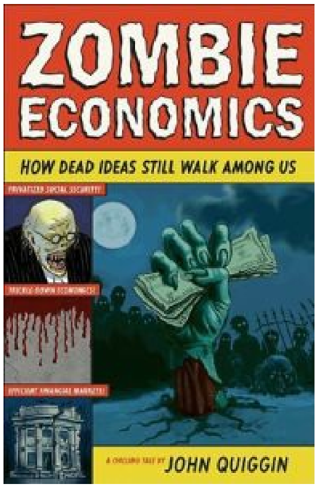

Book Zombie Economics

How Dead Ideas Still Walk Among Us

John Quiggin
Princeton UP, 2010
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Recommendation

Like the villain in a horror movie, discredited economic theories can return to haunt you. Australian economist John Quiggin claims that some of these ideas – like total privatization, perfectly rational markets and trickle-down policies – nearly destroyed the world's economy, and that they are trying to make one more comeback. In an attempt to drive the final stake through the brain-eating, dead soul of "zombie economics," he knifes through the five most dangerous principles of "market liberalism." With no apparent fear of being controversial, he presents a compelling case as to why each of those "zombie ideas" failed and describes a new, alternative approach, melding the best of free-market capitalism with judicious use of government involvement to address crucial social needs. Quiggin heavily annotates his work and provides a thoughtfully researched bibliography. Though the economic jargon can, at times, slow your progress, Quiggin's book rewards your persistence. *BooksInShort* recommends this eerie tour through defunct yet durable economics to anyone who enjoys a good scare. Find your silver bullets, construct your booby traps and carry your axes for good measure: Quiggin says it is high time to kill those zombies once and for all.

Take-Aways

- Economic theories continue to live as "zombie ideas" even after events refute them.
- The 2008 "Global Financial Crisis" exposed the fallacy of five hard-to-kill principles that fueled "market liberalism":
- First, beginning in the 1990s, "the Great Moderation" claimed business cycles had stilled.
- Second, the "Efficient Markets Hypothesis" assumed markets have perfect information.
- Third, full employment fell away under "Dynamic Stochastic General Equilibrium," which says that free markets would determine labor and capital allocations.
- Fourth, "trickle-down economics" said that enriching the wealthy benefits everyone.
- And fifth, "privatization" advocates said government cannot run an economy as well as private sector interests can, though many privatization efforts failed.
- Persistently high unemployment results in "hysteresis," in which idled workers' job skills deteriorate, entrenching chronic joblessness.
- Many countries reaped cash by selling national assets but ended up being harmed by the long-term fiscal impact of such divestiture.
- A "mixed economy" recognizes government's role in the long-term interests of society.

Summary

Die, Already!

Even when events ultimately disprove them, popular economic theories can take on a life of their own. Their influence, honed over decades, is hard to shake, and their impact lingers long after reality refutes them. The 2008 "Global Financial Crisis" laid bare the failures of five long-held principles that guided policymakers, economists, investors, bankers and just about everyone with financial interests, from the early 1980s until the bust. These ideas underpinned an economic philosophy that had a variety of names – "Thatcherism" in the UK, "Reaganism" in the US, "the Washington Consensus," "neoliberalism" and "market liberalism" – but relied on the same five zombie ideas:

1. "The Great Moderation" – No More Boom and Bust

This idea proclaimed the death of the traditional business cycle. Throughout history, pundits have greeted recurring financial ups and downs with the declaration that the present cycle is dead and a permanent boom is arriving. This happens, usually and uncannily, just before the next bust. So it was in 1929, and throughout the 1990s and early 2000s. In 2004, before he became chairman of the US Federal Reserve, Ben Bernanke popularized the term "The Great Moderation" in a 2004 speech describing a period of economic growth leavened by relatively weak, short recessions. Economists attributed the stubbornly good times to "the liberation of markets," deregulation and the fall of the Soviet Union. Their focus on quarterly statistics showed reduced volatility in inflation and employment worldwide, except in Japan. Market liberalism appeared to have saved the world's economies from the failure of Keynesian, government-led policies. Apparently, central bankers had only to manage short-term interest rates to keep world economies steady. Unfettered financial markets could handle the rest, allowing "capital to flow freely where its return was highest."

> "The ideas that caused the crisis and were, at least briefly, laid to rest by it are already reviving and clawing their way through up the soft earth."

If the private sector could handle risk better than government could – so went the thinking – then government needed to get out of people's economic lives, including in such areas as consumer and environmental protection. If employment were steady, economists said, anyone who lost a job would find another one easily. So workers' benefits like health insurance and retirement – indeed, much of the safety net – "began to fray." Massive layoffs in the name of flexibility and profitability became common. This "Great Risk Shift" from government to individuals transferred uncertainty and responsibility to individual employees, now called "human resources." However, not much risk shifted to the rich: Failed CEOs continued to receive hefty severance packages, and firms regularly reset executive stock options so departing execs "always seemed to get paid."

> "If we do not kill these zombie ideas...they will do even more damage next time."

Advocates of the Great Moderation didn't explain the statistics showing growing income gaps between the wealthy and the middle class. In fact, the oxymoronic term "jobless recovery" characterized the post-1990 upturns. Expanding financial markets and new investment tools that aggregated debt instruments into salable securities "weakened links between economic variables such as income and consumption." People borrowed to compensate for their inadequate paychecks, using the rising values of their homes to finance their lives. Meanwhile, "animal spirits," or the emotions unleashed by perceived good times, kept speculators, investors and borrowers in motion, until the Global Financial Crisis put slaughtered the Great Moderation.

2. "The Efficient Markets Hypothesis" – Bursting the Bubbles

This theory, which says that markets are all knowing and can correctly set investment prices, is "the central theoretical doctrine of market liberalism." The Efficient Markets Hypothesis (EMH) says an asset's price incorporates all its available data, whether the asset is a stock, a bond or real estate. Given all that information, the theory maintains, markets are the best judges of an asset's short- and long-term value. Because everyone has access to all pertinent data about an investment, EMH says, speculative bubbles cannot exist, and if anomalies do appear, the market will trade on them and quickly return prices to normal. If markets can handle risk appropriately, then government has little else to do, except perhaps to comment on the markets' "irrational exuberance," as then-Fed chairman Alan Greenspan did in 1996. Under EMH, the US financial industry's "share of corporate profits" grew from about 10% to 40% in less than 30 years.

> "An approach to economics that has been dominant for more than three decades will not go away simply because its predictions are inconsistent with the facts."

Yet inconsistencies to EMH cropped up again and again. Severe mid-1990s financial crises in Asia and Latin America afflicted economies that had adopted Washington Consensus policies. The Long-Term Capital Management (LTCM) hedge fund paradoxically profited on discrepancies in "efficient market pricing" but collapsed spectacularly when its highly leveraged capital fell behind its mounting losses. These financial canaries in the coal mine revealed EMH's underlying glitches, but proponents saw the government-engineered rescue of LTCM as evidence of the "Greenspan put": Just as a put option is a "one-way bet" in a rising market, so financial markets believed government would rescue institutions that were "too interconnected to fail." The "dot-com" boom and bust of the early 2000s also disproved EMH, as stock in companies with unrealized profits and potential traded to fad-driven buyers at astronomical prices.

> "Following World War II, financial markets were tightly regulated. As a result, financial crises disappeared almost entirely from the experience and memory of the developed world."

The Global Financial Crisis brought these irregularities to light and provoked a rethinking of economics. A "mixed economy" that allows short-term risk taking in private markets while entrusting government to handle society's longer term, strategic interests offers a middle ground between total market liberalism and government-centric Keynesianism.

3. "Dynamic Stochastic General Equilibrium" – Micro Versus Macro

The idea that microeconomics – the actions of individuals in a market – trumps government's macroeconomic management stemmed from a challenge to John Maynard Keynes. His economic concepts dominated the post-World War II era and promoted government use of macroeconomic tools like inflation and employment as levers to manage the economy.

> "The Great Risk Shift in economic policy was part of a bigger backlash against social risk management, which has been equally ferocious when directed against action to mitigate environmental risks such as climate change."

In the wake of high inflation and stunted economic growth in the 1970s, "freshwater" economists at the University of Chicago attacked Keynes's formulation of the relationships between inflation and employment. Economist Milton Friedman said macroeconomics could not maintain economic stability, which required having free markets determine steady prices. The Dynamic Stochastic General Equilibrium model, or "DSGE to its friends," posited that such price stability comes from how households make their "work, leisure and consumption choices" as they "interact" with profit-making companies. The DSGE assumes that everyone in an economy always acts rationally and that all markets are "complete [and] perfectly competitive."

> "Every crisis is an opportunity."

Prime Minister Margaret Thatcher of Great Britain first employed DSGE to tame inflation by cutting the UK's money supply while allowing unemployment to grow; high joblessness persisted for years. New Zealand followed suit, while Australia took a less dogmatic approach. By 2000, New Zealand's per capita income trailed Australia's by one-third. Persistently elevated unemployment causes "hysteresis," in which idled workers' networks and job skills deteriorate so much that finding work becomes even more difficult, thus entrenching chronic unemployment. The Global Financial Crisis finally killed Dynamic Stochastic General Equilibrium, which neither predicted the upset nor questioned the inconsistencies bubbling up through the 2000s. With interest rates near zero and money supply management gone awry, governments responded to the crisis with old-fashioned Keynesianism. They bailed out failing institutions and pumped massive amounts of currency into the global financial system.

4. "Trickle-Down Economics" – From the Few to the Many

This notion, which stipulates that enriching the wealthy benefits everyone, opened a road to making the rich richer. Popularized in the 1980s as "supply-side economics," it took on new guises such as "dynamic efficiency" and "new tax responsiveness" during the Great Moderation. Historically, economic growth after 1945 bred a burgeoning middle class, but by the 1990s, Gini coefficients ("a standard statistical measure of income inequality") rose in such countries as the UK, New Zealand, Canada and Ireland, which enthusiastically pursued free-market policies and reduced marginal tax rates for the wealthiest. Armed with statistics showing that "higher tax rates produced less revenue," US Republicans pushed for lower taxes in the 1980s. They argued that incremental growth driven by economic incentives and reduced regulation would cover any short-term budget deficits. In fact, over time, tax receipts grew less than income, and Republican President George W. Bush's 2001 tax cuts had the Keynesian effect of stimulating consumption in a depressed economy.

> "The Global Financial Crisis gives the economics profession the chance to bury the zombie ideas ...and to produce a more realistic, humble and, above all, socially useful body of thought."

If the goal is to ensure economic progress for everyone, do tax reductions for the wealthy benefit everyone? In a "progressive" tax system, the government assesses more taxes on higher incomes, yet with deductions, loopholes and creative accounting, "many high income earners pay a smaller proportion of their income in tax than the population as a whole." Payroll and consumption taxes, which are regressive and primarily hit wage earners, represent more than half of tax receipts.

> "Success breeds hubris, and hubris leads us to ignore the lessons of the past."

Most proponents of trickle-down economics point to the difference between "equality of outcome" and "equality of opportunity." They advocate "making the pie bigger, rather than sharing it out more equally." Yet supply-side economics hasn't had either effect: US middle income earners saw annual increases of only 0.4% from 1973 to 2008, while top earners' incomes doubled – and for the top 0.1%, quadrupled – in the same period. In 2008, more than 67 million Americans were "food insecure," meaning they sometimes went hungry, a figure double that of 2000. Fifteen percent carried no health insurance; 1.6 million, many of them children, used homeless shelters in 2007. In sum, "in the early years of the 21st century...Americans were more likely to go bankrupt than to get divorced." Once seen as the "land of opportunity," the US now ranks lowest among industrialized countries on "social mobility" measures. Today in the US, "starting out poor doubles the risk of ending up poor."

5. "Privatization" – A Zombie's Last Word

This ideology maintains that the private sector can do anything and everything better than the public sector can. In the 1970s, privatization's proponents criticized government ownership of companies, a structure that once seemed to provide necessary infrastructure and other social benefits. Government bureaucrats became the symbols of bloated, ineffective public interference in private interests in contrast to private-sector managers who supposedly sought efficiency to create profits for their shareholders. Privatization – a word coined by the Nazis – meant "systematic removal of the state from the production and provision of goods and services."

> "Resources are always constrained...budgets must ultimately balance [and] wages and other incomes cannot, for long, exceed the value of production."

Then, the former Soviet bloc opened up, and the IMF and the World Bank adopted the "Washington Consensus," a package of economic reforms they "sought to impose" on less-developed countries. These events added impetus to the movement toward "denationalization," particularly in countries that needed ready cash. Selling state-owned enterprises earned momentary economic benefits, but policymakers did not consider how disposing of income-producing entities would affect government budgets in the long-term. The financial industry, which reaped huge fees for arranging divestitures, ardently advocated privatization.

> "The money was all appropriated for the top in the hopes that it would trickle down to the needy...Give it to the people at the bottom and the people at the top will have it before night, anyhow. But it will at least have passed through the poor fellow's hands." (Will Rogers, cowboy and comedian)

But the "belief that there is always a net social benefit" in private over public ownership fell flat even before the Global Financial Crisis: The UK had to "renationalize" its railways after private ownership bombed, and New Zealand's government took back health care administration after privatization failed. In 2008, the US nearly nationalized its banks and auto manufacturers. Yet privatization has succeeded in certain industries, particularly in developing countries. Because government pays for its projects with bonds, which cost less to issue than equities, public investment in longer-term ventures makes economic sense. Socially necessary infrastructures – health, education, pensions, crime prevention – work best under public aegis in a mixed economy, which addresses public and private interests in the most cost-effective, socially beneficial way.

About the Author

John Quiggin is an economics professor at the University of Queensland in Australia.