

Political economy and the crisis

Where next for robust economics and public policy?

28 June 2011, Steve Baker MP

Political economy and the crisis

- ❖ Invitation

- ❖ Is it time for political economy?
- ❖ Which is the appropriate political economy?
- ❖ Does the Austrian School matter?

- ❖ Challenge

- ❖ If not the Austrian critique of the crisis, what?
- ❖ If the Austrian critique, where next for banking?

Is it time for political economy?

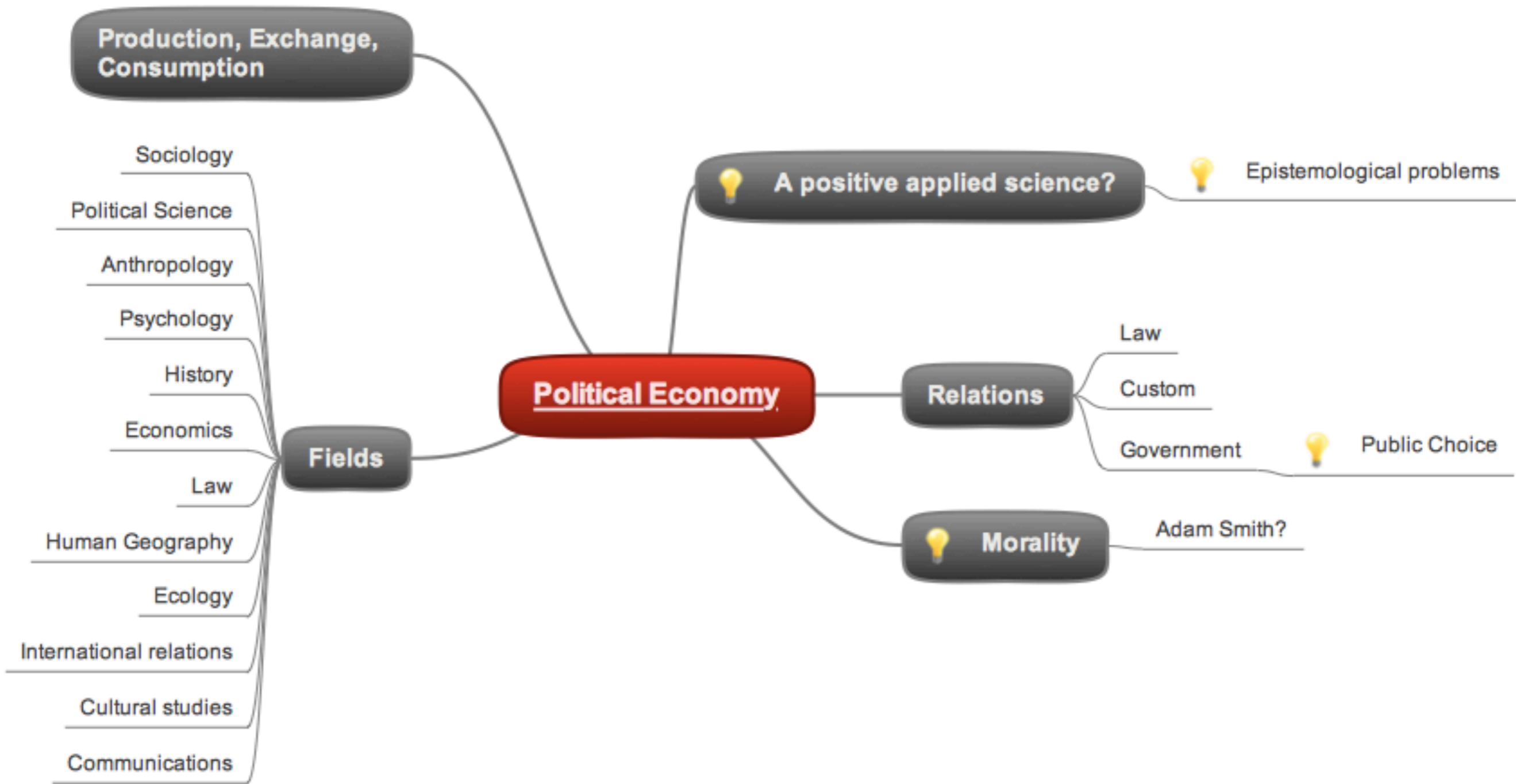
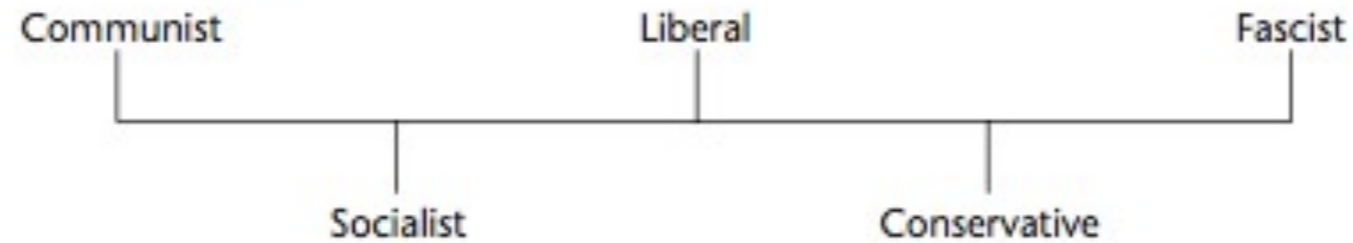
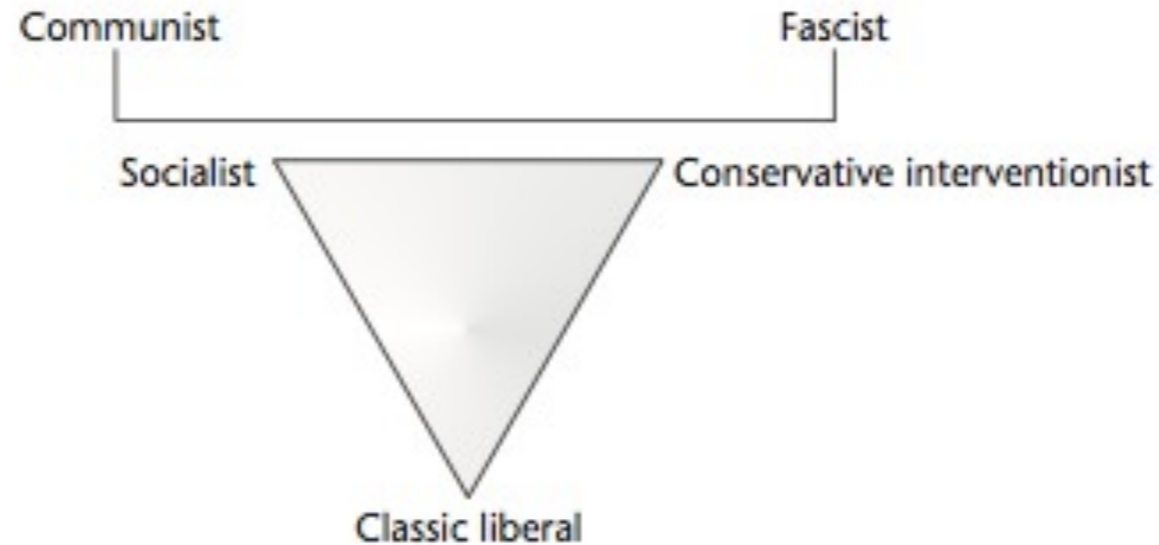


Figure 1 **Alternative schematic representations of political ideologies**

Conventional left/right spectrum



Hayek's triangle



An appropriate political economy?

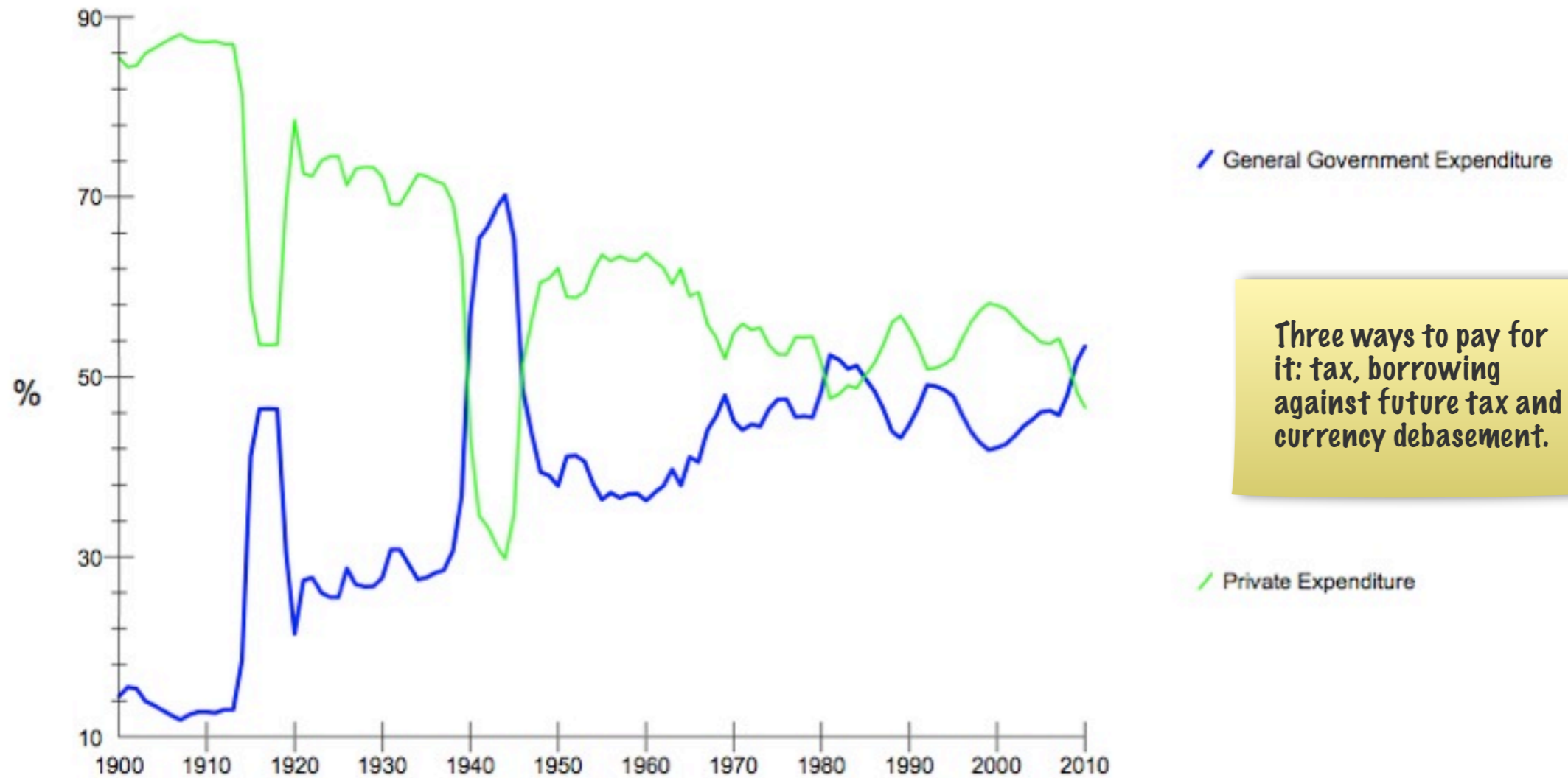
From *Living with Leviathan*, Smith, IEA, 2006

Does the Austrian School matter?

- ❖ Methodological individualism
- ❖ Society as a dynamic process
- ❖ Complexity, subjectivism and deduction
- ❖ Profit and prices
- ❖ Time and capital
- ❖ The agony of interventionism



Chart 1: Ratios of UK general government expenditure and private expenditure to UK GDP at Factor Cost 1900- 2008 with implied Budget forecasts for 2009 and 2010

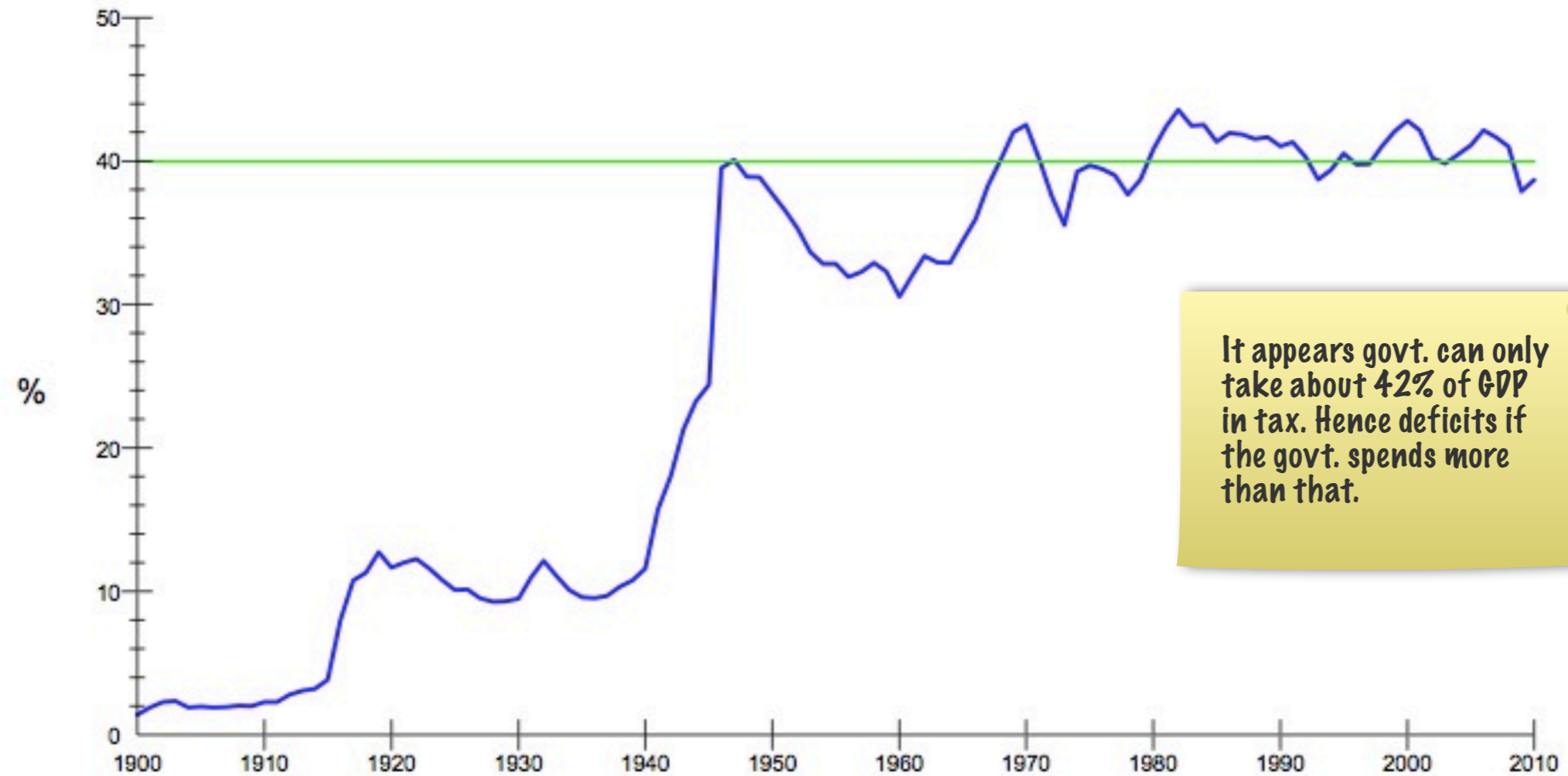


UK govt and private expenditure

As a proportion of GDP at factor cost

Source: *How Should Britain's Government Spending and Tax Burdens be Measured?*, David B Smith, IEA, Jun 2009

Chart 3: Ratio of UK non-oil tax receipts to UK non-oil GDP at factor cost 1900- 2008 with implied Budget forecasts for 2009 and 2010

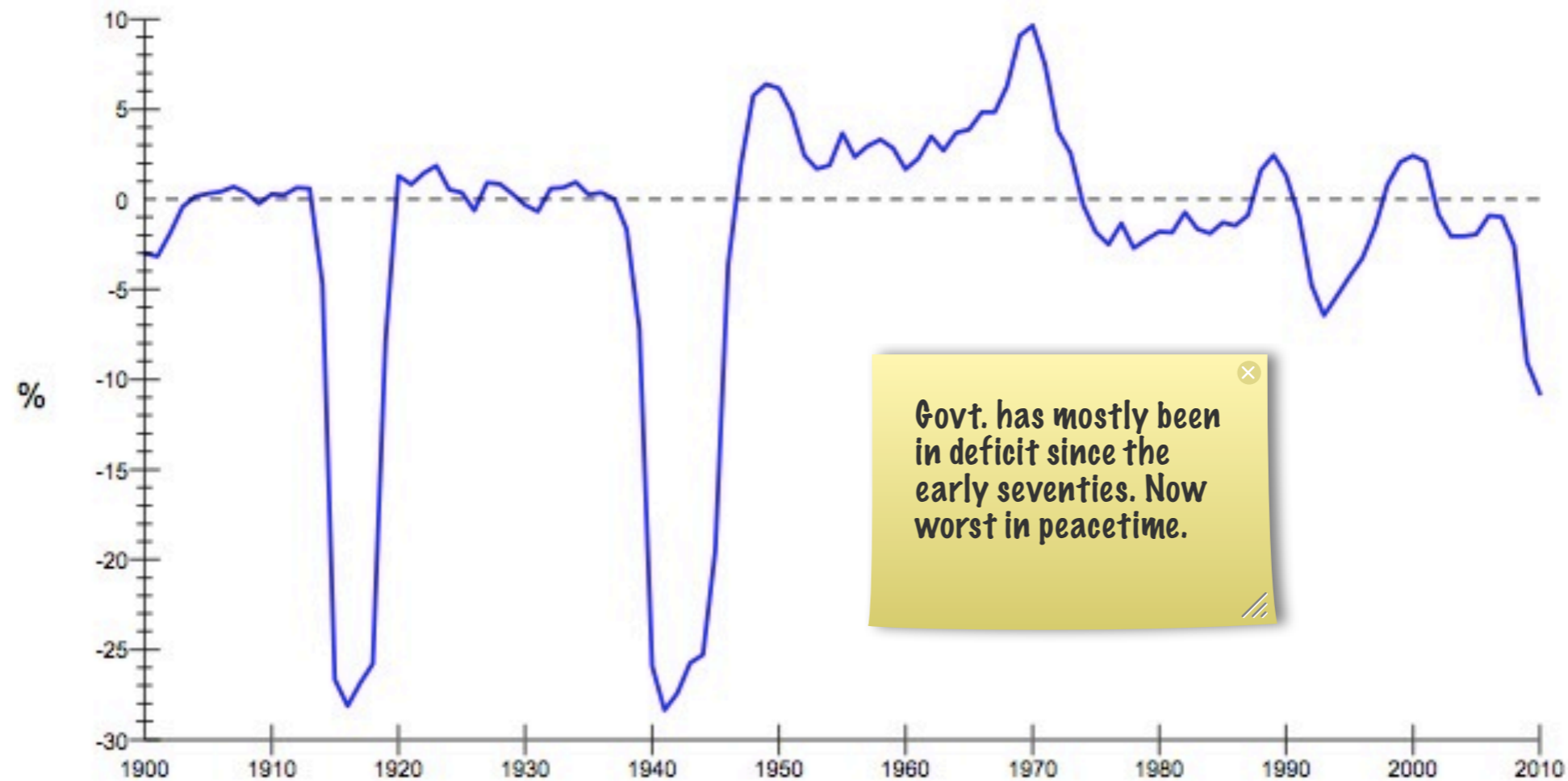


The tax burden

The pips are squeaking

Source: *How Should Britain's Government Spending and Tax Burdens be Measured?*, David B Smith, IEA, Jun 2009

Chart 5: Ratio of UK general government surplus to UK GDP at factor cost 1900-2008 with implied Budget forecasts for 2009 and 2010



What about borrowing?

Only total war has caused larger deficits than we have today.

Source: *How Should Britain's Government Spending and Tax Burdens be Measured?*, David B Smith, IEA, Jun 2009

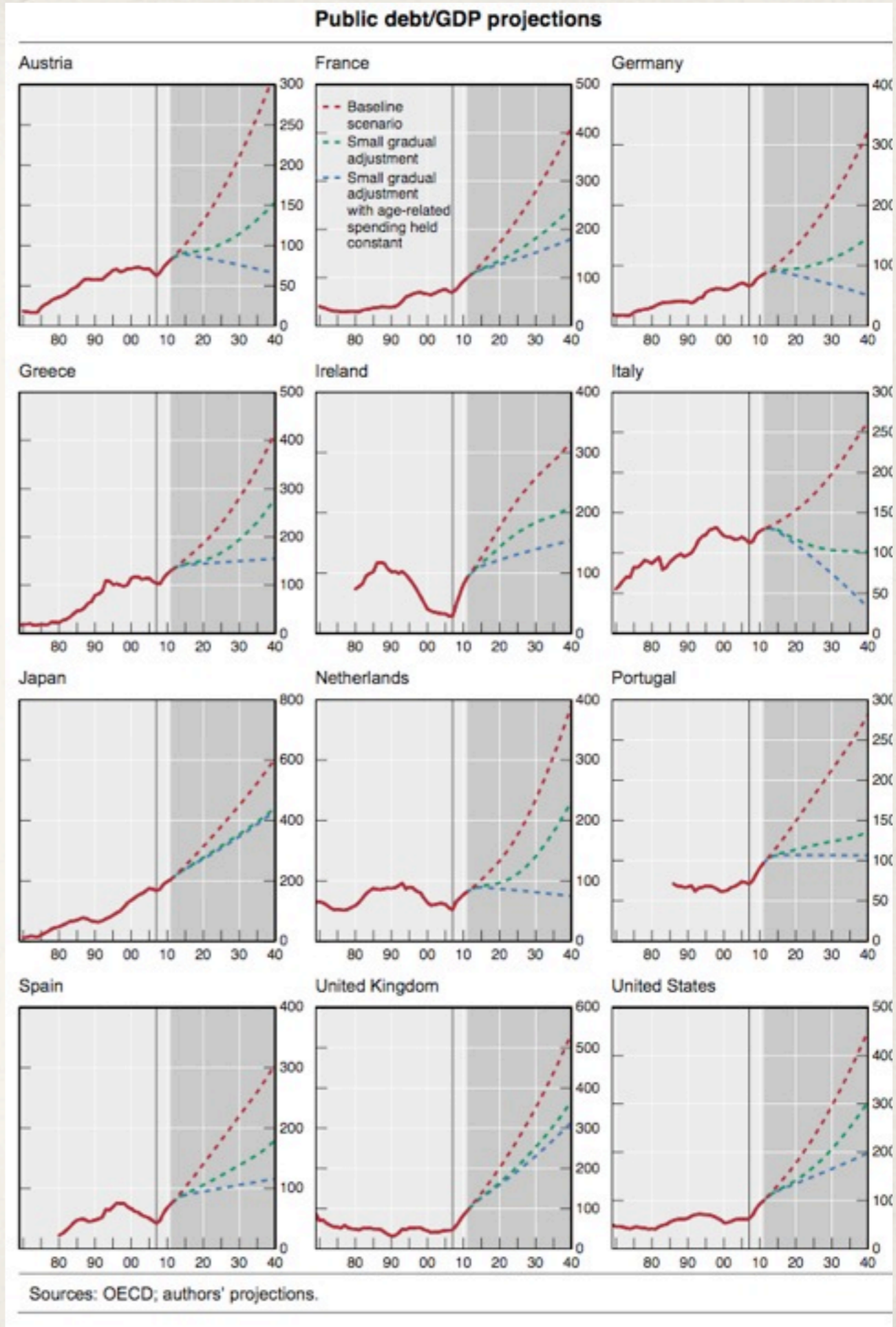
BIS debt projections

See also IEA, TPA, Cobden Centre

Public debts across the world are unsustainable.

Things that cannot go on will end.

Source: *The future of public debt: prospects and implications*, BIS, Cecchetti et al, Working Paper 300, March 2010



Currency debasement

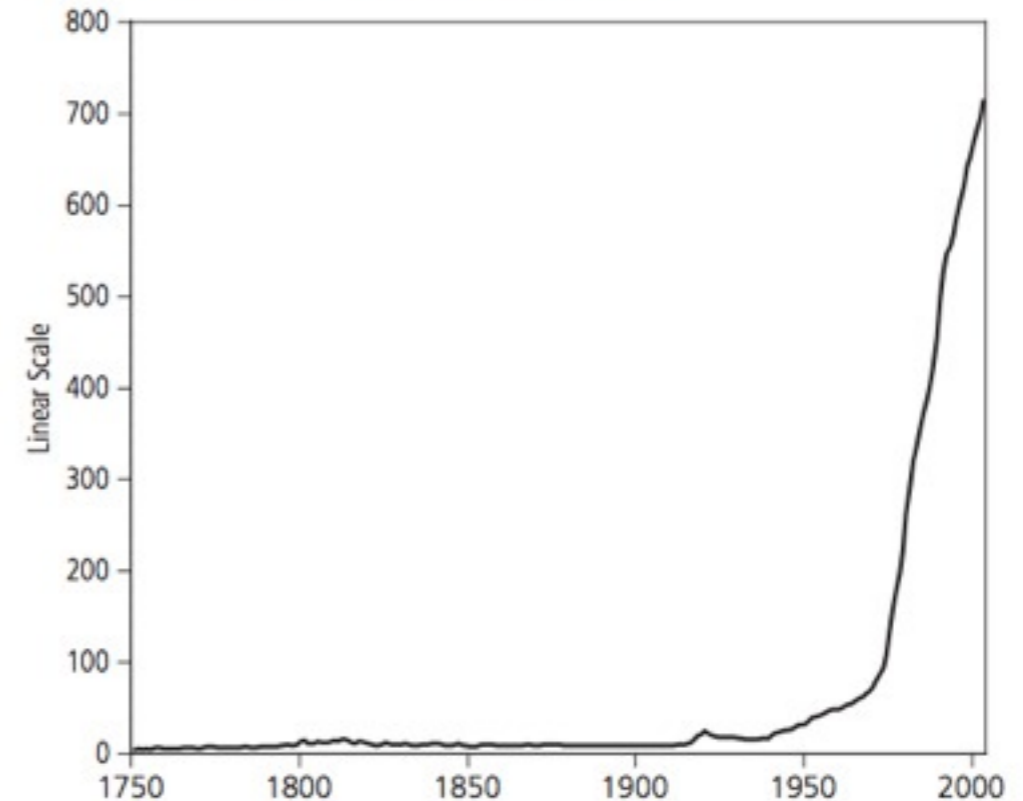
1800-1900 vs 1945-2010

There has been a massive increase in the money supply since 1971, when Bretton Woods finally collapsed.

Money more or less held its value in the C19th, but lost almost all of it in C20th. The consequences have been profound on normal life, on saving and on the structure of the economy

Source: Consumer Price Inflation since 1750, O'Donoghue et al, Office for National Statistics, 10 March 2004

Composite Price Index 1750 to 2003, January 1974 = 100 (linear scale)



Composite Price Index 1750 to 2003, January 1974 = 100 (logarithmic scale)



Challenge to economists

- ❖ If not the Austrian critique of the crisis, what?
 - ❖ More of the same?
 - ❖ Where does it end?
- ❖ If the Austrian critique, where next for banking?
 - ❖ Can free-marketeers agree?

I agree with Mervyn

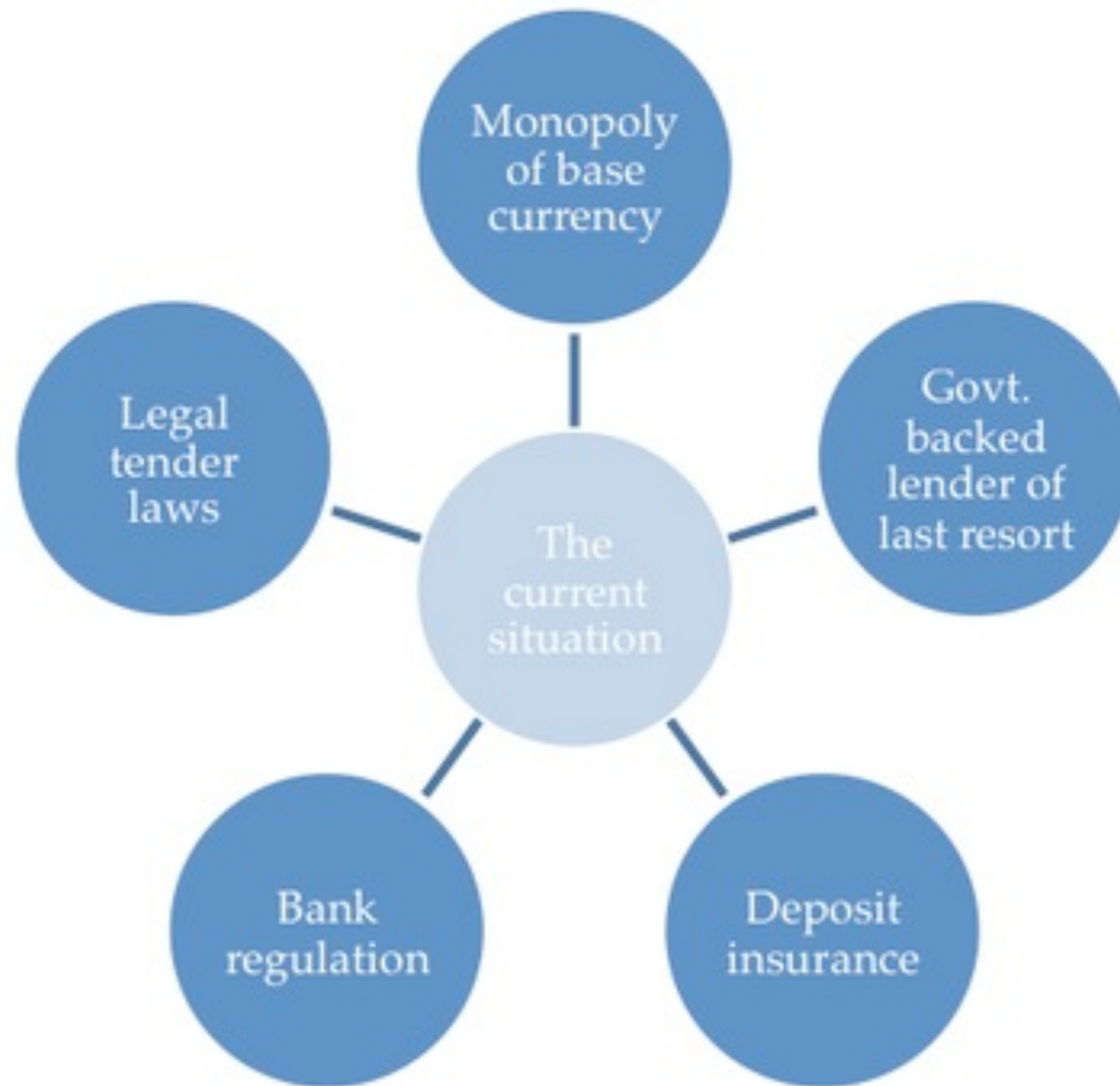
“Of all the many ways of organising banking, the worst is the one we have today.”

Mervyn King, Governor of the Bank of England

“Banking: From Bagehot to Basel, and Back Again”
The Second Bagehot Lecture Buttonwood Gathering, New York City
Monday 25 October 2010

Conclusion

- ❖ Economics should become political economy
- ❖ Classical liberalism is the most robust political economy
- ❖ The Austrian School offers important insights
 - ❖ The Austrians predicted and intellectually survived the crisis
 - ❖ That is, or should be, a challenge to the contemporary paradigm
- ❖ The implications for financial reform are profound



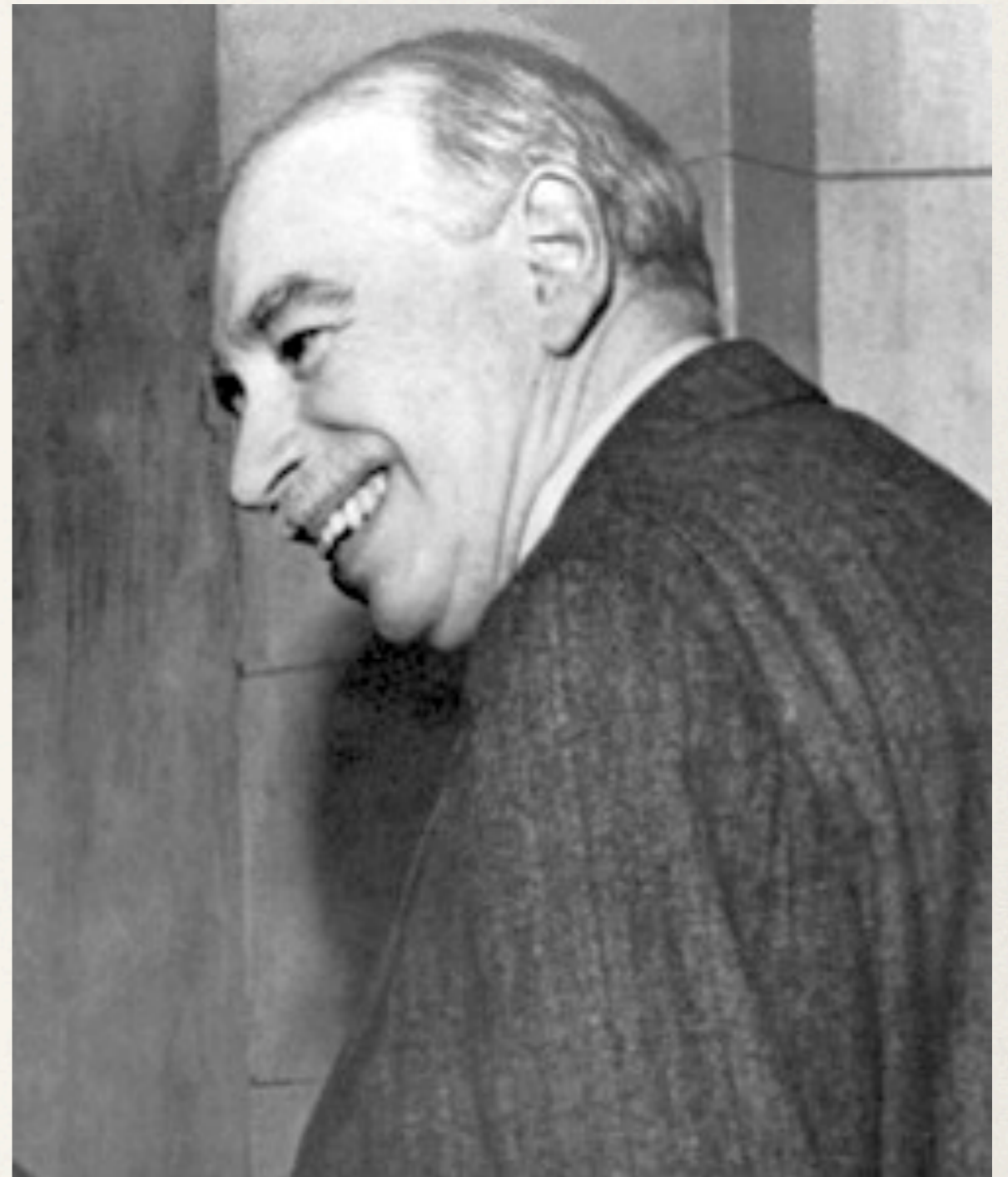
The character of banking

Source: Dr Anthony J Evans, ESCP Europe

By "Inflation", I mean an increase in the money supply, which causes prices to increase as a consequence of that debasement.

Keynes on inflation

The Economic Consequences of the Peace,
Chapter VI, pg.235-236



Keynes on inflation

“... By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. ...

...There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

New money came from the banks expansion of credit. But can bank credit expansion create real wealth?

Ludwig von Mises

Tu ne cede malis sed contra audentior ito

Mises wrote about all this before and after the Great Depression in particular.



Mises on credit expansion

“Credit expansion cannot increase the supply of real goods. It merely brings about a rearrangement. It diverts capital investment away from the course prescribed by the state of economic wealth and market conditions. It causes production to pursue paths which it would not follow unless the economy were to acquire an increase in material goods.

As a result, the upswing lacks a solid base. It is not real prosperity. It is illusory prosperity. It did not develop from an increase in economic wealth. Rather, it arose because the credit expansion created the illusion of such an increase. Sooner or later it must become apparent that this economic situation is built on sand.”