# Economics: For Money or People?

## Introduction

My original motivation in writing this paper was concern at the calls for cuts in the government's deficit, not just because of likely job cuts in the public sector but the wider implications for the economy, and thus the country, as a whole. I was greatly concerned that the effect of taking so much money out of the economy when so many other sectors were so weak would result in a 'double dip' recession. This was what happened in the Great Depression when in 1937 in both the US and UK anxieties about the government deficit caused public spending to be cut.

Other work delayed my beginning writing and now we have had a noticeable change of tone in the early part of 2010 as the very modest growth in the fourth quarter of 2009 showed that the recovery was far less embedded than had been hoped and any deep cuts too soon would be damaging. As well as calls for the reform of financial institutions, which in my view should encompass not just how they do business but what business they should do and their place in the economy as a whole, there is also a deeper debate about the model upon which the economy is built. The economic crisis calls into question the neo-classical model of economics which has held sway for the past 30 years and for a while at least has seen a return to the work of John Maynard Keynes, whose theory was formed in the light of the policy mistakes of the 1930s depression. The crisis should also make us question the extent to which we have become (in the words of Michael Sandel in his 2009 Reith lectures) a market society rather than a market economy. Should not the economy exist for us rather than us being driven by economics?

## Financial Crisis

Much of the comment and debate about the economic downturn seems superficial and seeks to apportion blame. The reaction to banker's bonuses is a case in point. Some of this may simply be jealousy at the obscene amounts of money being received, this year it seems, for little effort in many cases as banks take advantage of favourable market conditions. Some of it may be due to a sense, when there appears to have been a change in spending habits and a return to saving or at least to paying down debts, that we are no longer intensely relaxed about people becoming filthy rich, in Lord Mandelson's phrase.

But there is a deeper question, which is: is it right for bankers and banks to make the making of money by whatever means with the minimum amount of regulation their principle aim, so that, if they don't like what the politicians as lawmakers propose to safeguard the wider public interest, they threaten to go where their unbridled money making is not likely to be so restricted? Lawmakers may have some further reason for their actions beyond protecting the public purse in the event of a bank collapse. As well as the scale and relative importance of the finance industry within the wider economy there may be issues of the ethics of how money is made, whether disproportionate returns are appropriate, and whether all that talent and effort might be better used in more socially productive and useful industries. As Roger Bootle (an economist who has worked as an advisor in the City for many years) shows in his book 'The Trouble with Markets: saving capitalism from itself', much of the trading activity that goes on in financial markets is simply to make money for its own sake not to provide a service of others (such as trading foreign exchange for a company buying or selling goods abroad). As such it is, he says, a zero sum game in that it is simply sophisticated betting on whether the price of whatever is traded will go up or down and hopefully make a handsome profit if the bet succeeds. A gain for one person must be a loss for another and nothing productive has been achieved. So there may be moral as well as pragmatic reasons for looking at banking regulation. And at last our politicians seem to have decided to attempt to do something, with the announcements of Obama and the UK government's and opposition parties' proposals, even if it remains to be seen how much is actually enacted.

At least we are now seeing some proposals, whereas for much of 2009, despite pronouncements at the April G20 Summit, politicians seemed timid in the extreme. The question is: do we do just enough to ensure that banks can't wreck the rest of the economy by transferring their losses from irresponsible trading onto the public debt, or are we prepared to have a more far-reaching debate? In the words of Larry Elliott in the Guardian (26 January 2010) now that we are (just) out of recession what comes next? 'After denial, complacency, disbelief and action comes a fifth phase. On past form this will be recovery, relapse, rehabilitation or reform.'

The assumptions of the bankers are perhaps just a reflection of the philosophy that underlies our economy, but in a more extreme form. This is that the market rules and is always right and self-righting; that everything else is subservient to this and that it is possible to model this mathematically, albeit with enormously complex equations. This is essentially the view of classical economics.

Economic Models

Classical economics is not the only show in town, but is the dominant one. Keynesian economic theories were in the ascendancy from the latter part of the depression in the 1930s until the 1970s but were once again supplanted by new classical economics after that. There are various reasons why Keynesianism fell out of favour in the 1970s. Some of the (new classical) monetarists would argue it was simply wrong, others that the so-called new Keynesians after Keynes died in 1946 misconstrued his thinking or in some cases treated it simply as a variation of classical economics, so that for whatever reason the full force of Keynes's theories were never implemented.

However, Keynesian theory has enjoyed something of a renaissance in the past eighteen months with fiscal as well as monetary stimuli being used to ameliorate the worst of the economic downturn with, arguably some success so far as unemployment has been concerned. But as the Nobel prize-winning economist Robert Lucas said, '...everyone is a Keynesian in a foxhole.' Now that the battle to prevent the meltdown of the economic system has abated the temptation seems to be to return to type and continue with classical economics, rather like the generals in the First World War. Joseph Stiglitz, in interviews given to support the publication of his new book (Freefall: Free Markets and the Sinking of the Global Economy), says he is surprised at how fast the forces in favour of the pre-2007 status quo have regrouped. I have to say I agree with him when he says, the optimist in me is hopeful that we won't need another crisis to finally motivate change, the pessimist in me says it may need to happen. Some Keynesians would say we simply need to bring back his theories and apply them properly. Robert Skidelsky, the author of an authoritative three volume biography of Keynes, in his more recent 'Keynes: The Return of the Master' is not so sure, pointing out that we are in a different world to the 1930s and '40s. That view may refer more to the kind of post-War Bretton Woods economic system that was based on Keynes's thinking but differed significantly in may major respects from his original proposals. None the less, for our present circumstances it would be helpful to look at the challenge Keynes's theories make to the forces of orthodoxy that are pulling us back to a re-run of past problems with serious consequences for ordinary people.

To understand Keynes properly, though, we have to see that there is more to the theory than throwing some money at the economy when we are in a hole. Keynesian economics is a fundamental critique of the basis of classical and neo-classical economics so that there is a different set of criteria about whether or not the economy is working. Should this be about monetary stability or full employment? It is possible to have in technical terms economic equilibrium and monetary stability at less than full employment, but the horror of unemployment in the 1930s persuaded Keynes that a way of managing the economy so that full employment was the aim needed to be created. Keynes accepted that the capitalist system was the best we had but that it needed to be guided to make it work better than under laissez faire or even the 'creative destruction' of Schumpeter, the consequences of which he saw in the 1930s depression. As a workplace chaplain who has been with people who have been made redundant and who studied economics in the

1970s just before Keynes fell out of favour, I take the view that we need to find ways of not wantonly destroying employment whilst at the same time ensuring that the economy renews itself for the benefit of the widest range of people.

Classical economics is based on the efficient markets theory – that decision-makers, from individual consumers to those making big investment decisions can see reliably into the future. They are able to make optimal choices on the basis of reliable information about events that have already occurred and the probability of events in the future, and thus allocate resources most efficiently. It is this 'ergodic axiom', that the future is on a trajectory determined by the past, which is the basis of the complex mathematical models used by financial institutions to guide their investment decisions. Under this model interventions by the state to influence the economy are 'external shocks' that can only be temporary changes of course before predetermined equilibrium is restored. The aim of the mathematical models is greater abstraction to make the problem more tractable. The Keynesian critique is that this is fundamentally flawed because it has lost connection with the real world and how people actually respond to what is, in fact, an uncertain future.

The efficient market theory says that where the future is known there will be full employment, but plainly, there are times when there is not full employment. Unemployment could be produced by workers pricing themselves out of the market, but in times of economic crisis (like the 1930s and like the present) the future is clearly not known. At many other times too, except when optimism abounds, where large amounts of money are to be spent that might have repercussions over a long time span and where a mistake could be costly, people 'know' that that they do not know what the future will be. In this case putting off a decision may be the wisest thing to do. In addition, because the future is not certain, people save or keep by them some money for a 'rainy day'. If there is greater uncertainty people will tend to spend less and save more. The effect of this is that markets decline, firms' output goes down and workers are laid off.

Saving may be wise for individuals in these circumstances but it is disastrous for the economy as a whole, which is why it is a mistake to think of the national economy as our own household writ large. What is prudent for us is not actually prudent for the country. Leaving aside the possible impact of exports if the exchange rate falls, if consumers reduce spending and firms do so as well because people are more cautious, turnover goes down and there are fewer jobs, then in these circumstances the spender of last resort must be the state.

Keynes also distinguished between consumption demand and investment demand. The propensity to consume across the economy is fairly stable as it depends largely on habit (so if income falls consumption tends to fall more slowly). But investment depends on expectations (and must be distinguished from saving, which is hoarding cash not a demand for capital goods); and for an economy (and employment) to grow there needs to be the conditions to encourage additions to its capital stock. For this reason the focus of government spending in a downturn should not be simply to keep consumption up by employing people in the public sector but to invest in such a way as to make the economy more efficient. This, incidentally, might explain why at present the level of investment in many businesses is low – it is not just the banks' failure to lend, but demand for borrowing for investment is reduced until confidence rises.

There are different forms of economic stimulus that can be used when the economy contracts (or there is negative growth – surely a non sequitur). Firstly, interest rates can be reduced so that the cost of borrowing becomes more attractive, assuming there is still sufficient confidence to consume or invest. Once interest rates are as low as they can go the next monetary stimulus is quantitative easing, which has been referred to as Keynesian but I don't think this is the case, as it is a mechanism for monetary expansion by getting money into the hands of banks. This is done by the central bank creating money (what is loosely termed 'printing money') with which to buy government (or commercial) bonds from commercial banks thus giving them liquid cash that they can use to lend out.

The Keynesian response would instead be to create a fiscal stimulus supported by the selling of bonds either to the public through the commercial banks or to the central bank. It can be argued that quantitative easing has been indirectly the Bank of England buying the government's new bonds insofar as it has freed up cash for the commercial banks to buy those bonds to finance the government's deficit. By increasing the demand and hence the price of long term government bonds, this reduces their effective interest rate, and the rate on other bonds, and so reduces the government's borrowing costs. The key thing is what is done with the money the government has to spend. According to Peter Clarke in his biography, 'Keynes: The Twentieth Century's Most Influential Economist', Keynes himself at first only believed it should be used for investment; it was one of his disciples who later persuaded him that reducing taxes (such as the VAT reduction and car scrappage scheme) might be part of the picture. Tax reductions can have a rapid effect provided consumers don't just use the money to pay down debts or increase saving but it may be fairly shallow (especially if the reduction is temporary) as far as long term confidence and investment is concerned. Public investment such as in new transport infrastructure, or education, or energy saving measures and subsidising research into environmental technologies are more long-term but should have a more lasting effect by increasing the efficiency of the economy and thus creating further economic growth.

The problem for the UK and many other economies is whether such fiscal stimuli can be afforded because of the 'structural' deficit built up in the years of boom with unrestrained government spending on public services because, in Mr Brown's words, we had seen the end of boom and bust and therefore didn't need to be prepared for a downturn. This spending may have been very desirable, necessary in some eyes, but it left the government in a weak position when the downturn did come. The banks have been bailed out by transferring private debt to the public debt but there was little left in reserve to restore the economy and now we face increasing pressure to 'get the deficit down' before the markets turn on us as they have with some of the weaker Euro-zone countries and on the Euro itself.

Pure Keynesians would argue that the expansion of the economy provided by the various stimuli should resolve any debt crisis because the debt will become a smaller proportion of the economy as economic growth increases GDP. This is the view of Paul Davidson in 'The Keynes Solution: the path to global economic prosperity', who argues that America's debt was greater at the end of the 1930s than the beginning because of the Roosevelt New Deal, and ballooned hugely during the second world war, but was never an issue because of the enormous economic expansion that took place subsequently. The only other supporter of this view that I have heard is Ann Pettifor, organiser of Jubilee 2000 debt campaign and now fellow of the New Economics Foundation, who spoke in similar terms to Davidson at both a CTBI conference in January 2009 and a TUC conference in November 2009 that I attended.

However, there are limits to Keynesian expansion. Having prevented banks from defaulting on their bad debts by bailing them out there arises the risk of countries defaulting. This may risk becoming a self-fulfilling prophecy if the markets fear default and force up the yields on government bonds, which is where the debate about the risk of losing the UK's AAA credit rating comes from. In normal economic times there is no problem about running a moderate deficit (e.g. the 40% golden rule of Gordon Brown when he was chancellor) but with higher levels of debt such as we now have, and low economic growth and low inflation or the fear of deflation, there is the risk of a 'debt trap' where the debt increases faster than the economy and will start to increase exponentially. By definition, if the government is running a year on year deficit of spending over revenue the deficit will increase, so further increasing interest payments. If the markets take fright and increase interest rates this adds yet more to the interest burden making a default almost inevitable in the end. Quite what the consequences would be if there were rises in bond interest rates or the market refused to buy UK bonds (a 'bond strike') or if there were even a partial default is difficult to imagine. One way of avoiding a default would be to engineer a technical partial default by increasing inflation but one can imagine the dim view of this that would be taken by those who view low inflation to be more important than unemployment.

Preventing fear of default and rising interest rates on government bonds is what lies behind the talk of a credible plan for getting the deficit down over the next few years. However, there is a fine line between satisfying the markets (and the threat of the consequences of not doing so) and painful cuts that affect the lives of ordinary people but particularly the weakest in society who depend most on public services and benefits. This is what is being played out at the time of writing in Ireland where very painful cuts have been made and in Greece where the population is finding it hard to accept the consequences of what it is being told is needed.

Consequences

We don't yet know what this will mean for the UK as none of the political parties will come clean this side of a general election about what they would do. But from my contacts as a chaplain with a number of local authorities and other public sector bodies it appears they are working on the basis of a 5% cut in spending year on year for the three years from 2011-14. There seem to be contradictory messages about the consequences. On the one hand, I have heard it claimed that it will be possible to achieve this by natural wastage and voluntary redundancies (already some are using internal redeployment to fill all but the most specialised vacancies); on the other hand there is press talk of cutting 10% of the public sector amounting to 600,000 jobs. Even the most optimistic scenario is not going to help unemployment much as it means there will be almost no jobs filled externally, and with private sector firms hoarding labour by working short time or having people under-employed, we are heading for a jobless recovery and the likelihood of increasing unemployment, followed by a long period of persistently high levels of people out of work. That will do little for the level of spending and the recovery of demand and confidence, and thus our escaping from the recession, hence my fear expressed at the beginning of this article of a double dip recession.

The county where I live is part of the government's 'Total Place' pilot where all of the public spending from all local and national public sector agencies is assessed and ways are identified to share resources and improve service delivery. From this exercise it has been estimated that, excluding benefit payments, which (hopefully) would not be reduced, a 5% cut per year in public spending would take £145 a year out of the local economy. I don't know what the total 'GDP' of the county is but this must still be a substantial proportion, and this does not take into account the cumulative effect of less spending (through less purchasing on their part and from their redundant employees, taking money out of the economy) leading to further job cuts. One model I was shown in late 2009 based on the 5% cuts for three years suggests some improvement but a fall back to around two thirds of the fall in GDP we have seen over the previous six quarters (i.e. a fall back to minus 4.5% GDP compared with the pre-recession high point in early 2008). I have also seen a similar graph from a number of sources that shows that every recession since the 1930s has been a double dip except in the 1990s. Most recessions last around eight years so it is being estimated by those concerned with economic regeneration that I am in touch with that it will be 2016-18 before unemployment returns to pre-recession levels.

Although there has been some optimism about and talk of firms 'positioning themselves for the recovery' the weak growth of Q4 of 2009 and the flat feel to early 2010 suggests that we have a long way to go and that policy measures to try to prevent further suffering are vitally important. A Chartered Institute of Personnel and Development (CIPD) report in January 2010 suggests that impact of the recession on unemployment is deeper than headline figures suggest. 1.3 million people have been made redundant in the recession, which is double the fall in employment and equivalent to 4.4% of people in work before the downturn. The report highlights the difficulty of getting full-time employment and says that two-thirds of people made redundant were paid 28% less when they managed to find another job. It says there were 6.2 million fresh claims for jobseeker's allowance between April 2008 and November 2009 – that is seven-and-a-half times the rise in the unemployment claim count during the recession. As the CIPD's economic advisor said:

> "Although the scale of job loss in the recession is much less than originally feared… it is evident that the direct experience of redundancy, repeat spells of unemployment and pay penalties has none the less been widespread. This is likely to have a much greater impact on perceptions of job security and consumer confidence during the recovery than the simple 'unemployment situation is better than feared' story of the moment would suggest."

The government's response was that thousands of people have found work very quickly through jobcentres, with 70% of people leaving unemployment benefit within six months. That is not the same as finding work and it also means that 30% have not stopped claiming benefits within six months. And an Institute of Public Policy Research report also in January 2010 has shown that not only, as is widely known, are 20% young people unemployed (nearly three times the adult rate) but that 48% of black people aged 18-24 are out of work. Black unemployment has risen 13% since March 2008 compared with 8% among white people and 6% among Asians.

To put a slightly more personal slant on these figures, as well as being an industrial missioner I am an associate priest in a parish that contains some of the most deprived parts of a city that might not be considered particularly needy (a county town in middle England), but it has areas within it that are within the top 10 and 20% (and in one case 5%) for unemployment in the country with other indicators of deprivation showing significant numbers. The bland term worklessness that covers those who have not been near a job for years hardly does justice to the effects on the lives of those affected, and whilst the reasons for this are many and complex I would simply observe that anything that causes increased unemployment generally makes the situation doubly hard for those farthest from the jobs 'market'. In our big cities, and regions with high levels of structural unemployment, the situation is substantially harder.

Longer Term

I have concentrated in this paper largely on the domestic effects of the recession but it is clear to me that Keynesian economics is about counter-cyclical measures, so that any loosening of economic policy during a downturn needs to be reversed when the upturn comes, precisely to prevent violent swings in the economy and to aim for equilibrium around full employment. I have not dealt with international issues such as the balance of trade, which have had a significant bearing on the predicament we are now in. Whilst there is much to be said about the danger of excessive debt in the UK, both personal and on the part of the government as well as the 'leverage' of financial institutions, the other side of the coin is that a case can be made, as Roger Bootle does, for surplus countries (i.e. those which have surpluses on their balance of trade and have large foreign exchange reserves, such as China and other SE Asian countries but also Germany) expanding their domestic investment and demand to rebalance world trade and the indebtedness of countries like the UK and US. There may well be reasons for their 'prudence' but the effect is to reduce overall wealth if the money is not being invested productively. This is true from the perspective of economic theory although there are questions about environmental sustainability and the extent to which investment and consumption can continue to grow, but this is a poor way of holding down the impact of economic growth on our planet.

I had hoped to say rather more about the views of Keynes and others about what our economy is for, beyond what is implied by the human value of aiming for full employment rather than equilibrium around financial measures. That, however, would be better covered by a more focussed separate paper.

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