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Three Public Lectures on Macroeconomics

First Lecture

Alconomics as in Alchemy: Theory and Policy in Neoclassical "Economics"

Morning Session
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Alconomics and Economics: Name and Shame

> …[W]hile they prate of economic laws, men and women are starving. We must lay hold of the fact that economic laws are not made by nature. They are made by human beings.
> Franklin D. Roosevelt 1936

> Any intelligent fool can make things bigger and more complex...It takes a touch of genius - and a lot of courage - to move in the opposite direction.
> [Albert Einstein]

> This paper, then, is a serious analysis of a ridiculous subject, which is of course the opposite of what is usual in economics.
> [Paul Krugman, 1978, "Theory of Interstellar Trade", http://www.princeton.edu/~pkrugman/interstellar.pdf]

Imagine alchemists seizing the chemistry laboratories, astrologers chasing the scientists from the observatories, and creationists taking over genetics. Each would be a defeat of the Enlightenment, reason and rationality. This happened in economics. Over the last thirty years, the alconomists seized the profession and purged the economists. They preach their own version of Creationism, that free and unregulated markets are the only possible way to organize society. Like the alchemists they have a Philosopher's Stone, competition. Similarly to their fellow charlatans the astrologers, they claim to see the future.

In my lectures I shall not use the phrase "mainstream economics" or "neoclassical economics". I shall apply the accurate identifier, "alconomics" or the "alconomics school", strictly analogous to the opposition between alchemy and chemistry, and astrology and astronomy. In order that this word not be interpreted as a mere term of abuse and insult (which it certainly is), I must define it.

Alconomics is the study of exchange relationships that have no counterpart in the real world. Those exchanges are endowed with metaphysical powers that bestow contentment and satisfaction upon their participants. These market exchanges are voluntary, timeless and carried out by a large number omniscient creatures of equal prowess. These creatures know all possible outcomes and the likelihood of every exchange, so they are never surprised. In alconomics no difference exists among the past, present ad future.

People who analyze the economy and how it operates in practice are dismissed by the alconomists as vulgar empiricists, ignorant and blasphemous. This vulgarity and ignorance is frequently attributed to insufficient use of mathematics. A useful way for the non-specialist to appreciate the role of alconomics in society is to recognize it as a religious sect with an extremely doctrinaire priesthood that zealously guards its doctrines, the most important of which is the magic of markets. The alconomists are no more economists than alchemists are chemists or astrologers are astronomers.

Why do so many people in so many countries revere the alconomists as gurus? In great part the undeserved credibility of the alconomists results from the systematic fostering of ignorance. Understanding how society sets about to produce and distribute commodities and services is not simple. However, it is no more difficult than understanding politics sufficiently to vote. People regularly go into voting booths and choose among candidates or reject them all. Many if not most of these same people would profess a degree of ignorance of economics that leaves them unable to evaluate competing claims about public policy, though it directly affects their lives.

This is the General Law of Economic Ignorance:

> The individual is capable of informed choices in all areas, **except** for economic policy, which we must leave to experts.

The General Law requires the belief in and obedience to the specific by-laws certified by alconomics. These include the Laws of 1) supply and demand; 2) that government is a wasteful and inefficient; and 3) that trade unions cause unemployment and inflation.

The Idolatry of Competition

From tiny acorns great oaks grow. And from low and banal theory, alconomics ascends to great ideological heights. With superficial and simplistic propositions alconomics constructs a great, complex ideological edifice from which it issues its oracle-like judgments over the affairs of humankind. The employment, inflation and anti-government parables of alconomics derive from a short-list of putatively incontestable propositions.

I can summarize this short list of absurdities briefly. People have a desire for goods and services beyond their current earning capacity, requiring them to make choices, to allocate their incomes among their wants in the manner that will best fulfill those wants. For all people added together, wants are unlimited and the resources to satisfy them are finite. Economics is the study of the personal allocation of scarce resources among unlimited wants. This process of allocation of scarce resources creates competitive markets in which private costs and benefits equate to social costs and benefits. Government actions restrict, limit and distort the ability of people to make their choices. Its role should be strictly limited to minimize those restrictions, limits and distortions.

In the ideological myopia of big money and its economic priests, markets are not only more efficient than alternative methods of allocation and distribution, they are the *only* efficient method. Even more, markets are efficient if and only if they are not regulated in any manner, when they are allowed to operate freely of intervention by non-market forces (i.e., governments). "Controlled" economies (socialist and communist) are by far the worst, and regulated markets in capitalist countries almost as bad.

Economic life organized through free markets is not merely the Best, it is the only Good. Even more than this, markets cannot be eliminated even in the most draconian communist state, they can only be "suppressed". As a result, attempts at regulation of markets, even more the banning of them, does no more than drive them underground ("black markets"), distorting the natural tendency of people to "truck, barter and exchange" (Adam Smith). In other words, human activity is market driven: There Is No Alternative, the TINA principle so commonly found in the public pronouncements of alconomists.

The Teflon Pseudo Science

The TINA principle derives from a motley collection of absurdities. Resources are not scarce, because they are rarely fully utilized. So-called personal preferences are socially determined. The fairy tale in which exchange creates a competitive process of harmonious interaction is so logically flawed that it fails to quality as either "analysis" or "theory".

First, market choices by people are not the result of preferences and desires arising at the individual level. That an individual has choices in markets is the result of a society with a division of labor that has organized its production and distribution in a specific historical manner. Second, whether or not people enter into exchanges "willingly" is a matter of definition. For example, no one is forced in the sense of physical coercion to decide to forego medical treatment because it is too expensive. That is, indeed, a choice many people make and a choice that would not be presented to a person in a humane society. Third, since preferences arise from a person's social interaction, and many choices are forced upon us (see box, Hobson's Choice), the collective actions of people to improve their societies by government interventions cannot be condemned as restricting freedom.

Opponents and critical supporters of markets have made these arguments many times. They never "stick". As with cooking utensils made of Teflon the ideology of alconomics can be wiped clean of criticism with astounding ease. No appeal to justice or decency has a long term or fundamental impact on the hegemony of alconomic ideology. This ideology clearly serves the interest of wealth and power, but that has been true for two hundred years, and during some of those years the current, absurd version was not hegemonic. Why now? Before that question can even be asked, the absurdity of the hegemonic mumbo-jumbo must be demonstrated.

Omniscient and omnipresent, "the market", like an ancient god, is both tyrannical and benevolent. It manifests its tyranny in its relentless control over production, distribution and allocation of the necessities of human life. Its benevolence is sublime, through the limitless pleasure it can deliver in individual consumption of the commodities it distributes. Like all gods it demands disciplined obedience to its fundamental laws, rewards the obedient with riches and punishes the disobedient with misery in a myriad of forms all resulting from vain-glorious attempts to challenge its will.

Like gods, it issues pronouncements, "judgment of markets", which are accepted with reverent passivity (see below for obvious examples). Be they about executive salaries or the price of heating oil, all the judgments carry the same divine authority: "you can't argue with supply and demand". These are universal laws of human interaction that can no more be altered than preventing water from running down hill.

We know that these laws are universal and inexorable because their operation has been theoretically explained and that explanation empirically verified by the science of the market, "economics". At the root of the current triumphant return of the nineteenth century anti-social arguments for "the market" is the ingrained belief, even among most progressives, of the logical power, technical strength and empirical validity of alconomic theory. As much as we may criticize the reactionary views of economists, at the end of the day, "you just can't deny market fundamentals".

Well, that's wrong. There are no "market fundamentals" in the sense that the alconomics coined the phrase. So-called neoclassical economics is not logically powerful, technically strong and empirically valid. On the contrary, its logic is contradictory, its techniques sloppy, and the actual economy refutes its generalizations with startling regularity.

Where the Alconomists Dwell

Everyday experience makes it obvious that markets are imperfect, so regulate them. The alconomists reject this sensible generalization out-of-hand as the superficial babbling of the ignorant. Markets are efficient. They allocate resources to optimal use. They bring consumers what they want, with the quality desired, at prices that correctly signal the social cost of providing those goods and services. Except in extraordinary cases, of which there are very few, regulation of markets reduces human welfare and happiness.

How do the alconomists sustain this market liberation propaganda when all experience is to the contrary? More important, why does the vast majority of people in the English-speaking developed countries believe it, when their everyday market transactions contradict it? Even turkeys squawk when confronted with their executioners, but not so with "consumers", most of whom accept the iron laws of supply and demand.

The first propaganda task is to convince people that they are not competent to assess their own market experiences; rather, those experiences must be interpreted through the lens of alconomics. We must all accept that our mundane exchange activities, buying food, paying rent or the mortgage, saving for unforeseen events, are governed by extremely complex processes that only the experts can fully understand. Partial understanding can be granted on a conditional basis to a few, for example bankers and hedge-fund speculators because of their instinctive reverence for unregulated markets. But not to the masses.

Once convinced that economics is for experts, the pro-market deed is done, because the experts present themselves as unanimous: markets are GOOD. The proof of unanimity is that only fools and nut-cases dissent. The proof that markets are GOOD is achieved through a analytical elimination: eliminate every possible source of problems that markets might generate and, contradictory to direct experience, perfection becomes the only possible conclusion.

First, treat distributions of wealth and income as independent of the operation of the markets themselves. They are "initial conditions" about which a subjective opinion is allowed, but it can not affect the benign conclusion. This treatment of distribution is absurd. What is produced and the their prices are determined by the structure of demand, and the structure of demand is determined by the distribution of income and wealth. Were there no billionaires there would be no sea-going yachts. It is not surprising that when an economist sings the praises of markets, he/she rarely prefaces that eulogy with, "by the way, I am assuming that the distribution of income has no impact on markets".

This "assumption" proves very convenient. It dismisses all market problems and outrages that result from unequal access to economic power. People enter market transactions with what they have, and to question distribution is to degenerate into anti-scientific subjectivity. This is the deadly sin of "normative" assessments in a "positive" science, a distinction in the 1950s made into the keystone of economics by Paul Samuelson (Bank of Sweden "Nobel" prize 1970). When to this we add the "assumption" that all exchanges are voluntary, the space for criticizing markets on the basis of inequalities reduces to zero.

Having taken care of qualms arising from the inequalities generated by markets, let's turn to the problems associated with access to information. This the free marketeers can dismiss with ease: assume that every market participant enjoys access to true and full information about every aspect of every potential exchange now and in the future ("perfect knowledge and foresight"). If treating distribution as given was absurd, this one is a howler. Misrepresentation of products, misleading advertising, insider trading, even the cost of acquiring information, forget them all and forge ahead in free market bliss. The alconomists might justify this analytical trick with more apparently respectable arguments, e.g., "rational expectations" and the "efficient market hypothesis". These are merely alternative hoots from the same howler.

The nagging problem of widespread market discrimination due to economic power remains. A person may have true and full information (I know relatively few that do), but still be cheated because he or she cannot access better market conditions though they exist. This problem arises because exchanges for any product happen at different times and places. All measures of sales by necessity refer to some specific time period, as in "food sales in August". Even in the absence of discrimination and fraud, the same item can be sold at different prices within a short period of time, for example, due to supermarkets discounting to "move" merchandise.

The commonly occurring variations in prices show that markets may be flexible, but they are not "efficient". The prices thrown up by markets are alleged by the alconomists to indicate the true cost of producing and distributing a commodity. If the price of a package of lettuce is two dollars when the supermarket opens, then cut to one dollar an hour before closing time (the "sell it or smell it" rule of pricing), which represented the true cost? If we take an average, are all sales equally representative, or the later (earlier) ones the more accurate "signals"? Alconomists cut this Gordian Knot, markets send *too many signals too often* to buyers and sellers, by an additional assumption, that exchanges occur simultaneously in one big market place, that by definition allows only one price for each transaction.

You might think that this journey into the absurd has reached its limit by now: 1) wealth and income distributed ignored; 2) buyers and sellers know everything that need be known; and 3) all exchanges occur simultaneously. However, there remains a nagging procedural problem. Who sets the price in these transactions? Because both the buyer and the seller seek to maximize the gain from the transactions, neither can be trusted by the other to set the price. Haggling back and forth cannot be allowed because it creates the possibility that the exchange will be influenced by market power, with the result that the agreed price will deviate from the true cost of production and distribution.

This is, indeed, a quandary. Exchanges are mutually agreed actions between consenting buyers and sellers, but if either makes a price offer the purity of markets is cast into doubt. For example, consistent price setting by the seller, as for almost all actual exchanges, in shop, store, online or by telephone, suggests the need for public oversight in some form. This oversight could be mild, through a consumer protection agency, or aggressive through laws limiting markets shares and collusion among sellers.

Escaping the logic for public regulation requires that the economists exclude from their models of markets the possibility of market power. Buyers and sellers cannot be permitted to discuss prices among themselves. Something dramatic and innovative is required to square this circle, and the salvation is The Auctioneer. Amid all the buyers and sellers, who wait eagerly to make their exchanges, stands The Auctioneer, whose role is to supply the price quotations for all exchanges.

The role of The Auctioneer is truly awe inspiring. The prices supplied must have a very specific outcome: no surpluses, no shortages and every buyer and seller happy. This is the imaginary land constructed by economists, in which markets function perfectly and public oversight is not only unnecessary, it is BAD. It is bad because any regulatory intervention prevents the outcome that leaves everyone content.

This contentment is achieved by passing through the looking glass into a land of the imagination of economists, with no production, only buying and selling. To review, this buying and selling occurs in one big market in which people come with a variety of commodities that they do not want to exchange for ones they do want. The market operates according to the following rules:

1. It is supervised by an all-powerful auctioneer.

2. The auctioneer announces to the buyers what is on sale, to the sellers announces what the buyers seek to purchase, and to both the prices at which exchange can occur. And,

3. All exchanges are at the same moment, and none occurs without the explicit approval of the auctioneer.

In this market place buyers and sellers have no influence on prices, because they believe that they must accept the prices announced by the auctioneer.

The discriminating reader might well ask why I have discussed this ridiculous farce, a market of simultaneous exchanges that never produces surpluses or shortages, and no haggling over prices occurs. The absurdity is farce because the absence of surpluses, shortages and haggling is purely *ex machina*. It results from no interaction of traders. It is the result of the imaginary auctioneer. To put it bluntly, this market has no surpluses, shortages or haggling because I have not allowed them. Similar to the methodology of the Bellman in Lewis Carroll's *The Hunting of the Snark*, these markets have no surpluses or shortages because, "What I tell you three times is true".

I present this credibility-challenged fantasy market because, as hard as it may be for the layperson to believe, it is the theoretical foundation of alconomics. Formally known as Walrasian General Equilibrium Theory, it is the stuff for which Nobel Prizes are awarded (see Box, "Nobel" Prizes for Nonsense), the "gold standard" of economic theory. On a website devoted to explaining economic theory, we read,

> Some of the problems with Walras general economic equilibrium theory included the fact that the perfect competition assumption was, of course, invalid. Also, how would new prices get established in the first place? Walras assumed that an auctioneer or "crier" would announce prices. (http://www.economictheories.org)

Alconomists have no theory to show that unregulated markets produce efficient results that are socially beneficial. Further, the excursion into madness that masquerades as that theory does not show that a market economy is guided by the "invisible hand" of Adam Smith, so dear to free market true believers. On the contrary, the theory of markets that guides alconomics, Walrasian general equilibrium analysis, has a very visible and heavy hand, a mythical auctioneer whose intervention presents markets from descending into disarray. There is no invisible hand, in practice or in theory.

Referring to the free market advocates that preceded him, J. M. Keynes famously commented, "...even the most practical man of affairs is usually in the thrall of the ideas of some long-dead economist". I regret to say that most of the economists defending the virtues of markets are very much alive and have proved to be as brilliant at free market propaganda as they are banal and trivial in their theorizing. The rest of this book attempts to dispel the lies their theory has marketed through smoke, mirrors and illusions, easily outdoing the Wizard of Oz.

Neoliberal Macro-alconomics

In terms of formal analysis, macroeconomics divides into two broad theoretical frameworks, one in which output is demand constrained and the other in which it is price constrained. A *price determined economy* is either in a unique full employment general equilibrium, or prevented from achieving that general equilibrium by private or public price "distortions". An economy is *demand determined* when its level of output is limited by one or all of the components of aggregate demand: consumption, private investment, government expenditure, or exports.

The price controlled framework is the *sine qua non* of alconomics economics, while the introduction of an aggregate demand constraint was the contribution and remains the legacies of Karl Marx and John Maynard Keynes. Even the most superficial knowledge of alconomics makes it obvious that price constrained analysis provides the theoretical basis for arguments in defense of private markets and against public intervention. It is equally obvious that whatever else Keynes may have intended, the central message of his demand constrained analysis was and is that markets are unstable and public intervention is essential to the effective functioning of a capitalist economy.

The formal statement of the two approaches disguises a profound ideological division, which sets the limits to the permissible debate over the role of the public sector in advanced capitalist societies. The price constrained framework is the policy ideology of the tiny minority that controls production and finance. The demand constrained framework provides the defense of public intervention that is analytical foundation of social democracy. In the former analysis, unemployment is voluntary and any public sector intervention in markets is a threat to efficiency and social welfare. In the latter, unemployment is an inherent curse of capitalism and in the absence of public intervention markets are unstable and dysfunctional.

The price determined framework is non-credible to the point of absurdity and beyond. In no other intellectual discipline would such a chaotic collection of logical inconsistencies and arbitrary assumptions be taken seriously. The price constrained framework is based on an unambiguously false premise: that the normal condition of capitalist economies is full employment. Yet, today, unlike in the immediate post-WW II years, the price constrained framework dominates academia, the media and political debate. The demand constrained framework, as obviously sensible as its opposite is absurd, has been relegated to the margins of the discipline.

This inversion, in which the absurd is embraced as sensible and the sensible is dismissed as absurd, reflects the great political victory of the minority over the majority during the final decades of the twentieth century, after a brief interruption during the middle of the century. For almost sixty years, 1870-1930, a relatively primitive form of the price constrained framework dominated the emerging economics profession. During the early stages of development of this framework, the undisguised purpose of leading economists was to refute Karl Marx and justify capitalism.

Two great human disasters prompted a rebellion against the free market doctrine, the Great Depression and the Second World War. It was obvious to all that the first resulted from the excesses of a capitalism unconstrained by public regulation. The second was the consequence of the first. Denying this chain of causally requires considerable ideological invention and not a small amount of intellectual dishonesty. By the end of the war a broad consensus emerged in Europe and North America that the excesses of capitalism demanded strict regulation of markets, and especially of the financial sector. This consensus could be found in the most prestigious journal of the profession, the *Economic Journal*, where social democrat K. W. Rothschild asserted that fascism was the fruit of unregulated markets:

> …[W]hen we enter the field of rivalry between [corporate] giants, the traditional separation of the political from the economic can no longer be maintained. Once we have recognised that the desire for a strong position ranks equally with the desire for immediate maximum profits we must follow this new dual approach to its logical end.
>
> Fascism…has been largely brought into power by this very struggle in an attempt of the most powerful oligopolists to strengthen, through political action, their position in the labour market and vis-à-vis their smaller competitors, and finally to strike out in order to change the world market situation in their favour. (Rothschild 1946: 317)

The minority that controlled production and finance considered this consensus a temporary arrangement to be destroyed as soon as possible, because its main economic consequence was to limit the freedom of capital. Those who judged post war regulated capitalism as a new norm would be quickly proved wrong. The system of international regulation of exchange rates ended in 1970, deregulation of the financial sector in the United States and parts of Europe began in the late 1970s, and the political base for a managed capitalism, the trade unions, fell into secular decline in most advanced countries. The collapse of the Soviet Union complemented these trends, eliminating the global rival to unmanaged capitalism.

The destruction the post war regulatory consensus liberated capital from civilizing constraints. The macroeconomics of Keynes and those he influenced provided both the theoretical explanation for why these constraints were needed and the practical policy tools to manage an economy within those constraints. The "Keynesian revolution" briefly institutionalized the singularly sensible principle that governments have policy tools that they can use to pursue the welfare of the populations they were elected to serve. The most important of the tools are fiscal policy, monetary policy and management of the exchange rate. The active use of all these tools was implied by another sensible proposition, the Tinbergen Rule, that achieving several policy goals requires an equal number of policy instruments. For example, a government seeking internal and external stability would use fiscal policy to reach a desired unemployment rate, monetary policy to make that unemployment rate consistent with a desired inflation rate, and adjustment of the exchange rate to maintain a sustainable balance of payments.

The obviously sensible proposition that governments should use the tools available to them to pursue the public welfare, while enforcing constraints on the excesses of capitalism, has been discredited in public debate by repeated ideological attacks beginning in the 1970s. The constraints have been dismantled and tools de-commissioned by increasingly reactionary governments. Against weak internal opposition the economics profession would provide the ideology for the de-commissioning of the policy tools to support those constraints.

What is Macroeconomics?

The over-throw of economics by alconomics corresponds to expelling macroeconomics in a reversion to microeconomics in its most arcane form. This expulsion took the headline form of a rejection of so-called Keynesian economics, but in practice involved abandoning aggregate economic theory in its entirety. Far from offering an alternative aggregate analysis, the alconomics counter-revolution replaces the aggregate with a thinly disguised single market partial equilibrium.

As a separable and distinct area of inquiry, macroeconomics is defined by two fundamental characteristics. First, macroeconomics constructs aggregate variables analytically prior to the manifestation of those variables at the microeconomic level. Macroeconomic variables are not the sum of micro or individual actions. On the contrary, individual behavior is the devolved manifestation of previously determined aggregates. Famous examples of this primacy of the aggregate are the "paradox of thrift" of Keynes, and Marx's principle that the extraction of surplus value occurs at the level of capital as a whole and is observed at the level of the enterprise. From this characteristic it follows that Marx, Ricardo and Keynes were the first true macroeconomists.

Second, macroeconomics as the study of aggregates, has as its basic foundation the manner in which many products of great diversity are combined into an analytically meaningful total. This appears as an issue of measurement, "the aggregation problem", but in essence is the theory of value. The process of aggregation implies there to be three different aggregates, two of which are strictly empirical. First, there is the collection of commodities in their material form. This collection exists as a real world phenomenon. It is an aggregate in the sense that one can conceive of it, all the economy's commodities brought together in a great pile.

The *sine qua non* of macroeconomics is the third aggregate that is the measure of the collection of diverse commodities in homogeneous units. These homogeneous units must be independent of the prices used to compute the total monetary value of commodities in order to avoid the index number problem. This third aggregate exists for the purpose of allowing for quantitative comparisons of different combinations of commodities. To avoid the ambiguous modifier "real", I shall refer to this third aggregate as the "price-independent" measure of output. The need for such an aggregate in order to create a field called "macroeconomics" is so obvious that elaboration of the concept may seem trivial. However, modern economics hardly deals with this issue at all, or does so only at the most superficial level.

This third aggregate allows one to construct short-run macro models and models of economic growth. On its basis we can make statements about the rate of flow of production and changes in society's productive assets. However, unlike the first two types of aggregates *the third is not directly observable.* A beer can be drunk and its price paid, but beer measured in homogeneous units that allow it to be added to other commodities can only be inferred. This third aggregate is an analogue of the material form of commodities, but cannot itself be measured in the physical units one uses to measure each commodity taken alone.

In my view Ricardo grappled with this problem seriously but unsuccessfully. Keynes clearly and explicitly recognized the problem of the "third aggregate" and his solution was the *labor unit*, "It is my belief that much unnecessary perplexity can be avoided if we limited ourselves strictly to the two units, money and labor, when we are dealing with the behavior of the system as a whole" (Keynes, 1936, 43). While innovative, this approach was also unsuccessful, leaving Marx as the aggregate theorist who came closest to producing an analytically sound third aggregate.

In contrast to these great thinkers and other macroeconomists, the alconomists dismiss the aggregation issue by dismissing aggregate analysis itself. The implicit assumption of all pseudo aggregate analysis in alconomics is that the economy has but one product.. This assumption is strictly equivalent to the microeconomic analysis of a single market with enterprises producing a homogeneous product. The absurdities of alconomics micro, scarcity of resources, individual preferences, Walrasian general equilibrium, and perfect competition re-appear in so-called alconomics macro, because there is no difference between the two. Even the use of Walrasian GE is invalidated by the assumption of one "aggregate" product. The apparent general equilibrium is nothing more than simultaneous clearing of the product and money markets under the assumption of neutrality.

Thus, the alleged analytical insights of the free market ideology are nothing more than the misrepresentation of the partial equilibrium, perfect competition single market model as aggregate analysis. The parables about neutrality of money and automatic adjustment to full employment are not merely invalid, they are irrelevant, false application of single market analysis. Equally invalid are the reactionary parables that are the *sine qua non* of alconomics "macro": 1) employment is not negatively related to the real wage; 2) interest rates do not allocate credit or capital; and 3) flexible exchange rates do not assure external balance; and 4) inflation is not a monetary phenomenon.

The rejection of these reactionary parables and the exposure of their illogical foundations lead me in my second lecture to the current tyranny of finance and austerity, what might be called the Era of the One Percent.

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Second Lecture

Finance, Money and the On-going Crisis: Deficit and Debt Scams in Europe and the USA

Morning Session
21 March 2012

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Practical advice to Wall Street bankers in the summer of 2008.

Let the Bad Times Roll

At the beginning of the twenty-first century, as people went about their daily affairs in the United States, Europe and Japan, few realized that the new millennium brought them to the cusp of a new era. In this era the hopeful anticipations of better living standards for successive generations would dissipate into distant and bitter memories of a by-gone golden age.

After brewing for two decades, in 2008 a Global Financial Crisis erupted in the United States. It spread across the Atlantic to strike the United Kingdom, then savage the euro zone, country by country, like a financial great plague. This, the first global recession of the twenty-first century, would institutionalize austerity. In January 2012, the Federal Reserve chairman predicted that full recovery of the US economy was "years away". His British counterpart at the Bank of England warned of no return to pre-crisis living standards this decade. In continental Europe prospects for the future are even worse, Greece in default, Italy and Spain on the brink, France awaiting its fate.

La noir epoque arrived in a return of the 1930s, this time for a longer run. We have our own Great Depression, without a Roosevelt or a progressive movement of substantial political importance in any major country. As Karl Marx famously wrote of Napoléon Bonaparte and Louis-Napoléon Bonaparte (Napoléon III), “first time as tragedy, second time as farce”, but a farce with limited mirth. The massive financial collapse in the United States and Europe very briefly prompted recognition its obvious cause, the reckless speculative behavior of the lords (and ladies) of finance. Brief that moment was, quickly overwhelmed by a rise in the influence and virulence of the reactionary right, which had its own story of the source of the gathering gloom of economic decline and social misery.

Ignoring the feckless follies of finance, the reactionary narrative asserts that the Great Depression of the new century comes from the errors of government. This crass propaganda seduces us to reject governments as instruments of social intervention for the public good. In this *faux* narrative for the new era of austerity, preaching "the road to hell is paved with good intentions" on steroids, government is the problem and austerity the solution. At the heart of this fable lurks the politics of neo-authoritarianism, cloaked as individualism. The formidable task of providing ideological justification for governments to enforce economic misery on the vast majority of people, the famous 99%, fell to the right wing of the economics profession, a task for which it spent over four decades preparing.

The salient characteristic of the era of austerity is the near-complete abandonment of rational economic analysis, replaced by the voodoo of alconomics. Paul Krugman has described this degeneration of the intellect well:

> …[W]hat we've witnessed pretty much throughout the western world is a kind of inverse miracle of intellectual failure. Given a crisis that should have been relatively easy to solve — and, more than that, a crisis that anyone who knew macroeconomics 101 should have been well-prepared to deal with — what we actually got was an obsession with problems we didn't have. We've obsessed over the deficit in the face of near-record low interest rates, obsessed over inflation in the face of stagnant wages, and counted on the confidence fairy to make job-destroying policies somehow job-creating.
>
> [http://krugman.blogs.nytimes.com/2011/08/02/macroeconomic-folly/]

This lecture considers three manifestations of that intellectual failure, the misrepresentation of public finances in the United States, the similar misrepresentation in the United Kingdom, and the Great Euro Austerity Scam. All three have in common ascendancy of finance over production, laying the basis for free market authoritarianism.

United States: Ideology, Deficits and Debt

> Hurricane Irene will most likely prove to be one of the 10 costliest catastrophes in the nation's history," with damage estimated at US$ 7-10 billion.
> ("Hurricane Irene Seen as Ranking among Top Ten," *NYT*, 31 Aug 2011, 1).

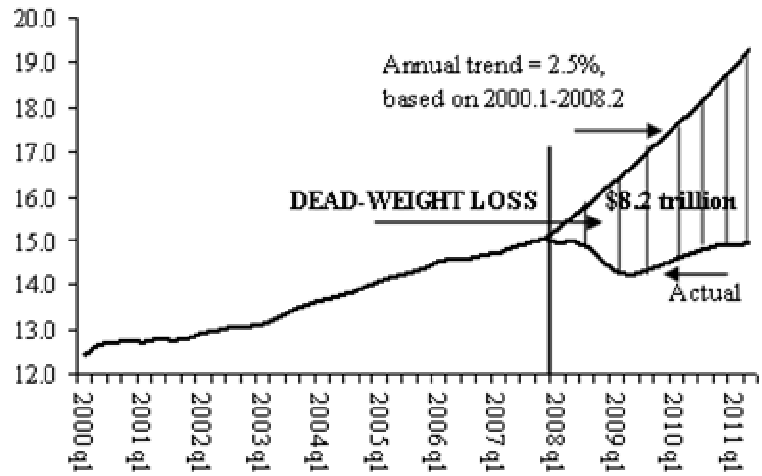
Alconomists frequently refer to market processes as "natural", coining such infamous terms as the "natural rate of unemployment". I can confidently assert that no hurricane or earthquake has ever or will ever approach the potential of markets to generate human disasters. To match the devastation, suffering and dead-weight loss of the Great Depression of the 1930s and the recent Financial Crisis, we move into the league of wars, famines and pogroms.

The statistics speak clearly. From the beginning of 2000 through the middle of 2008, US total output ("gross national product") grew at an annual rate of 2.5 percent. Four years latter total output is barely at the peak of mid-2008. Had the US economy experienced no growth over those years and output stagnated at the level of mid-2008, the income gain would have been almost $5 trillion compared to the actual outcome, equal to about one-third of GDP in 2011.

This is a not a relevant comparison, because in no three year period since the end of World War II has the US economy stagnated, even less has it declined. Over those 65 years, in no year has output been lower that it was three years previously. Only once before, 1974-1975, output declined for two consecutive years. Five trillion dollars may far exceed the estimated cost of any earthquake or hurricane in the history of humankind, but it is a considerable underestimate of the money cost of the 2008 unnatural catastrophe.

What if US output had continued to grow at 2.5 percent, as it did in the 2000s before the catastrophe? Despite all the prattle about a "New Economy", this rate was not unusually high, well below the average of 1946-1999 (which was 3.6 percent). The answer is shown in the chart below. It measures GDP at the price level of the first six months of this year, eliminating increases do to inflation. Had the "natural" working of financial markets not reeked havoc and the economy continued to grow at 2.5 percent, the annual GDP for 2011 would be almost twenty trillion dollars, rather than the stagnant level of less than fifteen. The accumulated loss for 2008-2011, dead-weight because it cannot be recovered, is $8.2 trillion (striped region in Figure 2.1).

Figure 2.1
Actual and Trend US GDP, 2000-2011,
trillions of dollars adjusted to prices of 2011



Source: Bureau of Economic Analysis of the US Department of Commerce.

During 2008-2011, total unemployment averaged thirteen million per year, and almost fifteen million for 2009-2011, when the rate never fell below nine percent of the labor force. Almost exactly half of this unemployment, an annual average of 6.7 million men and women during 2008-2011, was above the post-war trend. That is, half was the direct cost of the financial crisis. Imagine a natural disaster that would so devastate the US economy that it threw an average of over six million people out of work for four years, a dead-weight loss of 27 million working years. It would be the Mother of All Hurricanes, and its name is "Market Forces".

There are big difference between hurricanes and market catastrophes. First, the market catastrophes are much more devastating than hurricanes. Second, we can prepare for hurricanes but we cannot prevent them. In contrast, market catastrophes can be prevented. They need never occur except as minor annoyances. Over six decades, 1950 through 2008, annual unemployment rose above nine percent in only two years, 1982 and 1983. At the end of 2011, the count went from two to six. The ways to prevent market catastrophes are known: tight regulation of financial markets and countercyclical fiscal policy.

Perhaps the most extraordinary aspect of this market-driven catastrophe is that is has not stimulated reform, but reactionary obsession with the UN fiscal deficit and public debt. A key characteristic of this obsession has been systematic misrepresentation. Assessing the federal deficit requires knowing what to measure. Total revenues minus total expenditures is the overall deficit. This is not the deficit for judging budget policy because it includes interest on the public debt. Cutting interest expenditure would imply defaulting on part or all the public debt, so it is excluded from serious discussions of deficit reduction. In the United States about forty percent off the interest is paid to government agencies (a mere change of public pockets), which is another reason for leaving out interest payments. Their exclusion results in the primary deficit. It is this measure that the International Monetary Fund applies for all its infamous "stabilization" programs.

It is a general principle of business finance that current revenue should cover current costs, and investment should be funded by borrowing (i.e., businesses going into debt). No successful business would spend years hoarding funds to pay up-front for a factory or office block expected to last twenty years. Banks exist to lend for such investment. The same principle applies to public investments. There is no rational economic argument for a government to pay up-front to build a toll road that would generate net income for years. The same argument applies if there is no toll, in which case the net income implicitly accrues to the users of the road. The appropriate rule of public finance is that current revenue should cover current expenditures, and borrow for capital expenditures, or the current deficit. The exception to this rule is when the economy is overheating.

Third, some expenditures and revenues are cyclical, the most obvious case is unemployment payments. When unemployment rises, payments to the unemployed and other social protection expenditures rise. The same applies to most taxes implying that deficits should be cyclically adjusted.

These measures of the deficit are estimated in the table below. We can see that the bottom fell out of revenue in 2009 and 2010, while the expenditure share increased (columns 2 and 3). Public revenue declined by $460 billion from its maximum in 2007 to its nadir in 2009. Over half of this fall was in personal income taxes, which dropped by twenty percent. Almost all of the remaining decline was in corporate tax, down by half. Meanwhile, from 2007 to 2009 expenditure increased by almost $800 billion. Of the civilian (non-military) part, two-fifths of the increase were in unemployment benefits, welfare payments and the temporary mortgage relief program.

Back in the days when economists studied the economy, these changes were called <u>automatic stabilizers</u> (Schultz 1964). When the economy declines reactions occur that reduce the potential decline. Among these are: 1) personal income tax receipts fall more than household income because the tax rates are mildly progressive as are various exemptions; 2) the corporate income tax declines dramatically because corporate profits absorb much of the initial fall in demand for goods and services; and 3) household income is partly stabilized by unemployment benefits and temporary welfare payments.

In those by-gone days before economic was seized by the alconomists, automatic stabilizers were considered a good thing. For alconomists this is a seriousness heresy. If one considers automatic stabilizers a good thing, it implies that fiscal deficits should increase during a recession, that the deficit increase prevents things from getting worst. Once this heretical blasphemy was the accepted wisdom just forty years ago.

The <u>overall deficit</u> rose from about one percent of GDP in 2007 to over ten percent in 2010, and the <u>primary deficit</u> reached 9.5 percent of GDP. If deficit reduction is called for, the relevant measure is the <u>current deficit</u>, that portion of government consumption expenditure not covered by current revenue. This was less than six percent of GDP, far below the "headline" ten percent cited by the deficit vultures. A full percentage point of the current deficit was the result of the increase in unemployment (see last column, Net Unemployment Payments, NUP). Leaving this out is a step toward measuring the cycle-free component of the deficit. In 2007 the taxes funding unemployment payments exceeded the benefits paid by $6 billion. By 2010 the payments exceeded tax revenue by over $140 billion.

These calculations produce a straight-forward conclusion. The US public sector deficit is large by historical comparison, about six percent of GDP when appropriately measured. It is high by historical comparison because the recession in which we find ourselves is severe by historical comparison. End the recession, end the deficit, which once was the accept wisdom of economists.

Table 2.1
US GDP and Public Finances, 2005-2010 (billions of dollars and percentages)

Year	GDP	Revenue	Expenditure	Balance	Less: Interest	Investment	NUP
2005	12,638	2,154	2,472	-318	184	392	7
2006	13,399	2,407	2,655	-248	219	425	10
2007	14,078	2,568	2,729	-161	223	462	6
2008	14,441	2,524	2,983	-459	232	496	-6
2009	14,256	2,105	3,518	-1413	169	514	-85
2010	14,660	2,165	3,721	-1556	168	540	-143
	% GDP	Revenue	Expenditure	Overall	Primary	Current	Less Unemp
	2005	17.0	19.6	-2.5	-1.1	2.0	2.0
	2006	18.0	19.8	-1.9	-0.2	3.0	2.9
	2007	18.2	19.4	-1.1	0.4	3.7	3.7
	2008	17.5	20.7	-3.2	-1.6	1.9	1.9
	2009	14.8	24.7	-9.9	-8.7	-5.1	-4.5
	2010	14.8	25.4	-10.6	-9.5	-5.8	-4.8

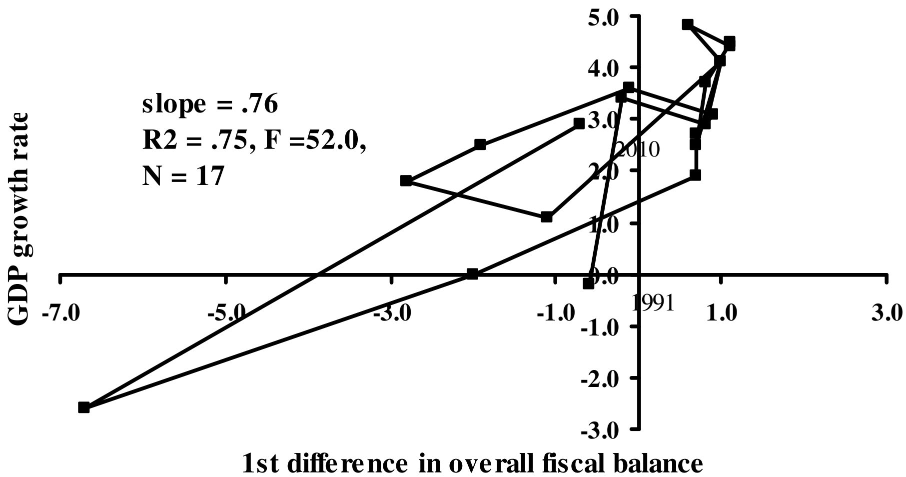
Notes: NUP is net unemployment revenue (tax minus payments). All numbers for 2010 preliminary.
Source: US Office of Management and Budget, reported at http://www.bea.gov/.

How to cut the deficit? The answer is obvious, though none dare speak its name: an <u>effective fiscal stimulus</u>. The process by which the stimulus would bring recovery was once so generally accepted that it is astounding that I apologize for explaining it: public expenditure would increase demand, employment would increase, reducing unemployment payments and welfare payments, and generating tax revenue. Rising household consumption demand would increase corporate profits, simultaneously raising corporate tax collections and stimulating productive investment.

This once generally accepted process is demonstrated in the chart below. If non-cyclical expenditures are treated as autonomously determined and taxes are income elastic, the level of GDP determines the fiscal balance, and the first difference of that balance should correlate with the GDP growth rate. The chart shows that even this crude hypothesis is supported by statistics over the last twenty years.

Quite the contrary say the alconomists. The public deficit is over ten percent of GDP with default and disaster stares the US government in the face as the omniscient financial markets tremble and quake. Cut expenditures. Cut education, health, social security payments, and unemployment benefits, too. Don't repair roads, bridges and schools. This reactionary ideology is not mere madness, it is madness with a purpose: using the recession and the public deficit as weapons further to strengthen the power of capital over social and political life in the United States. The forces of reaction are following the advice of Rahm Emanuel, President Obama's former chief of staff. A good crisis cannot, and should not, be wasted**.**

Figure 2.2: United States,
First Difference in the overall fiscal balance & GDP growth rate, 1991-2010



Source: Economic Reports of the President and US Department of Commerce.

But what of the public debt? It is not dangerously large, threatening to "unsettle financial markets"? No, the US public debt is not large by any rational measure, and the "burden" it imposes is tiny. Demonstrating the validity of this additional heresy requires knowledge of an arcane and obscure subject, arithmetic, plus a bit of commonsense. The common sense consists of three general rules.

The first is that a debt is a potential problem if it is owed to someone else. A debt owed to yourself is not a debt. Second, there is a difference between the gross and the net debt of a person, household, business or government. The net debt equals what is owed to others minus liquid assets on hand. Third, the cost or burden of a debt is what the debtor must pay to others in interest and to reduce the original value of the debt. The running cost of a mortgage, for example, is not the amount, but the periodic interest and repayment of principle ("debt service").

This same common sense can be applied to the US government, and this is done in the table below. At the end of 2010, the federal public debt of the United States was just over fourteen trillion dollars, equivalent to about 96 percent of gross national product for that year. Forty percent of this debt was owed by the federal government to the federal government itself, and the interest payments involved a shift of funds from one pocket to another. Even more, much of this shift had the positive purpose of funding the social security system. The US debt in the social security trust fund is an **asset** for the beneficiaries of system, generating their retirement income.

Next, the liquid assets of the US government, gold reserves, holdings of foreign currencies, bonds, etc., should be subtracted out to obtain the **net** debt. By the international standard methodology of the Organization of Economic Cooperation and Development (OECD), the net debt of the United States was just over six trillion dollars at the end of 2010, well less than half of the nominal total of 14 trillion. In other words, take out what the government owes itself, take out government liquid assets, and the debt was just over forty percent of GDP, not close to 100 percent.

But that's not the end of the story. The major reason that the press and politicians carry on about the debt is the terror of the merciless "financial markets". So, how much of the debt, gross or net, is held by these gnomes of finance? This is difficult to estimate precisely, but there are obvious candidates for exclusion, beginning with state and local governments. This portion of the federal debt, which includes public employee pension funds, was five percent of the total in 2010. This brings the maximum possible "financial market debt" down to about 7.5 trillion gross and barely six trillion **net**.

Finally, there is the debt owed to China, $1.1 trillion at the end of 2010. Whatever nefarious plans the Chinese government may or may not have for its debt holdings, they do not include financial speculation. Nor is there any safer liquid form in which the Chinese government could hold its massive foreign exchange reserves. When we make the reasonable subtraction of the Chinese debt from the total, the maximum gross debt potentially vulnerable to speculation falls to $6.5 trillion, considerably less than half of GDP. The **net** equivalent drops to less than a third of GDP.

To summarize, when we take out what the federal government owes itself, the US public debt is a smaller proportion of GDP than the same debt measure for any other major developed country. Indeed, it is so low that it is no problem. When other obvious calculations are made, **net** instead of gross, public bonds held by local and state governments, you have to think, where is the problem?

Table 2.2
US Public Debt, End of 2010

Ownership categories	US$ bns	% of total	% of GDP
Total federal public debt	14,206	100.0	95.7
owed to itself	5,656	40.3	38.6
owed to others	8,370	59.7	57.1
Net debt to others	6,017	42.9	41.1
Non-financial owners			
State & local gov'ts	706	5.0	4.8
China	1,160	8.2	7.9
Everyone else*, **gross**	6,504	46.4	44.4
Everyone else*, **net**	4,677	33.3	31.9

*Maximum possible value for debt entering "financial markets".
Sources:
US debt: gross, Economic Report of the President 2011; net, OECD (OECD *Economic Outlook 89* database).

Table 2.3
Gross Interest Payments on Public Debt
Percentage of GDP, 2010

		net
United Kingdom	2.6	
France	2.3	
Germany	2.0	
USA	1.6	1.0
Japan	1.4	

Source: OECD *Economic Outlook 89* database

Ah, but the problem is not the size of the debt, say the neo-Scroogians. The problem is servicing it, paying the interest. Not much a problem for the United States, I fear, as the table below shows clearly. Of the five largest developed countries, payments on the US gross debt as a percentage of GDP was lower only for Japan. By contrast, putatively frugal German government paid out considerably more than the United States

Treasury, and France and the United Kingdom were far above. Even more, the interest on the **net** debt was just one percent of US GDP in 2010.

For over 150 years the US government has not failed to meet its debt obligations. It has flagrantly failed to meet the obligations of providing for the education and health of its population, repairing the country's public infrastructure, and preventing state and local governments from going bankrupt, thus reducing or eliminating their ability to do their social duty. The false claims of federal default are the mechanism by which the rich and powerful, aided by the rating agencies, will further enforce the real default on social and economic justice for people in the United States of America.

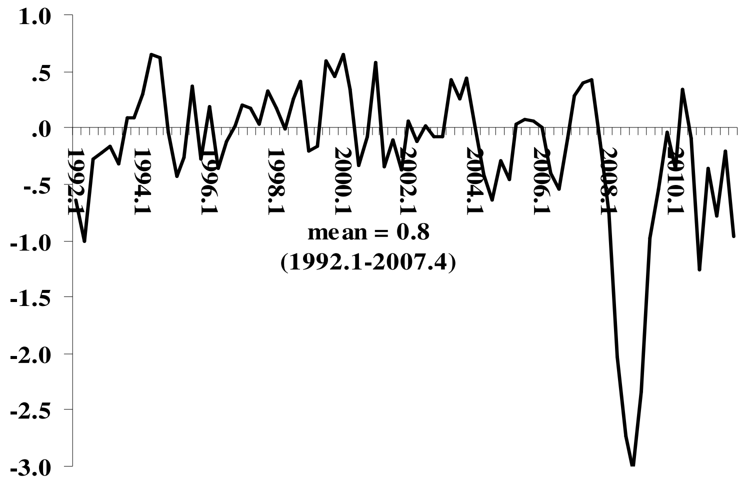
United Kingdom: Fostering Recession

In the United States a putative left-of-centre Democratic administration panders to the deficit and debt narrative of far-right Republicans. In the United Kingdom, a right-wing government convinces the opposition and much of the electorate of the same deficit and debt voodoo. The Tory-led coalition enforces draconian budget cuts unprecedented for over seventy-five years. The opposition leadership accepts that cuts are necessary for "credibility with financial markets", and promises to cut, but "less and slower". The government and the opposition unite in ignorance of basic macroeconomics.

UK economic performance has been dismal since 2008. In the Figure 2.3 quarterly growth rates are measured as deviations from the sixteen year average, 1992-2007. Since the end of 2007, in only one quarter was the growth rate above that average (2010.2, the last quarter of the Gordon Brown's Labour Government). In the subsequent six quarters as well as below the average, the growth rate was negative in two and zero in one. There is no hint of recovery.

The recession-inducing austerity policy of the government is allegedly in response to the infamous trillion pound public debt that hit the headlines in January of this year. That much-trumpeted number refers to the *gross* public debt. By that measure Norway would be close to the well-known Maastricht criterion of 60 percent of GDP. However, the country’s treasury holds **net** assets of 150 percent of GDP. At the end of 2011, the UK net debt stood at 62 percent of GDP, which was below the same statistic for the United States and not far from the German ratio (56%).

Figure 2.3: UK GDP growth, deviations from average, 1992-2011



Source: UK Office of National Statistics website.

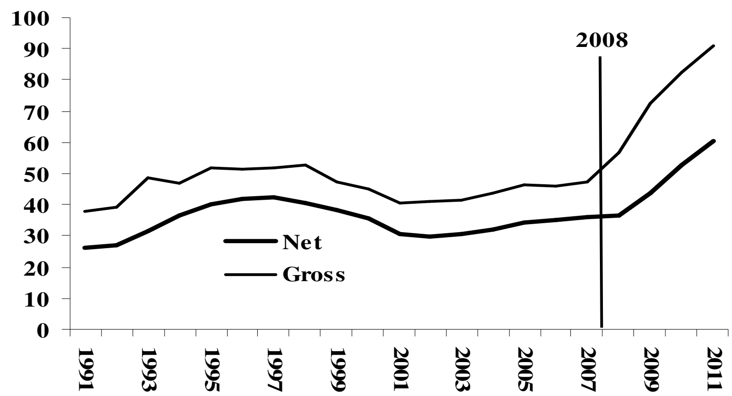
Inspection of the gross and net debt in Figure 2.4 makes it obvious that the increase in the UK debt-GDP ratio, as in the United States, was a phenomenon of the global financial crisis. Even into the crisis at the end of 2008 the net debt ratio was lower than it had been in the second half of the 1990s (41% for 1995-99, compared to 37). Basic macroeconomics predicts this outcome, that recession generates fiscal deficits, and the borrowing to cover those deficits manifests itself in increased public debt.

As I did for the United States, I can chart the interaction between growth and the first difference in the fiscal balance, shown for 1992-2011 in Figure 2.5. As before, this approximation ignores changes in tax rates and expenditure programs, but is statistically significant and corresponds to what theory predicts, with a slope quite close to unity.

Applying macroeconomics rather than alconomics to available statistics we reach the conclusion that the UK public sector deficit and the increasing debt to which it adds resulted from the severe recession that struck the global economy in 2008. With causality identified, we can move to the policy issue, is the deficit so large that it requires immediate expenditure and tax measures?

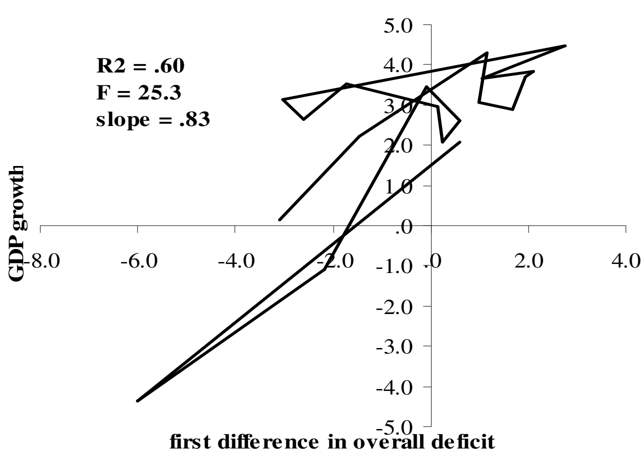
As for the United States, the relevant measures are the *primary* and current deficits, shown in Figure 2.6. The chart reports three deficits over the twenty-one years 1991-2011, overall, current and current primary. As the previous scatter chart suggested, the deficits show a clear cyclical pattern. A few obvious inferences can be drawn. First, the deep deficits are not substantially different from the experience of the mid-1990s by any of the three measures. For 1993-1994 the overall deficit averaged 7.5 percent of GDP, compared to 8.3 for 2010-2011. Because recessionary conditions were more severe during the latter years, it is surprising that the deficit was not larger. The annual overall deficit for 2009-2011 was almost exactly the same as for 1993-1995 (7.2 and 7.1). Second, five years of growth at an average of 3.5 percent during 1994-1998 brought the overall deficit into surplus, not expenditure reduction or tax increases.

Figure 2.4: UK Gross and Net public debt, percent of GDP, 1991-2011



Source: Office of National Statistics January 2012, end of year values.

Figure 2.5: UK GDP growth rate and 1st difference of the public sector Borrowing requirement (percent of GDP)

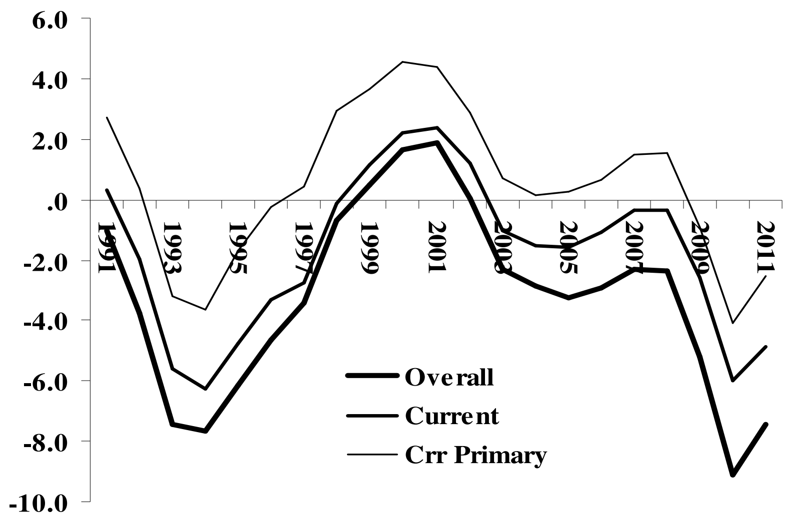


Source: Office of National Statistics January 2012.

Third, the primary deficit during 2009-2011 was 5.1 percent of GDP and the current primary deficit was 2.5 percent. A deficit on current expenditures is never sound fiscal policy, but not necessarily cause for alarm. During 1993-1995 the same measure was substantially higher, 4.7, and it did not prompt the ruling Conservative government to undertake the type of substantial fiscal adjustment that the Coalition has. Finally, during 1993-1995 the public sector paid an average of six percent to borrow, while during 2009-2011 bond yields were below one percent.

Theory and evidence indicate that the current UK debt and deficit statistics are recession generated, and would be reduced through growth. The deficit levels are similar to those in the mid-1990s and more easily financed because of the much lower national and international bond rates. The hypothesis that deficit and debt reduction should be the first fiscal priority is more than unconfirmed, it is ridiculous. It is pure alconomics.

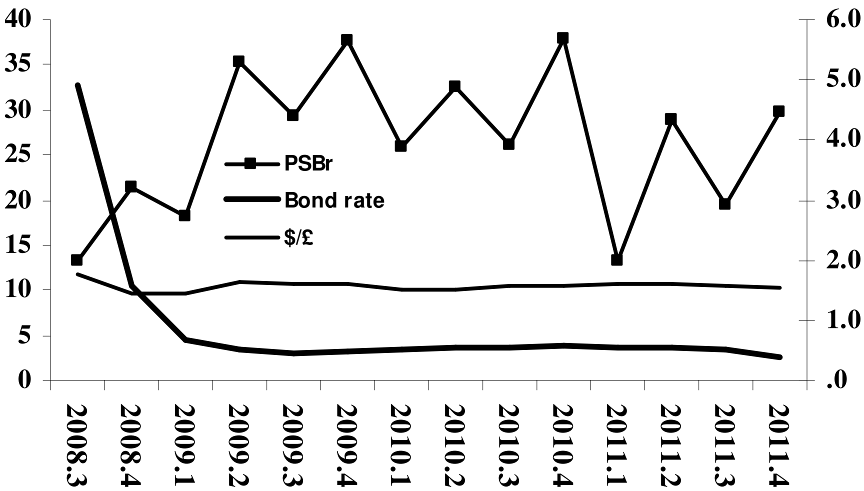
Figure 2.6: UK public sector fiscal balances, overall, current and current primary (less interest payments), 1991-2011, percent of GDP



Note: The overall deficit is total public sector borrowing.
Source: Office of National Statistics January 2012.

Could the austerity hypothesis be sustained by reference to the probable reaction of "financial markets" to the continuation of debt and deficits at the current levels? The answer is "no". In light of the statistics presented above, it is reasonable to infer that "financial markets", however defined, should not be alarmed by the state of UK public finances. This is what the evidence suggests. Figure 2.7 shows public sector borrowing by quarter for 2008-2011 (measured in billions on left hand axis), and the UK treasury bond rate and dollar-sterling exchange rate (right hand axis, percentage and ratio $/£). After the first quarter of 2009 both the yield on public bonds and the dollar exchange rate have been almost constant (coefficients of variation of .11 and .03, respectively), while public sector borrowing showed major fluctuations and debt grew by over £300 billion. If some believe that UK public finances require immediate expenditure and tax adjustment, so-called financial markets do not appear agree with them.

Figure 2.7: Quarterly public sector borrowing (left axis, billions) and the treasury bond rate and $/£ exchange rate (right axis, % and ratio), 2008-2011



Sources: Office of National Statistics January 2012, and Bank of England website

All reasonable people should agree that it is not sufficient to assert the possibility of financial market instability. As an empirical discipline, economics requires clear specification of the conditions under which a theoretical process occurs, then some empirical evidence to assess its importance. There is none. A more fundamental issue lurks in the background. The negative expectation effect on financial markets requires that the economy be price constrained, not demand constrained. As every economist of every theoretical persuasion knows, an economy is price constrained if and only if there are no idle resources. If there are idle resources, more can be produced at prevailing factor and product prices; i.e., the economy is demand constrained.

Unless there is some very esoteric process at work that is hidden from view, the evidence for a demand constrained UK economy is overwhelming. For example, if crowding out of private investment were a practical problem, it is difficult to explain why the UK Treasury could borrow in excess of £300 billion over three years and have no impact on bond yields.

Because the economy is quantity constrained, recovery requires a demand stimulus. This will not come from domestic business because of the lack of demand itself. It will not come from consumption because the larger part of consumption is a function of the income generated in the private sector which is demand constrained. With the continental European countries in the throes of their own recession, the stimulus is unlikely to come from exports. I lack the time to discuss monetary policy other than to suggest that it has not been notably effective despite substantial "quantitative easing".

It follows as practical matter that the policy choices are continued stagnation and decline, aggravated by the Coalition government's reductions in public sector demand, or a policy reversal that favors a fiscal stimulus. This conclusion is not "Keynesian" nor is it ideological. It is the analytical and practical implication of recognizing 1) that the UK economy is demand constrained, 2) the present levels of the public deficit measures are neither unusual nor a source of alarm, and 3) "financial markets" have demonstrated no concern with the state of public finances.

The fiscal stimulus would be financed by a combination of personal income tax increases and public borrowing. The tax increases would be expansionary through the well-known "balanced budget multiplier" process (part of the taxed income would have been saved). With present bond yields, the borrowing would be at negative real interest rates. Once the recovery begins, both the deficit and the debt-GDP ratio would fall. As economists we once understood and practiced this policy process, guided by a wealth of empirical evidence. There was a time when economists knew all this and governments acted accordingly.

Finance Capital and the Euro Scam

The crisis of the euro currency zone is an excellent example of how lies can successfully convert into accepted wisdom. Almost every generalization about the crisis found in the mainstream media is false. As a result, most media punditries on the crisis are ideological polemics masquerading as analysis. Further, often progressive critiques of the reactionary "austerity" policies accept the mainstream *faux*-facts about the crisis, fuelling the There-Is-No-Alternative (TINA) syndrome.

The reactionary alconomics narrative tells a simple story. Several European Union governments, most of them on the southern periphery of the region, have for years languished in economic mismanagement. The principle form of this mismanagement has been social expenditures in excess of what these countries can afford. The excessive weight of the welfare state has left these countries uncompetitive due to high labor costs due to short working hours, high unemployment benefits and early retirement, among other market rigidities.

Thus, the welfare state caused the euro crisis. It will be solved through the reduction of public provision throughout the European Union. Proof is found in the excessive debt, deficits and social expenditures of the countries suffering from speculative attack on their bonds (Portugal, Italy, Greece and Spain, the "PIGS"), and the absence of these ills in those few countries not under attack, most notably Germany.

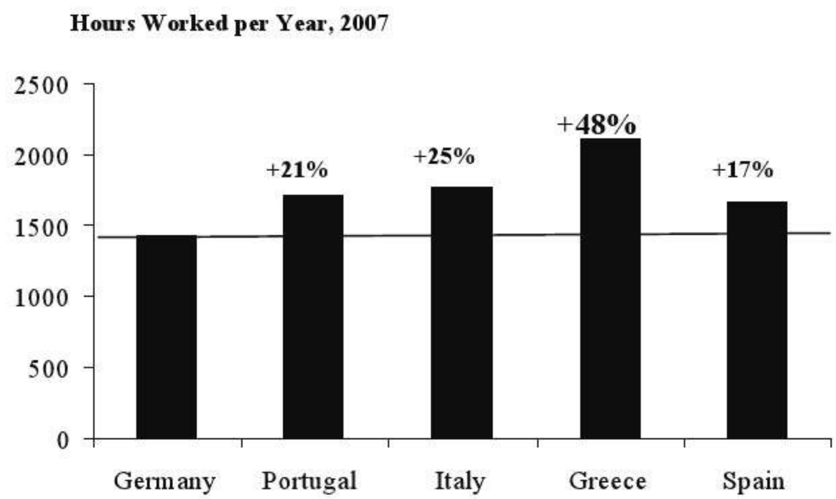
The common response of European progressives to this narrative it that the vast majority of Greeks, Italians, etc, have struggled long and hard for their social benefits, and it is a crime that they, the majority, must pay for the greed of a tiny financial oligarchy. The reactionaries say that in the European South especially people are paid too much, work too little, receive excessive public benefits and retire early; progressives respond that these are legitimate rights forged in struggle.

There is a problem with this diagnosis of the euro crisis. It is false on all counts, left, right and center. To begin with the most obvious lie, the retirement age for the state pension is the same for men in Germany, France and each of the PIGS, 65, though in Italy and Greece women can take the pension at 60. Pension programs allowing for earlier retirement can be found in the PIGS, and that is also true in Germany, the United

Kingdom and France, where accusations of labor fecklessness do not dominate discussions of economic policy (except, perhaps, from the employer associations).

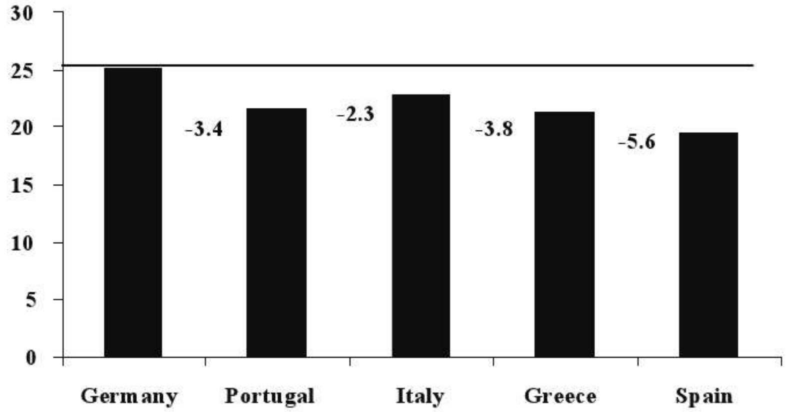
What about those short working hours in the crisis-hit countries? This well known "fact" turns out to be the opposite of the truth. In order that the labor statistics not be distorted by the financial crisis, I look at 2007. As Figure 2.8 shows, the average number of annual working hours per employee in Germany in 2007 was less than 1500 (about 30 a week), compared to the average Greek worker at over 2100 (all statistics from the OECD data base, oecd.org). The statistics show that every one of the PIGS had longer working years than Germany, the closest being Spain with seventeen percent more.

Figure 2.8: Working Longer in the PIGS, 2007



Though people in the PIGS may not retire any sooner, and they may work longer hours than in Germany and France, what about the well known fact that excessive social expenditures characterize the euro-south? It may be well known but it is not a fact (see Figure 2.9). In 2007, government social expenditure in Germany was 25.3 percent of GDP (pensions, education and health care being the most important). Every one of the PIGS was lower, from Spain over five percentage points below, to Italy at 2.3 percentage points less. This result should surprise no one who has a bit of commonsense: Germany is the only bona fide social democracy in Chart 2, and more social spending is what social democracies do (or should do).

Figure 2.9: Less Social Spending in the PIGS,
Government Social Spending, percent of GDP, 2007



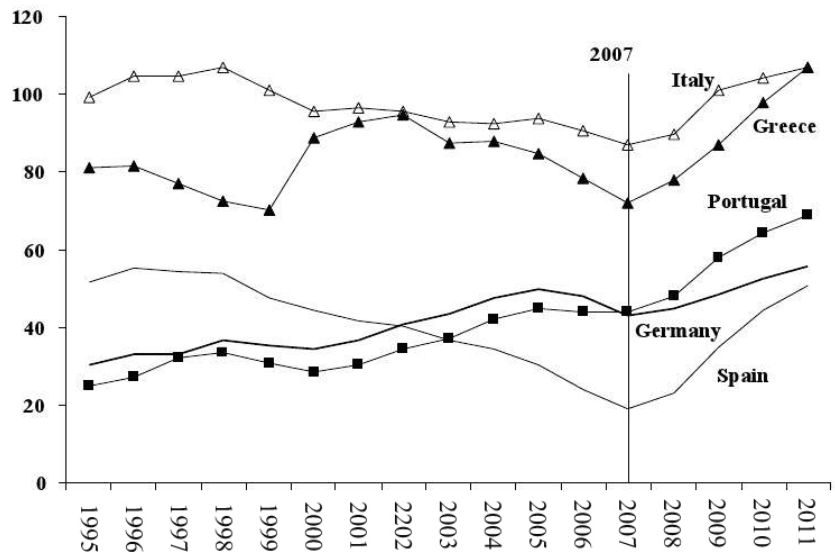
If the peripheral PIGS are not guilty of the mainstream accusation of excessive social expenditure and work longer hours, how do we explain their excessive public debts and unmanageable fiscal deficits? The answer is straight-forward: the debts are not excessive and the deficits are not unmanageable. An essential element in the alconomics narrative is the fiscal prudence of the German government (and, by implication, Germans in general). Were this prudence fact, we would expect that Germany would have the smallest public debt of the euro zone. We find that it is larger than that of Spain and not much less than Portugal.

Figure 2.10 demonstrates that in 2007, just before the Global Financial Crisis struck, for Portugal and Germany net public debt as a portion of national income was the same (44%), and both were more than double the ratio for Spain (19%). Further, Greece, the first of the PIGS to suffer speculative attack on its public bonds, was far from the most indebted of the four, about 80% of national income compared to Italy near 100%. During the crisis relative debt burdens grew for all five countries, because national income declined or stagnated. The denominator goes down and the ratio goes up, an outcome obvious and much to the delight of public bond speculators.

The debts of Germany, the PIGS and all other countries are excessive if and only if economies do not grow. They pass from excessive to disastrously unsustainable when austerity policies make growth impossible.

Among the most flagrant lies of omission in the mainstream narrative is the admonishment of Spain for its unsustainable debt, without adding 1) it is relatively and absolutely lower than Germany's, and 2) its increase after 2008 resulted from the social democratic government bailing out the country's private banks. In a classical case of no good deed goes unpunished, the mismanaged banks used their bailout funds to speculate on the very bonds that had saved them.

Figure 2.10: Net Public Debt as share of National Income, Germany and the PIGS, 1995-2011 (annual)



The fiscal deficit narrative/lie is similar to that for debts (see Figure 2.11). In 2007, just before finance hit the fan, Spain could claim the largest public sector balance, a surplus of almost two percent of national income. In that last pre-crisis year, only Greece at about minus five percent had a public sector balance in excess of European Union rules (the infamous "Maastricht criterion"). Germany did not have the lowest deficit in 2007; indeed, over the pre-crisis years, 1995-2007, it had the lowest in only one, 2000. Believe it or not, in 1995 (due to temporary factors associated with reunification), the German public deficit was the largest in the European Union, and for three years, 2002-2004, was greater than the deficits of Spain, Portugal or Italy.

To know why the German government could claim a deficit relatively lower than for all the PIGS in 2011 (by less than half a percentage point over "spend-thrift" Spain), look no further than growth rates (see next chart, "Who grew and who didn't"). During 2008 all five countries suffered recession, with the declines greatest for Germany and Italy. Beginning in 2009, one country suffered drastic decline (Greece), three "flat-lined"

(Portugal, Italy and Spain), and Germany grew in every subsequent three month period. As a result, Germany was the only country of the five with a national income higher at the end of 2011 than it was at the beginning of 2009. Grow and the deficit declines, not rocket science.

Figure 2.11: Who has the smallest public deficit?
Public Sector balance as share of GDP, Germany and the PIGS, 1995-2011 (annual)

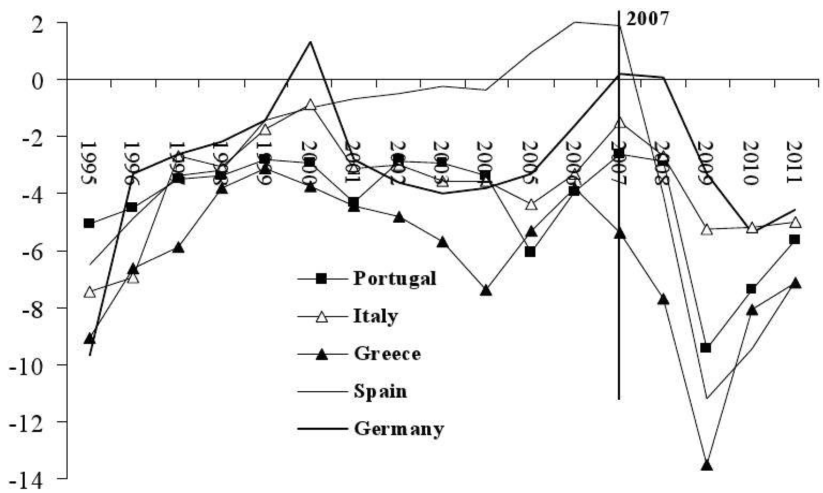
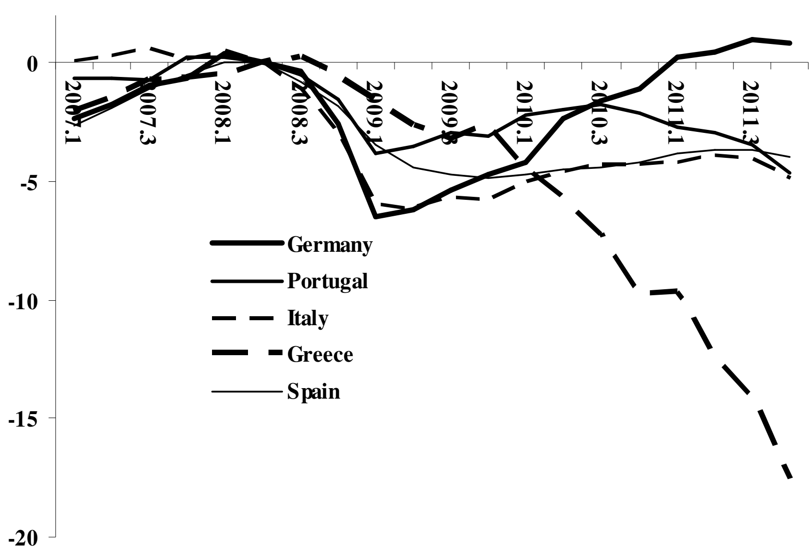


Figure 2.12: Real GDP, percentage point deviations from 2nd quarter of 2008, 2007.1 - 2011.4



Why did Germany grow but not the others? It was because Germany economic policy was beggar-thy-neighbor export-led (see Figure 2.13), implemented through keeping the growth of real wages flat as productivity increased and direct export subsidies through tax relief. In 2000-2001 German, France and the PIGS all had either small trade surpluses or small deficits. An extraordinary change occurred after 2001. From a small deficit in 2000, Germany began to accumulate enormous surpluses, acquiring the world's largest net trade balances in some years and second largest in all the others (behind China).

In case it is not obvious that Germany's export surplus was the PIGS's trade deficit, look at Figure 2.14 with the German current account balance measured horizontally and that of the "PIGS" vertically ("current account" is the gross addition to short term national debts, sum of the trade balance, services balance and net income flows such as remittances). In 2001 the current account was zero for Germany and minus US$ 47 billion for the PIGS (Spain accounting for about half of the latter). During 2002-2007, Germany accumulated US$ 785 billion in surplus, while the PIGS added US$ 804 billion to their previously small collective deficit. During the three years of crisis and recession 2007-2010, Germany kept piling on the surplus to the tune of US$ 600 billion, and the PIGS followed in near lock-step with minus 623 billion.

Figure 2.13: External Current Account Balances, Six Euro Countries,
2000-2010, US$ bns

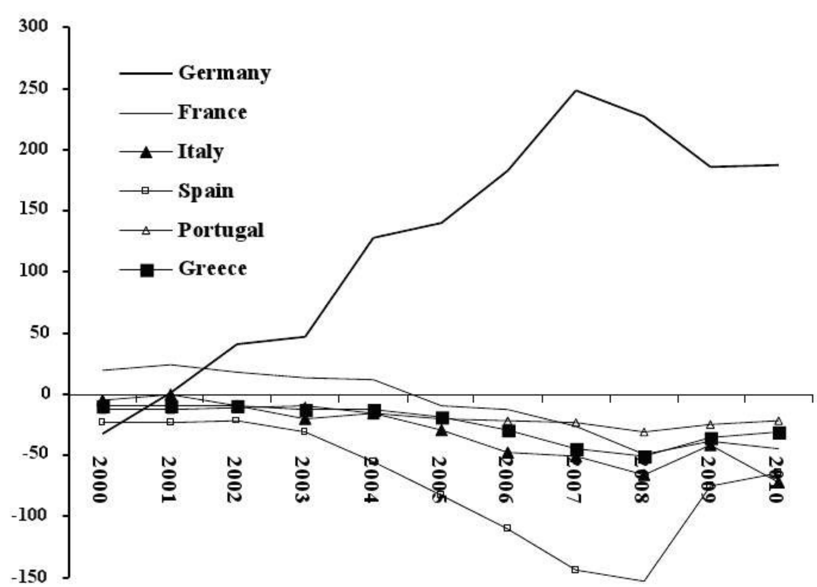
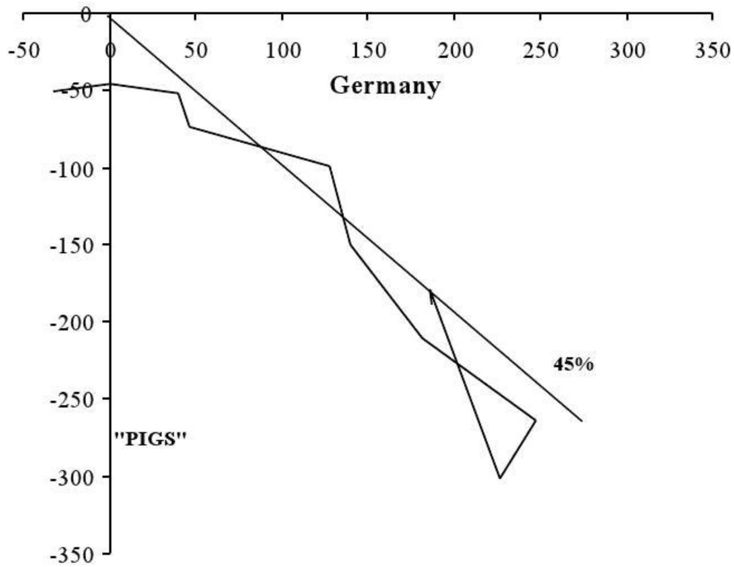


Figure 2.14: Beggar thy neighbor in the Euro Zone:
Current Account Balances, Germany (horizontal) and the PIGS (vertical), 2000-2010, US$ bns



The mainstream faux-news tells us that inefficiencies generated by the welfare state caused the euro crisis and public sector cuts are the solution. The Real News is that German trade policies caused the euro crisis. The "back-story" of the euro crisis is German de facto mercantilism. Through tight monetary and fiscal policy combined with money wage restraint, the German government successfully pursued a policy of export led growth. One does not need to be an expert in economics to know that success in export led growth by one country will result in import led recession for the trading partners when global demand declines, as it did after 2007.

What is the real solution? At the 1944 Bretton Woods conference that created the IMF and the World Bank, John Maynard Keynes made a bold proposal. He argued that the world monetary and trading system should be governed by the guideline that trade imbalances be corrected through adjustment by the surplus countries.

At that time his proposal implied that the war-torn countries of Europe would not eliminate their trade deficits through austerity policies. Instead, the United States government, enjoying a huge trade surplus, would pursue expansionary macroeconomic policies, which would increase US demand for European exports. The surplus country would expand and import, and the deficit countries would also expand through export demand. This plan, a global full employment policy, suffered total rejection by the government of the United States, which used the Marshall Plan to deal partially with the European trade deficits.

The solution to the imminent collapse of the euro was easily avoided by following Keynes's proposal. In 2010 thirteen million Greeks lived in a country with a net public debt of 190 billion euros, which was less than one percent of the total assets of the European Central Bank (almost 26 trillion euros). The European Central Bank should have bought the entire Greek public debt, and the German government should have simultaneously embarked on a fiscal expansion. The debt purchase would have definitively precluded speculative attacks, and the fiscal expansion by the zone's largest economy would have reduced the intra-euro trade imbalances allowing space for structural changes in the deficit countries. Any burning desire of the German and French governments to punish the "lazy PIGS" through fiscal austerity would have been limited to Greece and much easier to implement than under euro-zone austerity. The European Central Bank did not do that, German government did the opposite of expansion, and now there are four countries at the brink instead of one (five when you count Ireland), plus the euro itself, of course.

The Euro Runs its Course

In August 1982 the government of Mexico announced it could not service its debts. Thus began an unnecessary, creditor-enforced depression that would sweep Latin American, and usher in the “Lost Decade” with appalling human suffering. Thirty years later we replay this grim history in Western Europe. The sorry fate of the European Union demonstrates the power of neo-liberalism. Begun by social and Christian democrats to end centuries of European civil wars and bring prosperity to a conflict-ravaged continent, the European Union can now be found in the vanguard of imposing neo-liberal austerity.

In May 2010 the government of Greece faced a debt service problem. In the context of the euro zone as a whole, the Greek difficulties were minor, equivalent to a US state government unable to balance its budget. In place of a rational approach to the

Greek problem, the non-elected officials in the European Commission and the European Central Bank, zealously encouraged by the German chancellor, imposed a deficit reduction program on the government of Greece that makes the 1980s Washington Consensus appear benign in retrospect. When the elected government of Greece proved unequal to the task of implementing economic madness, the lords and ladies of the Euro zone took the austerity to its logical conclusion: if an elected Greek government would not do the dirty work, impose a un-elected one. It is rather bad luck for the Commission and the chancellor that the Greek constitution requires an election be held this year (in April unless this bothersome democratic requirement can be avoided).

Against all rationality, the overlords/ladies of the euro zone managed to achieve an improbable outcome, converting the debt service problem of a country with less than eleven million people (smaller than ten American states) into an imminent catastrophe for a continent. In May 2010 when the Greek problem could have been easily solved, the growth rates of France, Germany and the four so-called PIGS (Portugal, Italy, Greece and Spain) were all positive.

Few outside of Europe (and not all within) understand the profoundly undemocratic nature of the European Union that created the current disaster. In retrospect it is clear that the long-term effect of the Maastricht Treaty and its infamous "criteria" are to remove economic policy from democratic oversight. The design of the European Central Bank completed the task. The anti-democratic control of fiscal policy is not an accident of the law of unintended consequences. It is the conscious fulfillment of the central political principle of alconomics and neo-liberalism, that economic policy is the preserve of experts, and should not be subject to the "populism" of democratic politics. It is an irony that the European Union is frequently assailed by right wing politicians in the United States as a haven of socialism. In reality the European Union represents exactly the end of democratic oversight that the Tea Party Republicans crave.

As disaster gathers on the European continent (a disaster that UK government economic policy eagerly works to emulate), one can imagine two paths of avoidance. The obviously rational approach would be for a German fiscal expansion coordinated with temporary export subsidies and import restrictions in the deficit countries. The European Central Bank would provide transitory coverage of trade deficits. The trade subsidies and restrictions would be combined with longer term policies for what might be termed "competition convergence". The probability of this sensible policy is zero.

At the time of the Latin American debt crisis of the 1980s, many commentators (I among them) argued that if two or more of the countries joined together in a debt renegotiation pact, the onerously debilitating Washington Consensus policies could have been avoided. Similarly, today in Europe a pact among the governments of Greece, Ireland, Italy, Portugal and Spain to coordinate a simultaneous withdrawal from the euro zone would offer a viable alternative to the imposed austerity programs. Together the output of these five countries is almost forty percent larger than Germany's. The probability of this feasible alternative may be as high as one in a million.

This leaves the two likely outcomes: euro zone depression with no defectors, or euro zone depression with chaotic defection. My guess is depression with defectors, Greece being the first.

How far we have fallen. The vision of a cooperative Europe, that began in 1950 with the Iron and Steel Community, is now realized as a collection of the weak and the strong caught in a spiral of beggar-thy-neighbor trade and austerity policies, in which the 99% are the losers even in Germany. The authoritarian governance of the EU has reached its fullest expression in the debt disasters of the 21st century, bringing on a continental depression.

Of all the bitter ironies of European unity gone viral, one stands out from all the others: a political project designed consciously to ensure that no country would again dominate the continent changed into the mechanism to achieve that domination.

SCHOOL OF ORIENTAL AND AFRICAN STUDIES
UNIVERSITY OF LONDON

Research on Money & Finance
& Centre for Development Policy & Research

Jornadas de Politica Economica
Universidad Nacional de Quilmes
Buenos Aires
20-22 March 2012

Three Public Lectures on Macroeconomics

Third Lecture

Economic Policy for a Capitalism Fit for Human Life

Morning Session
22 March 2012

John Weeks
Professor Emeritus
University of London (SOAS)
http://jweeks.org

A Wall Street Occupier has his economics right (12 October 2011).

> When the accumulation of wealth is no longer of high social importance, there will be great changes in the code of morals. We shall be able to rid ourselves of many of the pseudo-moral principles which have hag-ridden us for two hundred years, by which we have exalted some of the most distasteful of human qualities into the position of the highest virtues. We shall…dare to assess the money-motive at its true value. The love of money as a possession…will be recognised for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease ...[J M Keynes, 'The Future', *Essays in Persuasion* 1931]

De-commissioning Policy

Until the Great Depression of the 1930s macroeconomic policy in the advanced countries meant monetary policy, with exchange rates tied to an international gold mechanism and fiscal policy constrained by an ideological goal to balance public budgets. Fiscal policy was used by a few governments during the depression, notably in the United States, but in an *ad hoc* manner. The first clear legal commitment to an active fiscal policy was the US Full Employment Act of 1946, the preamble of which states,

> The [US] Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means…with the assistance and cooperation of industry, agriculture, labor, and State and local governments...to promote maximum employment, production, and purchasing power.

In the early 1970s, the aspirant alconomists would initiate an assault on this legal commitment, seeking an analytical de-commissioning of fiscal policy. Their overtly ideological analysis was as follows. In the simple case of a closed, price constrained one commodity economy with no public sector, all markets clear in an instantaneous process. No exchanges occur at prices other than those in the price set which would prevail at full employment general equilibrium (no 'false trading'). Consumers and producers take prices as 'signals' to determine the quantities they buy and sell. In this system governments have no role except the enforcement of contracts and keeping public order.

Thus, the first argument to decommission fiscal policy is that it is unnecessary. It cannot stimulate employment, which achieves its maximum possible value automatically. However, this is a rather weak argument against fiscal policy if the economy is plagued by unemployment (see Figures 3.1 and 3.2).

The argument that an active fiscal policy is unnecessary must be reinforced by two mutually complementary arguments to approach credibility. First, it must be the case that the unemployment one observes is almost entirely voluntary, and, second, that an active fiscal policy would increase unemployment, be it voluntary or involuntary.

Figure 3.1: Unemployment rate in the United States, 1950-2011

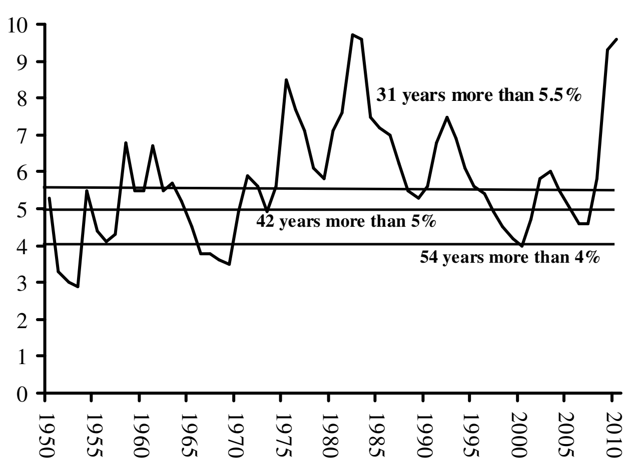
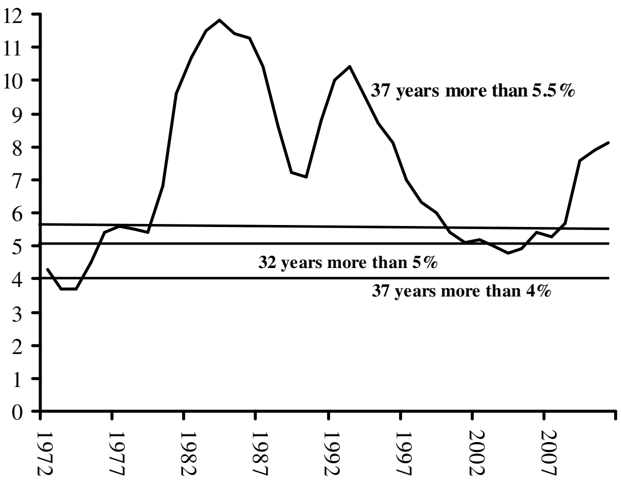


Figure 3.2: Unemployment rate in the United Kingdom, 1972-2011



Pre-Keynesian economists argued that the unemployment one observes is voluntary, the result of minimum wages and trade union action through labor negotiations and political lobbying. Because the membership and economic strength of trade unions has declined in most advanced countries, rendering this always spurious argument absurd. The problems of enforcement and erosion of minimum wages through inflation made it an extremely weak reed for a general theory of voluntary unemployment. Unemployment compensation itself, a major reform arising from the Great Depression, offers the alconomist an alternative explanation: unemployment persists because payments to the unemployed reduce the incentive to seek work. A variant of this argument that would garner the "Nobel" Prize in Economics in 2010. This attempt to discredit support to the unemployed carries great political power, because it converts involuntary misery into willing avoidance of work, and cautions that well-meaning reforms make matters worse (the road to hell is paved with unemployment checks).

The combination of Walrasian general equilibrium and benefit-induced unemployment are necessary elements to de-commission fiscal policy. The ideologically sufficient argument is that active fiscal measures, even if they were to temporarily reduce unemployment, are intrinsically undesirable. An active fiscal policy is rendered undesirable through three complementary and equally fallacious arguments, all focusing on public sector deficits: direct crowding out of private expenditure, inflationary impact and reduction of private confidence.

The possibility that a fiscal expansion might directly reduce private expenditure (crowding out) would be caused through a rise in interest rates. If the economy is below full employment, the extent of crowding out depends on how a fiscal expansion is financed and the elasticity of investment with respect to interest rates. In a recession the latter will be low, and crowding out is completely avoided by monetizing the fiscal expansion. The fiscal-expansion-causes-inflation argument is in part designed to rescue the crowding out argument. Financing through bond sales is rejected because of its putative impact on interest rates and private investment.

The alternative method of finance, monetization, is slandered as "printing money" and alleged invariably to cause inflation. The inflation allegation is contrary to the pre-alconomics neoclassical analysis, which unambiguously concluded that an increase in the money supply when an economy is below full employment increases output, and the accompanying increase in the price of output is not by any definition inflationary, but a necessary adjustment to a lower real wage.

One is left with the private sector confidence argument, whose great strength lies in its vagueness, making it almost impossible to refute (the "confidence fairy" Krugman calls it). In 2010 the right wing British government presented this argument under the imaginatively oxymoronic title of an "expansionary fiscal contraction", reinforced with the pseudo-analytical term "structural deficit". The essence of this and similar arguments against fiscal policy is that the public sector deficit and the debt it creates are a direct cause of the reduction of private sector "confidence", which results in a fall in private sector investment. At the end of the 2000s and into the following decade, the marginally more plausible crowding out argument could not be made because nominal interest rates were close to zero and could not fall further.

The more respectable version of this anti-deficit argument suggests that private agents consider that a fiscal deficit equivalent to a future tax increase, and reduce their expenditures accordingly (so-called Ricardian Equivalence). Even if this argument were logically valid on other grounds, the increase in the individual tax burden would be very low, as well as discounted into the future. George Irvin demonstrated the absurdity of this argument, pointing out that it opportunistically stresses the cost of public borrowing while ignoring the cost of the output foregone if the absence of a fiscal stimulus (http://www.guardian.co.uk/commentisfree/2010/nov/07/myths-swallowed-by-george-osborne).

All such arguments against public deficits and debt fail to accept that the public bonds held by the private sector are income generating assets. If they represent outside wealth, then they should stimulate private expenditure. If the Ricardian Equivalence holds, then they are inside wealth and cancel themselves out.

These ideological arguments against an active fiscal policy have inspired political moves in the US Congress to restrict the federal government from deficit finance, such as the "Budget Enforcement Act of 1990". The essential purpose of this and other legislation to restrict public sector deficits is to remove fiscal policy from the democratic process of bourgeois society, however flawed that process may be. Perhaps the most venal version of de-commissioning fiscal policy is the current proposal in the European Union to institutionalize fiscal rules. Under this proposal, the non-elected and unaccountable European Commission would have the power to assess and discipline countries for fiscal transgressions.

In an impressively clever move, the Commission chose the neo-fascist government of Hungary to test this authoritarian approach to budgetary management. IN February of this year, the Commission threaten to restrict "structural funds" from the EC if the Hungarian government did not lower the public sector overall deficit. This profoundly anti-democratic intervention presents de-commissioning of fiscal policy as a technical measure, designed to prevent irresponsible politicians from embarking on "populist" vote-buying.

The alconomists and the interests they serve are not completely wrong about fiscal policy. There is an important sense in which public sector deficits do reduce "business confidence". The driving mission of the capital at the beginning of the twenty-first century is to minimize the role of the public sector in order to maximize the power of capital. Discretionary fiscal policy is a barrier to achieving that mission. The minority that controls production and finance made considerable progress in de-commissioning fiscal policy by the second decade of the twenty-first century. In the case of monetary policy its de-commissioning was almost complete.

The often reactionary rule of US central bankers has obscured one of the few progressive aspects of US economic policy institutions, the legally mandated political oversight of the central bank, the Federal Reserve System (FRS). This oversight is through mandated reports to Congress, which typically take the form of testimony by the FRS chairman. In addition there is a requirement that the board of governors of the Federal Reserve System have "fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country". Perhaps more important, the Federal Reserve System has a mandate that requires it to consider employment as well as inflation: "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (Mishkin 2007). In practice the effectiveness of the political oversight has had little importance.

Conventional wisdom holds that in the final decades of the twentieth century the power of central banks increased dramatically in almost all countries, including the United States. The truth is quite the opposite. The role of central banks in most countries, advanced and underdeveloped, narrowed substantially towards the end of the twentieth century. The vehicle for this narrowing was their so-called operational independence.

The inherently reactionary nature of alconomics is manifested in a broadly held preference in the profession for the complete separation of central banking from political oversight. This predilection is justified by the argument that without independence, governments will force central banks to pursue reckless monetary expansion to fuel populist fiscal policy. Vindication of this argument is found in evidence allegedly showing that the more independent a central bank, the lower the inflation rate in a country (Grilli, Masciandaro and Tabellini 1991; Crowe and Meade 2008).

The so-called independence of central banks, a dogma zealously pursued by the International Monetary Fund, is profoundly anti-democratic. The essence of the argument is that monetary policy is a technical matter, and any degree of democratic oversight results in reckless and irresponsible policies. As for fiscal policy, monetary decisions are not a matter for public involvement. They should be under the dictatorship of a technical elite.

As is well-known and dutifully taught to students, the Mundell-Fleming version of an open economy reaches the conclusion that flexible exchange rates automatically bring external balance, leaving governments free to concentrate fiscal and monetary policy on domestic goals. Add to this that an active fiscal policy is unnecessary (the domestic economy will correct itself automatically) and counter-productive (deficits crowd out private expenditure). While monetary policy is necessary, its focus should be control of inflation. Taken together, these allegedly technical arguments produce a profoundly reactionary program of public sector inaction.

This reactionary program is especially pernicious because it is rarely defended on its intrinsic merits. Its ultimate justification is the infamous TINA principle: there is no alternative. The theoretical conclusion that flexible exchange rates stabilize economies may prove wrong in practice, but would be of no practical consequence because there is no alternative. A balanced public budget may have a pro-cyclical effect on the economy, depending recessions and exaggerating booms, but deficits would produce worse outcomes. Using monetary policy in the single-minded pursuit of lower inflation may result in persistent unemployment and slow growth, but failing to do so courts disaster. Balanced budgets, low inflation and flexible exchange rates are all necessary to prevent adverse reaction in "financial markets.

The power of these arguments comes from their repetition, not from their theoretical or empirical validity. They are all based on a theory that is internally contradictory and ideologically driven. I treated the anti-fiscal policy argument in my second lecture and shall not repeat it. De-commissioning monetary policy by limiting it to the targeting of inflation presupposes that money is neutral capitalist economies tend automatically to full employment.

The case non-intervention in currency markets is the weakest of the three. This is demonstrated in practice by the small number of countries that meet the IMF's definition of flexible rates. On a theoretical level, it is astounding that the Mundell-Fleming model was ever taken seriously given its fundamental logical error. As I have demonstrated in my recent book, the model's conclusions require that exchange rate adjustment have no impact on the domestic price level, an analytical impossibility (Weeks 2012, Chapter 14).

The fog of alconomics ideology on all policy issues can be cleared in a simple manner. The fundamental issue in a democratic society is not whether inflation, deficits or unemployment are too high or too low. The fundamental issue is, who decides? The general rule in bourgeois democratic societies is that experts advise and democratically elected representatives decide. Alconomics provides the ideological foundation for canceling that rule: elected representatives enact laws that make the advice of neoclassical experts legally binding and beyond popular control. Thus, the danger that the many may pressure for policies that limit the privileges of the few is minimized.

Capitalism Fit for Human Life

Thomas Hobbes, with more insight than Adam Smith, recognized that pursuit of individual self interest result in a "state of war" and lives that would be "solitary, poor, nasty, brutish, and short" (Leviathan I, 13). There is an alternative to the Hobbesian neoclassical world in which the capitalist minority defines and limits social and economic policy. As happened in the 1930s in the United States, the crisis of the 2000s demonstrated that a range of government actions could be effective to rescue national economies from collapse. The experience of the United States and Western Europe after the Second World War, during the so-called golden age of capitalism, suggests what the component parts of the alternative must be. The reconstruction of that managed capitalism will require, above all, the reassertion of the strength of the working class in the advanced countries.

Controlling capitalism would require four fundamental reforms, whose purpose would be to severely restrict the economic and political power of capital. First, because capitalist economies do not automatically adjust to full employment, governments must institutionalize an active countercyclical macroeconomic program. The active element in the countercyclical program would be fiscal policy, supported by an accommodating monetary policy, and, if necessary, exchange rate management and capital controls to stabilize the balance of payments.

Countercyclical policies, and many other sensible and humane economic measures, are dismissed as impractical because of the alleged affect they might have on "financial markets". This personification of markets, universal in the media and appallingly common in the economics profession, is an essential part of the justification of a capitalist economy free from the constraints of democratic oversight. This personification is applied across all types of markets, as if the market itself were an independent actor in society. In the twenty-first century it became integral to the justification of a socially dysfunctional financial system, national and global.

This personification, an ideological abstraction from the real world of speculators and financial fraud, is an essential part of the mystification of financial behavior. It facilitates the mythology that the dysfunctional financial system is not the work of men and women (mostly the former) within institutions that have socially irrational rules and norms. It promotes the disempowering argument that financial dysfunction is a manifestation of the inexorable operation of laws of nature that no government can change. It seeks to hide that specific financial speculators wish to coerce governments to take actions in their narrow economic interests.

In a humane and decent society no one should be homeless, education should not be limited by its cost to the individual, no one's access to health care should be budget constrained, and no one should be undernourished. How do we achieve these goals? The progressive *liberal* philosophy is that these are achieved through individual behavior in markets, facilitated by public policy including redistribution if necessary. The social democratic approach is quite different: achieving these goals is a social process that requires restricting markets. Restricting markets includes protecting people by limiting their interactions and choices in markets. An essential operating principle in social democracy is that having "greater choice" in markets can be detrimental to individuals and society.

The separation of production from use through the intervention of exchange is the source of the dynamism of capitalism, and also its social destructiveness. Liberalism recognizes the former but fails to appreciate the latter. The social democratic task is to eliminate the destructive tendencies of exchange while maintaining the dynamism, in a phrase, to civilize capitalism. The civilizing strategy has two elements, restricting the political and economic power of capital, and reducing the degree to which basic needs are commodities. Limiting the power of capital would prevent crises such as the recent global financial collapse, but would not house, educate, render healthy and feed society.

Reducing the exchange component of the basic needs of households differentiates social democracy from liberalism, even egalitarian liberalism. In its most progressive form the latter seeks the good society through a combination of progressive taxation and a poverty eliminating mechanism such as a guaranteed minimum income for all. While it can include both of these, the social democratic agenda goes beyond them and restricts the role of commodities.

Reducing inequality without addressing exchange itself leaves households vulnerable to the instability and amorality of markets. Housing is a clear example. Instability and amorality manifested themselves in housing markets in virulent form in the United States during the global financial crisis. While most attention has focused on the defaults of poor families, mortgage foreclosures affected the non-poor as well. A million Americans lost their homes to mortgage foreclosures in 2010, many through flagrant fraud. Millions more had the equity in their houses fall below ten percent of property value.

Borrowing on equity in the United States was the middle class equivalent of the sub-prime crisis and demonstrates dangers of housing-as-a-commodity. Prior to the 1990s, borrowing on the value of one's home was rare in the United States, as it is rare in Europe now. The development of financial "products" to facilitate this borrowing was hailed by most US commentators was a democratization of the financial system. It was encouraged because it allegedly allowed the common man/woman to "invest" in financial markets. In practice the borrowing financed consumption, fuelling the so-called consumer led boom at the end of the last century and into the 2000s.

When the US financial system collapsed during 2007-2009 and required rescue with public funds, the consequences of housing-as-a-commodity became clear. As hundreds of thousands of Americans lost their homes and more fell behind in mortgage payments, returns boomed to financial derivates based on repossession of properties (see Floyd Norris, *International Herald Tribune*, 24-26 December 2010, p. 22). Equally grotesque, repossessed homes in depression-hit Detroit became buy-to-let "investment" opportunities for US and overseas speculators (*The Observer* 30 January 2011, p. 44). People lost their homes; "markets" boomed.

This combination of household misery and speculator profit could occur because housing in the United States is completely commoditized. It is not merely bought and sold; it is an "asset" that was used to generate unsustainable debt. The solution to this travesty is to insolate housing from market forces, make it less of a commodity. The least radical anti-commodity measures include rent control (which covered almost all rented property in New York City after World War II), subsidies for interest rates on mortgages, and restrictions to personal borrowing on household equity.

The more fundamental social democratic solution for housing is the creation of an entitlement not to be homeless, through public provision. In 1970 in the United Kingdom thirty percent of homes were publicly owned (about 15 percent now), and the percentage in Sweden is currently about a quarter of the housing stock. The creation of a substantial public housing sector, and it need not be as much as half, reduces the commodity nature of housing in two ways. For those who live in public housing accommodation is only nominally a commodity because *de facto* tenants cannot be evicted. More important, it provides an alternative to private accommodation that moderates commercial rents, raises private housing standards through competition, and greatly reduces the potential for the private sector to exploit the poor. An adequately funded public housing sector is the most effective measure for eliminating the social scourge of homelessness. With a thriving public sector, homeownership becomes an alternative available rather than a debt-laden necessity.

The best approach to housing, public provision, is the only decent approach for health care, for which there is no justification for individual choice in markets. As Nobel Laureate Kenneth Arrow demonstrated a half century ago, because people cannot obtain the information necessary to make rational choices about their health care, market provision is inefficient. More basic, in a humane society no one should be presented with a market choice between health and other needs. Adequate health care is a choice made by society for all its members, not an issue of individual preference.

For education social provision is equally essential. If one accepts the generalization that no one would choose an education of low quality to one of high quality, there is no basis for market provision except as price rationing in favor of the rich; i.e., rationing based on ability to pay, wealth. The justification of market provision is that competition lowers cost and/or raises quality. The quality justification contradicts the principle that quality in education should be the same for all "providers". The price competition argument presumes existence of inefficiencies that could be eliminated, which, if true, should be eliminated by all "providers".

Social democracy is much more than a "welfare state" consisting of a set of entitlements and "safety nets". It is a mixed economy in which the political and economic power of capital has been severely restricted, and many of the basic needs of people either are not commodities (health care) or commodities that are substantially mediated by public provision and regulation (housing and education).

While it is in the interests of capital to exaggerate the power of finance, the dire warnings about the behavior of financial markets carry some truth. The solution to this threat to humane macroeconomic policies is to tame financial markets, not to yield to them. The manner to tame them is public control of finance. In part this could be through direct nationalization, and in part by conversion of financial activities into non-profit or limited profit associations such as mutual societies and savings and loan institutions (building societies). Even in the United States, the heartland of minimalist public regulation, non-profit and limited profit financial institutions have been common in the past.

Third, government regulation of internal markets would be based on the principle of the International Labor Organization that "labor is not a commodity". The purpose would be to eliminate unemployment as an instrument of labor discipline. The most effective method to achieve this would be a universal basic income program. A properly designed universal income program would facilitate labor mobility, by reducing the extent to which people were tied to their specific employer. Also, by reducing the volatility of household income, it would provide an automatic stabilizer at the base of the economy. It would be similar to the automatic stabilizing effect of unemployment compensation, and more effective.

Fourth, and the basis for all of all others would be the protection of workers' right to organize. The program of fundamental reform of capitalism would be based on the political power of the working class, in alliance with elements of the middle classes. This is the political alliance that brought about major reforms throughout Europe after the

Second World War. An effective reform of capitalism that constrains its economic and social outrages requires a democracy of labor and its allies in which the political power of capital is marginalized.

For three hundred years a struggle has waxed and waned to restrict, control or eliminate the ills generated by capitalist accumulation: exploitation of labor, class and ethic repression, international armed conflict, and despoiling of the environment. When a progressive majority has allied, this struggle has brought important gains. When capitalists, the tiny minority, have been successful in creating their own anti-reform and counter-revolutionary majority much is lost. The last thirty years of the twentieth century and into the twenty-first was such an anti-reform period during which capital achieved a degree of liberation it had not enjoyed since before the Great Depression. With the rise of capital many of the more absurd elements of neoclassical economics, such as the alleged stabilizing effect of financial speculation, manifested themselves in reality, as nature imitated bad art.

At the beginning I pointed out that the sufferings caused by the Great Depression of the 1930s, quickly followed by the horrors of the Second World War, generated a broad reform consensus in the developed countries. This consensus agreed on the need for public intervention to protect people against the instability and criminality that results from the accumulation of economic and political power by great corporations. Franklin D. Roosevelt, four times elected president of the United States, had this dangerous power in mind when he addressed the US Congress in 1938:

> Unhappy events abroad have retaught us two simple truths about the liberty of a democratic people. The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic State itself. That, in its essence, is fascism — ownership of government by an individual, by a group or by any other controlling private power. The second truth is that the liberty of a democracy is not safe if its business system does not provide employment and produce and distribute goods in such a way as to sustain an acceptable standard of living. Both lessons hit home. Among us today a concentration of private power without equal in history is growing.

The advanced industrial countries, especially the United States and the United Kingdom, reached the point early in the twenty-first century in which private power was stronger than "their democratic state”. This private power manifested itself in unconstrained corporate power that over-rides democratic decisions, justified by an ideology of self-adjusting markets. Rejection of that ideology and fundamental reform of those markets is required to prevent unconstrained corporate power from a latter-day fulfillment of Roosevelt’s warning against fascism.

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