



Tomorrow's Capitalism

Roundtable summary

The Institute for Public Policy Research (ippr), in conjunction with Friends Provident Foundation, last year launched Tomorrow's Capitalism, a major new programme of work that aims to explore whether the financial and economic system that has dominated global markets over the past twenty years is sustainable in its current form.

As part of the Tomorrow's Capitalism programme a series of high-level seminars are taking place to discuss flaws in the capitalist system and possible options for reform.

'Flaws in the capitalist system', 26 February 2009, ippr offices with Gerald Holtham, Managing Partner, Cadwyn Capital LLP

Holtham's thesis

The underlying problem facing the world economy is an incipient problem of deficient demand caused by profits outstripping wages in a world of global excess labour.

Up to the mid-1980s, recessions were caused by the battle between employees and employers over their share of total income. This led to wage-price spirals. Governments and central banks had to tackle these by tightening policy to create slack in the system and so forcing inflation down.

Since the 1980s, the abolition of exchange controls has allowed capital to flow freely to where potential profits are highest. This weakened labour relative to capital and profit shares increased. The situation was exacerbated by the liberalisation of China, introducing huge numbers of cheap workers into the global capitalist economy and giving a further boost to the profit share.

Strong profit growth encouraged borrowing to gear up returns, which led to rapid asset price inflation... until US house prices reached a level that were so clearly overvalued that they started to fall. This led to forced sales of assets backed by US mortgages and the whole house of cards collapsed.

Recommended policy responses:

- Central banks to focus more on asset prices, less on the wage-price spiral
- Creation of a body to monitor global credit creation
- Creation of a mechanism to pressure countries who could imbalance the global economy
- International agreements on financial regulation and capital taxation
- Separation of deposit-taking commercial banks and investment banks

Discussion

There was some debate over Holtham's underlying thesis. The opposing view was that capitalism is driven by the profit motive and that a high level of profits is associated with high investment and strong potential growth. There are also instances in history (post WWI and in the 1970s) when a high wage share has turned out to be very bad for the economy. Against

this, it was argued that, while the addition of China's urban labour force was a stimulus to the world economy, it had not benefited ordinary workers, particularly in the US. It was noted that the income share of the top 1% of earners in the US/UK has increased sharply over the last 30 years. As a result, the progressive bargain with capitalism (that it is acceptable as long as real wages across the population are growing in line with productivity) has broken down.

Discussion moved on to the extent of the problems in the financial system. It was generally agreed that people within the system chose to ignore the risks because they became excessively excited with the returns they were earning. It was also agreed that there were plenty of people outside the system predicting some sort of financial/economic disaster, but they were ignored because of a mistaken belief that any mess would not be so bad that it could not be tackled. It was pointed out that Alan Blinder has identified six major (US) policy errors (failure to regulate derivatives, failure to control the overall level of leverage in the system, failure to control sub-prime lending, failure to limit foreclosures, letting Lehman go bust and mismanagement of the TARP).

It was felt that the policy response is being hindered because it is hard to do anything that smacks of helping out the banks and, in some quarters, because of a mistaken view that as excessive debt got us into this problem, creating more debt cannot be the solution. The worry was that inadequate policy responses could lead to social unrest, nationalism and protectionist pressures. For example, some are already arguing that a little protectionism now might be needed to avoid a lot of protectionism at a later date.

There was disagreement over the wisdom of marking 'toxic assets' to market. From an economist's perspective, forcing banks to do so increased the risk of continued cuts in lending and an unnecessarily bad economic outcome. It would be preferable to take an optimistic view and take these assets off the banks at a higher price. If this was undesirable, because it boosted bank profits undeservedly, then banks should be nationalised first (so that the taxpayer gained not shareholders). Against this, it was argued that individual insurance companies and pension funds had to mark-to-market for reasons of transparency, even if it produced a less than optimal outcome at the aggregate level. They had to be able to show the value of assets should they need to be sold immediately.

Other points covered more briefly were:

- The China-US imbalance, how much this might shrink as a result of the recession and the need for China to consume more of its own income in the medium-term.
- Action at the EU level would be better than action by individual countries.
- Although letting Lehman Brothers go bust was a mistake, other American actions last autumn saved capitalism, in particular by averting a dollar crisis (though some felt this risk had not yet passed completely).
- The paradox that the countries at the core of the problem (US, UK) are doing better than countries like Germany and Japan.
- The extent to which the challenges facing policymakers are political rather than economic, for example arguing the case for free trade over protectionism.
- The lessons from Keynes that we can reach a bad economic equilibrium as easily as a good one and that excessive profits/surpluses are as damaging as excessive deficits.

No one wanted to be optimistic, though it was said that the next few years will not be as bad as the 1930s, though they could be as bad as Japan in the 1990s.

Conclusion

We are only in the very early stages of identifying what went wrong, why and how to deal with it. Policymakers are in uncharted territory and are making it up as they go along. Globalisation means global solutions are required for global problems. But getting countries to act in the world's interests, rather than in their own narrow interest, will be difficult.