemic crisis which not only threatens the world's financial system, but has every chance of impacting on world economic growth and stability. Those Anglo-American salad days of permanent and rising debt, permanent and rising deficits on current account, permanent and rising property and equity markets, not to mention expensive and unending foreign wars seem to be numbered. The market correction seems to be advancing like some unstoppable juggernaut. We will have moved from the Brezhnev to the Gorbochov stage of reckoning; delusions of grandeur will no longer be an option. Of course every effort will be made to prolong the ancien regime and may even on occasion result in partial successes, but this will not stop the overall trend now it is beginning to gain traction and momentum.

In addition, the ripple effects of this eruption will be that those countries, mostly in East Asia, whose economic strategy has been based upon export led growth will not only find that their chief export market – the United States and to a lesser extent Europe – collapsing, but also the value of their dollar surpluses, in the case of China £1.5 trillion, taking a massive hit as the dollar's value shrivels.

What emerges after this is anybody's guess. As I stated in *Beyond Blair* ''After the great meltdown the world that emerges will be fundamentally reconfigured. The pendulum may well overshoot before it moves back to its equilibrium position. American debts will be written down by dollar hyperinflation, but the dollar will no longer be the global reserve currency. The global reserve currency may turn out to be the Euro after all. Or there could be a re-emergence of some type of de facto gold standard.''

What a pity the UK lost its chance to join the Euro.