Deficit Reduction - Ideology or Necessity?
Social Liberal Forum Inaugural Conference Paper – 18 June 2011

Delivered by Ed Randall – Senior Lecturer in Politics and Social Policy, Goldsmiths University of London – at City University (in the course of a discussion with Vince Cable, Secretary of State at BIS)

I hope you will bear with me.   I've got a lot to say and not much time to say it in.

I have a habit of getting rather excited when I'm giving a talk about something I'm really enthusiastic about. And I can tell you I am really keen to convey the general outline of an argument I hope that you will find persuasive.

I have three Irish grandparents and once, when listening to coverage of a rugby game, I heard the commentator describe the Irish team as temperamental: 50% temper and 50% mental...If you think this applies to me please forgive me and put it down to enthusiasm and try to focus on my arguments rather than my presentation.

* The Social Liberal Forum wants to know whether Coalition austerity is ideology or necessity.

Well I have an answer - and it embraces both ideology and necessity.

But I want to explain, before I go any further, that I wasn't simply asked to talk about the necessity (or otherwise) of deficit reduction.

I was also asked to range across the Liberal Democrats' political goals as well as economic strategy.

And that is what I intend to do.

* I've called my talk **ideology AND necessity**.

- I'm going to respond to the title of the session with a YES **<u>and</u>** a NO.
- I 'm going to say something about the work of Richard Koo – the foremost exponent of the notion of a 'balance sheet recession'.
- I'm going to go on and say something about what I regard as Liberal Democrat necessities – which don't, in my opinion, have to include deficit reduction.
- [And I should warn you that] The first of the necessities comes with a parade.
- The second - from my perspective the most important – wasn't on the minds of so-called classical Liberal thinkers at all

<u>and</u>

- The third is about the greatest crimes of the current century – crimes that have gone largely unpunished.

[Main Slide ONE]

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Is the muscular austerity of the coalition ideological?

Of course it is!

*
However, it isn't the fact that it's ideological that troubles me – it's the ideology behind it that troubles me.

* I can't really imagine any economic policy that is free from ideology.

Economics is an intensely ideological business. Beware of anyone who claims that it is value free.

* *

The problem is that the Coalition started out with an agreement to treat 'deficit reduction as **its <u>paramount goal</u>**'.

* A notion that may be highly convivial to George Osborne!

But it isn’t (at least it shouldn’t be) for all those Liberal Democrats who care about the future of the British people and the UK economy as a whole.

* Pursuing a policy which gives priority to big Finance and the asset values which most concern (what I am going to call) ‘**big Finance’** does not reflect my priorities or, I suspect, those of a majority of Liberal Democrats.

We (Liberal Democrats) should be explaining why George Osborne needs a different economic map as well as a new sense of direction.

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But we are not saying: “Hold on George” OR even asking him “Where are you going?” or “Are you sure you know where you are going?”

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[Main Slide TWO]

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Is the Coalition deficit reduction strategy plain necessity?

No, it isn't!

* Lest this be misunderstood...no Liberal Democrat I know is saying or arguing that **government deficits do not have to be managed**.

What Liberal Democrats **and others** I respect are saying is:

"It is how deficits are managed that is critical; crucial to our country's future prosperity and to its social cohesion".

* I believe – and I'm certainly not alone in believing this, that the UK government's deficit reduction strategy is misguided.

* Frankly it is as though we have entered Thatcherland – remember that is the land populated with Tina's!

* But there are alternatives!

The Tina in the cartoon may have been brought up on Classical Liberalism... But the Liberalism of late 18th and early 19th centuries has limited relevance to our contemporary economic, social and political problems.

* Modern liberal political economy is incredibly rich and highly sophisticated; it takes account of the complexity and reach of government and of the extensive interdependence that characterises modern economies and societies; it pays (or should pay) particular attention to the role of human psychology in economic behaviour.

If all we are being offered is Tina then I suggest we go in search of TARA (**There Are Real Alternatives**). Tara really isn't hard to find.

[**Main Slide THREE]**

One of the most important economists in the world – though he is not well covered in Mr. Murdoch's rags – is Richard Koo.

Richard is a native of Kobe-Japan and a US citizen.

I believe he spends most of his time in Tokyo, where he is Chief Economist at the Nomura Research Institute. He is a frequent visitor to the US and has worked for the US Federal Reserve as well as advising ministers in the Japanese government on economic questions.

If I were looking for a modern counterpart to Mr. Keynes...someone intimately involved with government and economic policy making, someone who had developed and shared a sophisticated and empirically grounded theory of the macro economy...Richard Koo would be my outstanding candidate.

*

Richard believes that Japan's economic collapse in the early 1990s and its stuttering recovery from collapse has lessons for the rest of the world. What Richard has learnt and shared, going back 15 and more years has become crucially relevant to policymakers in Europe and the US since the crash of 2007/2008.

> [**and**] Richard has been kind enough to tell me that I can "use anything and everything that [he has] produced to **save the UK economy" .**

I know that the Dutch government invited him to Holland in 2009. They told him they would pay whatever was needed to get him there. So he made the trip to Holland "and spent two full days with ministers and top officials, talking about balance sheet recessions".

Richard's idea of a balance sheet recession reflects the conclusions he's drawn from his extensive research and involvement in economic policy making in Japan and elsewhere.

!!!!!

Economic behaviour, reflecting our labile (every changeable) human psychology, can be profoundly affected by mounting debt and a crash in asset values.

I have in mind the kind of decline in asset values and growth in household and company debt that occurs during a big bust, the prelude to economic depression, rather than what you might refer to as ‘an everyday recession’.

*

In Richard Koo's terms the Yang (or normal) economy is transformed into a Yin economy in which both households and corporations become obsessed with deleveraging/paying down debt/ rebuilding balance sheets.

In such circumstances there will be failures of aggregate demand which impede and imperil economic recovery, unless there is government intervention.

As in the 1930s – when Keynes was trying to obtain a hearing for his new economic ideas – it is government that is needed to boost demand. However, Keynesian automatic stabilisers will not be sufficient to support economic recovery, prevent a double-dip recession or - more likely in present circumstances - an **anaemic** recovery.

*

In a balance sheet recession monetary remedies – conventional and unconventional - don't work; they are up against **the zero bound and Yin deleveraging psychology**. **Richard's data from around the world shows that very clearly**.

*

I have no doubt that Japan was saved from depression (though not a very prolonged recession) because of advice from Richard... and others who shared his views.

The first of the two diagrams on the slide I've put up represents the actual path of a slow and painful recovery in Japan since 1990; one, despite its apparent slowness and modesty, which was aided by government fiscal policy.

Also shown is the likely course of events without that government intervention.

I don't have the time now to give an economics lecture but I can tell you that the data and the arguments are really persuasive. The UK government needs to hear the arguments and consider the data.

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What we are engaged in at the moment in the UK is, I fear, a painful and misdirected austerity (something, I fear, that will be borne out by economic data in the course of the next few years).

Of course students of economic strategies and policies in Western societies know how difficult it can be to actually persuade a convinced policymaker to change.

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Just take a look at Alan Greenspan - he had to bring the house down before he would admit that there was even a possibility that he had got things wrong.

I believe Greenspan, who admitted a flaw in his attitude to financial regulation, wasn't simply wrong about how markets responded to deregulation, he was wrong in many many other ways too.

*

His dismissal of fiscal policy, unwavering commitment to the efficient market hypothesis and unswerving commitment to the proposition that financial innovation reduces market risk have all revealed flaws in his underlying economic beliefs/philosophy.

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Amongst the charts that Richard Koo has produced is a chart which shows the lack of traction of UK monetary policy, including quantitative easing.

QE has had no discernible effect on money supply – that is the money **actually circulating** in the UK economy. QE may have helped the banks repair their balance sheets but it has fallen far short of restoring the economy as a whole.

Richard has told me (in an e-mail received just a few days ago) that:

> **“The flow of funds data for the UK indicates that <u>it is in perfect balance sheet recession</u>, with both household and corporate sectors deleveraging in the face of the lowest interest rates in decades if not in centuries.”**

He has also told me that:

> **“...as you noted, the monetary aggregates in the UK are moving exactly the way Japanese monetary aggregates moved during the last 20 years. So I think we (you and I) have a strong case.”**

The case he had in mind was for a change of economic strategy in the UK.

[Main Slide FOUR – part two of the conference paper]

*

There are my fellow Liberal Democrats, necessities.

Liberal Democrat necessities – perhaps even *'bare/bear'* necessities.

They are both ideological and practical.

*

I want to say something about each of them.

It seems to me that we (British Liberal Democrats) have three great concerns or organising ideas, which we want to be/believe should be reflected in government policy.

*

The first of them has to do with an extraordinary and deeply depressing trend in incomes and life chances.

(i) The <u>growth in social and economic inequality and the need to halt and reverse it</u>.

* Tory politicians may insist that "We are all in this together" - but, even with our help, they are not believed.

See the little man running away with the wheelbarrow full of cash (in the cartoon I'm showing on the screen right now)? The cartoon suggests that he is leaving those from whom the cash has been extracted to fall to the bottom of the cliff.

Of course that is short-sighted behaviour... but the economic ruin of others may seem, at least for the moment, like 'a price worth paying' to those who are desperate to cling on to their wealth. We know (or suspect) it will turn out to be a self-defeating strategy...but that is only likely to become apparent to many less engaged observers in time.

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(ii) **The second of my necessities concerns <u>protection of the shared environment</u>**.

In 1939 Britain faced an existential crisis – the possibility of invasion and subjugation. Deficit management was a second order issue in the face of that threat, and quite right too.

The challenge of environmental depletion and destruction, in our own times, is more serious still... and Sir Nicholas Stern joins me (or rather I join him) in saying so.

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(iii) The third of my necessities is <u>developing an economic policy that halts and then reverses the depredations of big Finance</u>.

We need to build institutions that are capable of directing investment resources so that they serve our country’s long-term interests.

The third image I chose – a US banknote with Ben Franklin’s head on it - represents my ideal; a productive collaboration between science, technical genius, government and money.

[Main Slide FIVE]

(1)*
(2)* (3)* (4)*
(5) *

The way I've chosen to represent mounting social and economic inequality relies on a brilliant representation of economic inequality. The author of that representation was someone called Jan Pen.

In 1971 Pen published his *<u>parade of dwarfs and a few giants</u>*.

He set out to capture - in a way that would really engage other people - the extraordinary inequalities that characterise our economic systems.

Those inequalities have actually increased markedly since the 1970s.

Recently published OECD summary data on economic and social inequality, in the OECD member states, has confirmed the trend; it is a trend which should deeply disturb Liberal Democrats.

For more than 30 years things have been going in the wrong direction.

*

Imagine a parade that lasts an hour. We are all assembled in ranks, according to our income – represented by how tall we are in relation to average income, which is represented by average height.

The vast majority of people are diminutive compared to those with the largest incomes. More than half of the population are clearly well below average height – where height is used to represent relative incomes.

I've put up the **second half** of the parade (the people who go by in the second half of the hour).

Those on the review stand won't see people of ordinary height until the parade has been going for at least 40 minutes.

At the very end of the parade the people who pass are miles high. You might not be able to make it out but, over on the right (in the diagram I am projecting), there is a boot. The boot dwarfs almost everything...it belongs to one of the tallest (richest) individuals, whose height represents the size of their income compared to the incomes of others. That person is miles high.

*

Now, appearing below, I've projected the second half of the parade - those who pass by in the first half hour. They are hard to detect, alongside their better paid cousins.

This, I am afraid to say, is an accurate graphical representation of the relative incomes of people in **our** society. It is a reflection of an economic system which Liberals surely cannot consider fit for Liberal Democrat purpose.

There is a great deal that governments can do, especially if they are prepared to cooperate, in order to ensure that income and life chances are made more equal.

Amongst those extraordinarily tall individuals are a great many cheats, who succeed in sheltering their incomes from the taxman.

We can and we should be doing much more about that.

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[Main Slide SIX]

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This slide represents the necessity for Liberal Democrats of developing an economic policy that is environmentally responsible.

I don't need to take much of your time to make the key points.

* [Note to self: Stern comment]

They have been made for me by Sir Nicholas Stern. He wrote the most important report yet written for the government of a developed nation about the economics of climate change.

Sir Nicholas did not beat about the bush:

<u>“Climate change is a result of the greatest market failure the world seen”</u>.

* * *

So, if I am permitted to link the first half of this talk to the second, I’d argue that:

* **What we should be saying is that, in the midst of a balance sheet recession, the economic opportunities to put**

hundreds of thousands to work in addressing the greatest environmental challenges we are facing, are simply too good to miss.

*

[Main Slide SEVEN]

The final member of my **TRIO of Liberal Democrat necessities** is represented on the slide I have now put up.

It is holding big Finance to account and ensuring that there is an institutional reformation which makes sure that what Christine Legarde refers to as A SERVICE INDUSTRY (she has banking in mind) **provides us with the services we need**.

*

James Galbraith told an academic audience in Croatia a few weeks ago:

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"If you don't realise that what happened in the US was the largest wave of financial crime in human history then you haven't been paying attention."

He told them that US financial regulators simply went AWOL.

He had a striking image to drive home his point. He told his audience about the head of the Office of Thrift Supervision in the US who had brought a chainsaw to a press conference (in 2003). The chainsaw was used to hack apart the code book containing Federal Regulations, regulations which governed underwriting standards.

Galbraith was in no doubt about the potency of the signal this sent to the financial sector.

*

High finance and crime were united as never before. Ninja loans and their packaging, as complex financial products, were part of a process in which *counterfeiters*, *launderers*, *fences* and ultimately *marks* (those who had been duped) all played their suspecting and unsuspecting parts.

Charles Ferguson, in **Inside Job,** has done a brilliant job of letting us know just what happened, helping us to understand why it happened and providing insights into what have been some of the consequences.

We cannot and should not expect to rebuild our financial system on those same rotten institutional foundations.

*

***   The reform of finance is intensely ideological and it should be viewed as absolutely critical for Liberal**

Democrats/for the development and maintenance of a liberal and democratic society – it should, in Liberal Democrat and Coalition government terminology, be a deal breaker.

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We have to be prepared to answer the question: What do you want when it comes to reforming big finance?

[Conclusion-peroration]

On the slide I've put up I have represented largely ineffective and outdated regulation **as a second-hand mousetrap**.

We have to do better than that – but the signs are not encouraging.

Jamie Dimon (of JP Morgan Chase and Co) and Bob Diamond (of Barclays Plc) have both said, in recent months, that it is time to move on (<u>they mean go back – go back to business as usual</u>).

A few days ago Mr. Dimon told Ben Bernanke there's no longer any reason to crack down on Wall Street because:

"Most of the bad actors are gone...[O]ff-balance-sheet businesses are virtually obliterated, ... money market funds are far more transparent [and]most very exotic derivatives are gone."

I do not believe we should accept that from Mr. Dimon...I hope and pray that a Liberal Democrat influenced government will not be so easily *conned*...**sorry, persuaded to move on and give up on radical reform**.