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Inequality as policy:
The United States since 1979[*]

John Schmitt[**] [Center for Economic and Policy Research, USA]

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Introduction

Since the end of the 1970s, the United States has seen a dramatic increase in economic inequality. While the United States has long been among the most unequal of the world's rich economies, the economic and social upheaval that began in the 1970s was a striking departure from the movement toward greater equality that began in the Great Depression, continued through World War II, and was a central feature of the first 30 years of the postwar period.

Despite the magnitude of the rise in inequality, the political discourse in the United States refers only obliquely to these developments. The public debate generally acknowledges neither the scale of the increase in inequality nor, except in the most superficial way, the causes of this sudden and sustained turn of events.

This short essay seeks to provide an alternative view of the postwar period in the United States, particularly of the last three decades. My argument is that the high and rising inequality in the United States is the direct result of a set of policies designed first and foremost to increase inequality. These policies, in turn, have their roots in a significant shift in political power against workers and in favor of their employers, a shift that began in the 1970s and continues through today.

The first section of the paper briefly documents the size of the rise in U.S. inequality and puts this change into historical context. The second section sketches an explanation for rising inequality, one that differs from the deeply rooted, but poorly articulated vision that lurks just below the surface of polite political discourse in the United States. The final section focuses on an important part of inequality in the United States that does not receive the attention it deserves.

Rise of inequality

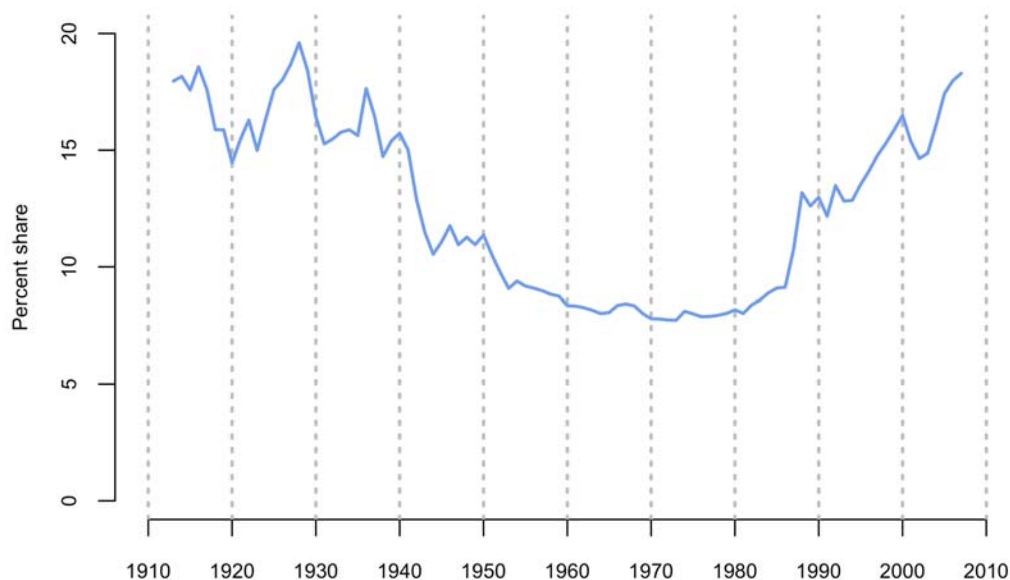
As economists Thomas Piketty and Emmanuel Saez have documented meticulously, for most of the 20th century, economic inequality in the United States was falling or flat.[1] (See **Figure 1**.) The last 30 years of increasing economic concentration are the exception, not the rule, of the last century of economic development in the United States.

From a peak just before the 1929 stock market crash through the early 1950s, wage and income inequality, broadly measured, were declining. From the early 1950s through the late 1970s, inequality was flat, or even falling slightly. Since the late 1970s, however, inequality has skyrocketed, climbing back to levels last seen in the 1920s. In 1979, for example, the top one percent of all U.S. taxpayers received about 8 percent of national

1 See Emmanuel Saez's homepage http://elsa.berkeley.edu/~saez/ and http://elsa.berkeley.edu/~saez/TabFig2007.xls for further details. For a comprehensive review of U.S. economic inequality, see Lawrence Mishel, Jared Bernstein, and Heidi Shierholz, *The State of Working America 2008-2009*, Ithaca, New York: Cornell University Press, 2008 and http://www.stateofworkingamerica.org/.

income; by 2007, the top one percent received over 18 percent. If we include income from capital gains in the calculation, the increase in inequality is even sharper, with the top one percent capturing 10 percent of all income in 1979, but over 23 percent in 2007.

FIGURE 1: Share of Total Income, Top 1% of U.S. Income Earners



Source: Piketty and Saez (2009).

The Piketty and Saez data are only the simplest (and among the most dramatic) ways to demonstrate the rise in economic inequality in the United States over the last thirty years. A full discussion of the many dimensions of increasing polarization across (and within) education levels, gender, race, and region are well documented in *The State of Working America*, produced every other year by the Economic Policy Institute.[2] The Piketty and Saez data, however, are sufficient to show an enormous increase in economic concentration that is unprecedented in modern U.S. history, roughly double in size and duration of the run-up in inequality in the 1920s.

Inequality as policy: Changing power relations

Early on, many conservative analysts in the United States went to great lengths to deny the increase in inequality, a particularly difficult task given that a host of survey and administrative data sets covering wages, compensation, incomes, and even net worth all showed sharp increases in inequality. From the late-1980s, however, the mainstream of the economics profession had turned its attention instead to explaining the rising inequality. The bulk of the profession fairly quickly settled on two likely suspects: “skills-biased technical change” and, to a lesser degree, “globalization.”

According to the first explanation, the diffusion of computers and related technology in the early 1980s steadily increased the demand for skilled workers relative to less-skilled workers, driving up the wages and incomes of more-educated workers and depressing the

2 Ibid. The wage data summarized in *The State of Working America* series, for example, show a sharp increase between 1979 and 2007 in the earnings of high-wage workers (those at the 90th percentile of the wage distribution) and low-wage workers (those at the 10th percentile).

wages and incomes of less-educated workers. From a political perspective, the skills-biased technical change view had several convenient features. At face value, it appeared to be broadly consistent with the data (even though economists on the left, such as David Howell and Lawrence Mishel, and more mainstream economists including David Card, John DiNardo, Alan Manning, and others have presented strong critiques[3]). At least as importantly, however, the technological explanation removed policy, politics, and power from the discussion of inequality, by attributing rising economic concentration to "technological progress," a force that could be resisted only at our peril. The skills-biased technical change explanation also put significant limits on the terms of policy debates: the problems of the three-fourths of the U.S. workforce without a university degree were either the result of the poor personal decision not to pursue enough education, or, at most, a sign that, as a society, we needed to invest more in education.

The second standard, though less favored, explanation for rising inequality was the elusive idea of "globalization." In the most common view, globalization is supposed to have lowered the earnings of less-educated workers by putting them in direct competition with low-wage workers around the world. This competition put pressure on wages through international trade in goods and services; through the relocation or threat of relocation of production facilities to overseas locations; through competition with immigrants in local labor markets; and through other channels.[4]

Globalization is the less favored explanation in the standard political discourse not because it does not offer what is at face value a coherent explanation of the rise in inequality, but because, by acknowledging the social costs of the increased integration of markets, the globalization explanation threatens to derail an important economic project of the elite. Economists and politicians in the United States spent much of the 1980s and 1990s arguing that the expansion of trade was the only path to national prosperity. In this context, blaming widening inequality on the same process of globalization that was supposed to be making us richer became quite awkward. (As an aside, I note that globalization has proved itself to be a flexible political tool in the U.S. and European debates. On the one hand, it seems, U.S. and European workers are told that their future prosperity depends on more globalization. On the other hand, they are also told that globalization means that our societies can no longer afford a generous welfare state.)

But the main problem with globalization as an explanation for rising inequality is that the typical ways in which the discussion is framed obscure the underlying process through which globalization actually acts on inequality. The standard framing presents globalization, like technological process, as an exogenous force, something that happens *to us*. In reality, globalization is a complex process of integrating capital, product, and labor markets, where almost every characteristic of those newly integrated markets is the subject of, or should be the subject of, political and regulatory debate. Contrary to the standard framing, which presents globalization as something that no nation can escape or even attempt to shape, we can choose the terms under which we integrate capital, product, and labor markets across

3 See, for example, Mishel, Bernstein, and Shierholz (2009); David Howell, "Theory-Driven Facts and the Growth in Earnings Inequality," *Review of Radical Political Economics*, vol. 31, no. 1 (October 1999), pp. 54-86; David Card and John DiNardo, "Skill Biased Technological Change and Rising Wage Inequality: Some Problems and Puzzles," National Bureau of Economic Research Working Paper No. 8779 (February 2002); Maarten Goos and Alan Manning, "Lousy and Lovely Jobs: The Rising Polarization of Work in Britain," *Review of Economics and Statistics*, vol. 89, no. 1 (February 2007), pp.118–133.

4 A complete discussion of the impact of globalization on economic inequality is beyond the scope of this essay. For an excellent overview, see Josh Bivens, *Everybody Wins, Except for Most of Us: What Economics Teaches About Globalization*, Washington, DC: Economic Policy Institute, 2008.

countries. Over the last 30 years we have indeed "chosen" a particular form of globalization in the United States – a form that benefits corporations and their owners at the expense of workers and their communities. If we had chosen globalization on different terms, however, economic integration would not have required rising inequality. Another globalization is possible.

In opposition to these two standard explanations for the recent rise in inequality, I want to offer an alternative view, one that explains inequality as a function of power, sustained by politics, and implemented as policy. In this alternative view, it is not technological progress nor the inevitable march of globalization, but rather the sharp shift in the strength of capital and employers relative to workers that explains the increasing concentration of wages, income, and wealth over the last three decades.

The decline in inequality from the end of the 1920s through the end of the 1970s – evident in the Piketty and Saez graph – was a function of a series of social movements over that same period that worked to reduce economic and social inequality. The 1930s saw the ascendancy of the U.S. labor movement, which went from a small force scattered across the national geography and industrial structure to an institution representing over one-third of U.S. private-sector workers by the mid-1950s. The civil rights movement of the 1950s and 1960s pressed for political, social, and economic equality for blacks. The women's movement of the 1960s and 1970s fought for social and economic equality for women. The labor movement, the civil rights movement, and the women's movement separately, but especially together, changed the way U.S. corporations did business. Wages and benefits rose for all workers, union and non-union. Employers were legally and socially prohibited from paying minority and women workers less than white men for the same work. Together with the environmental and consumer movements of the 1960s and 1970s, which sought to constrain U.S. businesses engaged in endangering the environment and consumers, these social movements had the effect of increasing incomes for those at the bottom and lowering incomes for those at the top (by raising the cost of doing business).

Throughout the entire period, employers resisted each of these movements (labor, civil rights, feminist, environmental, and consumer) but employers especially resisted the corresponding legislation that accompanied each of these efforts. The economic elite, while eventually comfortable with the social aims of all of these movements, almost uniformly opposed the accompanying legislation, including: making union organizing easier; guaranteeing workers' health and safety; prohibiting discrimination against racial minorities and women in labor markets and in other markets such as housing and credit; protecting the nation's air and water; and ensuring the safety of consumer products. From the 1930s through the 1970s, capital generally fought a losing battle, able to shape and contain the specific policies that grew out of the various social movements, but ultimately unable to prevent the enactment and enforcement of a host of policies that worked strongly against employers' immediate economic interests.

By the end of the 1970s, however, employer opposition coalesced and the economic disruption caused by two oil crises in the 1970s gave capital and employers a political opening. Even while Jimmy Carter, a Democrat, was in the White House, a subtle but important shift in U.S. politics occurred – a shift away from the core constituency of the Democratic party (labor, women, racial minorities, and environmentalists) – and toward

employer interests.[5] By the time Carter lost the presidency to Ronald Reagan in 1980, the corporate backlash against almost fifty years of social progress was in full swing.[6]

The backlash was sold as a response to the economic crisis of the 1970s and the emphasis was overwhelmingly on improving the efficiency of the U.S. economy, which was described (and is still described today by many on the right) as sclerotic, overly unionized, and overly regulated. Each of the major policy initiatives of the last three decades claimed to offer important efficiency advantages. The long decline in the inflation-adjusted value of the minimum wage was supposed to correct a distortion in the low-wage labor market. The deregulation (more accurately, re-regulation) of the airline, trucking, railway, financial, and telecommunications industries was supposed to lower consumer prices in those markets. The liberalization of foreign trade through a plethora of bilateral and multilateral trade agreements was similarly supposed to lower consumer prices on imported goods. The privatization of many federal, state, and local government functions – from school bus drivers to the administration of welfare policy and even much of the U.S. war in Iraq and Afghanistan – was supposed to lower the cost of government. The steady, policy-enabled, deterioration of unionization in the private sector – from over one-third of workers in the 1950s to about eight percent today – was supposed to improve the competitiveness of U.S. firms.

These policies, sold as ways to enhance national efficiency, however, also had another common thread. They all worked to lower the bargaining power of workers relative to their employers. In many cases, the alleged efficiency gains have not materialized.[7] In every case, however, the negative impact on workers has been obvious and substantial. The inflation-adjusted value of the minimum wage is now about 30 percent lower than it was at its peak in the 1960s. Workers in deregulated industries –airlines and trucking, most obviously – have seen their wages and benefits stagnate and fall. Even many mainstream economists acknowledge an important role for corporate-oriented international trade and commercial agreements in depressing the wages of less-educated workers, who have been forced to compete directly on world markets with workers often making only a small fraction of U.S. manufacturing wages. Privatization has been a windfall for the companies who win government contracts, while their main efficiency gains hinge on their ability to pay non-unionized, private-sector workers less than more unionized public-sector employees. The huge decline in unionization in the private sector has decimated the U.S. working class, which depends on the union wages and benefit premium to secure a middle-class standard of living.[8]

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5 Jimmy Carter was, in many respects, the first New Democrat president. His push for deregulation, his opposition to union-backed labor law reform, and his appointment of Paul Volcker to head the Federal Reserve Board foreshadowed the shifts within the Democratic Party that gave birth to the Democratic Leadership Council in 1985 and the Clinton presidency in 1992.

6 For historical accounts, see Samuel Bowles, David M. Gordon, and Thomas E. Weisskopf, *Beyond the Wasteland: A Democratic Alternative to Economic Decline*, New York: Doubleday, 1984 and Dean Baker, *The United States Since 1980*, Cambridge: Cambridge University Press, 2007. For a global perspective on these same issues, see Vicente Navarro, "The Worldwide Class Struggle," *Monthly Review*, vol. 58, no. 4 (September 2006), pp. 18-33.

7 The restructuring of the U.S. economy generally failed in its drive for efficiency and economic and productivity growth did not return to the earlier postwar pace. See, for example, Dean Baker and David Rosnick, "'Usable Productivity' Growth in the United States: An International Comparison, 1980-2005," Center for Economic and Policy Research Briefing Paper, June 2007. http://www.cepr.net/documents/publications/productivity_2007_06.pdf.

8 For an analysis of factors behind the falling rate of private-sector unionization in the United States, see John Schmitt and Ben Zipperer, "Dropping the Ax: Illegal Firings During Union Election Campaigns, 1951-2007," Center for Economic and Policy Research Briefing Paper, March 2009. http://www.cepr.net/documents/publications/dropping-the-ax-update-2009-03.pdf.

Taken together, these policies – a low and falling minimum wage; the de- or re-regulation of major industries; the corporate-directed liberalization of international capital, product, and labor markets; the privatization of many government services; the decline in unionization; and other closely related policies – are the proximate cause of the rise in inequality. Of course, the underlying cause is a shift at the end of the 1970s in the balance of economic and political power following almost five decades of ascendancy of labor and other social movements.

I am not simply arguing that the explosion of inequality was a side-effect of these policies. I am arguing, rather, that the explosion of inequality – what is, effectively, the upward redistribution of the large majority of the benefits of economic growth since the late 1970s – was the *purpose* of these policies. The purported efficiency gains, which were realized in some cases but not in others, were merely a political distraction.

Beyond wages and income

So far, I've focused on the rise of inequality and the explanations for it. The measures I've referred to are based almost exclusively on the distributions of wages, incomes, and wealth. But, these distributions, which are – correctly – the centerpiece of any analysis of inequality, also miss an important part of the problem facing U.S. workers, their families, and their communities.

Wages for large swaths of workers, particularly for non-college-educated workers who make up about three-fourths of the U.S. workforce, have trailed far behind growth in productivity over the last thirty years,[9] and, for many groups of workers, wages have actually stagnated or even fallen in inflation-adjusted terms.[10] While raising wages for workers at the middle and bottom is important, increasing wages will not be enough. Restoring real wage growth to the two or even three percent per-year rates experienced during the first thirty years of the postwar period would certainly help. But the main problems that U.S. workers face cannot be solved simply with faster real wage growth.

In my experience, European workers, even European economists familiar with the U.S. economic system, have trouble appreciating just how unprotected U.S. workers are; and it is not just workers in the low-wage labor market that are unprotected[11] – even relatively well-off U.S. professionals work in a legal and social environment that almost no worker in western Europe would have to tolerate.

One key issue is job security. In the United States, with rare exceptions, workers are what our legal code refers to as "at-will employees" – that is, employees work at the will of the employer, with no legal claim to their job or to severance pay in the case of layoff.[12] To be clear, in the overwhelming majority of cases, U.S. employers can fire a worker without reason or advanced notice and without any legal obligation to provide severance pay. The major

9 See Dean Baker, "Behind the Gap between Productivity and Wage Growth," Center for Economic and Policy Research Briefing Paper, February 2007. http://www.cepr.net/documents/publications/0702_productivity.pdf

10 For a detailed discussion of wage trends in the United States since the mid-1970s, see Mishel, Bernstein, and Shierholz (2009).

11 See, for example, the comparison of low-wage work in the Denmark, France, Germany, the Netherlands, the United Kingdom, and the United States, in Jerome Gautie and John Schmitt (eds.), *Low-Wage Work in the Wealthy World*, New York: Russell Sage Foundation, (2009, forthcoming).

12 The International Labor Organization has published an excellent overview of the relevant U.S. labor law here: http://www.ilo.int/public/english/dialogue/ifpdial/info/termination/countries/usa.htm.

exceptions to this arrangement are the 13 percent of the workforce that is unionized and a small share of high-end workers such as company officers who negotiate individual contracts with their employers. One remnant of the civil rights and women's movement is that employers cannot fire workers for reasons of race, ethnicity, gender, religion, or certain other characteristics; but an employer can fire a worker without notice for almost any other reason: for arriving late to work, for refusing to work overtime, for arguing with the boss about a schedule change, or essentially any reason, reasonable or not, that does not involve discrimination. The "employment at will" doctrine creates a profound structural imbalance of power between the overwhelmingly non-unionized workforce and their employers, and is a central cause of the problems facing the low-wage workers featured in Roger Weisberg's superb documentary film "Waging a Living."

When workers do lose their jobs, the social safety net has many holes. Historically, only about 40 percent of unemployed workers receive unemployment insurance benefits and these are stingy by international standards.[13]

The large majority of U.S. workers also depend on their job (or their spouse's job) for health insurance. With the typical employer-provided health insurance plan costing about $5,000 per year for individual coverage and about $13,000 per year for family coverage,[14] higher wages alone will not go far in providing quality health insurance, particularly for lower- and middle-income workers.

U.S. workers also suffer from a severe time squeeze, which is exacerbated by the lack of any legally required paid time off. U.S. law, for example, does not mandate any form of paid time off for any purpose. As a result, almost one-fourth of U.S. workers have no paid vacation or paid holidays, and the average U.S. worker has only nine days of paid vacation and six days of paid public holidays per year, with many having less than the average.[15] Nor does U.S. law require employers to provide paid parental leave.[16] In fact, the U.S. law that requires employers to provide 12 weeks of *unpaid* parental leave has exemptions for employer-size and job tenure that effectively remove a large share of the U.S. workforce from coverage.[17] U.S. workers are not even legally entitled to paid (or unpaid) sick days.[18] As a result, over 40 percent of U.S. private-sector workers have no paid sick days, and, given the "employment at will" doctrine, are at risk of losing their jobs if they miss work when they are sick. Higher wages alone would do little to give workers the time they seek to handle their many non-work responsibilities.

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13 Before the current recession, the share of unemployed workers who received unemployment insurance benefits in the 2000s varied between 35 and 45 percent (Robert Greenstein and Chad Stone, "Addressing Longstanding Gaps in Unemployment Insurance Coverage," Center for Budget and Policy Priorities, August 2007. http://www.cbpp.org/cms/index.cfm?fa=view&id=517

14 Kaiser Family Foundation and Health Research & Educational Trust, 2009 Employer Health Benefits Survey, p. 14. http://ehbs.kff.org/pdf/2009/7936.pdf

15 See Rebecca Ray and John Schmitt, "No-Vacation Nation," Center for Economic and Policy Research Briefing Paper, May 2007. http://www.cepr.net/documents/publications/2007-05-no-vacation-nation.pdf.

16 See Rebecca Ray, Janet Gornick, and John Schmitt, "Parental Leave Policies in 21 Countries Assessing Generosity and Gender Equality," Center for Economic and Policy Research Briefing Paper, June 2009 (revised). http://www.cepr.net/documents/publications/parental_2008_09.pdf

17 See Heather Boushey and John Schmitt, "Job Tenure and Firm Size Provisions Exclude Many Young Parents from Family and Medical Leave," Center for Economic and Policy Research Issue Brief, June 2007. http://www.cepr.net/documents/publications/firmsize_2008_02.pdf

18 See Jody Heymann, Hye Jin Rho, John Schmitt, and Alison Earle, "Contagion Nation: A Comparison of Paid Sick Day Policies in 22 Countries," Center for Economic and Policy Research Briefing Paper, May 2009. http://www.cepr.net/documents/publications/paid-sick-days-2009-05.pdf

All of these non-wage issues – the lack of legal job protections, the lack of a safety net for most of the unemployed, the strong dependence of workers on their employers for health insurance, the lack of paid time off, and others – are major challenges for workers at almost all levels of wage distribution. But these problems are particularly acute for low-wage workers, who are not just the worst paid, but also the least likely to have union-representation, the least likely to have employer-provided health insurance (or insurance of any kind), and the least likely to have any form of paid time off.[19]

Conclusion

In the standard neoclassical economics framework, low wages are simply a symptom of low levels of skill. Wage levels, however, are also a function of unionization rates; the level of the minimum wage; the entire regulatory framework governing the terms and conditions of employment, from job security legislation to paid time off; the size and scope of the public sector; the degree of competition in national and international product markets; and other fundamentally political issues, all of which have little or nothing to do with workers' skills.

The sharp and sustained increase in economic inequality in the United States over the last 30 years is not a reflection of a national preference for inequality (discussed more blandly as "flexibility"), and not the continuation of an inexorable increase in inequality from 1776 to the present. The last 30 years, in fact, mark a significant departure from a five-decade trend toward greater economic and social equality. What changed was not the demand for skilled workers, but the balance of power between workers and their employers.

* This is a revised version of a lecture presented at the University of Coimbra (Portugal) on September 28, 2009.
** The author would like to thank Julio Marques Mota, Adelaide Duarte, Adelino Fortunato, Vicente Navarro, and participants in a conference at the Economics Faculty of the University of Coimbra in Portugal for many helpful comments and Travis McArthur for assistance with the data.

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19 See John Schmitt, Margy Waller, Shawn Fremstad, and Ben Zipperer "Unions and Upward Mobility for Low-wage Workers," WorkingUSA: The Journal of Labor and Society, vol. 11 (2008), no. 3 (September), pp. 337-348. http://www3.interscience.wiley.com/journal/121398549/abstract?CRETRY=1&SRETRY=0

Global commons and common sense

Jorge Buzaglo* [Sweden]

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1. Introduction

Globalisation is the result of economic growth and technical progress. Production systems have attained global reach. However, the rules and institutions that regulate the systems' relations of production and exchange are still mostly national. Furthermore, national regulation systems have been drastically eroded in the past three decades of deregulation, liberalisation and privatisation. The present global economic crisis is clearly the result of this inconsistency or contradiction.

We could say with Marx in the famous Preface to the *Contribution* that the global 'material productive forces of society [have] come into conflict with the existing relations of production […] From forms of development of the productive forces these relations turn into their fetters.'

For Marx this should mark the 'beginning of an era of social revolution. The changes in the economic foundation lead sooner or later to the transformation of the whole immense superstructure.' Be that as it may, many — including many members of the economic and political establishment — seem to agree on the necessity of new, global rules and institutions for the management of the largely unregulated global economic and financial system.

To forge global rules and institutions does not seem to be an easy thing. The idea here is in a way to follow the path of least resistance. An area in which there is already global consensus about the urgent need of global regulation is climate change.

A new domain in which awareness seems to be forming about the need of global regulation is global finance and international liquidity. Liquidity is about trust and confidence. There is liquidity when there is confidence that promises of payment will be honoured. International liquidity may be seen as a global commons of financial trust and confidence.

The reach of the productive force of technology is paralleled by the reach of its destructive power. The real possibility of MAD (mutual assured destruction) gives testimony to that. The maintenance of global peace and security is also an area in which the logic of the commons can suggest possible ways of progress.

As in the case of MAD, competition for common limited resources has sometimes been described as a game of 'Chicken,' in which two drivers head against each other from opposite directions — the first to swerve is the loser. In the race for world resources, those who most voraciously exploit and deplete them are the momentary winners of the suicidal game. To avoid mutual destruction, the logic of conflict suggests the formation of a 'social norm' to be collectively followed. An ancient social norm, found in most ethical traditions, is the rule of reciprocity, which applied to the utilisation of a common exhaustible resource gives the norm of equal rights for all. Standard utilitarianism also would conclude that aggregate utility is maximised by equal distribution.

The world's oceans and seas cover about 70 percent of the earth's surface; 20 percent of this area is claimed under national jurisdiction. The ocean fisheries are typical commons, which tend to be overexploited and depleted in the absence of regulation. Fish stocks have collapsed in nearly one-third of all ocean fisheries. Global regulation of the resources of the sea is as needed as the global regulation of carbon dioxide emissions, or the global management of international liquidity.

A closely related realm is the realm of what economists used to call Land. That is, a privately owned natural resource, producing a differential rent, the income of a particular class of factor owners. There are old and venerable redistributive institutions like the biblical Jubilee (by which plots were periodically permuted) based on the idea that the land belongs to YHWH, and that humans are only tenants. There are also strong ethical arguments (Spinoza) for the common property of land, to be rented to producers — or alternatively for taxation of land rent. There is general acceptance of the idea, reflected in most tax codes, that land rent and other 'non-earned incomes' due to fortuitous factors such as location are not fully legitimate and should (at least partially) be taxed away.

The argument applies to other natural resources such as mineral and oil deposits, which also give rise to differential rents. The fact that in most countries oil is a collectively owned resource and underground resources in general are prima facie considered as belonging to the commonwealth, suggests that mineral resources are naturally seen as the common property of the commonwealth. What is *not* reflected in most natural resource legislations is the legal consequence of collective ownership, namely the equal allocation of dividends, a question that is central to the global redistributive mechanisms discussed here.

However, the question still hovers around who belongs to the commonwealth. Who composes the commonwealth? Wich commonwealth is relevant? Which commonwealth is the legitimate owner of the natural resources? These questions will acquire increasing relevance with rising expected rents accruing from rapidly increasing scarcity, and the resulting wars for the control of resources. Many wars, and perhaps most current and planned wars, are about the control of resources — oil in particular. The unfortunate fact is that there is no factually legitimate form of exclusive/exclusionary ownership. All forms of privately or nationally restricted forms of property are contestable, and in fact often contested. The only stable, uncontestable form of resource ownership is collective ownership by the global society, according to clear and effective rules of use, acceptable to all. And again, the often avoided question of the equal distribution of dividends must be considered simultaneously.

So we have here introduced three critically important areas of common resources that are in great need of being globally regulated: greenhouse gas emissions, international liquidity, and natural resources. It is admittedly a great pretension on my part, as an individual

citizen of the world, not representing any state or any other organisation, to try to candidly analyse and formulate possible solutions for these enormous questions. However, I do it in the conviction that it is precisely what is needed: a candid, open, unconditioned approach, with all humanity in mind. A plain, common sense look may show that the emperor is in fact naked. Such a look may also serve to suggest the kind of clothes that could fit her/him rather well.

2. Global warming: the atmosphere is a commons[20]

The sun shall be darkened, | earth sinks in the sea,
Glide from the heaven | the glittering stars;
Smoke-reek rages | and reddening fire:
The high heat licks | against heaven itself.
The Edda (LI. Frá Ragnarökum)

As diverse factors as Hurricane Katrina, the IPCC (2007) report, Al Gore's film (*An Inconvenient Truth*), and the Stern (2007) review, have dramatically increased world awareness about the dangers of global warming. Different approaches to possible solutions are beginning to surface in the public debate. In Scandinavia, for instance, the ecologists' radical vision of a simpler life close to Nature and away from the Market confronts the dream of a high growth, innovative capitalism, where the magic of technology solves all problems. These are often imaginative visions, but what is still lacking in all of them is a clear and explicit acknowledgment of the strictly global character of the climate change problem. What is lacking in the debate is the overt acceptance of the fact that in the global warming problem 'we are all in the same boat,' that is, all of the globe's population. Global problems need global solutions. A solution to global warming poses from the start the problem of the extremely biased world income and wealth distribution. A realistic solution should necessarily incorporate global redistributive mechanisms, including market mechanisms.

The lack of common sense analyses of the global warming problem is perhaps due to the difficulty of adopting a universalistic, humanity-wide perspective. Most analyses, even the most reputable, such as Stern (2007) and IPCC (2007) lack such a perspective. They are thought from the perspective of a national state (as in the case of Stern) or from an international perspective, reflecting the balance of power and influence between states. The cosmopolitan perspective — rare today — should serve as a benchmark or horizon to which all other solution proposals should be compared.

The cosmopolitan perspective is very easy to formulate, but until now very difficult to implement, in a world where inequalities are huge and steadily growing. The cosmopolitan perspective is the point of departure of the extant 'universal constitutional rights,' established in 1948 by the United Nations Declaration of Human Rights. It states in its Preamble that 'recognition of the inherent dignity and of the equal and inalienable rights of all members of the human family is the foundation of freedom, justice and peace in the world.' The profound and clear insight of the Declaration is: without equality in rights and dignity among all human beings, there is no freedom, peace nor justice in the world.

The root of this idea is very old, and belongs to the basic ethical insight of most cultures. In the western cultural realm the insight is usually formulated as: 'Do unto others as

[20] This section and the following two are largely based on Buzaglo (2007).

you would have them do unto you.' An equivalent, less demanding formulation is: 'Do not do unto others as you would not have them do unto you.'

Kant's *categorical imperative* may also be traced to the same basic ethical insight. Kant's moral imperative is to act only according to that maxim whereby you can at the same time will that it should become a universal law. Practical reason understands that if what I do unto others should become the general rule, then it should have them do unto me. Therefore, I should not do unto others as I would not have them do unto me.

Before Kant, Baruch de Spinoza derived this same ethical principle using the 'geometrical method,' i.e. by logical deduction from precise definitions and self-evident axioms. Rational human beings, who endeavour to preserve their own being, and who seek that which is useful in accordance with reason, desire for themselves nothing, says Spinoza, which they do not also desire for the rest of mankind (*The Ethics* IV, Prop.18, Note).

Applied to the management of common resources such as the atmosphere the above ethical principles give a clear orientation. With Kant's or Spinoza's logic, if everybody were allowed to emit greenhouse gases as much as I can, I should not emit more than the globally sustainable average. That is the only sustainable way in which my individual action can be universal law and adopted by the rest of humankind. Or in Spinoza's terms, as a rational human being, I do not desire to pollute the atmosphere at a level that would be unsustainable if also achieved by the rest of humankind. When it comes to the election of rules and systems for the allocation of rights, the only effective *rational choice* for every individual on the planet is the norm of equal emission rights for all.

This ethic of reciprocity and cooperation is most probably the result of millennia of observation and experience of human conflict. Game theory arrives at similar conclusions in the analyses of games that are repeated an unlimited number of times, and where the participants can be thought to learn through experience. In infinitely iterated games, history, learning, context and negotiation can bring solutions that are more desirable than mutual or collective destruction.

The conflict about the contamination of the atmosphere, a shared resource, can be compared to the so-called Hawk-Dove game. In the Hawk-Dove game analysed by biologists, species competing for a common resource can chose between cooperation and conflict. A formally identical game is the Chicken game, which models the situation where two drivers drive towards each other on a collision course: one must swerve, or both may die in the crash. The game has also been used to describe MAD, the mutual assured destruction of nuclear warfare.

The results of game theoretic analyses, and in particular, the results of repeated Chicken game analysis, based as they are in extremely simplified and abstract situations (such as explicit, clearly specified and fixed rules of the game, two players, quantifiable 'payoffs,' etc.) are very far away from reality. The conclusions are however close to common sense and experience: it is found that the optimal method of playing the repeated game is to cooperate and play a socially optimum strategy according to a 'social norm.' However, in an iterated game of Chicken, a stable compromise can only be achieved through 'brinkmanship,' that is, pushing the situation to the brink by forcing the opposition to back down and make concessions. In the case of greenhouse gas emissions, this would mean for low polluters

(largely the poor countries) to convincingly show that they are prepared to push their emissions to the level of heavy polluters (largely the rich countries).

3. A solution to global warming when mutual destruction is barred

The essence of the challenge of a cooperative solution to the problem of a shared resource can be grasped through the simplified situation of an imaginary island economy. Thriving inhabitants and successful consumers are expanding the island garbage dump at a high and increasing rate. The poisonous substances in the garbage seep into the ground and infect the groundwater. Careful study of the situation by experts concludes that the explosive growth of the garbage dump must stop. The amount of waste produced cannot continue to grow. The question for the islanders is how to achieve that. One islander proposes a straightforward solution: nobody can increase his/her present amount of waste. (It happens to be a rich islander who produces a high amount of garbage.) Another islander, a small waste producer, thinks that the allowed amount of waste anyone can leave must be equal for all. Shall big polluters be rewarded with prolongation of their privilege? No Sir, all islanders have the same rights, she says. After long discussions, there is a vote. The supporters of equal waste quotas win the referendum with wide margin — high waste islanders are a small minority. From now on, all islanders have the right to dump the same share of the permissible/sustainable amount of garbage.

Economists know that market exchange can improve the solution for all those whose garbage output is different from the established quota. The equally allotted waste rights might be exchanged in a (real or virtual) market created to that effect. Those who do not use all their allotted rights can sell their surplus to those who want to dump more waste that the allotted quantity, and are able to pay for it. The system has a bonus: it reduces income inequalities.

According to climate scientists (IPCC 2007) our cosmic island is in a similar condition — yet much worse. Global greenhouse gas emissions must at least be *halved* by 2050. What can be done? Shall every country reduce their emissions by 50 percent, as in the rich islander's proposal ('grandfathering')? Shall the U.S. halve its carbon dioxide emissions from present 20 metric tons per capita to 10 tons by 2050, while Vietnam halves its only ton (latest data from the World Bank's website, for 2005)?

This does not look like a convincing solution for the 84 percent of the world's population not living in high income countries. They produce only 3 tons per capita on average — less than a fourth of what is produced by the inhabitants of the rich world. If the world had a democratically elected parliament, or should a world referendum take place, the poor islander's principle of equal rights would likely win by a large margin.

Equal, fixed emission quotas for all would imply that all rich countries must at once limit their greenhouse gas emissions to the world average of 5 tons per inhabitant, and then gradually reduce them to 2.5 tons year 2050 (if we assume for simplicity a constant population). For low polluters such as Sweden or Switzerland, which emit 6 tons per inhabitant, this does not look like an impossible undertaking or a catastrophic welfare loss. But it would certainly be for most other rich countries.

With tradable emission rights, rich countries would of course not need to drastically reduce their emissions to 5 tons per inhabitant. They would buy emission rights from low-

polluting countries such as Vietnam or Guinea. They could so reduce their emissions cost-efficiently, only to the level at which the unit cost of emission-reducing measures remains lower than the market price of a unit emission permit. Poor, low-polluting countries, on the other hand, would gain large incomes from their sales of emission permits. Böhringer and Welsch (2006) simulated the effects of different ways of sharing the costs of lowering global greenhouse gas emissions. An equal allocation of emission permits in proportion to population would give Sub-Saharan Africa and India the greatest gains. Smaller benefits would accrue to the Middle East and North Africa, and even smaller yet to Latin America. China would be more or less unaffected by the scheme. The costs are mainly disbursed by the rich countries and Eastern Europe/ex-Soviet Union.

4. Reclaiming the commons: The atmosphere

Achieving this type of market-based solution to climate change would involve of course grand institutional innovations. The point of departure of Peter Barnes' (2006) institutional analysis is the 'tragedy of the commons.' Resources without clearly defined rules of utilisation or ownership tend to be overexploited and eventually exhausted. If, for instance, the atmosphere were owned by a Waste Management Inc., it would charge dumpers a fee and limit emissions.

However, even for neoliberals, a privately owned atmosphere is unthinkable. Barnes suggests instead endowing the management of the atmosphere to a trust. If instead of Waste Management Inc., a trust owned the sky there would be a bonus: every citizen would get a yearly dividend check. This is not just a dream: since the 1980s in the US such an institution, the Alaska Permanent Fund, manages that state's oil resources and distributes dividends among its inhabitants.

The solution is thus to develop strong institutions that have ownership rights over common resources. This is an important insight, but ignores the fact that global warming is a global problem. The atmosphere is a global good, and the tragedy is being played out on the world stage. A system whose rules are followed by just a few and whose legitimacy is not recognised by all is not an effective system. Think if the world's three billion poor find it legitimate for them to achieve the same greenhouse gas emission levels as the rich...

The Kyoto Protocol was a first attempt at constructing a governance structure for the atmosphere. It must be recalled though, that the Kyoto protocol is not global. It covers at present not more than 30 percent of global emissions and a much smaller share of the global population — neither the US nor the developing countries participate. Similarly, the effective part of the EU's emission rights system represents only 8 percent of global emissions (Nordhaus 2006).

Management of global resources requires global instruments. Even if ineffectual when partially implemented at the local or national level, Barnes' idea of a climate trust fund might be a powerful initiative at the global level. What could indeed be effective is an atmosphera.org, a global trust fund with the mandate of managing the atmosphere on behalf of future generations and of investing its revenues in social programs and environmental projects worldwide, according to the equal rights principle.

This type of scheme would attract the developing countries, and also answer two objections commonly raised by the rich countries. First, it is suggested that a large share of the incomes accruing to poor countries could end in the pockets of corrupt officials and politicians. Second, it could also be possible that these incomes, even in the absence of corruption, might not benefit the poor — in many countries, public expenditures only increase the bias of an already unequal income distribution. A global, independent trust with clear mandate, power and accountability should see to it that the scheme is free from corruption and that its revenues benefit the 'carbon-poor.'

If mandated by nation states, such an institution could even bypass local governments, and operate a somewhat futuristic direct global monitoring and redistribution scheme. With present-day computing and storage capabilities, (almost) every citizen on earth could have a 'CO2 credit card' — e.g. coupled to a bank credit card — on which the CO2 (equivalent) content of consumption is drawn. Periodically, the card would be credited with the amount corresponding to CO2 consumption below the overall emission right, and debited for consumption in excess of the general quota. A system of virtual or real *tâtonnement* would regulate the price of the emission right so as to equate supplies of CO2 under-consumers with demands of over-consumers.

A universal system of individually allocated carbon quotas is clearly superior in that the 'commons' nature of the problem underlying it is explicitly incorporated in the mechanism — an important trait in itself. But of course, also in the case of nationally allocated emission rights or a global CO2 tax, the equality principle should be incorporated into the dividend rules.

5. Reclaiming the financial commons

> *Nothing is quite so effective in concentrating the political mind as a financial crisis—fear of systemic collapse can help drive significant reforms when a crisis strikes. If the current semi-system fails to muddle through, in particular if the US economy is significantly damaged, then steps such as explicit creation of a World Financial Authority […] could well become politically feasible and even desirable. Lance Taylor (2002: 76)*

Present-day financial markets are as global as the atmosphere. Financial flows move around the world even more fluidly than greenhouse gases. Average daily global foreign exchange market turnover in 2007 was 3.2 trillion dollars, 'an unprecedented growth of 69% since 2004' (BIS 2007:1). *Daily* financial flows represented then 6% of the world's *annual* GDP — 30 times the (average daily) global international merchandise trade.

Liquidity is basically about trust. It reflects trust that a promise of payment will be honoured. Until the collapse of the Breton Woods' fixed exchange rate regime in the 1970s national states and their central banks were the main providers and endorsers of trust. With the general adoption of different forms of flexible exchange regimes and the deregulation and liberalisation of international financial flows in most countries, the creation of trust and liquidity became increasingly privatised and internationalised (*extraterritorialised*, we should more accurately say). The evolution was from nationally based, largely closed and closely regulated financial systems towards a largely extraterritorial, unregulated financial system.

The instability of the unregulated global financial system has been shown by successive crises, starting in the 1980s with the debt crisis in the periphery of the system, followed by other crises in increasingly important financial centres, until the present and most severe one, at the very core of the global financial system.

It does not seem possible that the unregulated global financial system could be re-started without significant changes — as it seems to have been the approach until now. The global financial system has proven to be highly unstable and in need of regulation, and its regulation must be exercised at the global level. The alternative to global regulation is regulation at lower, national and/or regional levels. However, regulation at lower levels would occur at much lower levels of output and international trade — a re-regulation *à la* 1930s. As argued by the UN Commission of Experts headed by Joseph Stiglitz: 'The weaker is the system of global regulation, the more segmented will financial markets have to be to ensure global stability' (UN 2009: 16).

Eatwell and Taylor (2000) were prescient to think that it would be wise to revise the global financial system before markets crash, but that if they should, the political equation would certainly change. Since then, the faith in the efficiency and stability of unregulated financial markets has been seriously shaken, but the horn has not yet sounded for their proposal of a World Financial Authority. The Global plan for recovery and reform adopted by the recent G20 London Summit, for instance, does not even mention that possibility (see G20 2009).

The World Financial Authority proposed by Eatwell and Taylor (2000) should provide the necessary regulatory framework within which the IMF could evolve as an effective lender of last resort, managing the system so as to avoid a swing back to widespread protectionism. However, one might ask if the IMF and the World Bank, with their undemocratic and conservative structures and policies, should continue to exist after the constitution of a World Financial Authority.

The UN Commission of Experts headed by Joseph Stiglitz recently made a similar proposal; to lay the groundwork for a Global Financial Regulatory Authority as the main instrument for the formulation of reforms of the global financial system (UN 2009: 15). According to the Commission, global financial supervision should ensure the safety of financial products — financial regulators should be mandated to ascertain the safety and appropriate use of financial instruments and practices. Global regulation should also be comprehensive — all types of financial institutions (including credit rating agencies) and instruments (including derivatives) should be supervised and regulated.

In my view, a World Financial Authority should have the clear evolutionary objective of becoming a World Central Bank. The function of a future World Central Bank should be to create and distribute liquidity to ensure global equity, stability and growth. In the same way as global regulation should limit CO2 emissions and other contaminants, regulation of global financial commons should limit 'toxic asset' creation, fraud and illicit financial flows (such as flows related to drug and arms trafficking, tax evasion, and illegal capital flight). Regulation of financial commons should generate global trust and liquidity in an equitable, stable and efficient manner.[21]

[21] In fact, one could futuristically imagine that such a global financial commons, an open credit and payments system, might start and develop spontaneously from the Internet. Creative capacities such as those that developed Linux (the open code, free access computer operating system) and Wikipedia (the open Internet encyclopaedia) could converge

There are several extant instruments and ideas that the World Financial Authority could immediately start with. The first is the expansion of the IMF 's Special Drawing Rights (SDR) composed of all currencies participating in the system, as suggested since the 1960s by many developing countries and several international documents, and most recently by China's central bank director. The Commission of Experts headed by Joseph Stiglitz proposes a New Global Reserve System, 'what may be viewed as a greatly expanded SDR' (UN 2009: 11).

Abundant SDR reserves in all countries would facilitate the introduction of global emission rights markets as discussed above, as they would remove the external payments' restriction for countries confronting simultaneously payments deficits and excess-demands of emission rights. Greatly expanded SDR, along with the significantly increased purchasing power in the hands of the billions of global 'CO2 poor,' would have a strong expansionary and anti-depressive effect on world demand. In fact, one can argue that the main reason of the present crisis is long run compression of world demand through stagnant real wages, declining wage shares, and increased income inequality, all caused by the neoliberal approach to globalisation (see e.g. Cornia 2004). Groups within the international labour movement propose, for instance, the creation of new SDR at 2% of global GDP, or $1 trillion, of which a half would be allocated to 'green investments' protecting the world's climate (GLS 2009: 31). The G20 London Summit agreed to support a very restricted SDR allocation of $250 billion, about 0.5% of global GDP.

Second, a greatly expanded SDR system under World Financial Authority management should help to definitively cancel the onerous debts of developing countries, once their legitimacy has been checked and their 'non-odious' character has been proven by the Authority. This should be the initial task of a permanent Sovereign Debt Restructuring Mechanism — a body proposed by UN (2009: 16).

Third, in the transition towards a global common currency — the natural evolutionary heir of a successful SDR system — the World Financial Authority should introduce the 'Tobin tax' on foreign currency transactions, as a main policy instrument for reducing volatility and instability in financial markets, increasing economic policy sovereignty, and removing the recessive bias introduced by unregulated financial flows. The 'financial commons' perspective of a World Financial Authority would imply that Tobin tax revenues, as emmission rights and/or carbon tax revenues, should be distributed according to the equal rights principle. James Tobin (1996: xvii), suggested that the tax rate 'should not exceed 0.25% and perhaps should be as low as 0.1%.' He estimated that at the 0.1% rate the revenue yield would be (in 1995) $94 billion. Since then and until 2007, the volume of foreign exchange transactions worldwide has increased by a factor of 2.5 (BIS 2007), so that today the revenue yield at a 0.1% rate should be somewhere between $200-250 billion a year. This sum can be compared to the estimated costs of achieving the UN's Millennium Development Goals (*inter alia* halving extreme poverty by 2015), that would imply an annual additional funding of $50 billion (Atkinson 2004). The figure also can be compared to the proposed (one time) SDR allocation of $250 billion by the G20 London Summit. So, even at the low rate of 0.1%, there would be enough revenue to go beyond the very modest Millennium Development Goals, and to share incomes with national governments, as an incentive for generalised adoption and a way to 'sweeten the pill' (Tobin 1996: xvii). There seems to exist increasing support in the US —

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to create a system of payments and credit that is transparent and effectively global. One can only hope that such a wide movement of spontaneous creativity will dare to defy Mammon himself.

until now a consistent 'Hawk' player in the multilateral Chicken game — for a financial transactions tax, which should also include foreign exchange transactions (see Baker 2008; Weaver, Dodd and Baker 2003; Pollin, Baker and Schaberg 2002). Both the UN (2009: 17) and the Global Unions (GU 2009: 8) support the adoption of the Tobin tax.

'Sand in the wheels' of international financial markets in the form of the Tobin tax should not substitute for the possibility of introducing different types of controls when capital flows and speculative attacks seem to drive the system or particular economies out of control. Also, and most importantly, unsustainable payment deficits and foreign debt accumulation should be avoided, and a non-recessive system of adjustment should be introduced, symmetrically treating surplus and deficit nations. Keynes proposed already in 1943 the creation of an International Clearing Union with these functions.

Fourth, the Financial Authority should promote new rules for liquidity creation by all central banks. Equal rights to the commons of global trust and liquidity imply that in addition to international allocation of SDR, Tobin tax and other financial resources according to *per capita* shares, credit expansion at national levels should also follow an even pattern. Also within countries should liquidity and credit creation follow a *per capita* basis. A source of inspiration might be David Schweickart's economic democracy model (Schweickart 2009; see also 2002), which allocates financial resources to a network of regional and local banks, each region getting its *per capita* share (adjustable by US Congress). Schweickart's ideas are thought for application in the US, but short of a total breakdown of the multilateral financial system and a return to strictly limited capital movements, it seems that the real future of the financial commons idea is at the global level, managed by a democratically instituted and controlled body such as the World Financial Authority. As Barnes' ideas on US emission rights, Schweickart's are plausible and viable only at the global level.

This substantial reorientation on the financial dimension of the global economy should be accompanied by a profound 'structural adjustment' at the root of the real-economy cause of the crisis. The deep structural cause of the crisis is a lack of global demand (due to compressed wages and increased inequality) coexistent with a greatly augmented productivity. A long period of restrictive (neoliberal) economic policies and regressive income redistribution in most countries should be followed by an expansive phase of progressive redistribution and expansive economic policies at the global scale.

6. Planning for global structural adjustment

> *By our reckoning (which is put forward with great diffidence), if the United States were to attempt to restore full employment by fiscal and monetary means alone, the balance of payments deficit would rise over the next, say, three to four years, to 6 percent of GDP or more—that is, to a level that could not possibly be sustained for a long period, let alone indefinitely. Yet, for trade to begin expanding sufficiently would require exports to grow faster than we are at present expecting, implying that in three to four years the level of exports would be 25 percent higher than it would have been with no adjustments. It is inconceivable that such a large rebalancing could occur without a drastic change in the institutions responsible for running the world economy—a change that would involve placing far less than total reliance on market forces. Goodley, Papadimitriou and Zezza (2008:5)*

The current undermining of trust in unregulated global financial markets is a process happening in the emotional depths of the collective economic psyche, where ‘market sentiments’ and ‘animal spirits’ dwell. On the ‘real’ side of the process are the huge, growing structural distortions and imbalances of the world economy. Major structural distortions of the world economy are the permanent US foreign trade (and savings) deficits, resulting in unsustainable levels of foreign (and internal) debt. A deregulated US economy developed eventually unsustainable imbalances, seemingly insurmountable by unregulated markets — insurmountable at least at present levels of output and trade. To paraphrase ‘getting prices right,’ the IMF mantra of the 1980s and 1990s, ‘getting structures right’ seems to be an indispensable task that the markets alone will not perform.

To quote again Goodley, Papadimitriou and Zezza (2008:5): ‘It is inconceivable that such a large rebalancing could occur without a drastic change in the institutions responsible for running the world economy—a change that would involve placing far less than total reliance on market forces.’ The alternative to ordered, internationally negotiated rebalancing, is of course laissez faire rebalancing. It would very much look like a global-scale IMF structural adjustment program of the kind applied to countries in payments’ crises. That is, equilibrium would be re-established at lower levels of income and trade — probably a global long term stagnation or depression.

The rebalancing that we are envisaging here is a large expansion of the global financial commons. The badly needed demand expansion is mainly to be provided by the lower 3-4 quintiles of the global income distribution — those whose incomes have stagnated in the last decades — in particular the global poor, the lower half living on less than $2 a day. A big global demand push should compensate for the US economy’s change from a huge net importer to a (perhaps modest) net exporter, able to service its gigantic gross external debt of over $12 trillion — equivalent to 86% of GDP, or one fourth of total US capital stock (CIA data; capital stock estimated by adopting a standard capital/output ratio of 3). Should the US pass, for example, from a present deficit of 6% of GDP to a surplus of 1%, world demand would contract by about $1 trillion annually, nearly 2% of world output. Global structural adjustment may even include the re-industrialisation of the US, and transforming it in a ‘post-financial,’ high-tech, ‘green’ economy, which exports industrial and investment goods to industrialising lower income countries, which in turn would temporarily expand their commodity exports. The deep origin of the ‘junk’ and ‘toxic asset’ financial crisis is the US economy’s need of annually generating over half a trillion dollar debt to be sold to foreign creditors in order to pay for the current account deficit, when genuinely productive assets such as industries and natural resources are not on sale (cf. the sovereign wealth fund debate in the US).

The necessary changes for ‘getting structures right’ must be analysed and formulated by a global, effective, real-economy body of governance. The UN proposes a Global Economic Coordination Council at the level of heads of state, ‘a globally representative forum to address areas of concern in the functioning of the global economic system in a comprehensive way’ (UN 2009: 12). The London Declaration of the international labour movement proposes a ‘grand global deal,’ a new global institutional architecture, including an effective and accountable structure of Global Economic Governance, ‘a new decision-making forum on economic and social policies at a global level which combines effectiveness, legitimacy and accountability’ (GU 2009: 12).

Both UN and GU proposals are however not very bold, and do not refer specifically to the sorts of structural distortions and inequities that must be addressed. What is needed is no less than a global Keynesian investment planning authority, with the mandate of 'organising investment on long views and on the basis of the general social advantage, taking into account the efficiency of investments' (Keynes 1936: 164). Keynes's lucid formulation needs only to be specified in the sense that by 'general social advantage' we should mean today the advantage of the whole world society and its natural environment. World demand should be managed so as to maintain high levels of output and employment, at the same time that the huge existent disparities in incomes are addressed, and the environment is saved. Investment, which is the strategically key component of global demand, should be kept at a level compatible with high employment, and allocated globally in order to achieve the highest advancement of democratically chosen, global objectives (on global democratic governance see e.g. Archibugi 2008). After decades of increased disparities and extended poverty in most countries, poverty reduction and increased economic equality are clear candidates for the short/medium term. But the all-embracing enlargement of human capabilities for all individuals seems to be the clearest indicator of 'the general social advantage' of a flourishing human society (Buzaglo 2003).

Humankind has already a set of clearly formulated, ambitious objectives for human development which could serve as transitional targets for a relatively long period. These objectives have the highest legitimacy imaginable, as they were postulated as *basic human rights* of all humanity by the foundational documents of the United Nations, but were never given the means to be implemented, ignoring the fact that '*l'oubli ou le mépris des droits de l'homme sont les seules causes des malheurs publics et de la corruption des gouvernements* [neglect or contempt of the rights of man are the sole cause of public calamities and of the corruption of governments]' (*Déclaration des Droits de l'Homme et du Citoyen*, 1789). The United Nations Declaration of Human Rights is supplemented by a series of other foundational documents which develop and particularise its themes. The universally recognised human rights include the rights to:

- life and liberty,
- a standard of living adequate for health and wellbeing, including food and housing,
- social protection in times of need,
- the highest attainable standard of physical and mental health,
- work and to just and favourable conditions of work,
- education and to access to information,
- participate in the political process and in cultural life
- physical security and integrity.

If an expansion of SDR big enough to compensate the decline in US net import demand were envisaged, and if both carbon emission rights (and/or taxes) and Tobin taxes were introduced with the global commons idea in mind, very large funds will be available for global investment, particularly large in the case of impoverished regions, with comparatively very low investment activity. The possibility would be open for seriously attempting to accomplish in time the Millennium Development Goals, and for fulfilling basic human rights for all humankind within the present generation.

The notion of investment of the Global Economic Governance body should thus be very encompassing, and not limited to physical investments such as investments in plant, equipment or infrastructure. Investment should also include social expenditure in health and education, and all other forms of expenditure which potentially increase productive capacities.

'Green investments,' aimed to preserve and upgrade the natural environment — in particular climate change abatement investments — are a fundamental expenditure category, also to be organised on long views and on the basis of the general social advantage, in coordination with the body in charge of climate control (our 'atmosphera.org' above).

After the demise of what was once called 'socialist planning,' the idea of a global investment planning agency might look scary to many. However, this body should only be an analytical and advisory body, aiming at giving concrete content to the types of sequences of actions needed for the efficient, long term realisation of the general aims of world society. The world planning body would formulate the general lines of the necessary changes in the allocation of global investment, along with the sectoral and regional distribution of investment activity that most effectively satisfy the democratically chosen objectives. This would give broad lines and relative certainty for project and program identification and design at a scale that for many regions and countries was unknown of before.

Global investment planning would thus design the broad lines of medium and long term development for a new world commonwealth. At this level would also be provided technology development and assistance, and also financial expertise. The detailed formulation, funding, and practical implementation of investment programmes and projects would be the provinces of local, national and regional levels' economic governance (cf. Schweickart 2009).

7. There are more commons

> *From the standpoint of a higher economic form of society, private ownership of the globe by single individuals will appear quite as absurd as private ownership of one man by another. Even a whole society, a nation, or even all simultaneously existing societies taken together, are not the owners of the globe. They are only its possessors, its usufructuaries, and, like boni patres familias [good family fathers, JB], they must hand it down to succeeding generations in an improved condition. K. Marx, Capital (vol. III, Ch.46)*

The list of global commons apparent to common sense is larger. It includes global peace, ocean fisheries, natural resources such as land, and ore deposits such as hydrocarbon, water and minerals. The extant store of scientific knowledge and cultural heritage, on the other hand, does not correspond to the idea of a commons, as its magnitude does not decrease with use — it can be said that on the contrary it increases by being more intensively used. Its material characteristics are such that it is typically difficult to exclude potential users, and their use is usually limited by artificial means such as patents and copyright laws. They correspond more closely to the idea of a *public good*.

The peace and security commons

Peace and security could be compared to financial trust, in the sense that both involve a feeling of confidence. In the case of peace and security, it involves the very basic feeling of confidence in the own physical integrity and survival. As an animal species, there is an innate instinct for humans, when pressed, to attempt to achieve security through violent means. Technical development seems to have set a logical limit to that tendency. The optimal method of playing the repeated game of Chicken — the ultimate form of the game in a

nuclear world — is to cooperate and play a socially optimum strategy according to a 'social norm.' But in the iterated game of Chicken, it might be rational to practice 'brinkmanship.' In the case of the nuclear contest, this means to develop your own nuclear weapons if you aim to be taken seriously as a multilateral partner.

So, our rational strategic analysts and mathematical modellers arrive at the conclusion that it is rational to play mad. (It can be said that an individual or state effectively playing mad would be phenomenologically undistinguishable from a psychotic and pathological one.) It is anyway the crucial task of our time, given the unacceptable costs of nuclear madness and collective self-destruction, to arrive to an acceptance of the idea of a peace commons, and to collectively limit pollution of the security commons.

The dangerous level attained by the degree of pollution of the global security commons has a clear economic indicator. A basic dysfunction of the global economic structure, not often put into question, is the role of the US military budget. The huge costs for the US of systematically playing global Hawk in the international game of Chicken, is one of the main structural causes of the present crisis. Currently at $1 trillion annually (Higgs 2007, about twice the spending of all other countries combined), military spending explains a large part of the US budget and trade deficits, and amounts to the single most important global structural distortion. (A particularly perverse result of this distortion is that US's creditors such as China and other lower income countries thus become paradoxical financiers of the adventures of the US 'military-financial complex.') A rebalancing of the global economy should imply a sharp reduction of the US military budget. The level, allocation and financing of global military expenditures should be one of the priorities for global structural adjustment for a body of Global Economic Governance.

By itself, a global commons approach to the global economic crisis would simultaneously increase peace and security in the world. A context of shared governance for increased global economic justice would bring down the level of conflict at all levels. A crucial ingredient of that context is reduction of US military expenditure. That means reduced conflict levels and reduced costs for maintaining peace and security, on the one side. On the other side, this means common responsibility and common financing of security.

The attempt by countries to achieve peace and security through the use of force ultimately increases overall insecurity. The only sustainable way of solving the collective security problem is for states to clearly comprehend the 'commons' character of the problem, and to arrive to a multilaterally shared approach to security.

Ocean fisheries

In the general competition for the exhaustible resources of the oceans, countries have built huge fishing fleets, often by subsidisation of new investment. The oceans are being rapidly depleted. The majority of fisheries' stocks are fully exploited. Fish stocks have collapsed in nearly one-third of all ocean fisheries — fisheries collapse is defined as catches dropping below 10% of the recorded maximum (Worm *et al.* 2006). All commercially valuable world fish stocks could completely collapse by 2048. As in the case of atmosphere, an international agreement and a new institution are needed, in order to regulate the use of ocean fisheries and other resources of the seas. The global commons perspective suggests the creation of tradable fishing rights entitling fishermen to a portion of the sustainable global catch. These rights to fish a certain amount are not permanent or hereditary or based on

tradition (as in the case of similar systems in countries as e.g. Iceland), but auctioned off periodically, annually for instance.

As is the case of emission rights, fishing rights should be global — fish move freely. As in the case of emission rights, they should also be equal for all; there are no bases for particular privileges. Citizens of both land-locked countries and countries with large ocean coasts and platforms should have the same rights. Fishing rights should be administered in a fashion similar to the atmosphere, by a specific entity, and the revenues distributed according to equal per capita shares.

Land and sub-surface resources

According to the classical economists, rents derived from the scarcity of a resource such as land are 'unearned income.' Land rent is due to the differential productivity of particular types of land, and not the result of the labour of workers or entrepreneurs. Should the import of corn be allowed, for instance, these ground rents would vanish. These rents made the income of an absentee class, a privileged category of people monopolising a common resource, who supposedly gained these lands long time ago by the right of conquest.

This insight is already in Spinoza's *Political Treatise* (1677). There is also in Spinoza the suggestion that the natural productivity of land should not become the unearned income of a particular class, but should be collectively owned: 'The fields, and the whole soil, and, if it can be managed, the houses should be public property' (Chapter VI.12).

The same reasoning could be applied to sub-surface natural resources such as ore and hydrocarbon (and even water) deposits. Intra-marginal natural resource producers get an unearned income, derived from the particular physical characteristics of the resource (accessibility, concentration, etc.). This is acknowledged by the fact that most governments use different types of taxes, royalties and license fees (ground rents) in order to capture part of the rent produced. In most countries oil is a collectively owned resource, and underground resources in general are prima facie considered as belonging to the commonwealth. This fact, reflected by most national legislations, suggests that underground resources are naturally seen as the common property of the commonwealth. What is *not* reflected in most natural resource legislations is the legal consequence of collective ownership, i.e., equal allocation of dividends.

Resource wars, in particular wars about ownership of oil resources, were frequent in the past, and they are also frequent in the present. A highly placed witness, Alan Greenspan (former head of the US Federal Reserve), has candidly 'acknowledge[d] what everyone knows: the Iraq war is largely about oil.' Valuated at current prices, Iraq's proved oil reserves amount to about $7 trillion, and compare well to the US gross foreign debt of $12 trillion, or to the net foreign debt of $2.4 trillion (gross debt and oil data for 2007, from CIA's website; the net investment position, also for 2007, is from Nguyen 2008). A future war against Iran would also be 'largely about oil' — the current value of Iran's reserves is about $8 trillion. The present relative strength of the dollar in spite of the US financial collapse might be due to market expectations about the US being able to stay in Iraq. Of course, market expectations may change, and usually do.

Frequent in the past and present, resource wars risk to become even more frequent in the future. With the rapid depletion of oil and other resources, the rising rents accruing from quickly increasing scarcity dramatically augment the future probability of wars (cf. the 'oil peaking' debate in the US). 'Wars of Chicken' for the control of resources will probably become more common in the future.

The cause of resource wars is that any particular distribution of ownership is felt to be arbitrary and artificial for participants who have the power to effectively contest for the resource. There is no internationally agreed and accepted concept of legitimacy when it comes to the property of the vast amounts of wealth which happen to be beneath the soil where a particular person or group of persons happen to be. As in the case of the atmosphere, the only stable, legitimate distribution of property rights for underground resources is the common property of all.

Both the logic of conflict and the human moral imperative reflected in most ethical traditions suggest the equal rights solution. Natural resources should be owned by all humankind, and managed for the common good of present and future generations. 'All humankind' should mean democratic, transparent, accountable power elected by all. Until such a power might be formed, a global foundation with clear mandate, power and accountability could be a transitional solution. For the use of natural resources (including land, as in the old Spinoza proposal), users should pay a rent (or tax, or quota rights) substracting the part of value added not contributed by labour or entrepreneurship, that is, the part which corresponds to natural differential productivity, and representing the 'productivity' of Nature, to be appropriated by the global commonwealth.

It is important to include as a fundamental part of the scheme that, reflecting the global ownership of natural resources, the proceeds or dividends should accrue equally to all. Equal revenue shares should be a basic element of the foundational documents of the system, and this should be carefully reflected in the construction of the implementation mechanisms.

8. Final comments

We have analysed the consequences of applying the logic of the commons to several critical domains of actual and potential global conflict. Effective, peaceful management of global commons requires the creation of global regulating institutions. To be acceptable, these institutions need to be seen as legitimate and equitable by all actors. This means that they should be democratic, transparent and accountable, and not prone to capture by any special interests, particularly the special interests of the rich and powerful.

Regulation should ensure long term sustainability of global resources. A basic aspect inherent in the regulation of global commons is the equality of rights to the revenues produced by global management of the commons, derived from equal property rights to the commons. Inherent in global regulation are thus powerful mechanisms for eliminating poverty and reducing global income inequalities. Given the high consumption propensities of the main beneficiaries of regulation schemes, and given the significant magnitude of the revenues generated, global regulation would also represent a strong demand push, which is today needed for avoiding a long global stagnation or depression. The serious imbalances and

structural distortions of the world economy would thus be solved without falling international trade and output, protectionism, and economic fragmentation.

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Managerialism and the demise of the Big Three

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Abstract: This essay is about the crisis of US automobile management and the difficulties that management educators and practitioners in America have had facing up to that crisis. It focuses on Detroit's Big Three but it also looks at the role Japanese firms played in transferring JMS (Japanese Management Systems) to America, particularly the transfer of TPS (the Toyota Production System) to Georgetown, Kentucky. It opens (I) with a discussion of the triumph of a science-based "New Paradigm" in business school management education and in industry, with reference to its critics, in order to establish the institutional framework within which US automobile management expanded and operated after World War II; then (II) a more general discussion ensues in which U.S. managerialism and JMS are compared, and the pathways and barriers to the transfer of JMS to America both to US firms and to Japanese transplants are explored, before in the last part (III) the focus narrows to a specific case of transfer: H. Thomas Johnson's analysis of Toyota's successful alternative Production System (TPS) at Georgetown and how it supersedes in theory and practice the managerial methods of the Big Three.

Managerialism -- What occurs when a special group, called management, ensconces itself systemically in organizations and deprives owners and employees of decision-making power (including the distribution of emoluments) – and justifies the takeover on the grounds of the group's education and exclusive possession of the codified bodies of knowledge and know-how necessary to the efficient running of organizations. – Locke 1996

A. The concept and reality of US management after World War II

In 2008 Rakesh Khurana published a history of American business schools in which he wrote an excellent chapter about "Disciplining the Business School Faculty: The Impact of the Foundations." He was not the first to do so. Robert R. Locke opened his 1989 book, *Management and Higher Education Since 1940*, with a chapter on a similar subject, in which he described the creation of a "New Paradigm" in business studies, the application of science to the solution of managerial problems, which took shape during and in the decades immediately after WWII ("The New Paradigm", 1-29). Whereas Locke concentrated primarily on the development of Operations Research in industry and higher education including business schools, Khurana concentrated his story on how a group of NGO bureaucrats (mainly from the Ford Foundation), in league with business school deans and corporation CEOs carried through a thorough transformation of business study programs and research agendas in the top twenty business schools of America. Even the Harvard Business School, which pedagogically clung to the case method of instruction in order to draw lessons from real-world experience in real companies, had in research and faculty recruitment to align itself with the "New Paradigm." Elsewhere, at the University of Chicago Graduate School of Business, the Stanford Graduate School of Business, Columbia Graduate Business School, the University of California business schools at Berkeley and Los Angeles, the Carnegie Institute of Technology GSIA, the Wharton School, etc. it completely triumphed.

Khurana's study centers on the economists' take-over of the business schools, after economics had itself been transformed into a "decision science" through its absorption of operations research techniques (mainly linear programming and mathematical modeling) from scientists working on government contracts at the Rand Corporation. J.-C. Spender (private communication 1.09.2009) calls the move of economists into prominent if not dominant positions in business schools "an attempt to 'colonize' the social sciences – to elbow 'real people' out of the analysis and replace them by rational self-maximizers" -- those equipped

"with the 'rigorous' thinking, of which economists believed they were the 'high priests'." H. Thomas Johnson relates how this colonization in his field (management accounting) occurred:

> "Managerial uses of accounting information…probably emanated from one primarily underlying cause – namely, the growing use of quantitative economic abstractions in national government planning during the 1940s. …It is not surprising, perhaps, that accounting professors in graduate business schools quickly saw an opportunity to capitalize on this belief in the merit of using economic statistics to run the national economy. After World War II, professors of accounting and finance in graduate business schools such as Harvard, Chicago, and Columbia started to show corporate executives how to use their accounting information to plan and control business activities in the same way that economists were showing government administrators how to use national accounting statistics to plan and control affairs of a national economy. In part this idea emanated from accounting professors who had received doctoral training in economics….But the idea also received impetus from accounting instructors, whose experience with wartime agencies had introduced them to advance use of operations research and mathematical economics…. Small wonder that immediately after World War II graduate business schools became immersed in ways to apply neo-classical economic models to accounting information in order to formulate a basis for decision making in business." (Johnson & Bröms: 57).

While "The New Paradigm" transformed business school faculties, in business and industry multi-divisional forms of corporate organization burgeoned. Although before 1940 most big firms organized managerial hierarchies along functional lines, by the 1920s a few "M" or multidivisional firms had already come into existence. After WWII "M" form corporate organization structures multiplied at home and abroad. The scholar who drew these developments to the attention of business historians, and transformed the subject of management studies (Alfred D. Chandler, Jr.) wrote a seminal article on the subject for a 1961 issue of the Business History Review, that is, just as "M" form structures consolidated their presence in the business world. (Chandler & Redlich). Thereafter, in a number of publications, including the Pulitzer-Prize winning *The Visible Hand* (1977), Chandler established a towering reputation not only within his field but outside – among economists, and businessmen. He contended that huge corporations escaped the fate of bigness, i.e., inefficiency, by establishing managerial hierarchies that used various managerial instruments to monitor operations and attain efficiency through cutting transaction costs. The special feature of the multidivisional corporation was the introduction of a top level of management to supervise divisions by using balance sheets and income statements to drive the activities of divisional managers.

Finance and controller functions gained ascendency at every level of management. So did the use of the new quantitative instruments that were being devised and taught in think tanks and business schools. Johnson observed:

> "Given this circumstance, successful managers believed they could make decisions without knowing the company's products, technologies, or customers. They had only to understand the intricacies of financial reporting. … [B]y the 1970s managers came primarily from the ranks of accountants and controllers, rather than from the ranks of engineers, designers, and marketers. [This new managerial class] moved frequently among companies without regard to the industry or markets they served. … A synergistic relationship developed between the management accounting taught in

MBA programs and the practices emanating from corporate controllers' offices, imparting to management accounting a life of its own and shaping the way managers ran businesses." (Johnson and Bröms: 57).

Not everybody accepted the "New Paradigm" in management study and practice. Locke pointed this out in the second chapter of his 1989 book ("The New Paradigm Revisited:" 30-55). He focused on Operations Research, noting that OR professors in business schools (e.g., Russell Ackoff at Wharton) had by the late 1970s pronounced the attempt to use mathematical modeling and linear programming in decision-making a failure. (Locke, 1989; Ackoff, 1978). More importantly, doubters other than OR people began to gather in business schools proper. In 1987 H. Thomas Johnson, who had worked with Chandler to describe the financial accounting systems developed for "M" Form companies (Johnson, 1978), and Robert Kaplan, a professor in the Harvard Business School, published a co-authored book that questioned that very management accounting, which was then as now being taught in business schools*: Relevance Lost: The Rise and Fall of Management Accounting. The Harvard Business Review* dubbed the book one of the more significant published on business in the past seventy-five years. Johnson carried the attack on management accounting forward in two subsequent books: *Relevance Regained* (1992) and, with Anders Bröms, *Profit Beyond Measure* (2000), the latter of which dealt specifically with production process.

Meanwhile, students of economics started to revolt against their professors who had been educated in the New Paradigm. In June 2000, a group in Paris openly protested about the "knowledge censorship" that they experienced in their studies. They explained in a public manifesto:

"Most of us have chosen to study economics so as to acquire a deep understanding of the economic phenomena with which the citizens of today are confronted. But the teaching that is offered, that is to say for the most part neoclassical theory or approaches derived from it, does not generally answer this expectation. Indeed, even when the theory legitimately detaches itself from contingencies in the first instance, it rarely carries out the necessary return to the facts. The empirical side (historical facts, functioning of institutions, and study of the behavior and strategies of the agents…) is almost nonexistent. Furthermore, this gap in the teaching, this disregard for concrete realities, poses an enormous problem for those who would like to render themselves useful to economic and social actors." (quoted in Fullbrook, 2003: 6)

The French rebels called neoclassic economics "autistic," meaning that it was cut off from the real world. They named their movement Autisme-Economie. Its manifesto of protest, published in Le Monde, gained the attention of the government, which promised investigations. The French rebellion led to a broad if thinly and unevenly spread international movement called Post-Autistic Economics that involves mainly professional economists, with their own review, this one, (originally called the *Post-Autistic Economics Review*, with over 11,000 subscribers.

Although these publications reveal serious dissent in academia about the New Paradigm, mainline US business schools mostly ignore them. They scarcely noticed the PAE movement. Perhaps that was inevitable, because the protesters failed to present a strong alternative study program in economics to which the disaffected could rally. They simply ask for "a pluralism of approaches adapted to the complexity of the objects and to the uncertainty surrounding most of the big questions in economics." (Fullbrook, 2003: 6). The feeble nature

of this statement indicates just how complete the "New Paradigm's" cognitive triumph has been. No strong competing paradigms appeared to which the protesters could adhere.

Nor did the criticism of quantitative control methods open the ears and minds of academics in the American citadel. Although Khurana thoroughly described the institutionalization of the New Paradigm in US business schools, he did not discuss the dissent. He ignored Locke's books, Johnson's books, and did not mention Post-Autistic Economics in his bibliography or text, even though the critiques had been around for years before he wrote. Unlike Locke in 1989, Khurana in 2008 did not write a chapter on the "New Paradigm Revisited." Rather in the book's last section he shifts emphasis to a criticism of New Investor Capitalism and the effects that Chicago School economics have had on moral education in business schools.

Johnson's books amounted to a detailed examination of the Financial Accounting system that Chandler considered an essential part of the successful functioning of management hierarchies, specifically in "M" form companies. The presence of Johnson's imposing critique, however, did not prevent the *Business History Review* from issuing a special retrospective on Chandler's work (Summer 2008), which amounted to hardly less than hagiography. None of the implicit or explicit criticism of Chandler work was discussed or cited in the volume -- this more than twenty years after Johnson and Kaplan declared the management accounting systems taught in US business schools and extant in US corporations irrelevant, and eight years after Johnson and Bröms had described viable and successful alternatives to U.S. management accounting quantitative methods. To issue a retrospective honoring the most significant business historian of the 20th century is not only acceptable but a proper thing for business historians to do. But a last chapter about Chandler and his critics should have been included to carry the appraisal of his life and work into the post-Chandlerian world.

Moreover, If Chandler's admirers could deal with his academic critics by simply ignoring them, Chandler's work could not escape the critique of reality in the shape of Japanese Management Systems (JMS). (Liker, Fruin, & Adler: 5-25)

B. Japanese management systems

One might think that the Japanese would have set to work immediately after World War II emulating US management and management educational models. Unlike the West Europeans, they did not increasingly accept the dominant American view that managers had become an indispensable functional caste in society possessed of particular knowledge and talent, who attend business schools to learn a corpus of managerially useful subjects.

To appreciate why, Westerns have to understand Japanese work ways, at first culturally, then in schools, then in the Japanese corporation.

1. Culture.

Scholars find the cooperative work practices employed in lean or "limited" manufacturing inherent in Japan's wetland rice cultivation. (see Johnson & Bröms: 101-3, for an important distinction between Japanese "limited" production systems that are called "lean" production systems in the United States but differ from them.) "Paddy cultivation," Sjhuji Hayashi argued, "encouraged group endeavors in village (*mura*) life. … The *mura* work is

decided by the group as a whole. Farmers work so close together that cooperation becomes second nature. … When paddy fields are irrigated, water pumped in is allowed to flow by gravity, the entire village field is worked at the same time. Even fertilizer had to be cooperatively applied because the water flow carries it everywhere (Hayashi: 68)." Dominique Turcq, using the same metaphor, notes that "Japanese culture is a culture of water. The study of the Japanese economy cannot be based on structures but on the flows existing between these structures." (Turcq: 55).

2. Schools

Other specialists observe how, despite changes in Japan brought on by Western emulation, group-process methods of work were taught in education. William K. Cummings noted that Japanese teachers spend an inordinate amount of time at the beginning of the school year just establishing order in the classroom, so that learning subsequently can take place. "Classroom order," Cummings affirmed, "is developed by having students cooperate in groups that prepare contributions for the rest of the class (Cummings: 150)." Classrooms break into groups, with teachers sitting by rather unobtrusively. Bright students work with slow learners whose performance they help raise to the group pace. Teachers and administrators do not discipline individuals, by, say, sending a pupil to the office, but let the group to which the problem-pupil belongs decide and administer "punishment." Assertive discipline is "antithetical" to the Japanese style of student management. Japanese teachers even at the preschool level defer discipline authority to pupils. Small work groups are held collectively responsible for homework assignments, so that if a group member does not do this work the others receive demerits. Groups are assigned tasks, sometimes too difficult to do, just to see how well they can handle them – they are stretched (Adams: 69).

Within the system moral education is taught by experience as well as by precept. The moral education furthers cooperative, family and community values. Its chief aim is process-not-results-oriented. Process involves a continuous change in time, a moving progressively from one point to another in a steady development towards a contemplated end. Process education stresses the procedure through which results are obtained, not the results themselves. W. Edwards Deming after working in Japan emphasized process as opposed to individual performance. He advocated making improvement in the process in which the individual works, not trying to eliminate individual "mistakes" (Deming, 1982, 1986). Kaoru Ishikara's famous fishbone diagrams used in Japanese manufacturing illustrate process orientation; they show the people involved how the entire process in which they work produces the results, so that they can learn to think of their work in terms of process improvement. "Japanese educators," Cummings remarked, "have never paid much attention to the innate abilities of learners. They have tended to assume that anybody can learn a task given a determined effort. Process modes of education emphasize the process, not individual abilities, and are perfectly suited to group cooperative forms of education." (Cummings: 150) Process moral education differs profoundly from moral instruction in America.

In other words, in a high-employee-dependent Japanese management system, management education takes place differently than in America. It occurs cooperatively in the primary, intermediate, and secondary school system not in business schools. The point: If people wish to organize a work process in which the employees participate in managing it and are not "managed" by a group external to it, what happens in the Japanese class room is management education.

At the tertiary level Japan's educational environment differed as well. Most rich and powerful NGOs and businessmen that wish to call on society to fulfill a need, usually find a

way to achieve their ends. This happened in the US when rich businessmen endowed business schools in famous universities. After WWII Japanese employer associations repeatedly asked for more and better higher education in Japan. They asked for scientists, engineers, computer specialists, for the creation of technical research facilities and for the establishment of closer cooperation between universities and industry. But the words “academic management education” seldom appeared in these requests. Since business and industrial spokesmen presented no real and persistent demand for this education no American style managerial education of the MBA business school type materialized (Locke, 1996).

This does not mean that Japanese firms did not want to hire educated people. They did, but they were much less interested in recruiting specialists in management subjects than people right out of college who had a liberal education in elite universities, because they did not intend to incorporate them into management systems like those being created in big US corporations.

3. In the firm

American M form corporations are pyramidal organizations; they hire people into a hierarchy of management and, when applicable, union approved job classification on the factory floor. In management the firms employ specialists at the entry and advanced levels in order to fill the manpower requirements listed in corporate organizational charts. The workforce and management consists of a web of skills that can be maintained from institutions of higher education, i.e., business schools, and from manpower markets inside (bulletin board open-job postings) or outside the firm, by fitting people into slots like interchangeable parts.

Johnson and Bröms despised these lifeless pyramidal structures imposed on work processes and managed by computer-oriented-production-control and expert-run cost accounting systems:

> “At first the abstract information compiled and transmitted by these computer systems merely supplemented the perspectives of managers who were already familiar with concrete details of the operations they managed, no matter how complicated and confused those operations became. Such individuals, prevalent in top management ranks before 1970 had a clear sense of the difference between ‘the map’ created by abstract computer calculations and “the territory’’ that people inhabited in the workplace. Increasingly after 1970, however, managers lacking in shop floor experience or in engineering training, often trained in graduate business schools, came to dominate American and European manufacturing establishments. In their hands the “map was the territory.” In other words, they considered reality to be the abstract quantitative models, the management accounting reports, and the computer scheduling algorithms….” (p. 23)

“Japanese companies…,” James Abegglen and George Stalk, Jr. wrote, “differ significantly from the Western pattern. The essence of the Japanese company is the people who compose it. It does not, as the American firm, belong to the stockholders and the managers they employ to control it, but it is under the control of the people who work in it, who pay limited attention to stockholder’s wishes. The company personnel, including directors who are themselves life-time employees and executives of the company, are very much part of the company.” (Abegglen & Stalk, 1988: 184). In Japanese corporations core employees, as distinguished from temporary employees, are not recruited as skills but as people whose chief qualification must be a capacity to assimilate quickly the corporate work

culture and production systems. Recruited employees are assumed to have no firm-and-job-specific skills. That is why firms spend so much money on in-house training and engage in job rotation and multi-skilling.

They allot great resources to core employee training because they expect them to stay with the firm. Upper level positions when they fall vacant are not replenished from an external job market but from within the firm. To separate out a special group called management, that is dedicated exclusively to serving its own interests (separate from the employees) and the interests of those who do not work in the firm (the stockholders in large public corporations), and who have developed financial-results-oriented management techniques to do so, does not conform to the traditional Japanese conception of the firm.

However, to say that American corporations and Japanese firms developed different management systems does not prove that one was more efficient than the other, or that even if they desired to do so American firms could import Japanese Management Systems and if they tried could succeed better with them in their endeavor than with their own, or that Japanese firms needed to transfer their management systems to their transplants in America in order to operate successfully in the US management context. Two factors, the technology involved in production and the managerial wherewithal of U.S. and Japanese firms, determined the desirability and the extent to which JMS could be imported into and successfully operated in the United States.

a. Limited transfer: The Japanese consumer electronics industry

Martin Kenney reports that the first Japanese industrial success story occurred in consumer electronics. In Japan, Hitachi, Toshiba, JVC, Matsushita, Sanyo, Sharp, and Sony operated factories with the same JMS features as other Japanese firms. (Kenney, 1999: 262). Surveys in the 1990s reported that consumer electronic product firms in Japan had created seniority based salary schedules, long-term employment, and enterprise unions. In production management they used JIT, had strong commitments to training in general and regularly used on-the-job training through job rotation in particular (Jenkins & Florida, 1999: 264-65). They enjoyed very low-labor turnovers and worked in groups and teams throughout the industry. Front line workers worked in job design and control, which in the US would have been "the purview of management and other professional employees." (Jenkins & Florida, 1999: 264-65). And regular male workers were involved in "setting standard process times, spearheading operations improvement, and conducting performance evaluations," jobs reserved for engineers and managers in U.S. firms. (Ibid., 263). The first significant transplants to America happened in this industry with the establishment of Japanese television assembly factories in America during the 1970s. By "1998 Japanese companies owned all the remaining television assembly factories operating in the United States." (Kenney, 1999: 257).

If Alfred D. Chandler, Jr.'s admiration of management at GM is out of place in the late 20th century, his general insight that different technologies produce different strategies and managerial structure is still correct. Although domestic Japanese consumer electronic plants and Japanese automobile factories used similar management systems, technical specs during production were different. Kenney's study, comparing Japanese television assembly transplants to Japanese automobile transplants, pointed out that for technical reasons "automobile manufacturing spent less on R&D than consumer electronics, had lower engineer to operator ratios, had lower automation, [and] used many more parts in assembly (30,000 to 40,000 to less than 2,000) in much longer assembly lines (1 kilometer to 100 meters).

Assembly time in an automobile factory per unit ran from 10-20 hours compared to 27 minutes in a television assembly plant. The role of operators was much greater in automobile assembly than in television production; automobile manufacturing required more on-the-job training and more interactive work. Automobile production technology needed employees with more interrelation skills. (Kenney: 273). To achieve results Japanese automobile transplants had to absorb more of the JMS from home than Japanese transplants in consumer electronics – and they did. Kenney stated:

> “the television transplants…all operated in a style far closer to that of U.S. factories than of Japanese factories. Even the companies, such as Sanyo, that consciously tried to introduce a Japanese-like system soon retreated and accepted the U.S. system. …. (p. 286) U.S. television assembly transplants diverged far more from their respective sister plants in Japan than auto assembly transplants did from theirs. Not only have they diverged in terms of management and production systems, but they have differed in the apparent eagerness or ability on the part of management to facilitate operator-and-factory-based knowledge creation.” (p, 287).

b. Limited transfer: The Big Three firms

Twenty-five years after Japanese firms began transplant operations in North America, just before the bankruptcy of two of the Big Three and near collapse of the other in 2008-2009, their performance looked like this (Table 1).

Table 1: 2006. Source: Schifferes: 5

	Sales (units)	Sales ($bn)	Profit ($bn)	Market Value ($bn)	Workforce
GM	8.3m	191	-10.9	20	335.000
Toyota	8.2m	176	+12.5	208	285.000
Ford	6.6m	153	-12.7	16	300.000
Volkswagen	5.2m	118	+5.2	43	344.000
Daimler/Chrysler	4.8m	185	-1.7*	65	382.000

*The losses occurred at Chrysler.

The fact that Table I shows dismal results indicates that US firms never successfully met the competitive challenge. Why?

It could not be from ignorance about Japanese Management Systems (JMS). Ronald Dore first drew the West’s attention to Japanese manufacturing in 1973. Robert Lutz, head of Ford’s operations in Europe and now a Vice-President at GM, sent scores of his people to Japan in 1979 to study production methods. GM entered into a joint-agreement with Toyota (New United Motor Manufacturing, NUMMI) in 1984 in order to introduce already acknowledged superior Toyota production methods into its operations at a plant in Fremont, California. GM managers trained at NUMMI brought lean production to Opel, especially in its new greenfield site in Eisenach, Germany. Studies about Japanese lean production

multiplied throughout the 1980s (700 articles were published in the US on JIT between 1985 and 1990), culminating in the universally touted book by J.F. Womack, D.T. Jones, and D. Roos, *The Machine That Changed the World* (1990). The studies about efforts to transfer JMS to the US continued to blossom in the 1990s, after the Japanese economy quit growing and Americans could stop admiring them. (See a collection of articles in Jeffrey K. Liker, W. Mark Fruin and Paul S. Adler, eds. *Remade in America: Transplanting & Transforming Japanese Management Systems*,1999, published by Oxford University Press in its Japan Business and Economics Series.

c. Barriers to transfer

Shorage of time

If alarmed U.S. automobile manufacturers learned a lot about JMS, they, paradoxically, delayed implementation. Incredulous at first, the world's greatest automobile manufacturers found it hard to believe c. 1980 that they had anything to learn from the Japanese about how to design and manufacture automobiles for Americans. They found every reason to explain their problems except inferior shop floor production and corporate governance systems [cheap labor in Japan, expensive labor in America, government CAFÉ standards (that US firms actually avoided), the unions, high overhead costs caused by generous medical insurance benefits and retirement plans (that US firms were rapidly cutting)].

Almost five hundred years ago, Niccolo Machiavelli wrote this about change:

> "There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle than to initiate a new order of things. For the reformer has enemies in all who profit from the old order, and only lukewarm defenders in all those who would profit by the new order. This lukewarmness arises partly from fear of their adversaries, who have the law in their favor, and partly from the incredulity of mankind who do not truly believe in anything new until they have had actual experience of it. (The Prince, 1513)

Like most men and women being driven relentlessly into a corner, Big Three automakers temporized. They "knew about Japanese Production Systems for at least fifteen years before they made serious efforts at…implementation" of JMS (Liker, Fruin,& Adler: 10).

Barriers posed by Big Three management structures and practices.

The very structure and practice of US automobile governance systems that JMS were to replace frustrated the replacement.

<u>Workforce resistance</u>. J.-C. Spender states that the automobile industry "has been consistently successful at achieving dominance over its work force." (Spender: 136). Nonetheless, blue collar workers in the American system of industrial relations fought hard to protect their interests. The adversarial relationship was part of firm governance.

In the hard struggles between management and labor in the US automobile industry, unions hammered out collective bargaining agreements, protecting job classifications, with different skills and pay gradients on the factory floor (on the average 45 job classifications per plant in 1989). (Pil & MacDuffie: 43).

This affected implementation of job rotation, multiple skilling, and group work practices that were necessary to a well-functioning work process modeled on JMS. By contrast, Japanese home plants had on average five job classification for production workers

and five for maintenance workers. Japanese transplants in the US had only one job classification for production workers and one or two for maintenance workers. Because workers and their unions were scared opponents of change, US manufacturers only managed to reduce the average number of job classifications on factory floors from 45 for production workers in 1989 to 37 in 1994 (Adler: 89).

Nor did the American firms eliminate status distinctions between blue and white collar workers in their plants, which disappeared in Japan after World War II. The elimination of blue-white-collar differentiation along with so many job skill classifications is considered to be essential to well-functioning JMS whose essence is solidarity and common purpose.

Resistance in management. Beyond blue collars, opposition to JMS arose on-and-off the factory floor primarily within the ranks of American automobile management itself. For managers, JMS transfer raised bread and butter issues.

In the US system managers held power and were (are) reluctant to relinquish it. Many of the agency, property rights, and transaction costs models used in Big Three governance did (do) not fit with the JMS wherein management and unions are not determined adversaries, and asymmetries between managers and employees in terms of voice, rights, and benefits are significantly muted. (Liker, Fruin, & Adler: 10).

JIT production methods were "dramatically opposed to the economic order and guiding principles of American manufacturing and to reliance on technologies such as MRP II for shop floor scheduling." (Liker, Fruin, & Adler: 10). In America "only engineering experts could develop scientifically accurate work methods" (Ibid). In America job design and quality control were traditionally the tasks of management.

In the JMS, on the other hand, engineers have always worked closely with line workers in running the production process. Japanese supervisors know all the jobs in their jurisdictions in detail and are generally selected as supervisors because they were the best operators. The adoption of JMS required a plant environment significantly "less autocratic and more participative than has been the norm on Big Three factory floors (Brannen, Liker, Fruin: 144).

In Big Three Middle Management there was not only a "lukewarmness" in will to effect this change but a lack of capacity. American managers did not have a lot of experience on the floor and, accordingly, had not traditionally contributed much to shop floor efficiency through hands-on work with line employees. But these were just the talents needed to transfer JMS to US factories.

Finally, management, separated from the work force in U.S. automobile firms, was accustomed to using and hearing a language of command. Philippe d'Iribarne observed that Classical American Management…"operates on the following behavioral principles: to define precisely and explicitly the responsibilities of each person, formulate his/her objectives clearly, give the person freedom in the choice of methods for meeting objectives, evaluate the results carefully, and reward or sanction the person according to his/her successes or failures." (Iribarne: 131). These principles call for a management where a "high degree of formalization, standardization, and centralization" reigns, where managers possess good conflict-resolution skills, "good top-down decision making abilities," "good problem solving analytical skills, and a capacity to devise good externally imposed evaluation systems" This is Taylorism *par excellence*.

JMS required group-oriented consensus-making, the cultivation of relational skills, and tacit learning, the kind that Ikujiro Nonaka and Hirotake Takeuchi describe in their 1995

book on "The Knowledge-Creating Company." Tacit knowledge is difficult to transfer and imbibe; especially when the recipients are Americans who are use to speaking explicitly in directives, and do not spend time socially with co-workers. To the extent that the JMS required American managers to impart tacit knowledge, the glue of the Japanese system, into American owned companies, transfer could only partially succeed.

Restraints of finance.

Another factor limiting the transfer of JMS to the Big Three is the greater financial environment in which management in the US firms operated. Although American automobile makers could not control this environment, the firms mostly thrived in it for seventy-five years. They raised huge amounts of capital from banks and from the sale of stocks and bonds brokered in Wall Street's financial firms. Events in late 20th century finance, however, proved detrimental.

One was the revolt of the stockholders against the executive boards and top management that accompanied declining profits. Suffering from negative or limited incomes over multiple years, US firms were often cash-strapped compared to their cash-flush Japanese rivals. Boards resorted to cutting costs (investments in R&D, cuts in workers' wages and benefits, reductions of dividends) that led to serious long-term declines in firms' market value (See Table 1) and a precipitous fall in the prices of company stocks.

This provoked stockholders discontent in favor of greater returns on their investments. As proprietary firms, that is, firms where owners elect board members and major owners sit on them, the stockholders could give voice to their concerns. At General Motors, for example, the billionaire outsider Kirk Kerkorian, who sat on the board but never worked in the firm, favored harsh restructuring to increase payouts to investors, including the sale of high-value company assets, like GMAC, which could have brought a windfall profit to a stockholder like Kerkorian, but could have also left the company without the wherewithal in the future to finance the sale of its vehicles or the cash to implement the transfer of JMS. The financial system is currently driving the dismantlement of the companies through the sell-off of their high value assets piece by piece.

Considering the existential nature of the threat, U.S. automobile firms inadequately assimilated JMS. As Liker, Fruin, and Adler put it in 1999 (p. 28):

> "The American companies that adopt Japanese practice, do not go quite so far and do not get quite the performance [as Japanese transplants]. The Big Three do not put the same effort into training and socializing,…and do not reach performance levels of their Japanese competitors in Japan or North America."

d. Maximum transfer: Japanese transplants in America

Japanese Transplants have not suffered recently like the Big Three in their greater institutional environment at home or in North America. They returned steady profits; they received subsidies from local communities to entice them to build plants located on greenfield sites; and they operated in a more favorable home financial environment. In Japanese firms, Joann Müller reminds us, "workers and the company itself are the de facto beneficiary owners" (Müller:1). Automobile stock is primarily in the hands of customer or supplier firms with which the automobile firms do business. These corporate stockholders do not much care about high dividends or share prices (they rarely sell the stock). They profit as companies primarily through expanded business opportunities with the automobile company in which they hold stock. Since major stockholders are not interested particularly in high stock prices

or dividends, Japanese automobile management policymakers can stress the long-term expansion of market share, which is essential to globalizing lean production, and re-invest profits into improved competence rather than pay out higher dividends. And they can tap funds to carry out their plans from banks in their industrial group (kereitsu) if the cash accumulated through years of very profitable operations is insufficient for planned expansions.

In America, moreover, Japanese transplants better cultivate fruitful relations with their suppliers in order to facilitate the transfer of JMS.

One example: MacDuffie and Helper's study of Honda's efforts, compared to Ford's, to work up an efficient supply chain. A quality expert at an American supplier firm that works with both Honda and Ford commented:

> "Honda cares about making the part fit the car, while Ford cares about making the part fit the blueprint. During product launch, Honda takes parts as soon as they are made and runs back to try them on the car. Then they tell us to change this, change that. Ford usually isn't here during our trials. They just want to be sure that we are meeting the spec. If there is a problem, they eventually issue an engineering change. But at Honda, the change happens in a matter of days. At first we thought they were nuts. But theirs is a great way to do business. You get what you want – a part that works on the vehicle – right away. Everything else ---like whether the blueprint is up-to-date – is secondary. Initially, it was incredibly frustrating because Honda was so detail-oriented and wanted responses from us immediately. But I find they are almost always right." (Quoted in MacDuffie & Helper: 168).

Japanese firms customarily include workers on teams involved in the transfer of technology. Even before WWII when Japanese sought to learn about scientific management in America, they included workers in the learning process because they knew that they would have to work closely with them in implementation. Okiie Yamashita, who chaired the Production Management Committee in 1938, observed that:

> "workers {in Japan} were accepted as co-researchers in a work study [about the transfer of Taylorism to Japan]." In the selection of survey participants, it was considered necessary not to choose just "first class men," i.e., management people, but to choose those who would be readily accepted by co-workers. "This was, it was understood, because there was a need to see to it that the results of work study would be acceptable to a broad segment of workers [who would work with the managers to implement it]." Such sensitivity to the views of coworkers about the transfer of scientific management to Japan was "in line with the reality of Japanese industry." (Yamashita, Quoted in Okuda, 1989, 195-96).

Japanese automobile transplants worked with liaison teams in "sister" plants at home to which the Americans hired in the transplants were sent to learn about the company's production management system, and from which expatriates were sent to the transplant to participate in the transfer of technology and work processes. Japanese transplants have been careful to eschew American management culture, since to the Japanese the ethos of US industrial relations is unsuitable for JMS. Japanese transplant managers interviewed in the 1990s criticized American managers for their lack of "commitment" and their abuse of power. They complain about the US managers' weak loyalty to their companies, about their high salary claims, and about their inability to forget "Fordist" modes of command-management. Martin Kenney and Richard Florida in their book about Japanese transplants emphasized this point. "In nearly every plant we visited, Japanese managers voiced concern about the manner by which American managers operate. An executive at Honda of America

told us that his greatest problem was teaching American managers the Honda way" (Kenney and Florida: 287).

Fritz K. Pil and John Paul MacDuffie concluded from their study of Japanese automobile transplants "that [through JMS their performances] are approaching those of their sister plants in Japan and thus show that national, cultural, and institutional boundaries, are not insurmountable obstacles." (Pil & MacDuffie, 1999: 68; Also, MacDuffie & Helper, 1997).

C. H. Thomas Johnson's analysis of the Toyota Production System (TPS) at Georgetown

In order to more clearly explain that the Japanese opened a new era in the management of complex process manufacturing, the focus now narrows to one plant: Toyota's first greenfield US facility located in Georgetown, Kentucky. To avoid disputes about how much the contents of TPS differ from JMS (Liker, Fruin, & Adler: 4-6) let it simply be stated that they are quite similar and both "refer to the family of production, factory, and corporate management practices found in world-class Japanese firms." (p. 4) In Johnson's view, moreover, TPS at Georgetown does not warrant such comparisons, because he considers it to be an archetypal process-management system beyond nationalist nomenclature that has replaced, on efficiency and moral grounds, a once triumphant American system of managerialism in the automobile industry, and elsewhere.

Like Chandler, Johnson thinks systemically, but whereas Chandler contemplated how strategy affects management structures and practice, Johnson and Toyota think about how relationships in the work process determine efficiency.

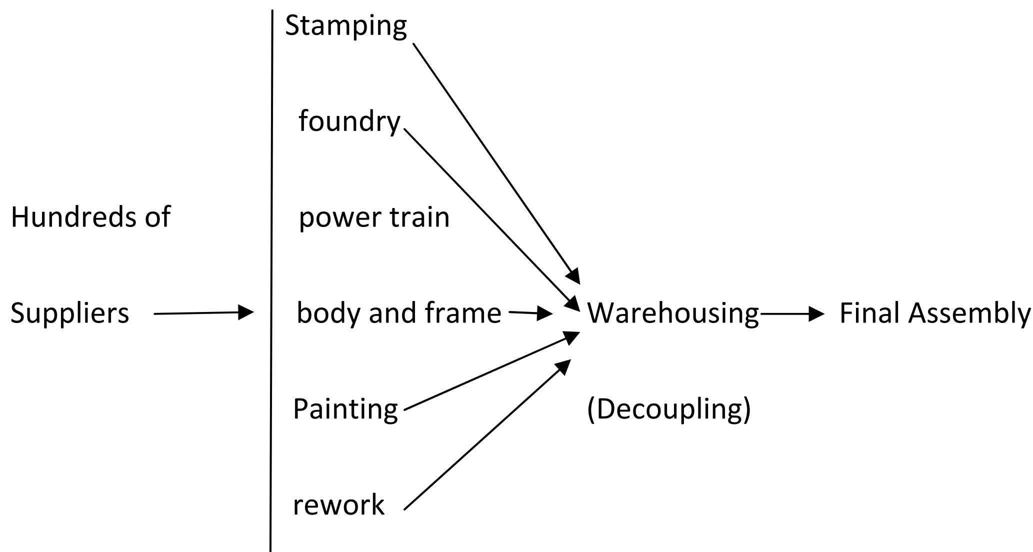
The issue here is the mass production of automobiles. In America the pace setter, Henry Ford, erected in the early 1920s a showcase plant at the River Rouge to minimize waste and maximize output and profits through a closely coordinated production system. "Ford's River Rouge plant," in Johnson's words,:

> "worked like clockwork to make a standardized product: [He] spoke proudly of turning iron ore, silica, and latex into finished vehicles in less than three and a half days, at the lowest cost in the world (Johnson, 1992: 37). The continuous, linked production in the River Rouge factory required that every process operate virtually at the same balanced rate, which could best be achieved by making one uniform product. (Johnson, 1992: 38).

But after WWII customers wanted a variety of products. So American engineers and production managers, in order to cope with the complexity of assembling a variety of vehicles in one plant…"decoupled the line," which "allowed different processes to operate at independent rates." They created inventory buffers to handle the imbalances appearing between the decoupled processes. "Henry Ford did not require inventory buffers at the River Rouge in the early 1920s. Most American manufacturing plants could not operate without such buffers by the end of the 1950s" (Johnson, 1992: 38).

Figure 1 portrays how the Big Three produced variety in a decoupled, long-run batch manufacturing process. After the initial production runs the semi-finished products were warehoused until they were needed for the batch produced vehicles that were finished and sent on to the dealers. The decoupling of production flows to obtain variety required the creation of a management Information system that could coordinate overall the now decoupled production process.

Figure 1



A Management Information System outside the direct work was charged with planning, production programming, factory forecasting, financial reporting, standard cost budgeting, production target setting, etc.)

Through the costs of warehousing, costs of personnel in Information management (whose numbers could exceed the workers and managers directly involved in work process), and the cost of equipment that sustained information management flows (mainframe computers and supplies) “overhead” costs in a Decoupled Batch Manufacturing Plant mushroomed. Management sought to pay for these “overheads” by utilizing the system of quantitative control and reporting measures it had devised, imposed and operated in an Information System outside the work process to speed up throughput in each detached production segment, thereby supposedly obtaining huge savings from volume production. However, total costs, driven up by rising “overhead,” invariably increased. The ostensible “savings” was reduced cost per unit of output as output volume rose faster than total cost.

History is replete with irony; at the time Alfred D.Chandler Jr.’s big, attractive idea was formulated, it had in process manufacturing become managerially anachronistic; few,however, perceived it in America. Chandler and the US system of management education (and American management experience itself) had indoctrinated people in the West with the belief that managers are a special caste within society, verging on a profession (which they had never been) that acquired knowledge and skills about the management task in MBA courses. A vast literature about the growth of management and management education, on both sides of the Atlantic, bases its treatment of the expansion of modern management and management education on these assumptions.

Johnson refers to Big Three management in these "decoupled" production plants as "Management by Results.' Headquarters sets financial targets for each part of the corporation, then compels lower managers to meet them. He refers to Toyota management of the work process as Management by Means (Johnson & Bröms: Chapters 2 & 3).

Just as Chandler thought Management by Results is achieved with the tools of science – through the quantification of business studies and management methods, so does Johnson believe that Management by Means at Toyota is grounded in science. But the science is not Chandler's. Johnson's reflections on work process efficiency have in fact been heavily influenced by W. Edwards Deming (Deming, 1982, 1986) and by work in modern physics and biology (see, Fritjof Capra, 1982, Locke, 1996) that has epistemologically undermined the Cartesian-Newtonian world view, upon which the "New Paradigm" in Management studies (with its emphasis on measurement and qualification) rests. Out went measurement, in came references to the three principles that characterize the efficient "operation of all natural living systems in the universe (Johnson & Bröms: 73):

> 1. Self-Organization: Creative energy continually and spontaneously materializing in self-organizing forms that strive to maintain their unique self-identity. ….
>
> 2. Interdependence: Interdependent natural systems interacting with each other through a web of relationships that connects everything in the universe, relationships, which express the essential nature of reality (everything exists 'in the context of something else')
>
> 3. Diversity: resulting from the continual interaction of unique identities always related to one another."

Johnson does not claim that Toyota is a "living natural system," but he does claim that the TPS is isomorphic to one. In the TPS management does not control the process from outside the work taking place on the line. Control is systemic. He remarked, after thoroughly studying the Georgetown Kentucky Plant, that Toyota "does not rely on internal shop floor control systems, such as MRP (Material Requirements Planning) to manage the flow of work in production. Toyota does not drive operations with statistical controls, standard cost variance, or any similar information from accounting or production control sources, which is standard procedure in Big Three Plants." (p. 105). The financial executive at Toyota Kentucky says, Johnson reported, that 'the company never had nor does it intend to have a standard cost accounting system that provides cost and variance information for controlling operations." (p. 110). Then, how was production controlled? The answer: As in a self-organizing, interdependent, diverse living natural system, by the TPS's work process itself – "real time as part of direct work that is done to make every vehicle." (p. 111).

Ford's River Rouge plant influenced Toyota's efforts to achieve the benefits of nonstop, continuous flow volume production. To satisfy demand after WWII the company had to inject product variety into Ford's single product line. And to introduce variety into a continuous flow production plant, Toyota had to avoid the long down times needed to change, say stamping dies for different models and the stockpiling on the line of the huge number of parts that variety production required but a continuous flow process could not tolerate.

There is no need to describe the now famous techniques that Toyota incorporated into its production line to achieve steady cuts in the waste of material and time that permitted continuous flow production to include variety. Suffice it simply to name some of them found at the Georgetown facility: Takt time production (so many seconds per vehicle), standardized work, Jidoka (the Andon stop cord), Just in Time delivery from suppliers in and outside the factory (only the necessary product, at the necessary time, in the necessary quantities),

Heijunka (level sequencing of production), continuous improvement, Total Quality Control, and Kanban.

In a complex continuous flow process, to use these techniques efficiently did not require honing individual skills but cultivating relationships, through group work, job rotation, and learning of work standards, so that the employees on line could readily recognize bad work, poor quality and defective products and quickly call for help during the production process itself in order to correct abnormalities and assure quality.

So it is the collective motivation and organizational learning capacity of people running the techniques not the techniques proper that matters. For instance, at Toyota's plant in Georgetown workers on the assembly lines pull the andon cord thousands of time a week in order to signal for a supervisor's assistance when they spot a problem. In contrast, workers at Ford's truck factory in Dearborn, Michigan, which installed Toyota's Andon Stop Cord, (ostensibly to let the workers on the line as in Georgetown improve quality and eliminate defects), "pull the cord only twice a week – the legacy of generations of mistrust between shop-floor workers and managers" (Schifferes: 1). Trust is based on a moral order in the firm, which resides in the inner self of employees. Such a moral order is absent in the Big Three because management-devised control and surveillance systems typical of managerialism left a legacy of fear and conflict between management and employees in factories. On-line workers at Ford also do not pull the cord because they are used to outside maintenance people and managers correcting defects after the fact. They are not schooled in including recognition of defects as part of their work repertoire, do not know process work standards sufficiently to be able quickly to identify system faults, and fear being blamed personally for the defect to which pulling the cord draws attention.

Johnson and Bröms refer to operations in the TPS as Management by Means, wherein management does not concentrate on the financial results (as in the Big Three) but wherein all plant employees work together to perfect the means (the production process) that creates the results. If the means are in order, the results are automatically excellent.

They juxtaposed a list of phrases that contrast behavioral traits suited to Big Three manufacturing and the Toyota Production System (pp. 186-87):

Big Three	TPS
The "I" stands alone	Relationships are reality
Control the result	Nuture relationships
Follow finance-driven rules	Master life-oriented practices
Manipulate output to control costs	Provide output as needed on time
Increase speed of work	Change how work is done
Specialize and decouple processes	Enhance continuous flow
An individual is the cause: blame	Mutual interaction is the cause: reflect

Was this management? Not in the Chandlerian sense or in the sense understood by purveyors of the "New Paradigm" in management education. But Management by Means produced much better results.

C. Conclusion

Robert Cole wrote in 1999 that about 1980 "enormous uncertainty gripped" top US managers (Cole: 203). They feared that the Japanese "had developed a large competitive advantage" in manufacturing. What could explain the cause of the problem facing American industry Cole had them ask.

"Was it quality?"

"Was it productivity?"

"Was it low-paid workers, and/or cheap capital?"

"Was it unfair Japanese government support for their competitors (the Japanese)?"

"Was it a combination of factors?" (p.203)

It is instructive that none of the questions that Cole said top managers asked in 1980, nor the topics that Cole suggested himself in 1999, included "Was it systemic U.S. management failure?" Most Americans on Main Street, in leadership positions, or in mainline business schools would not have answered "Yes," then or today. But this essay about "managerialism" in the Big Three has answered in the affirmative.

Not that the distress the Big Three faced in 2008-09 was entirely the managers' fault. In "normal" times, automakers with serious money problems could have turned to Wall Street to find the cash needed to fund continuing operations and probably have gotten it. But the world-wide collapse and subsequent paralysis of the financial system created exceptional times, which prevented top Big Three management from appealing successfully to shaken financial institutions for the money to get them through a severe liquidity crisis. In the long run, however, the financial crisis of 2008-09 was just a final episode. The Big Three's fall really resulted from managers' failure to meet the JMS challenge at factory floor and corporate levels, and completely end the "Fordist" production regime. The source of that failure was the systemic inadequacies of U. S. managerialism that have been described here. Imprisoned in a management system in which they were the chief beneficiaries, trained to it in their skills, predilections, and modes of thinking, and lacking the skills and aptitudes necessary to running JMS, Big Three management was too lukewarm about the need to pursue the implementation of JMS in their own firms to carry transfer through energetically and effectively.

Of course, U.S. companies survive and thrive because managerialism is not co-extensive with American management. At the time U.S. firms failed to match Japanese managed transplants in transferring JMS in traditional staple U. S. industries (automobiles, steel, rubber, consumer electronics, machine tools, etc.), American entrepreneurs, participating in intricate webs of entrepreneurship located in complex regional habitats, carried through a new industrial revolution in Information Technology that spawned another generation of icon US firms (Microsoft, Intel, Oracle, Hewlett-Packard, etc.) (Saxanian, 1994, Best, 2001, Locke & Schöne, 2004). Once again, it amounted to a case of new technologies generating different managerial strategies and structures.

But even in these new technology businesses, failure to give precedence to "managing the means," as opposed to chasing Wall Street financial targets, has proved costly. Within US firms nothing entirely escapes the heritage of managerialism. As start-ups in IT mature, the entrepreneurial pioneers are sloughed off in boardrooms, to be replaced by MBA managers trained in the values and techniques of the New Paradigm. Even where quite

successful U.S. IT companies have borrowed JMS techniques the habits of managerialism have frustrated the borrowing. For example, Hewlett-Packard management, operating by MBO, a results oriented system, refused to transfer quality assessment techniques (*boshin* planning), that had crystallized in Japan in the 1970s and within HP's own Japanese subsidiary, until the 1990s, despite the subsidiary's urgings, because HP U.S. managers evaluated the implementation of the system in terms of Management by Results accounting, i. e., "financial performance." (Cole, 1999: 226).

Finally, the behavior and thinking of managerialism is responsible for the recent financial debacle that brought a cascade of firms including Two of the Big Three down. Unless the mathematicians in business schools had devised the financial instruments, "the abstract quantitative models," the fruit of "The New Paradigm," that bankers and brokers leveraged and sold to investors world-wide, they could not have exposed their institutions to such systemic risk and failure. Unless greedy brokers and top managers separated their interests from those of their clients and the general public (which is managerialism), they would not have pressed the sale of the mathematically contrived securities so relentlessly.

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The demise of neoliberalism?

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Introduction

The recent onset of the most severe, synchronised global economic slump since the 1930s depression has rekindled controversies over the contradictory “laws of motion” of capitalism and the very nature of capitalist money in the wake of the global financial meltdown, which preceded the slump. The evidence suggests that these recurrent crises have become more frequent, severe and prolonged during the neoliberal era from the mid-1970s onward and appear to have coincided with the policies of financial deregulation enacted during this period. Many heterodox critics have argued that the phenomenon of “financialisation” lies at the very core of these recurrent financial crises. The aim of this very brief analysis is to examine the dynamics of the current debilitating phase of financial instability from a historical standpoint. What are the implications of “financialisation”? Does the present conjuncture signify the final historical vestiges of the neoliberal project?

The neoliberal ascendancy

In a broader historical context, capitalist crises are functional and strategic. These crises signify the culmination of one process and the beginning of another. In a continuous, latent process of transformation, all of the subterranean, conflicting forces come to the surface and bring to light the very paradoxes of history itself. Through the dynamics of catharsis and reconstruction, capitalist crises provide the material basis by which profitability is restored once again. The “slaughtering of capital values”, to paraphrase Marx, is a necessary, though irrational means which allows the restructuring of production to establish the material and technological basis for yet another phase of accumulation. The recovery, however, is neither automatic nor entirely endogenous. The outcome will ultimately depend upon the complex relation of class forces. As Dobb quite perceptively contends: “To study crises was *ipso facto* to study the dynamics of the system, and this study could only be undertaken as part of an examination of the forms of movement of class relations and of class revenues which were their market expression” (Dobb, 1937: 81).

The ascendancy of finance capital after the long period of “financial repression” during the post-war Keynesian era was an integral element of a much broader strategy by the capitalist state to re-assert the hegemony of capital through the policies of neoliberal restructuring. The persistence of severe excess capacity, however, was never fully resolved. To be sure, the forcible ejection of superfluous capacity is precisely the functional role performed by capitalist crises to counteract a falling rate of profit and establish the basis for a renewed phase of accumulation. Although the strategy of imposing the rationalising logic of the market succeeded in winding back the previous gains of the working class, the restoration of profitability inevitably encountered the limits set by the chronic lack of effective demand. In most advanced capitalist countries, income inequalities only worsened over time as real wages stagnated. In order to maintain their real purchasing power in the face of stagnating real wages, workers were compelled to resort more than ever to the privations of debt servitude. Real purchasing power was increasingly augmented by burgeoning levels of household debt (Barba & Pivetti, 2009: 122). On the other hand, the wealth effect of rising asset prices transformed millions of ordinary workers into investors and acted as a powerful

transmission mechanism in the maintenance of the purchasing power of consumers. In 1987, 25 per cent of US households had a stake in the stock market. By the late 1990s, over half of all US households owned shares, either directly or indirectly through mutual funds (Harmes, 2001). Indeed, the financial assets of mutual and pension funds had grown by almost ten-fold since 1980, estimated at about $20 trillion in the late 1990s (Gilpin, 2000: 32). In the decade 1997-2007, real estate values had more than doubled – from about US$10 trillion to over US$20 trillion. Home mortgage liabilities rose even faster during this period – from US$2 trillion to over US$10 trillion (Wray, 2007: 27). The ratio of the median house price to median household income increased from about 3 to 1 in 2000, which reflected a relatively stable ratio over the previous three decades, to a historically unprecedented ratio of 5 to 1 in 2006 (Lim, 2008: 2). Indeed, between 1995 and 2007, house prices had risen by more than 70 per cent in real terms (adjusting for inflation). This represented an additional US$8 trillion generated by the housing wealth effect (Baker, 2007: 2).

Yet these neoliberal victories were always problematic and contingent. As the current crisis unfolds, it is becoming increasingly evident that the neoliberal transformation was to a large extent self-defeating. As the state regains a central role amidst the ruins of bankrupt financial institutions and the desperate attempts by the state to socialise losses and privatise profits, neoliberal ideology appears to have lost all credibility and legitimacy, not least from the standpoint of capital itself. The current crisis can be said to signify the final lingering remnants of a discredited neoliberal project. The re-alignment of class forces will doubtless determine how these complex ideological struggles will be consummated. The crisis will also sharpen these contradictory class conflicts and breed anti-systemic social forces. A brief history of neoliberalism reveals the limits of its own self-serving ideological and dystopian conceit. Despite the rather pyrrhic victories over the labour movement and the relative success in restoring the hegemony of capital, the neoliberal strategy could not resolve the fundamental problems of over-accumulation and economic stagnation. The successive speculative asset-price and equity booms have to some extent temporarily counter-acted these stagnationist tendencies but ultimately proved to be illusory for the mass of the population as the financial meltdown has testified. At the same time, the three decade-long Monetarist struggle against inflation has left in its wake stagnant economic growth; rising levels of structural unemployment; greater job insecurities and income inequities; and the re-emergence of deflationary forces inextricably associated with the chronic depression of effective demand.

The basic failure of the neoliberal strategy has been the unfounded faith that the market mechanism would automatically ensure that increased profits generated through the reduction of the wages share of national income were ultimately channelled into productive investment. In retrospect, however, the evidence suggests that the restoration of the rate of profit was achieved overwhelmingly through intensive rather than extensive forms of exploitation, which have had the overall effect of increasing the rate of productivity via the restructuring and rationalisation of the labour market. Consequently, the purgative forces induced by an intensification of competition have failed to reignite productive and technological dynamism; or what Schumpeter had alluded to as the gales of “creative destruction”. Instead of providing the foundations for technological reconversion and industrial upgrading, the sharp increases in aggregate profits were dissipated into corporate mergers and acquisitions, speculative financial engineering, and other forms of rent-seeking and entirely unproductive expenditures. In the aftermath of financial deregulation in the early 1980s, these speculative propensities reached truly astounding proportions and led to an unprecedented series of asset price booms. The business cycle has become almost entirely

dependent upon asset price bubbles. The real vulnerability of this finance-led regime of accumulation is that it has been based upon the greatest equity boom in modern history. The 1990s speculative boom in the United States has already reached its zenith. The bursting of the financial bubble is now reverberating on a global scale.

The myth of the market – depicted by the high priests of neoclassical economics as the bearer of allocative efficiency and the source of competitive and innovative dynamism – was in reality an ideological device to conceal the real interests of powerful corporate oligopolies. The consolidation of class rule involved the gradual redistribution of wealth through tax cuts, privatisation and deregulation, from ordinary wage earners to the upper echelons of wealthy shareholders and their subaltern corporate-class allies. Regardless of its party-political incumbents, the neoliberal state relentlessly pursued the dystopian vision of an informal empire of free enterprise (Arrighi, 1978). The mantra of free trade and the drive to deregulate labour markets accompanied these neoliberal nostrums, while wholesale privatisations provided a fertile terrain in the expanded reproduction of capital into formerly state-owned and regulated sectors (i.e., transportation, education, utilities, social infrastructure and services, natural resources, etc). These processes of "accumulation by dispossession" have been starkly portrayed by Harvey: "If the main achievements of neoliberalism have been redistributive rather than generative, then ways had to be found to transfer assets and redistribute wealth and income from the mass of the population towards the upper classes, or from the vulnerable to richer countries (i.e., accumulation by dispossession)" (Harvey, 2006: 43).

Financialisation

> In modern complex economies, a large and growing part of money capital (i.e., money invested with a view to earning more money) is not directly transformed into productive capital serving as a means by which surplus value is extracted from the productive utilization of labour power. Instead it is used to buy interest-bearing or dividend-yielding financial instruments...Many capitalists are being offered an enormous variety of financial instruments to choose from – stocks and bonds, certificates of deposit, money-market funds, titles to all sorts of assets, options to buy and sell, futures contracts, and so on. There is no presumption, let alone assurance, that money invested in any of these instruments will find its way, directly or indirectly, into real capital formation. It may just as well remain in the form of money capital circulating around in the financial sector, fuelling the growth of financial markets which increasingly take on a life of their own. (Magdoff & Sweezy, 1987: 96-97)

The ascendancy of finance capital was the driving force behind neoliberalism. The powerful rentier interests, who had been in long hibernation during the post-war "golden era" of Keynesianism, now assumed centre stage, propagating the doctrines of "shareholder value" and "sound finance". The onset of stagflation in the 1970s and 1980s as a result of successive oil price shocks, witnessed the rise of Monetarism as rentiers clamoured to restore the value of their financial assets from the depredations of inflation and the threat posed by the labour movement as it sought to increase the relative share of wages. Indeed, Kalecki had already foreseen the political aspects of full employment in his seminal article in 1943. Kalecki argued that full employment would not be tolerated by the "captains of industry" because of the threat this would pose for the maintenance of worker discipline in the factories and would ultimately weaken the role performed by the reserve army of labour in depressing

wages (Kalecki, 1943). The rise of Monetarism was precisely the panacea that Kalecki had uncannily foreseen, which would ostensibly restore profitability and shareholder value. The revival of pre-Keynesian economic doctrines witnessed the revival of Say's law of the market in its modern guise as the "efficient markets hypothesis". The ideology of these laissez faire doctrines was embellished with the dogma of budget surpluses, the abandonment of full employment policies and the winding back of the state. In the absence of countervailing modes of state regulation and governance, market fundamentalism inevitably destroyed the post-war Keynesian institutions and modes of regulation (Boyer 1996: 108). The persistence of high levels of unemployment, more volatile financial panics and the emergence of semi-permanent overcapacity have characterised the neoliberal era since the mid-1970s.

The crisis of over-accumulation means that markets have become saturated and in order to reinvest profitably, financial markets become the channels through which a growing proportion of capital is held and reinvested in its liquid form, while an ever-growing volume is devoted almost entirely to short-term speculation. To be sure, the successive waves of financialisation since the mid-1970s have been marked by speculative and predatory asset price booms and busts. Financial deregulation unleashed these powerful redistributive forces of accumulation by dispossession. The quite extraordinary rise in private indebtedness reduced whole populations into debt peonage and attracted millions into the vortex of speculative manias emanating from the stock market casinos. Ordinary workers were now drawn into the maelstrom of the financial markets as their wealth, in the form of real estate and mutual/pension funds, was increasingly subjected to the vicissitudes of these volatile markets. In short, the logic of financialisation has penetrated the ordinary lives of wage earners and inserted the ideology of the market in the reproduction of capitalist social relations. This process was reinforced by the dominant ideology of neoliberalism, which was pursued remorselessly by the neoliberal state as it proceeded to open up the public sphere to private investment and ownership. With the curtailment of state intervention and public investment, privatisation and the policies of deregulation gradually destroyed the institutions and regimes of regulation established during the post-war Keynesian era.

Financialisation propagated the doctrine of shareholder value, which soon began to govern the imperatives of corporate governance. Short-term financial gains based upon the maximisation of share market returns soon eclipsed and eventually undermined long-term investment strategies. A parasitical managerial class, motivated by short-term, speculative gains in the form of stock options and bonuses, became the new corporate predators. The pursuit of short-term shareholder value was frequently invoked to promote the downsizing of the workforce and the distribution of retained earnings to shareholders (Lapavitsas, 2008: 25-26). This strategy also led to the recurrent waves of hostile mergers and acquisitions during the equity booms of the 1980s and 1990s and ultimately to the massive over-valuation of market capitalisation spurred by booming equity prices and sustained by unprecedented leveraging operations. This whole process supported and accentuated the stock market boom of the 1990s and generated the illusory enrichment created by temporary asset price bubbles and the equally hallucinatory wealth effects induced by the financial euphoria. Initially led by the pension and mutual funds and later emulated by the more risk-seeking hedge funds, the theology of shareholder value mobilised and converted millions of ordinary workers into shareholders. Neoliberal ideology alone could not have mobilised this vast popular movement. As Minsky notes: "The pension and mutual funds have made business management especially sensitive to the current stock market valuation of the firm. They are an essential ingredient in the accentuation of the predatory nature of current American capitalism" (Minsky, 1996: 363).

In terms of stock market capitalisation, the value of financial assets and finance-based income has risen dramatically since the neoliberal era. In the US, for instance, stock market capitalisation as a percentage of GDP increased from its long-term average of about 50 per cent during the post-war era to more than 128 per cent in 2002 after peaking at 185 per cent at the zenith of the dot.com bubble in 1999. The ratio of profits of financial institutions to the profits of non-financial corporations rose from about 15 per cent on average in the 1950s and 1960s to almost 50 per cent in 2001 (Crotty, 2005: 85). Another indicator of the degree of financialisation is the level of private debt or the relative size of the US credit market. In 1981, for instance, the value of the US credit market was estimated at 168 per cent of GDP. By 2007, this figure was over 350 per cent. At the same time, the share of total corporate profits accrued in the financial sector expanded from only 10 per cent in the early 1980s to 40 per cent in 2006 (Crotty, 2008: 10). The increasing reliance of large corporations on the issuing of debt via the open financial markets rather than borrowing from the commercial banks reinforced this whole process of financialisation. The commercial banks were therefore deprived of their traditional sources of lending to corporations and began to engage in direct speculative operations in the real estate and equity markets. The other major new outlet for the commercial banks was the saturation of the household credit markets in mortgages and consumer credit. After financial deregulation, commercial banks also expanded their presence in financial market mediation through transactions in securities, derivatives, insurance and so on. Doubtless the most astounding evidence of financialisation was the astronomical rise of derivative contracts. The volume of the derivatives market in the US alone rose from about 3 times global GDP in 1999 to an estimated 11 times of global GDP in 2007. Credit default swap derivatives were estimated at $US62 trillion in 2007 (Crotty, 2008: 10). As Bryan and Rafferty note:

> In global currency markets daily turnover has grown 50-fold since the early 1980s, and is now about $US1.9 trillion a day. Two thirds of this is transacted in derivatives markets, with three quarters of this derivatives trade (half the overall market) made up of foreign exchange swaps. To put this daily $US1.9 trillion turnover in some perspective, the annual value of international trade is less than $US6 trillion; equal to roughly 3 days trade in foreign exchange markets. (Bryan & Rafferty, 2006: 55)

The overall effect of the decoupling of financial intermediation by the commercial banks has been to render the entire banking system more fragile (Toporowsky, 2008: 9-10). As Minsky warned quite presciently, financial innovation through the process of “securitisation”, has shifted the whole structure of the financial system towards a state of perilous and chronic instability: “In securitization, the underlying financial instruments (such as home mortgage loans) and the cash flows they are expected to generate are the proximate basis for issuing marketable paper. Income from paper (cash flows) is substituted for the profits earned by real assets, household incomes, or tax receipts as the source of the cash flow to support paper pledges” (Minsky, 2008: 4). Financial deregulation accelerated this Minskian process of pushing the financial system into a zone of extreme instability. The repeal of the Glass-Steagall Act in the US in 1999, which had prevented commercial banks from engaging in investment banking activity, represents a historical landmark in the annals of recent financial history. To be sure, the elimination of this legislation, which was put in place amidst the collapse of the US banking system in the 1930s, was the culmination of over three decades of radical financial deregulation. In retrospect, there is a very sound argument to suggest that the financial turmoil of 2008-09 signifies the final destructive cataclysm of more than three decades of disastrous neoliberal economic policies.

Conclusion

The current crisis reveals quite starkly the limitations of existing neoclassical theories of general equilibrium and debunks the monetarist myth of monetary neutrality. Quite ironically, policy-makers throughout the world have sought some guidance in the revival of neo-Keynesian theories and have attempted to re-learn some of the lessons of the 1930s depression. Whether these short-term expansionary fiscal and monetary policies will be sufficient to stabilise the slump and re-activate a synchronised recovery still remains to be seen. For the first time in over six decades, the world economy is now at the threshold of a severe synchronized downturn, which has engulfed the three major poles of accumulation in East Asia, the EU and the US. The only question that remains is over the severity of the emerging slump. In other words, will the dynamic of debt-deflation and excess capacity characterise the core economies of Europe, the United States and East Asia? Furthermore, is there a real likelihood that the world economy could relapse into another phase of depression?

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JEL: B5, B14, B16, B23
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Money manager capitalism and the global financial crisis[1]

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Abstract
This paper applies Hyman Minsky's approach to provide an analysis of the causes of the global financial crisis. Rather than finding the origins in recent developments, this paper links the crisis to the long term transformation of the economy from a robust financial structure in the 1950s to the fragile one that existed at the beginning of this crisis. As Minsky said, "stability is destabilizing": the relative stability of the economy in the early postwar period encouraged this transformation of the economy. Today's crisis is rooted in what he called "money manager capitalism", the current stage of capitalism dominated by highly leveraged funds seeking maximum returns in an environment that systematically under-prices risk. With little regulation or supervision of financial institutions, money managers have concocted increasingly esoteric instruments that quickly spread around the world. Those playing along are rewarded with high returns because highly leveraged funding drives up prices for the underlying assets. Since each subsequent bust only wipes out a portion of the managed money, a new boom inevitably rises. Perhaps this will prove to be the end of this stage of capitalism—the money manager phase. Of course, it is too early to even speculate on the form capitalism will take. I will only briefly outline some policy implications.

Keywords: Hyman Minsky, money manager capitalism, financial crisis, financial instability hypothesis, asset backed securities, commodities futures markets
JEL codes: G01, G2, E02, E12, E32, E44

Introduction

At the beginning of 2009, the world faces the worst economic crisis since the 1930s. Even mainstream economists have begun to talk about the possibility of a depression. References to Keynesian theory and policy are now commonplace, with only truly committed free marketeers arguing against massive government spending to cushion the collapse and re-regulation to prevent future crises. The final months of 2008 saw huge job losses in the US and elsewhere, and few believe that recovery will begin soon even with President Obama's fiscal stimulus package. All sorts of explanations have been proffered for the causes of the crisis: lax regulation and oversight, rising inequality that encouraged households to borrow to support spending, greed and irrational exuberance, and excessive global liquidity—spurred by easy money policy in the US and by US current account deficits that flooded the world with too many dollars.

Hyman Minsky's work has enjoyed unprecedented interest, with many calling this the "Minsky Moment" or "Minsky Crisis". (Cassidy 2008, Chancellor 2007, McCulley 2007, Whalen 2007) In this chapter I will not be able to address all rival explanations of the cause of the crisis. What I will do instead is to provide a sharper "Minskian" analysis than the superficial explanations that many others have offered. We should not view this as a "moment" that can be traced to recent developments. Rather, as Minsky had been arguing for nearly fifty years, what we have seen is a slow transformation of the financial system toward fragility. In the final years before his death in 1996, he had developed a "stages" approach to this evolution, identifying the current phase as "money manager capitalism". This chapter will focus on the role that money managers played in creating this crisis. It is essential to recognize that we have had a long series of crises, and the trend has been toward more

[1] This article is based on an update of "Financial Markets Meltdown: what can we learn from Minsky", and "The Commodities Market Bubble: Money Manager Capitalism and the Financialization of Commodities", both published by the Levy Economics Institute and available at www.levy.org.

severe and more frequent crises: REITs in the early 1970s; LDC debt in the early 1980s; commercial real estate, junk bonds and the thrift crisis in the US (with banking crises in many other nations) in the 1980s; stock market crashes in 1987 and again in 2000 with the Dot-com bust; the Japanese meltdown from the early 1980s; LTCM, the Russian default and Asian debt crises in the late 1990s; and so on. Until the current crisis, each of these was resolved (some more painfully than others; one could argue that Japan never successfully resolved its crisis) with some combination of central bank or international institution (IMF, World Bank) intervention plus a fiscal rescue (often taking the form of US Treasury spending of last resort to prop up the US economy to maintain imports).

Minsky always insisted that there are two essential propositions of his "financial instability hypothesis". (See Papadimitriou and Wray 1998 for a summary of Minsky's approach.) The first is that there are two financing "regimes"—one that is consistent with stability and the other in which the economy is subject to instability. The second proposition is that "stability is destabilizing", so that endogenous processes will tend to move a stable system toward fragility. While Minsky is best-known for his analysis of the crisis, he argued that the strongest force in a modern capitalist economy operates in the other direction—toward an unconstrained speculative boom. The current crisis is a natural outcome of these processes—an unsustainable explosion of real estate prices, mortgage debt and leveraged positions in collateralized securities in conjunction with a similarly unsustainable explosion of commodities prices. Unlike some popular explanations of the causes of the meltdown, Minsky would not blame "irrational exuberance" or "manias" or "bubbles". Those who had been caught up in the boom behaved "rationally" at least according to the "model of the model" they had developed to guide their behavior.

Following Hyman Minsky, I blame money manager capitalism—the economic system characterized by highly leveraged funds seeking maximum returns in an environment that systematically under-prices risk. With little regulation or supervision of financial institutions, money managers have concocted increasingly esoteric instruments that quickly spread around the world. Contrary to economic theory, markets generate perverse incentives for excess risk, punishing the timid. Those playing along are rewarded with high returns because highly leveraged funding drives up prices for the underlying assets—whether they are dot-com stocks, Las Vegas homes, or corn futures. Since each subsequent bust only wipes out a portion of the managed money, a new boom inevitably rises. However, this current crisis is probably so severe that it will not only destroy a considerable part of the managed money, but it has already thoroughly discredited the money managers. Right now, it seems unlikely that "business as usual" will return. Perhaps this will prove to be the end of this stage of capitalism—the money manager phase. Of course, it is too early to even speculate on the form capitalism will take. I will only briefly outline some policy implications.

The demise of banking and the rise of money managers

In the developed world there has been a long term transition away from relatively tightly regulated banking toward "market-based" financial institutions. This transformation is most clear in the US, which had separated commercial banking (loans and deposits) from investment banking (broader array of financial instruments including equities and securities). Two decades ago there was a lot of discussion of the benefits of the "universal banking" model adopted abroad (Germany, Japan), and there was some movement in the US in that direction. However, of far greater importance was the development of the "originate to

distribute" model best represented by securitization, and use of "off-balance sheet" operations. Ironically, the push to increase safety and soundness through creation of international standards as adopted in the Basle agreements actually encouraged these developments—which as we now know greatly increased systemic risk. Here I will focus on developments in the US, although to a lesser degree there was a similar transformation in other developed nations. This is not at all surprising given the importance of the US in the world economy and given that similar ideas were guiding policy makers and financial institution management around the world.

Modern securitization of home mortgages began in the early 1980s. While securitization is usually presented as a technological innovation that came out of private sector initiative to spread risk, in reality—as Minsky (1987) argued--it was a response to policy initiated by Chairman Volcker in 1979. (See also Kuttner 2007) This was the infamous experiment in monetarism, during which the Fed purportedly targeted money growth to fight inflation—pushing the fed funds rate above 20%. (Wray 1994) In the new policy regime, no financial institution could afford to be stuck with long term fixed rate mortgages. Hence, regulators and supervisors "freed" regulated banks and thrifts to pursue higher return, and riskier, activities. There is no need to recount the sordid details of that fiasco. (Wray 1994; Black 2005) However, the long term consequence was the recognition that the mortgage "market" had to change—with banks and thrifts shifting assets off their books through securitization.

Minsky (1987) was one of the few commentators who understood the true potential of securitization. In principle, all mortgages (indeed, most bank assets) could be packaged into a variety of risk classes, with differential pricing to cover risk. Investors could choose the desired risk-return trade-off. Financial institutions would earn fee income for loan origination, for assessing risk, and for servicing the mortgages. Wall Street would place the collateralized debt obligations (CDOs), slicing and dicing to suit the needs of investors. Securitization contributed to an apparent democratization of access to credit as homeownership rates rose to record levels over the coming decades—and it initially appeared that banks and thrifts were insulated from interest rate risk.

Minsky (1987) argued that securitization reflected two additional developments. First, it was part and parcel of the globalization of finance, as securitization creates assets freed from national boundaries. As Minsky was fond of pointing out, the unparalleled post-WWII depression-free expansion in the developed world (and even in much of the developing world) has created a global pool of managed money seeking returns. Packaged securities were appealing for global investors trying to achieve the desired proportion of dollar-denominated assets. It would be no surprise to Minsky to find that the value of securitized American mortgages eventually exceeded the value of the global market for federal government debt.

The second development is the relative decline of the importance of banks in favor of "markets". (The bank share of all financial assets fell from around 50% in the 1950s to around 25% in the 1990s.) This was encouraged by the experiment in Monetarism (that decimated the regulated portion of the sector in favor of the relatively unregulated "markets"), but it was also by continual erosion of the portion of the financial sphere that had been allocated by rules, regulations, and tradition to banks. The growth of competition on both sides of banking business—checkable deposits at non-bank financial institutions that could pay market interest rates; and rise of the commercial paper market that allowed firms to bypass commercial banks—squeezed the profitability of banking. Minsky (1987) observed that banks appear to

require a spread of about 450 basis points between interest rates earned on assets less that paid on liabilities. This covers the normal rate of return on capital, plus the required reserve "tax" imposed on banks (reserves are non-earning assets), and the costs of servicing customers. By contrast, financial markets can operate with much lower spreads precisely because they are exempt from required reserve ratios, regulated capital requirements, and much of the costs of relationship banking.

To restore profitability in the aftermath of Monetarism, banks and thrifts would earn fee income for loan origination, but by moving the mortgages off their books they could escape reserve and capital requirements. Investment banks purchased and pooled mortgages, then sold securities to investors. As Minsky (1987) argued, investment banks would pay ratings agencies to bless the securities, and hire economists to develop models to demonstrate that interest earnings would more than compensate for risks. Risk raters and economic modelers essentially served as credit enhancers, certifying that prospective defaults on subprimes would be little different from those on conventional mortgages—so that the subprime-backed securities could receive the investment-grade rating required by insurance and pension funds. Later, other "credit enhancements" were added to the securities, such as large penalties for early payment and buy-back guarantees in the event of capital losses due to unexpectedly high delinquencies and foreclosures—the latter became important when the crisis hit because the risks came right back to banks due to the guarantees. One other credit enhancement played an essential role—insurance on the securities, sold by MBIA (the world's largest insurer), AMBAC, FGIC Corp., and CFIG. Without affordable insurance, and without high credit ratings for the insurers, themselves, the market for pools of mortgages would have been limited. (Richard and Gutscher 2007) As soon as the crisis hit, the insurers were downgraded, which automatically led to downgrading of the securities—a nice vicious cycle.

The problem is that the incentive structure was sure to create problems. In the aftermath of the 2000 equity market crash, investors looked for alternative sources of profits. Low interest rate policy by Greenspan's Fed meant that traditional money markets could not offer adequate returns. Investors lusted for higher risks, and mortgage originators offered subprimes and other "affordability products" with ever lower underwriting standards. Brokers were richly rewarded for inducing borrowers to accept unfavorable terms, which increased the value of the securities. New and risky types of mortgages—hybrid ARMs (adjustable rate mortgages) that offered low teaser rates for two or three years, with very high reset rates—were pushed.[2] Chairman Greenspan approved the practice, urging homebuyers to take on adjustable rate debt.

As originators would not hold the mortgages, there was little reason to worry about ability to pay. Indeed, since banks, thrifts, and mortgage brokers relied on fee income, rather than interest, their incentive was to increase through-put, originating as many mortgages as possible. By design, the Orwellian-named "affordability products" were not affordable—at the time of reset, the homeowner would need to refinance, generating early payment penalties and more fees for originators, securitizers, holders of securities, and all others in the home finance food chain. The fate of homeowners was sealed by bankruptcy "reform" that makes it

[2] According to an analysis of $2.5 trillion worth of subprime loans performed for the *Wall Street Journal*, most of those who obtained subprime loans would have qualified for better terms. For example, in 2006 61% of subprime borrowers had credit scores high enough to obtain conventional loans. Because brokers were rewarded for persuading borrowers to take on higher interest rates than those they qualified for, there was strong pressure to avoid conventional loans with lower rates. (Brooks and Simon, 2007) This may also explain why brokers accepted little documentation from borrowers.

virtually impossible to get out of mortgage debt—another nice "credit enhancement" provided by Congress.

The combination of incentives to increase throughput, plus credit enhancements led to virtually no reluctance to purchase securities with the riskiest underlying debts. While relationship banking had based loans on the relevant characteristics of the borrower (such as income, credit history, assets), the new arrangements appeared to offer a nearly infinite supply of impersonal mortgage credit with no need to evaluate borrower ability to repay. Instead, "quant models" based on historical data regarding default rates of purportedly similar borrowers would replace costly relationship banking, enhancing efficiencies and narrowing interest rate spreads. (Kregel 2007) Risky mortgages were pooled and sliced into a variety of tranches to meet the risk-return profile desired by investors. Senior tranches would be paid first; more junior, non-investment grade, tranches could be sold to hedge funds that would receive payments only if the senior securities were fully serviced. (Incredibly, junior tranches could be pooled a second time, and even third time, and sliced into senior and junior tranches—transforming the riskiest junk into investment-grade senior securities.)

In sum, by 2000, the nature of the real estate finance market had changed in a fundamental manner so that it would evolve toward fragility. The growth of securitization led to a tremendous increase of leverage ratios—typically at least 15-to-1 and often much greater--with the owners (for example, hedge funds) putting up very little of their own money while issuing potentially volatile commercial paper or other liabilities to fund positions in the securities.[3] A virtuous cycle was created over the course of the 1990s that led to the boom and subsequent bust. The economic stability encouraged financial innovations that "stretched liquidity" in Minsky's terminology; this plus competition urged financial institutions to increase leverage ratios, increasing credit availability. This is because for given expected losses, higher leverage raises return on equity. With easy credit, asset prices could be bid up, and rising prices encouraged yet more innovation and competition to further increase leverage. Innovations expanded loan supply, fueled homebuying and drove up the value of real estate, which increased the size of loans required and justified rising leverage ratios (loan-to-value and loan-to-income) since homes could always be refinanced or sold later at higher prices if problems developed. The virtuous cycle ensured that the financial system would move through the structures that Minsky labeled hedge, speculative and finally Ponzi--which requires asset price appreciation to validate it. Indeed, the virtuous cycle made Ponzi position-taking nearly inevitable.

The new "originate and distribute" model is much less subject to control by policy, and is also less amenable to assistance when things go bad. Instead of a closely regulated industry, home finance became a mostly unsupervised, highly leveraged, speculative activity. The Ponzi phase would end only if rates rose or prices stopped rising. Of course, both events were inevitable, indeed, were dynamically linked because Fed rate hikes would slow speculation, attenuating rising property values, and increasing risk spreads. When losses on subprimes began to exceed expectations based on historical experience, prices of securities began to fall. Problems spread to other markets, including money market mutual funds and commercial paper markets, and banks became reluctant to lend even for short periods. With big leverage ratios, money managers faced huge losses greatly exceeding their capital, and

[3] As Chancellor (2007) reports, modern risk management techniques use historical volatility as a proxy for risk. As volatility falls, risk is presumed to fall, which induces managers to increase leverage ratios. The period called "the great moderation" by Bernanke (2004) suggested that volatility would be permanently lower, hence, higher leverage ratios were deemed prudent. Chancellor reports that a hedge fund with only $10 million of own funds could leverage that up to $850 million of collateralized mortgage obligations—a leverage ratio of 85 to 1.

began to de-leverage by selling, putting more downward pressure on prices. As the subprime market unraveled, fears spread to other asset-backed securities, including commercial real estate loans, and to other bond markets such as that for municipal bonds. Markets recognized that there were systemic problems with the credit ratings assigned by the credit ratings agencies. Further, they realized that if mortgage-backed securities, other asset-backed securities, and muni bonds are riskier than previously believed, then the insurers will have greater than expected losses. Ratings agencies downgraded the credit ratings of the insurers. As the financial position of insurers was questioned, the insurance that guaranteed the assets became worthless—so the ratings on bonds and securities were downgraded. In many cases, investment banks had a piece of this action, holding the worst of the securities, and they had promised to take back mortgages or had positions in the insurers—in retrospect, a huge mistake.

As of January 2009, US financial institutions had written off $1 trillion of bad assets. The Treasury had injected nearly $400 billion of "bail-out" funds either through asset purchases, by taking non-voting equity shares, and by subsidizing mergers. The Fed's balance sheet had expanded to nearly $2 trillion as it lent reserves to US banks and to foreign central banks. Even the most conventional projections expect at least another $1 trillion of bank write-downs. Most observers believe many more banks will fail, and that Treasury costs of the bail-outs to come could be in the trillions of dollars. Note that the total securitized universe was only $10 trillion, of which subprimes were $2.5 trillion. It is clear that the losses incurred and expected to be incurred are not simply a matter of some bad mortgage loans made to low income borrowers to buy suburban mansions they could not afford. Rather, this is a crisis of the whole money manager system. And because so much of it is unregulated, unreported, and off-balance sheet, there is no way to even guess the ultimate scale of losses.

Commodities boom and bust

Over the course of the 2000s, we also saw a commodities market boom. I begin with an analysis of three explanations for the explosion of commodities prices. While often presented as rivals, I argue that simply because one explanation is valid that does not make the others incorrect. Indeed, there are synergies enabling the several forces driving prices higher to reinforce one another. Supply and demand is the explanation provided by most economists. Supplies are naturally constrained while demand is climbing—pushing prices higher. The second story involves market manipulation by commodities producers and traders. Finally, there is a growing belief that speculation in commodities futures markets is the real culprit. I argue that all three explanations are plausible and the identified mechanisms are mutually reinforcing. However, the rise of investments in commodities indexes (called "index speculation") is the most important cause. Further, commodities merely represent the latest asset class identified by money manager capitalism as ripe for financialization. If money manager capitalism is at the root of the problem, then it is the system that must be changed.

By fall 2008 commodities prices reversed course. To a large extent this seems to be due to the decision made by index speculators to pull out of futures markets (fearing that Congress will tighten regulations—and providing support to the view that the price boom was indeed fueled by their speculation).While this brings welcome relief it does not mean we are out of the woods. Falling commodity prices will generate problems: production decisions as well as portfolio allocations have been made on the expectation of rising prices, so just as falling real estate prices are devastating for households, for the real estate sector generally,

and for financial markets, there will be significant fall-out from falling commodities prices. Thus, a policy response is still necessary.

A. Supply and demand

Most of the press has focused on rising oil, corn, and gold prices. But in fact, the boom has taken place across a wide range of commodities, and indeed is unprecedented in scope and size. According to Frank Veneroso (2008a), over the course of the twentieth century, there were previously just 13 instances in which the price of a single commodity rose by 500% or more. For example, the price of sugar rose 641% in 1920, and in the same year the price of cotton rose 538%. During the Hunt brothers episode in 1980, silver prices were driven up by 3813%. If we look at the current boom, there were eight commodities whose price rise equaled 500% or more: heating oil (1313%), nickel (1273%), crude oil (1205%), lead (870%), copper (606%), zinc (616%), tin (510%), and wheat (500%). Many other agricultural, energy, and metals commodities also had large price hikes, albeit below that threshold (for the 25 commodities typically included in the commodities indexes, the average rise since 2003 has been 203%). (Masters and White 2008) There is no evidence of any other commodities boom to match the current one in terms of scope.

We “know” from our principles of economics textbook that the cause must lie somewhere between the “scissors” of supply and excess demand that drives prices higher. While it is true that there have been supply problems associated with some of these commodities, none was significant enough to explain such price hikes. Thus, most of those favoring the supply and demand story look to the demand side, in particular, to the rapid development of China and India. While appealing, the story is flawed. World growth has not been unusually high—rapid expansion in parts of Asia is offset by sluggish economies in Africa and Europe. Nor has growth of oil demand been rapid enough to explain price hikes. While it is true that China’s demand was growing very rapidly early in this decade, the growth rate fell off as oil prices rose. US consumption stabilized by mid-decade, long before oil prices peaked. Finally, although demand has fallen off as economies slipped into recession, actual consumption of most commodities has fallen only slightly—not enough to explain the rapid price deflation observed.

Further, if markets were perfectly competitive, i.e., they contain so many buyers and sellers that none can influence the price, then the story provided by economists makes some sense. Trouble is, commodities markets – especially oil – are far from perfectly competitive. Many are produced in conditions of oligopoly (a few producers—OPEC and Russia in the case of oil) and/or are sold to oligopsonists (a few buyers--ADM and Cargill in the case of grains) who intermediate between many producers and final consumers. In addition, many commodities are targeted by government policy. As crude oil prices rose, Congress decided to subsidize on a massive scale biofuels production—boosting corn and soy prices even as biofuels production increased use of oil (given US agricultural practices, production of the crops is energy-intensive). Attributing these price pressures to “supply and demand” is misleading.

B. Manipulation of prices

In recent years there have been several well-publicized cases of manipulation of commodities prices. For example, in winter 2004 British Petroleum monopolized 90% of all US TET propane supplies, withholding enough to drive prices up. In 2007 it reached a court

settlement, agreeing to pay $303 million in penalties and restitution. (Stupak 2007) Amaranth manipulated natural gas spot prices by driving down futures prices in the last 30 minutes of trading for the March, April and May 2006 contracts, making profits shorting positions in the ICE (International Commodities Exchange) market before collapsing. (ibid) Other well-known cases include the Hunt brothers manipulation of silver prices, the Hamanaka affair in copper, the Marc Rich and Manny Weiss manipulation of aluminum, and the Tiger affair in palladium. (Veneroso 2008a) In any case, there is little doubt that manipulation has played *some* role.

After crude oil prices exploded, the CFTC put together a Nationwide Crude Oil Investigation that culminated in charges levied against Optiver for price manipulation back in March 2007, finding its traders had successfully moved prices by small amounts to their benefit. Since 2002 the CFTC has filed 42 enforcement actions charging 72 defendants with manipulation; in addition, the Department of Justice has filed more than 47 criminal complaints. (Veneroso 2008b; Lukken 2008)

However, so long as the term “manipulation” is limited to the actions of individual traders, it cannot play a large role in the current commodities boom since the most important markets—oil, soy, corn, wheat—are too big to be influenced for anything but the shortest period. As we will discuss in the next section, it is possible that commodities prices have been pushed by massive inflows of managed money *legally* following a “buy and hold” strategy that is self-reinforcing precisely because it will be successful so long as the flows are large enough.

C. Index speculation in commodities futures markets

After equity prices collapsed in 2000, a number of researchers demonstrated that commodities prices are uncorrelated with returns from fixed income instruments (for example, bonds) and equities (stocks). Thus, holding commodities reduces volatility of portfolios. Further, it was shown that commodities provide an inflation hedge. However, holding commodities is expensive—there are substantial storage costs. Hence, money managers looked to the futures market—paper claims to commodities. Because a futures contract would expire on the contracted date, the holder of the paper would then be in a position to receive the commodities. Of course, money managers do not want to *ever* receive the commodities scheduled to be delivered, so the contracts are “rolled” on the scheduled date—into another futures contract with a delivery date farther into the future.

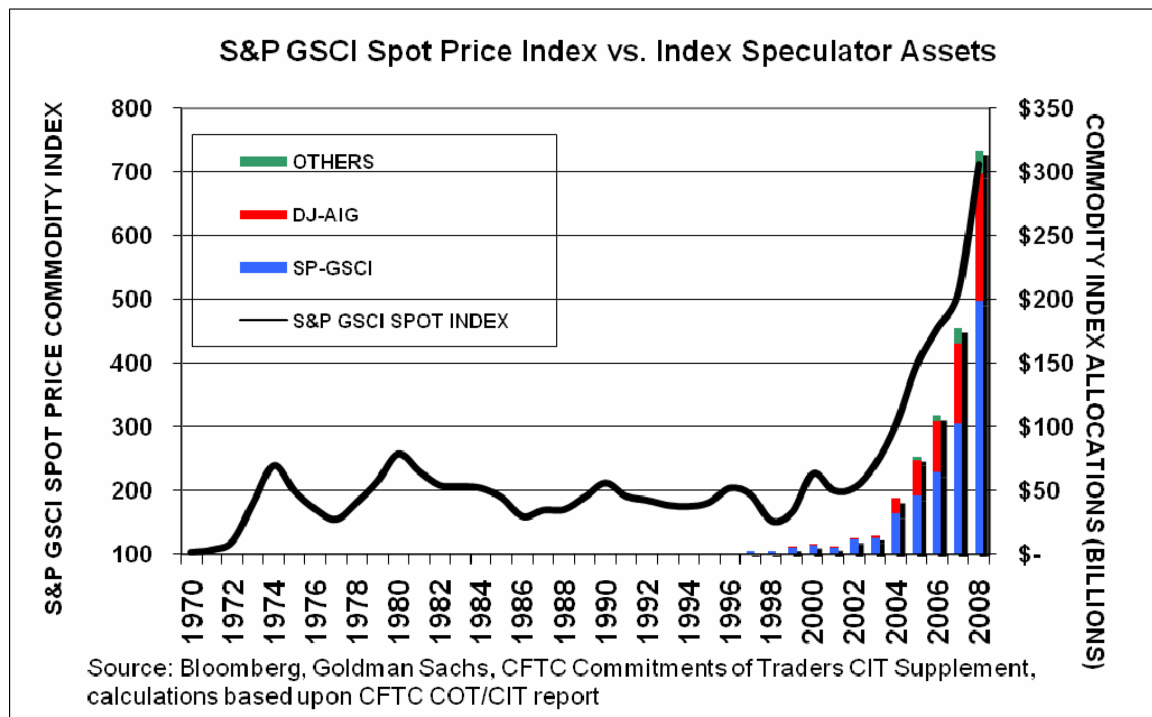
There are three main types of participants in these markets: hedgers, traditional speculators, and index speculators. Index speculators are typically hedge funds, pension funds, university endowments, life insurance companies, sovereign wealth funds, and banks. Most importantly, they only take long positions—it is a buy and hold strategy, allocating a specific portion of the portfolio to commodities. To simplify allocation, managed money replicates one of the commodity futures indexes—hence the term “index speculator”. The biggest are SP-GSCI and DJ-AIG. If index prices rise, index speculators earn returns. Indeed, because commodities futures contracts do not pay any yield, the only possible source of return is an increase of the price of the futures contracts. For this reason, purchase of a commodities futures index is fundamentally a speculative activity. Prior to the 1990s, the Prudent Investor rule prohibited pensions from buying such contracts. (Masters and White 2008) It was the collapse of the equities market in 2000 and the discovery that the performance of commodities was not correlated with equities that led to use of futures

contracts to reduce portfolio risk. This is what allowed Goldman, Sachs & Co. as well as other indexers to successfully push commodities futures as a new asset class for prudent investors.

Energy commodities dominate these indexes, with petroleum-related products accounting for 58%. The biggest agricultural commodities weightings are given to corn, soybeans, and wheat; the biggest shares for metals are in aluminum, copper and gold. Typically, managed money allocates 4 or 5% of a portfolio to commodities. While this might appear small, the size of managed money funds is gargantuan relative to the size of commodities. For comparison purposes, Masters (2008a, 2008b) pointed out that the total increase of Chinese consumption of oil over the past five years totaled 920 million barrels, while index speculators increased their holdings of oil contracts by 848 million barrels during the same period. As another example, index speculators hold contracts for over 1.3 million tons of copper, out of a total annual production of less than 18 million tons. (Masters and White 2008 p. 18) Indeed, index speculators hold a sufficient quantity of wheat futures to supply America's demand for wheat for two years, and contracts on enough corn to supply the US ethanol industry for a year. (ibid) Masters and White (2008 p. 20) estimate that the total volume of futures contracts purchased in the past five and a half years has increased by about 5.3 million, of which index speculators bought 2.7 million—or just over half. By contrast, physical hedgers purchased just a fifth. In 2002 there was a total of about $50 billion of managed money in the indexes, growing above $100 billion in 2006 and above $300 billion at the peak. (Masters 2008a) It is hard to avoid the conclusion that the index speculator tail is wagging the physical hedger dog.

The case that these inflows of funds have driven commodity prices ever-higher seems easy to make. Figure 1 plots the spot price of the S&P GSCI index—which reflects the current market price of 25 basic commodities—with the flow of managed money into futures markets. This is because the concern is whether activity in futures markets is impacting today's commodities prices.

Figure 1: S&P GSCI Spot Price Index vs Index Speculator Assets



Source: Bloomberg, Goldman Sachs, CFTC Commitments of Traders CIT Supplement, calculations based upon CFTC COT/CIT report

The correlation is remarkable: higher money inflows lead to higher prices. However, as any economist will warn, correlation never proves causation. And, indeed, the causation must go both ways: rising prices encourage more inflows, and more inflows generate higher prices. But even with that caveat, the evidence appears at least superficially quite strong that it is a speculatively-driven run-up of commodities prices.

The economist urges caution. Why would purchases of futures contracts drive up today's spot prices? (Orthodoxy presumes the reverse: fundamentals determine spot prices, and expectations of future spot prices determine futures prices.) The reason is "price discovery". Commodities production is often local, while final consumption is more geographically dispersed. For example, wheat is farmed in several distinct rural regions in the US, with ultimate consumers more than a thousand miles away. Farmers sell to local grain elevator owners who act as intermediaries. Neither the farmer nor the local grain elevator owner has much information about the price the grain might fetch when sold to food processors. However, unlike the local market for the physical commodity, the commodity futures market is national and even international. Futures prices are readily available and reflect real time "supply and demand". Thus, local commodities markets have come to rely on futures markets as the primary source of price information. There is then an adjustment made to reflect local conditions—much as Kelly's Blue Book adjusts used car values to reflect local market conditions by zipcode.

The use of commodities futures markets has eliminated the sometimes large differences between prices in various regional spot markets that existed prior to the 1980s. (Masters 2008b) Now, as the CFTC describes it, "In many physical commodities (especially agricultural commodities), cash market participants base spot and forward prices on the futures prices that are 'discovered' in the competitive, open auction market of a futures exchange." (quoted in Masters 2008b) Describing oil pricing, Platts (the biggest pricing service for the energy industry) writes "In the spot market, therefore, negotiations for physical oils will typically use NYMEX as a reference point, with bids/offers and deals expressed as a differential to the futures price." (Platts 2007) Ironically, even the S&P-GSCI and the DJ-AIG "spot" price commodity indexes are actually "based predominantly upon the prices of the nearest-to-expiration futures contracts for their respective set of commodities". (Masters and White 2008, p. 8) Finally, Masters emphasizes the point: *"In the present system, price changes for key agricultural and energy commodities originate in the futures markets and then are transmitted directly to the spot markets."* (Masters 2008b, emphasis in original)

In summary, index speculators have driven prices for commodities to historic levels. Commodities markets deviate substantially from the textbook models, with prices that are administered rather than set by fundamental forces of supply and demand. In many cases, spot prices are determined directly by futures prices. Futures prices, in turn, are influenced by a variety of forces including attempts by buyers and sellers to hedge price risk, by traditional speculators to go short or long as they make guesses about price movements, and by index speculators diversifying portfolios into a new asset class—commodities. It is no coincidence that futures prices soared over the past four years as managed money flowed into markets--coming from pension funds, sovereign wealth funds, hedge funds, and banks (mostly European). This reinforced other factors that had been driving up prices, including rapid growth in China and India as well as some supply constraints and inventory manipulation. Government policies, including export restrictions and US biofuels incentives, also played a role. These policy choices were themselves prodded by rising commodities prices, even as

they contributed to rising prices. A perfect storm was created in which almost every participant's interest lay in continued price gains.

Once managed money achieved the desired allocation of commodities, the large volumes of inflows subsided. Further, when Congress began to investigate the role of managed money in commodities markets, pension funds retreated fearing bad publicity and possible regulation. Suddenly prices stopped rising. Traditional speculators revised their expectations and some began to short commodities. A strong price reversal took place between mid-July, when the price of oil brushed up against $150 a barrel, and mid-August, when it had dropped below $115. (By January 2009 the price had plummeted toward $40; it is estimated that one-third of all the managed money had fled the market by fall 2008.) Producers who had made business plans based on rising prices find that they cannot succeed in an environment of falling commodities prices. We have seen the result of falling agricultural commodities prices several times during the past century; of course the most significant was during the period described in *The Grapes of Wrath*. The consequences for rural America and its banks can be severe. Farmers in rural areas around the globe are already feeling the pinch. While starvation hit urban areas in the price boom, now it is the rural poor that are starving.

Policy responses

Let us first deal with the commodities market crisis because that appears simplest to resolve. Much of the managed money engaged in index speculation benefits from explicit or implicit government guarantees (such as the insurance that stands behind pensions) and from tax benefits (tax-advantaged savings). If Congress should find that public interest is threatened by index speculation, then it should prohibit commodity index replication strategies. Masters and White (2008) have argued for revision of the Prudent Investor rule to explicitly prohibit pension investment in commodities. Alternatively, they note that if all profits from speculation in commodities were subject to tax, it would severely reduce the attractiveness of these markets for tax-advantaged savings. While it is beyond the scope of this chapter, it is also necessary to close the various loopholes that allow commodities speculation to escape regulation and oversight.

Assuming the commodities market boom is coming to an ugly end, Congress also needs to consider what can be done to cushion the collapse. Those holding futures contracts that cannot be rolled without catastrophic losses include pension funds, banks, and hedge funds. Further, to the extent that futures prices affect spot prices, producers of agricultural commodities are now finding that market prices won't cover costs incurred. Already tight global food supplies will be restricted further if farmers react the way they usually do to falling prices: by destroying crops and slaughtering animals. Alternative energy suppliers will be hurt by falling crude oil prices. To help relieve distress, Congress needs to ramp-up global food aid this year, purchasing agricultural output to help US farmers facing falling prices, to be distributed to the world's hungry. American producers—especially of alternative energy—also need to be protected from falling commodities prices. More subsidies for wind, solar, and geothermal energy will be needed.

More generally, the commodities market bubble (and coming crash) is the third such episode in the past decade that resulted from unfettered, lemming-like herding of money over the cliff. To be sure, there have been many earlier examples—muni bonds in the 1960s,

commercial paper in the late 1960s, REITs in the early 1970s, commercial real estate and LBOs in the 1980s, and so on. The problem is that managed money has grown tremendously, and leverage ratios have risen as taste for risk grew even as ability to perceive risk became ever scarcer. (Minsky used to attribute this to fading memories of the Great Depression; many of today's money managers cannot even remember the 1980s—much less the 1930s.) As a result, we have—we might say—command over too much money chasing too few good asset classes with what are perceived to be acceptable returns.

The US (and global) financial sector continues to reel from the crisis that began with subprime mortgages; falling commodities prices will only make that very much worse. Pension funds will be threatened, depleting the Pension Benefit Guarantee Corporation. The FDIC's "insurance" fund is already insolvent on any honest accounting basis. A lot of bail-out funds have already been spent in the US and abroad, and more will be spent. Still, if a lot of wealth is not wiped out, there will be tremendous pressure on money managers to find yet another asset class ripe with possibilities for lofty returns. Without greater oversight, the "cure" could be worse than the disease. So bail-outs will be needed, but strings must be attached in the form of regulatory constraint to prevent another boom/bust cycle.

Time and economic growth can go a long way in restoring financial health—if incomes can grow sufficiently, it becomes easier to service debt. The private sector cannot be the main source of demand stimulus as it has been running up debt, spending more than its income for a decade. While the government budget deficit is already growing as the economy slows, this results from deterioration of employment and income (which lowers taxes and increases transfers)—thus it will not proactively create growth although it will help to constrain the depths of recession. What is needed is a massive fiscal stimulus—probably twice the $800 billion that the Obama team will propose—and then a permanently larger fiscal presence to allow growth without relying on private sector debt.

We will also have to have mortgage relief. President Roosevelt created an RFC-like agency, the Home Owners' Loan Corporation (HOLC), to take on the tasks of saving small home owners. This successfully refinanced 20% of the nation's mortgages, issuing bonds to raise the funds. While a fifth of those loans eventually were foreclosed, the HOLC actually managed to earn a small surplus on its activities, which was paid to the Treasury when it was liquidated in 1951. Clearly, there are lessons to be learned from that experience: refinance is preferable to foreclosure as it preserves homeownership and communities. Congress must promulgate regulations on mortgage originators to establish new licensing requirements, put restrictions on saddling borrowers with riskier loans, and provide liability for financial institutions that sell mortgages. In addition, Congress should set new standards to be met by originators regarding ability of borrowers to make payments. New regulations of appraisers, risk rating agencies, and accounting firms will be required.

Policy should avoid promotion of financial institution consolidation—a natural result of financial crises that can be boosted by policy-arranged bail-outs. Minsky always preferred policy that would promote small-to-medium sized financial institutions. Unfortunately, policy-makers who are biased toward "free markets" instinctively prefer to use public money to subsidize private institution take-overs of failing financial firms. The Roosevelt alternative should be adopted: temporary "nationalization" of failing institutions with a view to eventually return them to the private sector at a small profit to the US Treasury. This is what Minsky advocated during the thrift crisis of the 1980s, but President Bush, senior, chose industry consolidation and public assumption of bad assets that resulted in Treasury losses—bad

policy repeated by Bush, Junior's Treasury Secretary Paulson. Policy should instead foster competition, with a bias against consolidation and with greater regulation of the banking, protected, sector.

Minsky argued that the Great Depression represented a failure of the small-government, Laissez-faire economic model, while the New Deal promoted a Big Government/Big Bank highly successful model for financial capitalism. The current crisis just as convincingly represents a failure of the Big Government/Neoconservative (or, outside the US, what is called neo-liberal) model that promotes deregulation, reduced supervision and oversight, privatization, and consolidation of market power. It replaced the New Deal reforms with self-supervision of markets, with greater reliance on "personal responsibility" as safety nets were shredded, and with monetary and fiscal policy that is biased against maintenance of full employment and adequate growth to generate rising living standards for most Americans. The model is in trouble—and not just with respect to the current global crisis, as the US faces record inequality and destruction of the middle class, a healthcare crisis, an incarceration disaster, and other problems beyond the scope of this analysis. (See Wray 2005 and Wray 2000)

We must return to a more sensible model, with enhanced oversight of financial institutions and with a financial structure that promotes stability rather than speculation. We need policy that promotes rising wages for the bottom half so that borrowing is less necessary to achieve middle class living standards. We need policy that promotes employment, rather than transfer payments—or worse, incarceration—for those left behind. Monetary policy must be turned away from using rate hikes to pre-empt inflation and toward a proper role: stabilizing interest rates, direct credit controls to prevent runaway speculation, and supervision.

Minsky insisted "the creation of new economic institutions which constrain the impact of uncertainty is necessary", arguing that the "aim of policy is to assure that the economic prerequisites for sustaining the civil and civilized standards of an open liberal society exist. If amplified uncertainty and extremes in income maldistribution and social inequalities attenuate the economic underpinnings of democracy, then the market behavior that creates these conditions has to be constrained." (Minsky 1996, pp 14, 15) It is time to take finance back from the clutches of Wall Street's casino.

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CEPR responds to the IMF's defense of its policies during the world recession

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The International Monetary Fund (IMF) presented a response to CEPR's latest paper, which looked at the macroeconomic policies of 41 countries that currently have agreements with the Fund. Our paper had found that 31 of the 41 countries had implemented pro-cyclical policies, that is, either fiscal or monetary policies that would be expected to exacerbate an economic downturn, when such downturns were occurring in these countries.

The IMF response was presented by James Roaf (Deputy Division Chief, Emerging Markets, Strategy, Policy and Review Department), in a PowerPoint presentation and panel discussion on October 15, 2009.[1] Most of the arguments, as well as graphs and charts, can also be found on the IMF web site,[2] and in two recent papers.[3]

The IMF's first argument is that its policies have been "countercyclical, not procyclical!" as expressed in the PowerPoint presentation. The IMF's presentation backs this up by looking at 15 emerging market countries and stating that program countries "Expanded fiscal deficits in 14 of 15" cases.[4] Similarly, the IMF's review of crisis policies in low-income countries finds that "Close to two-thirds of the programs designed in 2007-09 increased the level of spending over time."[5]

How can this be reconciled with CEPR's finding that 31 of 41 countries with current policies have implemented counter-cyclical policies? After all, we are all using the same data, which comes from IMF documents and databases.

There are two main reasons for the competing claims. First, the IMF is ignoring its agreements that were signed in 2008, when the world economy was sliding into recession. This is when most of the 31 agreements with pro-cyclical policies were signed. As we acknowledged in our paper, in many cases the pro-cyclical policies, such as reducing the fiscal deficit, were later loosened. However, since there are up to four to six months, and sometimes longer, before such agreements are reviewed, the decision to tighten fiscal and/or monetary policy during the downturn can still be expected to cause damage.

Second, the IMF's response to CEPR's paper, as well as its own papers, did not deal with monetary policy, but instead was limited to fiscal policy. Although 14 of the 31 countries where pro-cyclical policies were found had both pro-cyclical fiscal and monetary policies, there were seven countries that only had pro-cyclical monetary policy. In many cases, tightening monetary policy during an economic downturn can be at least as damaging as tightening fiscal policy.

This decision to tighten fiscal and monetary policy during an economic downturn in 31 countries represents a significant policy mistake, and a continuation of a long-term policy bias toward overly-restrictive fiscal and monetary policies, for which the IMF has been subject to criticism – some coming from its own Independent Evaluation Office[6] - over many years. The Fund should therefore acknowledge these mistakes, rather than trying to paper them over, and take measures to make sure that they do not happen again.

This is especially important in light of the uncertainties surrounding the recovery of the world economy next year. As the IMF's latest World Economic Outlook notes,[7] there are many downside risks with regard to the expected recovery of the world economy next year. This is especially true of the US economy, which accounts for about one quarter of world GDP. The fiscal stimulus that has been allocated for 2009, for example, is a small fraction – perhaps about one-tenth – of the falloff in private demand that could be expected from the collapse of the U.S. housing bubble.[8] It is not yet clear whether the Congress will provide additional fiscal stimulus.

Given the acknowledged downside risks to the recovery, it is important in the IMF's reviews of current agreements, as well as new ones, that it err on the side of caution. As the Federal Reserve of the United States has pledged to do, it should be careful not to hobble the recovery by premature tightening of monetary policy, or fiscal policy as well.

When is fiscal policy counter-cyclical or pro-cyclical?

Another important issue that came up in this discussion is the definition of pro-cyclical fiscal policy. In our paper on the IMF's current agreements, we adopted a criterion that was overly conservative – that is, it did not count as pro-cyclical some fiscal policy stances that would be widely seen as such, for example in the United States.

In our paper, we only counted as pro-cyclical fiscal policy cases where the fiscal deficit was programmed to narrow (or surplus to increase), while the economy was in a downturn. This was done for the sake of argument, and also because we did not have access to data that would allow a calculation of the structural fiscal balance (see below). When the IMF states that program countries "Expanded fiscal deficits in 14 of 15" cases, and cites this as evidence of "Countercyclical, not Procyclical!" policy,[9] it is limiting the definition of pro-cyclical to those cases where the fiscal deficit narrows during a downturn.

However, this definition is too narrow. Suppose, for example, that the economy is at full employment and is running a balanced budget. Economists would call this a structural fiscal balance of zero. Then, as the economy slows or heads into recession, revenues fall. The budget is now in deficit, but the structural balance remains at zero. The government has not adopted any counter-cyclical fiscal policy.

Now suppose that there are automatic stabilizers on the spending side. For example, in the United States, spending on federal programs such as food stamps, unemployment insurance, and other aid will automatically increase as the economy heads into recession. The government could reduce these benefits in order to cut off some of the increase in spending that would otherwise happen automatically. Thus, it could tighten the eligibility requirements, or size or duration of benefits for the unemployed or poor.

In this case, the budget deficit would still widen because of the lost revenues and possibly even increased spending. Yet this would hardly be considered counter-cyclical policy[10] – certainly not in the United States. In fact, there would be quite a political backlash in the U.S. if our government tried to cut social programs in this way during a recession (the U.S. government has done the opposite in the current recession, for example by extending unemployment benefits and covering part of unemployed workers' health insurance).

Thus, any widening of the fiscal deficit during a downturn or recession should not necessarily be counted as counter-cyclical fiscal policy.

In the IMF paper “Review of Recent Crisis Countries” last month, the Fund states:

> “Deficits were allowed to rise in response to falling revenues and, in cases where domestic and external financing was lacking, this was facilitated by channeling Fund resources directly to the budget. *In many instances, however, underlying concerns about debt sustainability and weak structural fiscal positions required limiting the full play of automatic stabilizers.*” (IMF 2009c, 3, emphasis added).

This is an acknowledgement that in “many” of the 15 countries reviewed in this paper, the full spending increases that would have automatically occurred during a downturn were not allowed. In other words, this is comparable to the U.S. government having cut food stamp eligibility or benefits, or done the same of other social programs, during the current recession – which would not be considered counter-cyclical policy here.

The countries where this occurred are shown in Figure 16, page 25 of its Review. This list turns out to include eight of the 15 countries reviewed in the paper: Ukraine, Belarus, Romania, Serbia, Bosnia and Herzegovina, Hungary, Mongolia and Pakistan. Thus, when the Fund says that there are “Expanded fiscal deficits in 14 of 15 cases,” it is ignoring that in eight of these cases, the governments actually tightened their fiscal stance, reducing the impact of automatic stabilizers. Therefore, by a more common economic definition these governments adopted a contractionary, pro-cyclical fiscal policy. It would be good if the Fund did this calculation for all of its borrowing countries.

The IMF’s “Review of Recent Crisis Countries” also notes that only four of the 15 countries “are expected to expand spending in real terms in 2009.” Furthermore the IMF finds that “Program countries show larger real spending cuts than non-program countries.”[11]

The Fund should support counter-cyclical policies that actually increase government spending, during a downturn, beyond what would be provided by automatic stabilizers. That is how the United States and other high-income countries have responded to the current recession. If there is some reason that this is not possible in a particular country, the Fund should provide a clear explanation of why it is not possible, even with the help of loans from the IMF. This would include not only the countries mentioned above, but also seven countries that, as the IMF acknowledged in its PowerPoint presentation last week, have contractionary fiscal policies according to its own more narrow criterion, in their latest reviews.[12]

Latvia

The case of Latvia was discussed in our previous paper and in the panel discussion. As noted previously, [13] it is important because it is a case where the economy has been sacrificed – in fact, devastated – in order to preserve a fixed, overvalued exchange rate – as was the case in Argentina from 1998-2002.

This policy, supported by both the IMF and the European Union, must be judged a failure on its face, without any necessity for counterfactual comparisons. The IMF projects Latvia’s real GDP to fall by 18 percent this year. The magnitude of this contraction is rare in

modern economic history (outside of war), even in the worst financial disasters of the past century. A recent paper by Carmen Reinhart and Kenneth Rogoff looked at 14 severe financial crises.14 The only declines greater than 18 percent are Argentina (-22 percent), which occurred over the four years 1998-2002; and the US in the Great Depression, a 29 percent drop that also occurred over four years. An 18 percent decline in one year therefore indicates a major policy failure in dealing with the crisis, regardless of the mistakes that led up to it, and despite the fact that Latvia's banking system did not (as of this writing) collapse. This indicates that even if the balance sheet effects of a currency devaluation – avoided in Latvia – were large, it would still have been better to deal with that problem rather than to undergo such a severe economic contraction, adopting pro-cyclical policies which have no doubt exacerbated it – in order to avoid devaluation.

Standards of comparison

In its two published reviews and last week's panel discussion, the Fund also defended its policies during the current downturn with comparisons to past crises, most notably the Asian economic crisis of 1997-1999 and others during the late nineties and early 2000s. The Fund points out that the huge interest rate spikes and exchange rate overshooting of past crises were avoided. This is true, and the IMF can note improvement in its policy recommendations on this account. However, this is much too low a bar. In the Asian crisis, the IMF was widely seen to have seriously exacerbated the downturn, and in fact the IMF's Independent Evaluation Office conceded that "[I]n Indonesia . . .the depth of the collapse makes it difficult to argue that things would have been worse without the IMF. . ."[15] The Fund's role in Argentina's crisis of 1998-2002 is also one of the worst episodes in its lending history; and in fact the IMF did not provide any net lending after the banking system and currency collapsed at the end of 2001.[16]

The Fund also presents a regression and scatter-plot diagram[17] in support of the argument that, although IMF program countries had much steeper declines in GDP than non-program countries, these differences were due to initial conditions and not to program effects. It is difficult to evaluate such results without more information about the analysis, including the data. However, we believe that IMF economists would agree that the econometric difficulties with this particular regression are enormous, and that it cannot be considered as any kind of conclusive evidence that the programs "worked." Furthermore, this is also too low a bar, since even if the evidence from this regression were compelling, it would only show that the IMF programs did not have a net harmful effect. In fact, we would want and expect the IMF programs, and access to foreign exchange, to have a positive net impact on borrowing countries.

The Fund also defends its initial, mostly 2008 agreements containing pro-cyclical policies on the grounds that their projections were over-optimistic. As discussed in our previous paper,[18] by the time of IMF's bad projections, there was plenty of available information and analysis to indicate that the impact of the U.S. and high-income countries' recession on low-and-middle-income countries would be severe. As noted above, the Fund now recognizes that asset bubbles should be taken into account when formulating economic policy.[19] But the problem of overly optimistic projections in conjunction with overly tight macroeconomic policy is one that has been noted before, not only by CEPR[20] but also by the IMF's Independent Evaluation Office:

> The report also finds evidence of weaknesses in program design in certain areas. There is a tendency to adopt fiscal targets based on overoptimistic assumptions about the pace of economic recovery leading inevitably to fiscal underperformance and frequent revisions of targets. The optimism about growth recovery in the short term is itself often the consequence of overoptimistic assumptions about the pace of revival of private investment when a more realistic assessment in certain circumstances could have justified the adoption of a more relaxed fiscal stance on contracyclical grounds. (IEO 2003b, vii).

We look forward to further discussion of IMF agreements and policy as the world economy recovers, and more loan agreements and reviews of current agreements are concluded.

Notes

1 For Mr. Roaf's PowerPoint presentation, and video recordings of this event, see CEPR 2009.
2 Dohlman and Joshi 2009.
3 See IMF 2009a and 2009b.
4 IMF 2009b.
5 IMF 2009a.
6 IEO 2003a.
7 IMF 2009c.
8 See Baker and Deutch 2009. In the current WEO, the IMF, to its credit, looks at housing prices and bubbles internationally. For the United States, the WEO concludes that further corrections in the U.S. "are likely to be small." (pg. 23). However, U.S. house prices, which are currently being supported by federal subsidies to homebuyers, are likely to need to fall significantly before reaching a sustainable level (see Baker 2009).
9. IMF PowerPoint presentation, CEPR 2009.
10 In the economic terms defined above, the structural balance would have gone from zero to a positive number, thus indicating a pro-cyclical policy.
11 See IMF 2009b, 24.
12 CEPR 2009.
13 See Cordero 2009.
14 Reinhart and Rogoff 2009.
15 IEO 2003a, 38.
16 See Weisbrot and Sandoval, 2007.
17IMF PowerPoint presentation, CEPR 2009.
18 See Weisbrot et al. 2009.
19 See *IMF Survey Magazine* 2009. See also the latest WEO, which has several pages on real estate bubbles in various countries (IMF 2009c, 20-26).
20 See Baker and Rosnick 2003 and Rosnick and Weisbrot 2007.

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A man for this season? Keynes

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The collapse of neoliberal economics, with its worship of the "self-regulating market," has had among its most significant consequences the revival of the great English economist John Maynard Keynes. It is not only his writings that make Keynes very contemporary. There is also the mood that permeates them, one that evokes the loss of faith in the old and the yearning for something that is yet to be born.

Aside from their prescience, his reflections on the condition of Europe after the First World War resonate with our current mix of disillusion and hope: In our present confusion of aims, is there enough clear-sighted public spirit left to preserve the balanced and complicated organization by which we live? Communism is discredited by events; socialism, in its old-fashioned interpretation, no longer interests the world; capitalism has lost its self-confidence. Unless men are united by a common aim or moved by objective principles, each one's hand will be against the rest and the unregulated pursuit of individual advantage may soon destroy the whole. [1]

Governing the market

That government must step in to remedy the failure of the market is, of course, the great lesson that Keynes imparted, one derived from his wrestling with the problem of how to bring the world out of the Great Depression of the 1930s. Left to itself, the market, Keynes said, would achieve equilibrium between supply and demand far below full employment and could stay there indefinitely. To kick-start the economy into a dynamic process that would move it toward full employment, the government had to serve as a deus ex machina, pouring massive quantities into spending that would create the "effective demand" that would restart and sustain the engine of capital accumulation.

President Obama's $780-billion stimulus package, as well as those of Europe and China, are classically Keynesian, being preemptive measures to stave off a depression; and a measure of the triumph of Keynes after nearly 30 years of being in the wilderness is the marginal impact on the public discourse of the howls of Republicans, Russ Limbaugh, the Cato Institute and other species of neoliberal dinosaurs about "passing on a huge debt to coming generations."

Uncertainty and animal spirits

The revival of Keynes is not, however, simply a policy matter. It involves as well the theoretical displacement of the assumption of the individual rationally maximizing his or her interest from the center of economic analysis by two ideas. One is the pervasiveness of uncertainty in the making of decisions, which investors try to deal with by working on the soothing but highly unlikely assumption that the future will be like the present, and by coming up with techniques to predict and manage the future based on these assumption. The related concept that Keynes is associated with is the notion that the economy is driven not by rational calculus but by "animal spirits" on the part of economic actors; that is, by their "spontaneous urge to action."[2]

Key among these animal spirits is confidence, the presence or absence of which is at the center of the collective action that drive expansions and contractions. Not rational calculation but behavioral or psychological factors predominate. From this standpoint, the economy is like a manic-depressive driven by chemical imbalances from one pole to the other, with government intervention and regulation playing a role akin to that of chemical mood stabilizers in the case of the clinically bipolar. Investment is not a matter of rational calculus but a manic process that Keynes described as “a game of Snap, of Old Maid, of Musical Chairs, the object of which to pass on the Old Maid—the toxic debt—to one’s neighbor before the music stops.”[3] Here, notes Robert Sidelsky, Keynes’s biographer, “is the recognizable anatomy of the ‘irrational exuberance,’ followed by blind panic, which has dominated the present crisis.”[4]

Economists as dentists

Unbridled investors and submissive regulators are not the only protagonists in the recent tragedy. The hubris of neoliberal economists also played a part, and here Keynes had some very relevant insights for our times. Economics, he saw, as “one of these pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future.” Indeed, he was, as Skidelsky notes, “famously skeptical about econometrics,” with numbers for him being “simply clues, triggers for the imagination,” rather than the expressions of certainties or probabilities of past and future events. With their model of rational homo economicus in tatters and econometrics in disrepute, contemporary economists would do well to pay heed to Keynes’s advice that if only “economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid.”

Yet, even as many welcome the resurrection of Keynes, others have doubts about his relevance to the current period—and these are not limited to neoliberal die-hards.

Limitations of Keynsianism

For one thing, some contend, Keynesianism is mainly a tool for reviving national economies, and globalization has severely complicated this problem. In the 1930s and 1940s, it was a case of reviving industrial capacity in relatively integrated capitalist economies that revolved around the domestic market. Nowadays, with so many industries and services having been transferred or outsourced to low-wage areas, the effects of Keynesian-type stimulus programs that put money into the hand of consumers to spend on goods would have much less impact as a mechanism of sustained recovery. Transnational corporations and TNC host China may reap profits, but the “multiplier effect” in de-industrialized economies like the US and Britain might be very limited.

Second, the biggest drag on the world economy is the massive gulf—in terms of income distribution, the pervasiveness of poverty, and the level of economic development—between the North and the South. A “globalized” Keynesian program of stimulus spending funded by aid and loans from the North is a very limited response to this problem. Keynesian spending may prevent economic collapse and even spur some growth, but sustained growth will demand structural reform of a radical kind—the kind that will involve a fundamental recasting of economic relations between the central capitalist economies and the global

periphery. Indeed, the fate of the periphery—the "colonies" in Keynes's day—did not elicit much concern in his thinking.

Third, Keynes's model of managed capitalism merely postpones rather than provides a solution to one of capitalism's central contradictions, which is the underlying cause of the current economic crisis: that of overproduction, in which productive capacity outpaces the growth of effective demand, driving down profits. Here, a bit of history might place things in perspective. The Keynesian-inspired activist capitalist state that emerged in the post-World War II period seemed, for a time, to be able to surmount the crisis of overproduction with its regime of relatively high wages and technocratic management of capital-labor relations. However, with the addition of massive new capacity from Japan, Germany and the newly industrializing countries in the 1960s and 1970s, its ability to do this began to falter, leading to the famous stagflation or coincidence of stagnation and inflation throughout the industrialized world in the late '70s.

The Keynesian Consensus collapsed, as capitalism sought to revive its profitability and overcome the crisis of overaccumulation by tearing up the capital-labor compromise, liberalization, deregulation, globalization and financialization. In this sense, these neoliberal policies constituted an escape route from the conundrum of overproduction on which the Keynesian welfare state had foundered. As we now know, they failed to bring back a return to the "golden years" of postwar capitalism, leading instead to today's economic collapse. It is not, however, likely that a return to pre-1980s Keynesianism is the solution to capitalism's persistent crisis of overproduction.

The great lacuna

Finally, and perhaps the greatest obstacle to a revived Keynesianism, is the revving up of global consumption and demand that is its key prescription for revitalizing capitalism in the context of the climate crisis. While the early Keynes had a Malthusian side, his later work hardly addressed what has now become the problematic relationship between capitalism and the environment. The challenge to economics at this point is raising the consumption levels of the global poor with minimal disruption of the environment while radically cutting back on consumption or overconsumption in the North, which is the greatest contributor to climate change. There is something that is simply foolish and irresponsible with all the talk about replacing the bankrupt American consumer with the Chinese peasant engaged in American-style consumption as the engine of global demand.

Given the primordial drive of the profit motive to transform living nature into dead commodities, it is increasingly doubtful that the reconciliation of ecology and economy can be done under capitalism—even under the state-managed technocratic capitalism promoted by Keynes.

'We are all Keynesians again?'

In other words, Keynesianism provides some answers to the current conjuncture but it does not provide the key to surmounting it. Global capitalism has been laid low by its inherent contradictions, but it is not self-evident that a second bout of Keynesianism is what it needs. Clearly, the deepening international crisis calls for severe checks on capital's freedom to move, tight regulation of financial as well as commodity markets, and massive government spending. However, the needs of the times go beyond these Keynesian measures to

encompass massive income distribution, a sustained attack on poverty, a radical transformation of class relations, deglobalization, and perhaps the transcendence of capitalism itself under the threat of environmental cataclysm.

"We are all Keynesians again"—to borrow but slightly modify Richard Nixon's much quoted phrase—might be said to be the theme that unites Barack Obama, Paul Krugman, Joseph Stiglitz, George Soros, Gordon Brown and Nicholas Sarkozy, though in the implementation of the master's prescriptions, they may have differences. But an uncritical revival of Keynes might simply end up with another confirmation of Marx's dictum that that history first occurs as tragedy, then repeats itself as farce. The period does not so much need Keynes as it needs its own Keynes.

Notes

1 Robert Skidelsky, John Maynard Keynes: the Economist as Savior (London: Penguin Books, 1992), p. 121.

2 George Akerloff and Robert Sherrill, Animal Spirits (Princeton: Princeton University Press, 2009).

3 Robert Skidelsky, "Keynes is Back," Prospect Magazine, Nov. 2008; http://www.prospect-magazine.co.uk/article_details.php?id=10451

4 Ibid.

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Economic theory and the crisis*

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> "*A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it.*"
> – Max Planck, A Scientific Autobiography (1949)

The first thing that comes to mind as one follows the debate among economists about the crisis is that economic theory was locked into a bubble that has now burst. The reactions have either been to ignore this and just to wait for the crisis to pass or to herald the return of one of our old heroes, Keynes. Economists seem to be victims of extremely short memories and an inability to anticipate the next theoretical development. We periodically come to believe that we have hit upon the "right model" and that all previous efforts can be consigned to the wastebasket of history. When the current model turns out to be completely at odds with reality, the reflex reaction is to go back to the previous model and to chide the modernists for having lost sight of it. A number of economists have tried to add a little historical perspective (in particular Reinhart and Rogoff (2008) have argued that this crisis is but one of many similar events), but the debate overall remains very short-sighted and ideologically motivated.

All of this seems to be misplaced. Suppose we accept that economic theory, like the economy, is a complex adaptive system. We should then expect to see it continually evolving to take into account both new theoretical insights and the evolution of the economy itself. We will not see theory evolving into a given model that more closely represents the economy since the economy itself is changing. However, we might expect theory to evolve to at least be able to envisage the occurrence of the major crises that periodically shake the economy, and this is where the problem with the response that "we have seen all this before" arises. If we believe that such crises are an inherent feature of the evolution of economies, then surely we should develop models that incorporate them. We might then avoid the usual habit of falling back on the standard equilibrium notions and claim that some major exogenous shock has hit the system. The latter rarely identifies the shock, and it is now widely recognised that almost every significant turning point in all of the major stock price indices was accompanied by no notable news, and hence no shock at all.

A much more reasonable approach would be to accept that these large and abrupt movements are due to the endogenous dynamics of the system. What has become the standard macroeconomic model, DGSE, is justified by its proponents on the grounds that it has more "scientific" foundations than its predecessors. By this they mean that it is based on rational, maximising individuals. But there are two problems with this.

Equilibrium

Firstly, we have known since the mid-1970s that aggregating the behaviour of lots of rational individuals will not necessarily lead to behaviour consistent with that of some "representative agent". The well-known Sonnenschein-Mantel-Debreu results show this and undermine the foundations of macroeconomics in general. Despite our heroic assumptions on the rationality of individuals, we can guarantee neither the uniqueness nor the stability of equilibria.

These are not just technical problems. If you cannot show that economies or markets will ever reach equilibrium, then the latter becomes a purely intellectual artefact. If you cannot guarantee the uniqueness of equilibria, then the usual exercise of studying the impact of some policy measure, i.e. comparative statics, makes no sense. The reason for resorting to the "representative agent" becomes obvious. In the one-person economy, there is a unique and stable equilibrium! However, this raises yet another problem. Even if we can construct a representative agent whose excess demand corresponds to the average excess demand of all the economic agents, it may be the case, as Mike Jerison (1997) pointed out, that those preferences contradict those of the population supposedly represented. Thus we can make no welfare judgements on the basis of that agent's utility (for a discussion of the weaknesses of the representative agent approach see Kirman 1992).

Theory vs. evidence

All of this assumes that we accept the standard axioms of rationality that lead to the second problem. The axioms that are used to define "rationality" are based on the introspection of economists and not on the observed behaviour of individuals. Economists from Pareto through Hicks to Koopmans have long made this point. Thus we have wound up in the weird position of developing models that unjustifiably claim to be scientific because they are based on the idea that the economy behaves like a rational individual, when behavioural economics provides a wealth of evidence showing that the rationality in question has little or nothing to do with how people behave.

Why do I say we do not look back far enough? Consider the efficient markets hypothesis, which has ruled the roost for some years in finance. Its originator was, by common accord, Louis Bachelier, who developed the notion of Brownian motion at the turn of the twentieth century. His argument that stock prices should follow this sort of stochastic process, after years of being ignored, was acclaimed by economists both for analytic and ideological reasons. Yet, shortly after having written his report on Bachelier's thesis, the great French mathematician Henri Poincaré (1905) observed that it would not be sensible to take this model as a basis for analysing financial markets. As he said, individuals who are close to each other, as they are in a market, do not take independent decisions – they watch each other and "herd". Thus Poincaré clearly envisaged one of the most prevalent features of financial markets long before modern economists took this theme up to explain "excess volatility".

And still, theory continued on its way, ignoring both the empirical evidence and theoretical criticisms, not just once but twice. The first of these was the development of optimal portfolio theory by Markowitz (1952), who developed his theory using the assumption that the changes in returns on assets had a Gaussian distribution. Despite the empirical evidence and the pleas of Mandelbrot and others, this assumption prevailed, since one could apply the central limit theorem to it, unlike the family of Levy stable distributions favoured by Mandelbrot. The same thing applies to the development of Black-Scholes (1973) option pricing. This again relies on the refutable and often-refuted assumption that the price of an asset follows a lognormal process. Theory ploughed ahead ignoring its own weaknesses, despite the criticisms of many mathematicians and economists.

With regard to general equilibrium models, which Walras pioneered, the same Poincaré wrote to Walras and chided him for his assumptions of infinite farsightedness and infinite selfishness. The latter he could believe at a pinch, but the former he found dubious to say the least. Yet, while in other areas of economics we have moved on from these assumptions, we are still faced today with macroeconomic models based on general equilibrium models, in which these two assumptions are central.

Thus both the development of the DSGE model and the evolution of the efficient market hypothesis share a common feature – despite the empirical evidence and despite their theoretical weaknesses, their development proceeded as if the criticism did not exist.

The future of economic theory

Why are we so reluctant to envisage different models and different tools? As somebody said, we economists went through the twentieth century developing and perfecting a model based on nineteenth-century physics, so perhaps in the twenty-first century we could move on to a model based on twentieth-century physics. But as Paul Krugman has pointed out, the vested interests are strong and to ask economists to take up a new set of tools is probably asking too much. To discard equilibrium in the standard sense and study out-of-equilibrium dynamics is perhaps too big a step.

No doubt it will eventually come, and undergraduates will study systems of interacting agents rather than *homo economicus*. Hans Foellmer (1974), in a pioneering paper, made the point that we cannot ignore the direct interaction between individuals and its influence on preferences. Yet he was, and still is, too far ahead of his time. For the moment, placing externalities, the influence of one person’s actions on another, at the centre of the action rather than regarding them as “imperfections” in our equilibrium model is a necessary step. Then, if we argue that the interaction between individuals is important, we have to specify the structure of that interaction. This means that we have to study the structure and fragility of the networks that govern the interaction between individuals and make this central in our analysis and not just a peripheral, albeit fascinating, topic. I have suggested how we might turn our minds to the idea of the economy as an interactive system and look at the problems just mentioned in Kirman (2009).

Such changes are essential if we are to progress, but the inertia in the economics profession is strong and whilst the economy has shown that it is capable of sliding rapidly into a new phase, economists may well organise to prevent this from happening in the immediate future. But in the end, we will move forward, as Max Planck said.

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