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Challenges Facing Macroeconomics

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Are we all mad, or economists?

There are many wise people, some even award-winning economists, who think that the West's economic problems can be easily repaired. The engine is just faltering. A bit more fuel and a tug on the right levers and it will be back to normal in no time.

Their solutions are certainly appealing, but they are also wrong.

Modern-day economists tell us that we can reflate struggling Western economies with financial aid, by printing money and encouraging consumers to spend again. They say that we should boost spending in developing countries where there is a vast untapped capacity to consume. Other countries need to liberalise their stifling market restrictions to unleash new opportunities.

We will soon be back on the road to growth, they say.

The trouble with these ideas is that they see the problem as the solution. They call for more spending, to generate more growth.

Encouraging people in the West to spend more is not a solution. It will only increase their debts. Persuading the citizens of spendthrift countries to consume more will only bring them the same troubles—too much debt, no savings, and societies focused on materialism. Trying to force the French, the South Koreans, the Japanese and others to liberalise their markets is also pointless. These countries do not want their markets liberalised. It is not their way.

Today's economists are still trying to reimpose a failed model of progress on us—one based on unrestricted markets, consumerism and short-term gain—in the hope that its wider application will somehow fix the system's obvious flaws. Apart from being morally vacuous and financially foolish, their obsession with growth also goes against the laws of nature. As human beings, we don't grow forever. We reach a steady state and then stay that way. Yet modern-day economists want us to believe that our economies are somehow different, that they should grow forever. As Kenneth Boulding, John F. Kennedy's environmental advisor put it, "anyone who believes in indefinite growth in anything physical, on a physically finite planet, is either mad—or an economist".

For the last 30 years, we have been led to think that growth was essential, that it was the best way to measure human progress. We were persuaded that unregulated free-markets were the most efficient way to allocate the world's resources. We thought that globalisation was advantageous for everyone, despite the unequal way in which the benefits accrued. We believed that big businesses and big banks would behave benevolently, and in our interests, just as long as they were free from government interference.

These wrong-headed ideas have failed. They have allowed economic power and wealth to become shamefully concentrated, with the combined wealth of the 793 richest people equal to that of the three billion poorest. They have encouraged us to squander the world's resources by underpricing them. They have supported business efforts to outsource production, undermine local employment, exploit workers overseas and pollute the seas and skies without any care.

We don't need any more of this sort of economic medicine, we need a different sort. We need new economic doctors, people with different ideas and a different approach. We need to return to something more like Adam Smith originally intended.

In classical economics, companies and societies are expected to think about the long term. Consumers should pay the full price for what they buy, not be subsidised by the environment and future generations. Markets should be regulated when necessary and scarce resources should be protected. The gap between rich and poor should to be managed. For Adam Smith, essential elements of economics were fairness and justice.

We need to dispense with stimulus packages and plan instead for government cutbacks, reduced consumer spending and tax hikes. Developed economies need to be pruned back until they are viable. Those who have gained too much need to be squeezed so that their gains are put to better use. Unearned income from speculation needs to end.

To be successful, we also need to change Western attitudes. Citizens have to accept that the level of economic activity of the past was neither normal, nor sustainable. It was a debt-fuelled bubble, a freak of economics, which carried consequences.

But we can look forward to something better in the end. A more socially balanced and sustainable society. A world where resources are properly valued, where products last longer and the gap between rich and poor is much narrower than today.

Ditching the ideas of modern economics is the first step on the road to a better world.

Almost everything we buy is too cheap

You don't have to work for Greenpeace to see that what we are doing to the planet is not sustainable. We are heating it up with potentially catastrophic consequences. We are polluting the rivers and skies. We are emptying the oceans of fish and the forests of trees and animals. We will leave our grandchildren a wasteland unless we stop.

In 1968, R. Buckminster Fuller wrote Operating Manual for Spaceship Earth. He saw us as astronauts flying through space on a ship with a fixed quantity of resources.

When we have used them up, they are gone.

Although it was not written as an assault on modern economics, parts of it could have been. Fuller talked about the problems of the world's resources being taken over by "the Great Pirates," a small group of greedy people, who controlled the world's raw materials for their own benefit.

During the last thirty years we have made this story real. Following the laissez-faire ideas of modern economists, we have increasingly believed that the best way to allocate the world's resources is through the free market. We have let individuals, a handful of big corporations and 'the market' decide what to do with them and how to price them.

In doing so we have made a grave error. We have badly under-priced them, accelerated their use and encouraged people to waste them. Moreover, while Enlightenment-era thinkers believed that we are answerable to nature, we now seem to think that nature should be bent to the will of humankind. We abuse nature for profit, ruin ecosystems without considering their full value and appear to think that species depletion does not matter.

Let the children pay

None of this follows the laws of classical economics. Traditional economic theory says we are supposed to pay for all of the hidden damage that our actions cause. The price we pay for our resources today should reflect the value of the loss of these resources to future generations. If not, then part of the price of using them today is eventually paid by someone else, our children. The costs do not go away just because we do not pay them. They are simply ignored by those who benefit today.

When a logging company clears a piece of rainforest, neither the company nor its customers pay for the loss of habitat, for the destruction of plants we have not yet studied, or for the ruin of the surrounding environment. We consign those costs to society and to future generations. We do not know if these costs are high or low. So we ignore them and pass them on.

Similarly, when a factory making plastic in China releases toxic waste into a river, it does not include the cost of this in the price it charges end-customers. So the plastic is cheaper than it should be. The consumers who use the plastic are being subsidised by those living downstream, who pay part of the cost through their ill health. The dead fish and poisoned aquatic life pay part of the cost too, as do the oceans into which the river flows.

In classical economics, the logging company or the plastics manufacturer are said to receive "unearned" profits from their actions. They make a gain that they should not. The consumers of the wood or plastic benefit unfairly too, because what they buy is cheaper than it should be. This gives them an incentive to buy even more and not to value what they have.

Adam Smith would not have liked modern-day economists

Adam Smith, remember him?

We have been led to believe that classical economics and today's economic ideas are the same. But they are not. Rather than paying properly for the resources we use, we have been held hostage by modern economic theorists and corporate libertarians, by those demanding less regulation, by those who say that government interference should always be minimised. As a consequence, we are using the world's raw materials too quickly and on the cheap, letting future generations and the environment pay the price.

We need to bring an end to undeserved gains and rethink how we use, allocate and price the world's resources. They belong to all of us, after all, not just a few greedy pirates.

For someone now seen as a corporate libertarian, Adam Smith's views on company profits might come as a shock. Even more surprising would be his views on the sort of free-market economics we follow today.

Adam Smith, the father of economics, was a canny Scot who had a strong belief in free-trade. He thought that businesses should be free from regulation too, or at least mostly free.

But Smith was also a moral man.

Before he took up economics, he was a professor of moral philosophy. He approached economics with a deep sense of right and wrong and talked about the need to maintain the 'laws of justice' in all things. Efficiency was important, but so was sustainability. With freedom came responsibility. Freedom did not mean that we could ravage the planet for short-term gain. It did not mean that mortgage salesmen could sell loans which would force the borrowers into penury. 'Freedom', in the enlightenment sense, always carried a responsibility to others and to society.

Smith also believed that wealth should not just benefit the individuals who created it but wider society too. So he thought that the rich should be taxed more than the poor. He also said that profits should not be too high. If they were, he said, ruin would soon follow.

"The rate of profit …is naturally low in rich, and high in poor countries, and it is always highest in the countries which are going fastest to ruin."

In Smith's sort of economics, profits were defined as returns sufficient to maintain a business long term. If they got too high, he believed that the invisible hand would ensure a stiff dose of competition brought them back into line. This was in everyone's interests because excessive profits act against social harmony. They increase income inequality.

We have abandoned Smith's sort of economics. In the technology and many other sectors, companies have generated huge profits because of a lack of competition. In the finance sector, profits have been excessive because of a lack of regulation.

Moreover, many of the financial institutions that have made the Western economic world so unstable in the last few years, have made their profits from speculating. They haven't just made excessive profits, they have not added any economic value either. The same is true of the trading houses, commodities brokers and property developers. Some of the big investment banks regularly make more than $100m a day simply betting on the market. They gamble–but fiddle the outcome in their favour.

With so many financial and economic problems facing us, we need to ask ourselves some fundamental questions again.

- What do we mean by the free-market?
- What do we want our banks and businesses to do for us?
- Do they carry some sort of social responsibility?
- Should economic growth be a goal or a consequence?
- Are we happy that many of our biggest industrial sectors are dominated by a just handful of companies?
- Is it acceptable that many of the largest companies in the world make their profits from gambling, rather than supporting economic growth or financing business development?
- Are we happy to weather the damaging social, economic and financial instability that this periodically creates?
- Are these the sorts of businesses which we want to encourage or restrict?

It's time we thought again about modern economics and what it means.

Free market failure: Isn't it time to consider a different model?

This article was originally published on BBC World News website during Davos 2012.

Many news stories this week seemed depressingly familiar.

David Cameron's foolhardy let's-blame-the-Europeans (again) speech in Davos, Christine Lagarde's scaremongering about another 1930s-style crisis and Mitt Romney's desire for the rich to pay less tax than the poor show how much the Western world lacks leadership, new ideas and a moral compass right now.

When they are not trying to blame someone else, make us fearful or enrich themselves, the West's politicians, bankers and economists keep banging the same drum.

They say we should go shopping, pay less tax and print more money to solve our problems.

If we can boost spending in Europe and America by getting the banks to lend again, uncork the hidden desire for consumption in the developing world in places like China and India, and liberalise competition in countries such as Japan, France and Italy, vast new opportunities will be unleashed, they tell us.

The trouble with these ideas is not just that they contain a whiff of self-interest, it is that they are also an attempt to reimpose a model which has failed.

Logically, their suggestions will only make the situation worse–which is exactly what is happening.

Another way?

These politicians and experts are also being intellectually dishonest. They refuse to consider a different approach, even one that seems to work better.

Many countries have avoided economic hardship in the past few years, not because they were lucky, but because they have a different economic philosophy.

In Asia, where economic growth has been strongest, the state has played a much bigger role than in the US or UK, with big businesses explicitly supported by governments.

China's 150 biggest companies are all government directed, with four of them now among the top ten companies in the world. It has also established many of the world's biggest banks, the second-largest producer of telecoms and internet equipment and the second-largest PC maker.

And it is not just in China. Many of Singapore and Malaysia's biggest and most successful companies are also state directed, while many of the firms that dominate South Korea retain close links to the state, too.

Governments help these companies in a variety of ways. They restrict unnecessary competition to help them build economies of scale. They provide them with finance, give them favoured access to local customers or use legislation to keep foreign rivals at bay.

Because they don't have to generate endlessly rising quarterly profits and dividends, these state-backed companies have been able to reinvest and grow more quickly.

Although Westerners see this approach as unfair, it is not. It is just a different way to compete, and perhaps a better way. It also ensures that skills, jobs and wealth are kept at home, not sucked away overseas.

When Chinese, South Korean or many South East Asian companies venture abroad, though, their governments are beside them too.

If Chinese companies bid to build power plants or railways in Africa or Eastern Europe, the state or one of its banks will provide the customer with low-cost financing. The government also helps Chinese businesses gain access to valuable resources. Schools, roads and bridges *are built by Chinese workers in return for coal, oil and iron ore. That way, China gets the business, the jobs and the resources.*

Self-interest

These countries see big international business deals as a way to win contracts and geopolitical influence at the same time. They are not just about making a quick buck–there are wider strategic interests. Many European countries also take a different approach to economic management, notably Germany, which remains one of the strongest economies in the world.

The German government believes it has a duty to regulate markets when they get out of control, when they create bubbles or widen the gap between rich and poor. German citizens want their markets to serve the needs of society, not a few fat-cats. They prefer harmony to greed, and are willing to accept greater regulation to achieve this.

Economists, politicians and financiers in America, Britain and many other countries have become obsessed with the free-market mantra, with their belief in consumption and minimal regulation, because it served them (sometimes personally) so well for so long.

In the end though, it failed.

Instead of telling us we need more of the same, isn't it time for them to reflect on how their model should be improved?