International Politics and Society

Capitalism needs a purpose

The biggest problem with capitalism is a dependency on increased spending

By Alfie Stirling | 03.05.2018

Traders and guests gather on the floor of the New York Stock Exchange

This summer will mark 10 years since the most important economic event in modern peacetime history. The 2007/08 financial crisis rocked the whole global economy, with annual world GDP contracting for the first time since World War II. Since then, almost every major economy has experienced one of the slowest recoveries on record.

In the immediate aftermath of such a dramatic crisis, most questions were necessarily short-term in nature. Chief among them was why economists and policy makers hadn't seen the crash coming.

It may seem unthinkable now, but prior to 2007 the most advanced and sophisticated models used by the most influential economists around the world barely included the financial sector in them at all. Most central banks treated finance as little more than a conduit through which other economic effects might pass. That finance could present a source of existential risk was thought to be impossible.

Though important, and arguably still largely unresolved, such methodological concerns have since given way to more fundamental questions about the very nature of our economy and about 'capitalism' itself.

Confidence 'on life support'

Economic recovery has been a key cause of concern. The life blood of capitalism is spending, or as economists refer to it, 'aggregate demand'. Money moves around the economy in a circular pattern: spending and investment on goods and services becomes taxes, wages and profits, before being converted back into spending again by governments, companies and families.

Furthermore, capitalism needs spending to increase, quarter-on-quarter, year-on-year. If spending increases are the fuel, then confidence is the catalyst.

From the US to Europe to Japan, central banks have gone to unprecedented lengths to keep the global economy afloat.

Confidence that spending will increase encourages people to borrow and invest, moving money from the future to the present, and in turn helps to make positive expectations a reality. But the reverse is also true, with concern for the future impacting spending today.

The issue since 2008 is that for most major economies, confidence and spending have been on life support. From the US to Europe to Japan, central banks have gone to unprecedented lengths to keep the global economy afloat. The prescribed medicine has been record low interest rates (including negative interest rates in places such as Japan and Switzerland) to encourage households and firms to take out loans.

For the first time though, ever lower interest rates are also losing their potency, reaching what economists call the 'effective lower bound' – a rate below which further positive effects on spending are thought to be marginal at best.

Money from nothing?

The sticking plaster to this problem has been so called 'quantitative easing' (QE). QE attempts to get around the problem of the lower bound by creating new money from nothing and investing in financial markets to reduce interest rates on debt. The idea is that this might simulate some of the effect that would otherwise have been achieved by a 'missing' cut in interest rates below the lower bound.

The deeper concern, however, is that low levels of spending and confidence are not just a hangover of the financial crisis, but a reflection of something much more structural, long-term and serious. A number of economists have pointed to a worrying trend in falling demand, stretching not just over decades, but centuries of capitalism.

The causes underpinning this recently revived thesis of 'secular stagnation' remain contested. Some point to the tendency of capitalism to suck demand out of itself through rising inequality. Those on the highest incomes are least likely to spend all of their resources – what economists call a 'lower marginal propensity to consume' – so as wealth and income concentrates, overall spending falls.

Other candidates for the cause of secularly declining demand include debt overhang in the west, a savings glut in emerging economies such as China, and an aging population in developed countries combined with the rate of population growth slowing down globally.

The issue too is that even exporting nations, like Germany, Japan and China are hardly less vulnerable to secular decline.

The issue for capitalism is that all of these forces are long term in nature. Their effects may have been temporarily concealed pre-2007.

For example, the US and UK funded unsustainably high levels of consumption from other countries before the crisis by selling off assets – land, equity and debt – to the rest of the world. But this mirage was broken when asset prices collapsed during the financial crisis.

The issue too is that even exporting nations, like Germany, Japan and China are hardly less vulnerable to secular decline – ultimately their export surpluses are dependent on the unsustainable trade deficits of other nations.

Create demand for what people actually need

The question now is, what is the alternative? At the New Economics Foundation, we are looking to start a new programme of work that explores two related answers: repurposing the direction of growth; and better distributing the wages and profits generated from the production of growth. Each hinges on getting the economy to better serve people.

Firstly, the idea that aggregate demand has not only a *level* or a *growth rate*, but also a *direction*, is largely ignored by economists and policy makers alike. Each essentially assumes that the direction of demand is singular: GDP is thought to either grow or not. The question of what things are being bought and sold, what is their value to society and what problems are technology and the economy solving for people, is secondary at best.

But this breaks down as soon as insights from behavioural economics, environmental economics and complex systems are used to show that the aggregation of individual choices based on imperfect information rarely, if ever, lead to the best outcomes for society as a whole.

If the structural causes of reduced spending are related to an aging population, and capitalism has failed to come up with an answer, then policy makers should redirect the economy towards industrial level creation and consumption of things like health, mobility and old age social care. If the greatest existential threat is society's environmental impact, policy makers should direct the economy towards a green transition.

Almost a decade on from the financial crisis, the most striking observation is how little the fundamentals of the capitalist model have changed.

Instead of relying largely on interest rates, policy makers should use more active credit guidance, public banking, industrial strategy and government tax and spending to actively co-create the direction of demand alongside markets.

By designing the direction of demand to fit our knowledge of the future, the level and growth rate are more likely to remain sustainable in the long term. Furthermore, if greater volumes of goods and services are produced and consumed locally, or at least in the same currency, then unsustainable trade surpluses and deficits are minimised internationally.

Secondly, if capitalism is destroying its own demand from the inside, then policy makers need to rewire the economy to better distribute the rewards of its production. Part of the answer lies in controlling the symptoms. That means taxing incomes much more progressively (so that people on low incomes give back a far lower proportion of their pay in taxes than those on larger incomes), and imposing higher taxes on wealth.

But the economy also needs to spread the rewards more fairly before taxation, with higher rates of pay relative to profits. Measures could include increased minimum wages, higher productivity and increased worker bargaining power, and distributing company ownership more evenly through the expansion of cooperatives and mutuals.

Almost a decade on from the financial crisis, the most striking observation is how little the fundamentals of the capitalist model have changed. We can only hope it doesn't take another crash to bring the change that's needed.