Andy Ross
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The Great Recession

Martin Wolf: *The Shifts and the Shocks*
Allen Lane, 488 pages

Martin Wolf is one of the best financial and economic commentators in London. His 2014 book on the theory and policy implications of the 2008 financial crisis offers as solid and credible an analysis of what went wrong and what needs to be done to prevent a recurrence as a reader can expect to find.

Briefly, banks need to work with lower capital ratios, to be more methodical in their risk assessment for consumer lending, and to separate high street banking from investment banking, while governments need to ensure that banks structured to maximise profits never become too big to fail. Further, central banks need to take a leadership role in regulating the money supply and to understand that deflation, with the ensuing unemployment and stagnation, can be a worse outcome in terms of opportunity cost than inflation with its destabilising effect on prices and savings. More locally, the euro crisis that followed the financial meltdown shows the catastrophic effect of a single currency on economies that lack centralised fiscal discipline and on governments too weak to resist policies that increase deficits. Wolf argues all this cogently at a level that will convince a professional audience.

What seems worth pondering in addition is the wider framework of ideas within which such economic and financial management is pursued. The economic theory of our time rests on an understanding of national and global societies and markets that invites deeper and more philosophical reflection. The social and personal psychology of value for both producers and consumers conditions the role of costs and benefits in an economic system in ways conventional theory tends to neglect.

This is not the place for a new theory of value, but human appetite and physical scarcity interact more subtly than graphs of demand and supply can easily reflect. In particular, our demand for goods, based on their value for us, varies unpredictably with our social environment and individual situation, as well as with technological and psychological factors relating to substitutes or alternatives for those goods. This variation affects demand directly and supply indirectly, to leave the value assignments we make to actual or possible goods in a virtual limbo where their commensurability in economic theory becomes moot. If I want a new mobile phone because it has new features that everyone I respect or admire seems to love, then of course I value it highly, but this is a labile valuation that can be transformed by untraced and perhaps untraceable changes in my circumstances.

Such shiftiness in conceptions of value underlying economic behaviour will come as no surprise to philosophically minded theorists, and may seem amenable to washout in the statistics of large consumer markets or product ranges. But the shifts in mood can be more pervasive, even in a global market for basic goods. Consider the possible future of the oil market in a world where climate change is a topic of increasing concern or where the prospects for new battery technology or solar panel efficiency suddenly look brighter. Such factors surrounding a commodity market can make huge differences to perceived value and hence to prices, projected revenue streams, investment decisions, and so on.

All this has a bearing on the Great Recession. The mass psychology of boom and bust leaves the rational egoist of economic theory, the agent who consistently minimises losses and maximises gains, far behind. A plausible case can be made for the idea that in the run-up to the crash of 2008 people were abandoning reason in their rush for giddy peaks, and that the crash, when it came, was a climactic release from denial about the fading of the American world hegemony, faced as it was by Islamic chaos in south Asia triggered by decades of repression and by a Chinese renaissance in east Asia following centuries of weakness. The catastrophic end of the Bush era was the operatic finale to a capitalist spree that in its scale and its excess surely surpassed all previous booms. But economists raised on rational expectation theory could only map the end. With the analytic tools at their disposal they could not predict it.

The root issue here is technology. The endless growth that capitalism needed to put savings to productive use continued for decades longer than many expected because the new ideas and new products just kept coming from researchers and engineers in the free world. The impact of new technology has always been a tricky issue for economists. Its role in increasing the efficiency of industrial processes and hence the measured level of productivity is what kept capitalism vibrant in countries where socialist revolutionaries threatened to derail the money train, and its role in creating entirely new markets has always been a gateway to paradise for venture capitalists with imagination, as early backers of Apple and Google might readily attest. But its role in shaping and locking in consumer behaviour through increasingly refined product differentiation and increasingly pervasive ecosystems of surrounding goods, such as apps for mobile phones or wi-fi hotspots in public places, is less well understood, since such goods add up to wider lifestyle changes that no one can see in advance. The global impact of online goods and services was hard to see as little as twenty years ago, and its future role in breaking down national and regional barriers is still hard to foresee.

New goods in the physical world are one thing, but new lifestyles in the social and psychological worlds are something else. They bring changes that upend the presumptions of established theory. One such change is in the world of business ethics. Corporations that promote responsible citizenship, sustainable business models, and green ideas generally are changing the game in business ecosystems previously dominated by company boards eager to maximise quarterly profits. Another example of changing ethics is the way online goods and services disrupt old business models and popularise open-source or peer-sharing ideas that subvert traditional property relations. It is easy to make too much of changes like this, but it was also easy decades ago to miss the signs that led to a peaceful end to the cold war or that heralded our present acceptance of planetary limits to global growth. In this context, an abrupt end to the fevered dreams of greedy money men was really no surprise.

An even deeper problem for economic orthodoxy is posed by ideological changes that go beyond the politics of social market economies to impact conceptions of the human place in the universe. An extreme example here is the economic chasm religious fundamentalists leap into when they trash productive or cultural infrastructure for ideological reasons. War and its ensuing devastation is just one kind of suicide that looms in such scenarios. What examples like this show is that the conception of a good life in a settled community that we take for granted in our managed market economies is far from absolute, and liable to radical transformation over a historical timescale that may well be much shorter than many imagine in our age of exponentially accelerating technological change.

We tend to expect such big ideological changes to be incremental, like our approach to sexual freedom or greener lifestyles, but they can also be transformative, as when nuclear weapons made our previous approaches to war untenable. A similar shock today might come if and when we make two-way contact with an advanced extraterrestrial civilisation. Another might come if a biological horror scenario came to pass that killed billions of people, and the survivors learned to live in an utterly different relation to nature. Or, more benignly, we might develop technology that any citizens with an excess of discretionary income could use to turn themselves into enhanced cyborgs for whom old medical or even mortal constraints no longer applied. The established certainties of the life insurance and pension markets would be obsolete in a world of cyborgs who could upload their minds to the cloud while they switched to a new robot incarnation and left their old meat body behind.

Martin Wolf has wisely refrained from opening any of these jumbo cans of worms and stuck to conventional economic ideas. But he does correctly compare the devastating impact of the 2008 crisis with that of a world war. It was a crisis brought on by poor understanding of new technologies and the destabilising changes they brought to financial markets. Those changes invalidated prevailing mathematical analyses of risk scenarios and triggered runaway debt-default contagion, via automated online trading that made a local meltdown global before anyone could stop it. At root this was a breakdown incubated by decades of reckless profiteering in markets where a new order of sobriety was clearly required. What this historic tragedy tells me is that some understanding of the wider context of economic orthodoxy is essential in our polity. For policy makers, therefore, Wolf's book is not sufficient reading, though it is necessary.