The Next Great Transformation

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The world's ability to manage global crises such as climate change depends on our ability to achieve broad-based economic prosperity and stability. Unfortunately, there is overwhelming evidence to suggest that policymakers and the economists on whom they rely have completely misread current macroeconomic trends.

AUSTIN – Two great specters loom over humankind. One is rapid extinction following a full-scale nuclear war, or a poisoned planet following a more limited one – a point made by the great physicist Andrei Sakharov in his day. The other specter is the slower extinction that would follow from runaway global warming. Getting ahead of that threat requires the largest effort of planning, investment, public education, and social insurance in human history – the mother of all New Deals. And yet efforts to confront it have been frustrated by mainstream economists.

For example, it is fanciful to think that economic processes that will have large and uncertain effects 50 or 100 years in the future can be dealt with through present-day market mechanisms – such as a price or tax on carbon – alone. And yet a leading economist in US President Barack Obama's administration (one of the good guys, relatively speaking) relayed this very idea to me some years ago, with the proviso that he was channeling his "inner Hayek." In the real world, we need an economics that can integrate resources, social stability, and the environment into one realistic, long-term framework.

Two themes from my recent work bear on this problem. One relates to economic growth in the twenty-first century, particularly after the 2008 financial crisis. The other concerns the measure and meaning of economic inequality. These issues represent enabling and constraining factors, respectively, in our efforts to tackle existential threats. Even as we work to avert nuclear war and mitigate global warming, we also must maintain a functioning system that provides the world's population with a decent standard of living. Otherwise, people will resist the great transformation that the climate threat, in particular, has made necessary. Perpetual economic instability will leave our hands perpetually tied.

THE ROAD FROM HAYEK

To mainstream economists, the market economy is a self-stabilizing system. To take the most egregious modern example of this worldview, mainstream economists considered the great 2008 financial crisis an unforeseen – and indeed unforeseeable – shock.

This interpretation was useful, because it protected those who held it from the charge that they should have seen the crisis coming and acted to prevent it. At the time, during one of my rare appearances on American television (*PBS NewsHour*), I suggested that, in response to the crisis, we might apply the naval principle of "command responsibility": when a ship runs aground, the captain is immediately removed, and a board of inquiry later determines whether he was actually responsible. This proposal was not well received. The captains were re-appointed at the US Federal Reserve and the Department of the Treasury, and one of them was spirited over from Harvard University to serve in the White House.

But one cannot really fault mainstream economists for taking this position. To do otherwise would have been to cast doubt on the intellectual primacy of their creed. It was necessary, therefore, that those who actually did foresee the crisis – and there were many, some on the academic fringes and others in finance – should be ignored.

The "unforeseeable shock" view further implied that after the crisis, a full recovery would follow. After all, if the system is inherently stable and self-balancing, an automatic return to the pre-crisis norm is what the model predicts. To be sure, while many in the mainstream listened to their inner Hayeks, we also heard from Keynesians. But because this camp was also tied in important ways to the underlying mainstream thinking, it could muster only relatively minor dissent, arguing that the inevitable recovery could be helped along with a bit of stimulus.

I never thought things would be so simple. In my 2014 book *The End of Normal*, I advanced an alternative perspective that rested on four broad hypotheses. Each offered reasons to expect that the future course of economic recovery and performance would be structurally inferior to the scenario anticipated by economists who had been brought up to think that the second half of the twentieth-century was normal. Simply put, I concluded that growth and employment would be weaker over the decades following the crisis than they had been in the preceding decades.

DIMINISHING RETURNS ON ENERGY AND CAPITAL

The first hypothesis concerned the increasing real (inflation-adjusted) cost of resources, especially energy, and the inherent instability of energy-market financialization. Over time, energy – a utility whose function is to deliver the most basic raw materials to the economy – has been converted into a major engine of speculative destabilization. I call this phenomenon the "choke-chain effect." A large economy that embarks on a path of strong growth will encounter rising resource costs, owing not only to the increasing real cost of acquiring the resources it needs, but also – and more so – to speculation by investors and hoarders over a much shorter timeframe.

Following the 2008 crisis, the development of hydraulic fracturing (fracking) to recover natural gas and oil from shale reserves relaxed the choke chain in the United States. This process greatly reduced the price of energy (albeit at a very high environmental cost) and had a noticeable short-run effect on the US economy. US manufacturing was revived, thanks partly to the relatively low cost of energy and hydrocarbon feedstocks, but how long this will last is largely unknown.

In Europe, the problem of resource costs has remained, not least because many European governments have made a commitment to adopt cleaner energy sources, while the US took the easy route (for now) via cheaper shale oil and gas. When you invest in what is initially a more expensive form of power generation, as Europeans did, you will have to spend more on it and less on everything else, and your final outputs will grow more slowly. It takes a lot of technological superiority to work around this problem and maintain a strong position in world markets, as Germany (almost alone in Europe) has done.1

The second hypothesis focused on declining long-run investment in physical capital, construction, and the infrastructure to support it. Specifically, brick-and-mortar investment as a share of total activity has declined for several decades in both the US and Europe, which means that overall investment contributes less to growth than it did before.

Declines in public investment are a big part of this problem. In the case of the US, one major factor is that the military has sucked up resources that could have gone to infrastructure, as anyone who travels on American highways can see. (The condition of railroads and urban public transport in places like New York and Boston is worse still.) The $685 billion allocated to the military this year represents an enormous drain of technical and engineering resources from the broader economy; much of it is unnecessary for national security and serves little purpose other than to sustain endless, fruitless wars.

Europe's problem is ideological, reflecting the era of austerity and the cult of privatization. British railways and other once-public services are plain examples. Globally, both Europe and the US are feeling the effects of China's expanding role in the investment mix. In the wider world, it is no longer the West that is taking the grand initiative. And while some Western exporters – namely Germany – have benefited from China's rise, that won't necessarily last. China is quickly developing its own engineering, transportation, and high-tech industries.

MISSING THE PICTURE ON TECHNOLOGY

My third hypothesis concerned the ongoing technological revolution, particularly the rise and spread of compact digital technologies. Economic statisticians are notoriously unable to apprehend the impact of these technologies, registering almost no effects at all, even though the technologies and their consequences are visible to everyone.

Obviously, many of the new technologies save labor, thereby displacing people from office and services employment, just as automotive technologies displaced horses from transportation and agriculture a century ago. The new technologies also radically reduce the costs of a wide array of services, and of the production and dissemination of information, news, and entertainment. A significant share of activity has effectively been removed from the measured rate of growth, because it involves the production of goods and services at a fixed cost with very little marginal spending for additional consumption.

What is often overlooked is that the new technologies also save capital, and so reduce the share of investment in total spending. This is not a bad thing. But it does mean less investment spending, fewer jobs created by that spending, and a lower measured growth rate. This effect of new technologies on investment spending could be offset, but only by more public investment or more household consumption, with the latter fueled either by incomes or debt.

Debt has played a far greater role in sustaining consumption and economic activity in the US over the last decade than it has in Europe. America is awash in student-loan debt, automobile debt, credit-card debt, housing debt, and every imaginable debt in between. Americans are addicted to debt in a way that Europeans are not. They have access to all the new technologies, but the instabilities associated with debt will hamper their ability to reap the full benefits. This problem will grow until the US corrects the income inequality that has resulted from moving a great deal of economic activity to sectors that are dominated by an exceptionally small number of people who capture most of the returns. I'll return to inequality below.

THE BIG GRIFT

Finally, I argued in 2014 that the 2008 crisis had exposed structural failings in the financial system, including hypertrophy, megalomania, predatory competition, bad judgment, and massive levels of fraud. Mainstream economists denied that such

problems were possible. Widespread fraud, they reasoned, could be ruled out on the basis of the reputational risk to the fraudster. (These same economists also relied on models in which the financial sector essentially did not exist.) In the real world, the exact opposite is true: the more fraudulent you are, the more successful you become, at least until you are exposed. Every country has oligarchs of this type.

Generally speaking, once a system built on fraud, self-dealing, and poor judgment has been exposed, it cannot be repaired except through aggressive, comprehensive reforms and the administration of justice. In the case of the 2008 crisis, that did not happen. The financial system was patched up, and existing institutions remained in place. Very little was done to reform them, and many of the same people were left in charge. Almost no one was prosecuted.

The result has been a loss of trust, as evidenced by the mad dash to higher-quality assets anytime the yield curve becomes inverted (as is happening now). Ironically, one of the main beneficiaries of this decadent system is the US Treasury, an institution that, compared to all the others, stands as a bastion of stability. Politically, the bank bailouts helped to bring us the presidency of Donald Trump, which has confirmed that many people prefer direct rule by oligarchs to smooth-talking front men.

The upshot is that we now have a financial sector that is structurally incapable of providing strategic direction to the real economy. Global finance is the sick man of capitalism. As with the Ottoman Empire before 1914 and the Soviet Union in the 1980s, its weaknesses are felt far and wide, and those who peer into the future do not believe that the future is very bright.

A NEW NEW DEAL

If these four hypotheses are at least partly correct, there will be no automatic return to past growth trends and employment levels, and simple-minded pseudo-Keynesian pump-priming won't work. If your car has a broken transmission, putting gas in the tank is of little use.

Instead, we need a comprehensive policy of institutional reform geared toward changing the very structure of the economy: that is, a new New Deal. Such a program would be designed to manage resource and environmental constraints, while preserving social stability and working toward an improved quality of life. It would target a more sensible use of resources, as well as a general relaxation of international tensions and conflict resolution.

More broadly, we should rethink the ingrained concept of strategic competition among individual countries, whereby each seeks to have the largest, fastest-growing, or richest economy. The tasks ahead require social stability, security, sustainability, and a good quality of life. These are existential requirements, and not things that can be tacked on to a competitive, predatory system. Achieving them will require time, commitment, and peace (in fact, this is another reason to disarm as much as possible, especially with respect to nuclear weapons).

Implementing a new New Deal will require broader and more effective social insurance. You cannot make major changes work unless you protect those who are displaced. In particular, there is a clear case to be made for a government job guarantee in each national economy, including the US, in order to eliminate the scourge of unemployment. A job guarantee would allow displaced workers to move back and forth to the private sector without suffering debilitating idleness, and at the same time ensure that a wide range of social needs are met.

Predatory financial capital is not sustainable; indeed, it is destabilizing by design. As with the original New Deal, which started with the Emergency Banking Relief Act of 1933, comprehensive financial reform must be the first step. After that, all other needed reforms may follow.

WHAT INEQUALITY IS TELLING US

This brings us to the other overarching issue that is affecting our ability to achieve a new "Great Transformation": economic inequality. In mainstream economic thought, the causes of rising inequality have are to be found in the labor market. According to this view, higher inequality reflects shifts in labor demand that are being fueled by skill-biased technological change and, on the supply side, by education, immigration, and other variables.

One needs evidence to challenge this view. Fortunately, it exists, and I have made it available through my work on the University of Texas Inequality Project over the past two decades. My students and I have developed a dense and consistent set of comparative measures of inequality covering the past half-century and more than 150 countries. The evidence on its face refutes the mainstream assumption that inequalities are the result of idiosyncratic labor-market dynamics within individual countries. Rather, there are common patterns across countries and over time.

These patterns show that economic inequality and global finance are two sides of the same coin. It follows that a large share of current mainstream microeconomic work – and not just on inequality – is conceptually obsolete. The main point of neoclassical microeconomics, after all, has always been to explain and rationalize distribution. Yet to do that in terms of local labor markets and "factor returns" is to obscure the dominant forces that are actually affecting the income distribution and the rate of profit. Evidence, alone, can tell us what those forces really are.

The evidence shows that economic inequality has risen worldwide in waves, beginning around 1980 with the debt crisis in the developing world. That initial wave passed through the collapse of the Soviet bloc in the late 1980s, and was followed by the liberalization of many Asian economies in the 1990s, culminating in the Asian financial crisis.

In 2000, inequality peaked in the US and elsewhere. After that, the situation across the world economy stabilized, roughly for the next 10-15 years. In some cases, such as in Latin America after 2000, inequality declined, owing to healthy export markets and the achievements of social-democratic governments there. Inequality also fell in China, as prosperity spread from the initial centers of modernization across the country, and in Russia as the economy recovered from the disasters of the 1990s. While inequality in all of these places remains far higher than in the past, the forces pushing it higher did break down for a time.

These patterns of cresting inequality show that the policies and practices of Big Finance have been driving global macroeconomic conditions – but also that they can be checked. Finance is not the only force acting on economic outcomes. But if you remove the common trend – which is traceable to finance – from the measures, you no longer observe a general rise in inequality within countries around the world. That is powerful evidence. We have been witnessing the consequences of conditions that were made possible by financial globalization.

To see how this process works in practice, consider the case of a small, open, "liberalized" economy that suffers through periodic currency overvaluation. In moments

of financial stress, capital flees and the currency collapses. Inequality within the country increases dramatically overnight, because incomes from outside, in foreign currency, rise relative to those earned inside the country, in the local currency. The only way to make the system stable and sustainable is to control the mechanisms driving such spikes in inequality. But that, in turn, is achievable only through policies and institutions that can regulate global finance effectively.

"Effectively" is the operative word here. Controlling global finance is no small feat. But it is necessary if we in the West want to play a role in setting the future direction of the world economy. Otherwise, China will gladly take on the job instead. The exponents of global finance know this, which may explain why Sino-American tensions have been rising.

In short, as my friend Kari Polanyi Levitt (the daughter of the twentieth-century economic historian Karl Polanyi) has also argued, the driving force behind inequality today has been the "Great Financialization" of the world economy over the past 40 years. The effects of this trend have varied, depending on the ability of national institutions to resist it. Larger or richer countries can insulate themselves from the effects of global finance better than smaller or poorer countries can. But a stable world will require a new system, one that is capable of protecting the weak from the strong.

LAST CHANCES

At its current level, inequality is the symptom of an economic illness that threatens the survival of organized, peaceful, and prosperous human life. Inequalities generated by financial booms and the concentration of income within speculative (bubble) sectors are inherently unsustainable. If we are concerned about environmental sustainability, we also need to be concerned about sustainability in the economic domain, because instability blocks effective action in the face of global challenges, including climate change and the nuclear threat.

If we do nothing, we will have tied our hands. Any approach that is tolerant of extreme inequality and bereft of public purpose is a formula for social disruption, international conflict, and a loss of freedoms that are already under threat just about everywhere.

Karl Polanyi is renowned for his examination of the institutional underpinnings of what he called the "Great Transformation" from feudalism to capitalism. We must pursue the same depth of understanding, while going even further. To bring about the institutional change we need will require much more creative thinking, and a lot less dogma, particularly in economics. That is what is required of us now, and it is what will be required of future generations.

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