

gathering evidence for corrective reformation



This month's issue might well be titled 'Ways out of the Swamp'. It's an ambitious enterprise for a group of planners to undertake; you might even say it's taking a diabolical liberty. Even a year ago, any attempt to invade the sacred temple of the economists could have been met with furious derision. But the temple itself, like its outposts in the banks and the business schools, is now under frontal assault. The priests have lost their sacred clothes.

But possibly this is an opportunity not for some Cultural Revolution in which the economists are sent into the country to clean the latrines, but for some kind of spiritual reformation, quietly re-examining the evidence and drawing lessons from it. In particular, we might ask what the great masters of the past said on the question and what, if brought back to a séance, they might say now. And we might triangulate that with the evidence from economic history – evidence that, because of the economists' notorious addiction to deductive modelling, they have too often ignored to their cost.

It's interesting, in this regard, that three of the greatest economists of all did not make that error. Although Karl Marx could scribble equations as enthusiastically as any – the unread Volume Two of *Das Kapital* consists of nothing else – his great concern was to learn the laws of capitalist motion through deep historic understanding. Joseph Schumpeter, who revered Marx and became his most cogent critic, distrusted the mathematics altogether, seeking instead to understand the capitalist process by making an almost day-to-day analysis of its underlying dynamics. John Maynard Keynes, who allowed himself the occasional equation, worked mainly through his own deep inside experience of the world of high finance. Thus their masterworks – Marx's *Capital*, Schumpeter's *Business Cycles*, Keynes's *General Theory* – are all masterpieces of prose, as unlike the typical academic paper in the *Economic Journal* or the *Quarterly Journal of Economics* as it is possible to find.

And, as I started to argue in the March edition of this column, their works prove to share something in common. Trying to summarise it in a short article is an exercise in what the French call *haute vulgarisation*, with the risk that it may not clear the first fence. But, in this context, it is perhaps worth a try.

The essence of Marx's argument was that capitalism was caught in a massive self-contradiction which it could never escape and would logically bring its downfall. On the production side, the constant pressure of competition forced individual firms to ever-greater efficiency, first by driving down wages and second by substituting capital equipment for labour – which, in the quaint Marxian terminology, is called raising the organic composition of capital. But the logical final consequence is an economic world operated entirely by machines, in which no wages are paid and the workers starve. And this is doomed to destruction because, on the demand side of the equation, there are no consumers left to provide a market for the ever-increasing surplus of goods.

Schumpeter, delving back into the history in the 1930s,¹ was able to identify the flaw in this logic. Capitalism could constantly re-invent itself through innovation – the application of inventions in technology and organisation to the productive process. This not only made existing processes more efficient but also created entire new industries that generated new incomes, both for the entrepreneurs who created them and also for their workers. Thus capitalism worked through a constant process of creative destruction² – Schumpeter's historic phrase – which destroyed old firms and old industries, but replaced them with fresh new ones. And, Schumpeter argued, this process worked through cataclysmic periodic long-term cycles – the so-called Kondratieff long waves, named after a Russian economist of the 1920s who first identified them – of about half a century, each marked by a boom and then a crash.

When Schumpeter was writing his huge tome on business cycles at Harvard University in the 1930s, the evidence of the Great Depression was all around him. As he predicted, just as he was writing new technologies were producing new industries – jet aircraft, electronics, new drugs – that would bring the world out of depression and into the long post Second World War boom.

Keynes, writing in the other Cambridge at just the same time, focused on shorter-term fluctuations. But, as we can now see more clearly than at the time, like Schumpeter and Marx he was centrally concerned with the laws of motion of the whole system. He was arguing (although subsequently his closest observer Hyman Minsky has argued that he did not fully appreciate his own logic) that capitalism is by its nature inherently unstable. Those within it are driven by what he called animal spirits, which will either carry the system upwards on a surge of self-confidence, or equally suck it downwards into a vortex. And a central role here is played by the banking system, because without finance the whole process cannot work, and because bankers in particular are driven by alternating fits of euphoria and depression. In other words, psychology – even morbid psychology – is at the heart of the system.³ In particular, if bankers cease to lend, there is a

evident even at the time when Marx wrote and Britain was the workshop of the world, exporting cheap manufactures to every other country and importing cheap food to feed its workers and cheap raw materials to feed into its factories. But the new version has cheap labour allied to the latest technology to produce a flood of low-cost, high-quality manufactured products, from refrigerators to computers to cars, for the former manufacturing countries of the west.

The second, allied to the first, is the remarkable development of consumer credit since the invention of the credit card in America (and, almost simultaneously, here in the UK) in the 1960s. Of course, consumer credit isn't new either: mortgages for house purchase were essentially an invention of the 1890s, as were their agents, the building societies (in America, the savings and loans) and overdrafts came even earlier; hire purchase to buy cars or refrigerators originated in America in the 1920s. But credit cards had an extraordinary impact in relieving the basic Marxian contradiction of too much production, too little consumption – at least for a time.

They did so, however, at very different speeds in different countries. Germany, which had a visceral fear of spending sprees after the hyper-inflation of 1923, was much slower to take them up than the US or Britain. China, where there is a deep cultural tradition of provident saving, has been even slower. This is one explanation of the extraordinary imbalance that has developed, over the past decade, between a high-saving, surplus-generating, capital-exporting China and a high-spending, deficit-generating, capital-importing America. Essentially, China produces a flood of manufactured goods for the world, generating profits which are then saved and exported to the developed world, in turn generating a flood of credit with which to buy the products: the United States is thus permitted and even encouraged to live on tick. It sounds like a perfect plot to destroy capitalism. But far from it: it has become the perfect device to keep it running – until now.

The third feature, the special role played in the process by property investment and speculation, is not new either: witness the excesses of residential real estate development in Florida and California in the 1920s, or the orgy of office-building in New York City at the end of that decade, culminating in the crash that left the Empire State as the Empty State Building. But it has been an equally notable feature of the most recent episode of capitalist history.

The Japanese urbanist Koicha Mera and World Bank economist Bertrand Renaud have traced the



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Above

Joseph Alois Schumpeter saw capitalism working through a constant process of creative destruction, in cataclysmic periodic long-term cycles – but can the system self-correct?

surplus of savings over investment, which paralyses the process.

Put these insights of the masters together, and you have a pretty powerful explanation of the events of the past 18 months.

But we probably need to add at least three other ingredients, all of which have been key developments of the most recent stage of evolution of the system, although at least some are really new versions of quite old phenomena.

The first is a new and all-encompassing international division of labour. Such a division was

critical role played by speculative real estate investments by Japanese banks in the collapse of that country's bubble economy, from which it took ten years to recover.⁴ There is a story yet to be told about the role of sub-prime mortgages and over-ambitious commercial property investments in this decade. What is certain is that animal spirits in the banking industry, intervening injudiciously in real estate, play a critical role in intensifying a major boom just before its impending collapse.

The basic lesson from the masters is that this is the way capitalism works. Schumpeter argued that the only real cause of a slump was a preceding boom, and the only real cause of a boom was the preceding slump. All this might suggest that the only proper response is a passive one: as in a world war (which, in a sense, this is), keep calm and carry on. But the most profound analysis of our present crisis reaches a diametrically opposite conclusion.

It comes from a Venezuelan economist, Carlota Perez. In a remarkable book published in 2003, but too little noticed at the time,⁵ she used a Schumpeterian framework to develop a thesis that indeed the capitalist system had gone through five major so-called surges – a term she prefers to long waves. And each had gone through four phases: irruption (of a new technology), frenzy (wildly enthusiastic investment in the new product),

The good news was that the crash would be followed by an age of expansion and affluence, such as the world experienced in the 1950s and 1960s. The more challenging news was that, each time, the process involved the creation of a new techno-economic paradigm: a total revolution in the way the world managed its business. And this was a job for government. The golden years of the post-war era rested on a firm foundation of public actions, remarkably similar in character from country to country, although differing in detail: in particular, the creation of new physical and social infrastructure (motorways, universities, hospitals) and the development of welfare systems to protect the basic living standards of ordinary people. Thus the system, as perceptive observers like Keynes had long ago observed, could not self-correct.

We are just at the start of such an era; we cannot yet see clearly the outlines of the new techno-economic paradigm. But, if property plays such a critical role, if the implosion of the mortgage market has been so important a feature of market failure in the last year, that should highlight the lesson that intervention in that market might be one fruitful direction for public policy.

Some, like Oxford University Professor John Kay, have argued that the demutualisation of building societies was a basic mistake that now should be reversed. Certainly, forging a new and more stable mortgage market would make an obvious – and also a vote-winning – priority. So would a fresh look at co-tenant finance, a concept that forged several model garden suburbs a century ago before Treasury opposition killed it off just after the First World War (this column, March 2009). The TCPA, which played such an important pioneering role then, should surely now be doing it all over again.

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Notes

- 1 J.A. Schumpeter: *Business Cycles: A Theoretical, Historical and Statistical Account of the Capitalist Process* (Two Volumes). Porcupine Press, Philadelphia, 1939, 1982
- 2 J.A. Schumpeter: *Capitalism, Socialism and Democracy*. Harper, New York, 1942
- 3 H.P. Minsky: *John Maynard Keynes*. McGraw-Hill, New York, 1975, 2008; and H.P. Minsky: *Stabilizing an Unstable Economy*. McGraw-Hill, New York, 1986, 2008
- 4 K. Mera and B. Renaud (Ed.): *Asia's Financial Crisis and the Role of Real Estate*. M.E. Sharpe Inc., Armonk, New York, 2000
- 5 C. Perez: *Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages*. Edward Elgar, Cheltenham, 2002

'We cannot yet see clearly the outlines of the new techno-economic paradigm. But, if property plays such a critical role, if the implosion of the mortgage market has been so important a feature of market failure in the last year, that should highlight the lesson that intervention in that market might be one fruitful direction for public policy'

synergy (a calming-down phase, in which the benefits diffuse), and maturity (when the process works itself out). Critically, at the end of each frenzy phase, finance capital became detached from production capital, resulting in wide excesses of hyperbole and outright fraud. And this culminated in a financial crash.