Crisis and Instability: Searching for Terra Firma

Give me a lever long enough and a fulcrum on which to place it and I shall move the world. Archimedes

Last week, Europe's nuclear research organization, CERN, announced that it believes that it has found some sub-atomic particles (neutrinos) that moved faster than the speed of light. Assuming that its findings are confirmed, the speed of light, which has been regarded for more than a century as a cosmic constant and the ultimate speed limit in the universe, may lose its special significance.

It has been a long haul, but the direction is clear. The fulcrum for Archimedes' lever has gradually been denied. Copernicus showed that the earth was not the center of the universe, or even the solar system. Darwin showed that the human species did not stand above nature and in fact is subject to the same evolutionary laws that were found through the plant and animal kingdoms. Freud showed that people were not even the master of their own houses; that they were influenced by unconscious desires. Adam Smith showed that the *invisible hand* transformed the pursuit of private vices into public virtues.

Market Economies have a History

All fixed, fast frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, all new formed ones become antiquated before they can ossify. All that is solid melts into the air; all that is holy is profaned and man is at last compelled to face with sober senses, his real conditions of life… Marx

The financial crisis, which is entering its fifth year, has removed the veneer and destroyed the hubris that allowed us to believe that we succeeded in taming capitalism. The Great Moderation for the better part of the last quarter century was an anomaly. Market economies are not stable. The price of attempting to stabilize the real economy has been to boost the volatility of the capital markets, which, as has become painfully evident, produces a negative feedback loop on the real economy.

After WWII, policy makers feared two things. A return to conditions of the Great Depression and the spread of communism, which in 1949, with the success of Mao's forces in China, looked to dominate great swathes of the world and its population. The two were understood to be intertwined. Simply put, economic growth was understood as the best antidote to the spread of communism

Communism appeared more likely to take root in agricultural societies that had not embraced modernity, including modern production and consumption values. Aid to Europe and developing countries as well as private direct investment (see *American Challenge* by Jean-Jacques Servan-Schrieber for a backlash that confirms the trend) was good for American business.

Growth

The economic growth after WWII was fueled by a number of forces. The rebuilding and reconstruction from the war was obviously a major factor. Technologies were developed in the war that would be dispersed to boost productivity and reduce the costs of transportation and communication. After all, there was pent up consumer demand after the war rationing.

The GI Bill in the US helped the veterans acquire the skills needed in the new economy, while much of the military remained mobilized. Unionization was strong in key industries and construction and this helped create the basis of a social contract. In exchange for not challenging the legitimacy of capitalism, workers, primarily men, would share in the spoils. Ultimately, wages and salaries would track gains in productivity.

The post-WWII financial system was based on limited capital mobility, fixed exchange rates and closely managed interest rates. The dollar-gold standard was very conservative in the sense that it was an attempt to re-create the British gold standard (circa pre-WWI).

Thus, the post-WWII order was under strains and pressures immediately. Currency adjustments were political nightmares. Countries were reluctant to reduce the tariffs that were arguably necessary during the initial stages of reconstruction, but were increasingly not justified. US policy was encouraging relatively large dollar outflows. Small reforms along the way, albeit often only after a crisis, eased the pressures, and in turn sustained the system.

Even after Nixon unilaterally severed the gold-dollar standard 40 years ago this past summer, world leaders were trying to simply reform the system through a series of agreements to adjust the foreign exchange pegs (Smithsonian Agreements). Officials only belated recognized something larger was at stake.

Cash Register

The old system had broken down. The elite did not have answers. The domestic social unrest in numerous advanced industrialized countries, including the US was generating social changes. The social contract was breaking down. Real wages began stagnating even though productivity and inflation continued to rise.

The oil and commodity shock of the early 1970s seemed to underscore the loss of control. The stagflation that was being experienced was thought to be impossible under orthodox economic thinking gave a sense of intellectual bankruptcy as well. It simply was not clear what was to be done.

There was a gap of several years between the breakdown of the old cash register and the construction of the new one. This is similar to where we are now, in-between. What is at stake is not the capitalist system as such, but how it is organized; not just economics, but political economy. How will productivity gains be distributed? What is the relation between employee and employer? What is their relation to the state? What is the relation between industrial and finance capital?

A battle among the elites resulted in a victory for the Reagan-Thatcher faction. It is an evolutionary process that means a new cash register had to be cobbled together -- mostly out of the old parts, but it had to become more flexible. Capital mobility would allow this process to grow and indeed would provide more efficient allocation of capital but also serve as another shock absorber. It meant the growth of finance capital. It would avoid tariff barriers to trade, but introduced other measures to allow the domestic producers to adjust, such as “voluntary export restrictions” and “orderly market agreements.”

The social contract had broken down and would not be replaced. If men’s wages were not going to keep pace with productivity or inflation, it meant that increasing number of families would need two incomes to make ends meet. This has far-reaching social, cultural and political consequences. The increasing deregulation of the capital markets also made it easier for households to get credit. At the same time, businesses increasingly managed to shift the retirement benefits responsibility to the employees through 401k type programs.

What Next?

It was not immediately clear to many when the current crisis began that it was going to be this kind of event. The G7 and IMF understand how the cash register works and has vast experience in tweaking the cash register from time to time. What is required now is a new cash register. It will mark as large of a change as Reagan-Thatcher represented at that time. Yet just as it was impossible to anticipate the Reagan-Thatcher cash register when Nixon introduced wage and price controls in 1971, so too is it impossible to anticipate the next cash register now.

Nevertheless, some elements seem more likely than others to shape it. Capital markets will become more regulated and transparent. Whether directly with a financial transaction tax or indirectly through regulation, the cost is likely to increase and this will serve to slow the rate of growth. This applies to financial innovation as well. It is, like James Tobin once suggested, putting some sand in the too-efficient wheels of the capital markets.

The distribution of productivity gains has never been more lopsided in the United States, and the disparity has grown to extreme levels in other major industrialized countries. The cash register has to redraw the balance for economic as well as political reasons. The top 5% of America's income earners account for almost 40% of all consumer purchases. If the new cash register is going to boost aggregate demand it must boost the base for consumption.

There are only a limited ways to achieve this, income, wealth or transfers (which is the result of someone else's income and wealth effect). During the post-WWII model, a more equitable distribution of productivity gains between labor and capital was consistent with rising profitability of American business, an expanding economy and rising living standards.

Governments are going to be put on more sound fiscal footing. There is a wide array of possibilities, including a reduction of the basket of public goods/services that governments provide and a higher price/cost for the one's that remain. This may entail greater joint ventures between the government and private sector, including the non-for-profit and NGO space.

The first post-WWII cash register worked partly as the war-generated technological innovations integrated into the broader economy of mass production of consumer durable and non-durable goods. The Reagan-Thatcher cash register was fueled by financial innovation but also the carving out of what was called at the time, the Wintel—the capital broadening force that denoted the deep penetration of the personal computer.

The internet, social networking and multi-media are likely to shape the third post-WWII cash register. It will make possible more flexible work patterns (work from home) as the social aspect of work is supplemented if not supplanted by other elements of networking. It may make for a greater balance between work and life than the second cash register generated.

The third cash register post-WWII may also recognize more fully that affluent consumers have a greater demand for services than goods. This also fits in well with greater concern about environmental sustainability. The ability to rent a bicycle or car may be simply the tip of a larger movement predicated on local networks. Education may increasingly become a life-long pursuit and free-time/leisure time may be redefined.

Conclusion

Much of the current focus is necessarily on cleaning up the mess left by the collapse of the debt bubble, which took on different forms depending on particular institutional arrangements and regulatory environments. The relationships associated with Reagan-Thatcher have broken and cannot be reanimated. New ones have to be found.

The fact that this is the third time in less than seventy years, speaks to the instability of modern political economy. The fact that a new one will be found speaks to its resiliency and dynamism. As an evolutionary process, the new cash register will appropriate aspects and features of the earlier registers. The trend, if it can be called such a thing, seems to be in the direction of flexibility, broadly understood.

Old forms, structures, and absolutes have yielded in the face of increasing educated work force with modern technological tools. Nothing less than absolute confidence that the speed of light is universal speed limit appears to have surrendered. Surely our ideological constructs, which answer questions about the relation between citizens and the state, between the state and markets and how productivity gains are distributed and what is personal and what is public, are also malleable. We can be confident our answers can change because they have changed in the past.

The dollar's role as the numeraire in the world economy survived the breakdown of Bretton Woods and the dollar-gold standard. It also fit in well with the second cash register, though there were some destabilizing bouts of appreciation (mid-1980s) and destabilizing declines (mid-1990s). The dollar's role as a reserve currency has declined a few percentage points over the past 30 years, though it remains the preeminent reserve asset. The second biggest is the euro, at less than have the US share and little more than the sum of its parts (ECU, DEM and FRF). The relative flexibility of the US political economy and the lack of a compelling alternative suggest that the greenback will also fit the new cash register.

But it would be nice if there was a place to put the fulcrum…

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