The crisis of market fundamentalism

By Anatole Kaletsky
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The biggest political surprise of 2016 was that everyone was so surprised. I certainly had no excuse to be caught unawares: soon after the 2008 crisis, I wrote a book suggesting that a collapse of confidence in political institutions would follow the economic collapse, with a lag of five years or so.

We've seen this sequence before. The first breakdown of globalization, described by Karl Marx and Friedrich Engels in their 1848 *The Communist Manifesto*, was followed by reform laws creating unprecedented rights for the working class. The breakdown of British imperialism after World War I was followed by the New Deal and the welfare state. And the breakdown of Keynesian economics after 1968 was followed by the Thatcher-Reagan revolution. In my book *Capitalism 4.0*, I argued that comparable political upheavals would follow the fourth systemic breakdown of global capitalism heralded by the 2008 crisis.

When a particular model of capitalism is working successfully, material progress relieves political pressures. But when the economy fails – and the failure is not just a transient phase but a symptom of deep contradictions – capitalism's disruptive social side effects can turn politically toxic.

That is what happened after 2008. Once the failure of free trade, deregulation, and monetarism came to be seen as leading to a "new normal" of permanent austerity and diminished expectations, rather than just to a temporary banking crisis, the inequalities, job losses, and cultural dislocations of the pre-crisis period could no longer be legitimized – just as the extortionate taxes of the 1950s and 1960s lost their legitimacy in the stagflation of the 1970s.

If we are witnessing this kind of transformation, then piecemeal reformers who try to address specific grievances about immigration, trade, or income inequality will lose out to radical politicians who challenge the entire system. And, in some ways, the radicals will be right.

The disappearance of "good" manufacturing jobs cannot be blamed on immigration, trade, or technology. But whereas these vectors of economic competition increase total national income, they do not necessarily distribute income gains in a socially acceptable way. To do that requires deliberate political intervention on at least two fronts.

First, macroeconomic management must ensure that demand always grows as strongly as the supply potential created by technology and globalization. This is the fundamental Keynesian insight that was temporarily rejected in the heyday of monetarism during the early 1980s, successfully reinstated in the 1990s (at least in the US and Britain), but then forgotten again in the deficit panic after 2009.

A return to Keynesian demand management could be the main economic benefit of Donald Trump's incoming US administration, as expansionary fiscal policies replace much less efficient efforts at monetary stimulus. The US may now be ready to abandon the monetarist dogmas of central-bank independence and inflation targeting, and to restore full employment as the top priority of demand management. For Europe, however, this revolution in macroeconomic thinking is still years away.

At the same time, a second, more momentous, intellectual revolution will be needed regarding government intervention in social outcomes and economic structures. Market fundamentalism conceals a profound contradiction. Free trade, technological progress, and other forces that promote economic "efficiency" are presented as beneficial to society, even if they harm individual workers or businesses, because growing national incomes allow winners to compensate losers, ensuring that nobody is left worse off.

This principle of so-called Pareto optimality underlies all moral claims for free-market economics. Liberalizing policies are justified in theory only by the assumption that political decisions will redistribute some of the gains from winners to losers in socially acceptable ways. But what happens if politicians do the opposite in practice?

By deregulating finance and trade, intensifying competition, and weakening unions, governments created the theoretical conditions that demanded redistribution from winners to losers. But advocates of market fundamentalism did not just forget redistribution; they forbade it.

The pretext was that taxes, welfare payments, and other government interventions impair incentives and distort competition, reducing economic growth for society as a whole. But, as Margaret Thatcher famously said, "[…] there's no such thing as society. There are individual men and women and there are families." By focusing on the social benefits of competition while ignoring the costs to specific people, the market fundamentalists disregarded the principle of individualism at the heart of their own ideology.

After this year's political upheavals, the fatal contradiction between social benefits and individual losses can no longer be ignored. If trade, competition, and technological progress are to power the next phase of capitalism, they will have to be paired with government interventions to redistribute the gains from growth in ways that Thatcher and Reagan declared taboo.

Breaking these taboos need not mean returning to the high tax rates, inflation, and dependency culture of the 1970s. Just as fiscal and monetary policy can be calibrated to minimize both unemployment and inflation, redistribution can be designed not merely to recycle taxes into welfare, but to help more directly when workers and communities suffer from globalization and technological change.

Instead of providing cash handouts that push people from work into long-term unemployment or retirement, governments can redistribute the benefits of growth by supporting employment and incomes with regional and industrial subsidies and minimum-wage laws. Among the most effective interventions of this type, demonstrated in Germany and Scandinavia, is to spend money on high-quality vocational education and re-training for workers and students outside universities, creating non-academic routes to a middle-class standard of living.

These may all sound like obvious nostrums, but governments have mostly done the opposite. They have made tax systems less progressive and slashed spending on education, industrial policies and regional subsidies, pouring money instead into health care, pensions, and cash hand-outs that encourage early retirement and disability. The redistribution has been away from low-paid young workers, whose jobs and wages are genuinely threatened by trade and immigration, and toward the managerial and financial elites, who have gained the most from globalization, and elderly retirees, whose guaranteed pensions protect them from economic disruptions.

Yet this year's political upheavals have been driven by elderly voters, while young voters mostly supported the *status quo*. This paradox shows the post-crisis confusion and disillusionment is not yet over. But the search for new economic models that I called "Capitalism 4.1" has clearly started – for better or worse.

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Nevertheless, market fundamentalism emerged as the dominant ideology in the 1980s, when financial markets started to become globalised and the US started to run a current account deficit. Globalisation allowed the US to suck up the savings of the rest of the world and consume more than it produced. The US current account deficit reached 6.2 per cent of gross national product in 2006.Â That made the crisis more severe than any since the second world war. Credit expansion must now be followed by a period of contraction, because some of the new credit instruments and practices are unsound and unsustainable. The ability of the financial authorities to stimulate the economy is constrained by the unwillingness of the rest of the world to accumulate additional dollar reserves.