Wanted: A

Does the field of economics need a giant rethink? In the spring issue, *TIE*'s David Smick wrote about the hubris of the economics profession and, given the limitations of macroeconomics, the need for perhaps a bit of "rethink" of how we understand world capital flows. Now iconoclast economist Paul Craig Roberts has offered his own rethink on today's economic challenges in a new book entitled *The Failure of Laissez Faire Capitalism and Economic Dissolution of the West.*

Roberts asks these questions: Has globalism eroded the efficacy of economic policy? Is capitalism no longer an efficient allocator of resources? Have the outsourcing of jobs and financial deregulation wrecked the U.S. economy? Is the European debt crisis being used to undermine national sovereignty and shift banking losses onto the taxpaying European public?

TIE asked two distinguished economic thinkers, Michael Hudson and Dan Ikenson, to respond to Roberts' analysis.

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I. Roberts Is a Rambling, Angry Nationalist!

BY DAN IKENSON

His book merely restates oft-repeated fallacies.

From a book ambitiously titled *The Failure of Laissez Faire Capitalism and Economic Dissolution of the West: Towards a New Economics for a Full World,* one should expect cogent arguments, structural coherence, weighing of competing theories, meticulous documentation, and other hallmarks of serious scholarship. Instead, this latest effort from Paul Craig Roberts summons vanquished arguments, meanders from grudge to grudge, entertains no alternative theses, and apparently considers quaint the notion that references and citations to trusted sources are essential to persuasive argumentation. Never judge a book by its cover, indeed!

With all of forty-nine endnotes, Roberts has written more of a rambling op-ed than a serious book—with page after breathless page of opinion, accusation, and hyperbole. It reads like one of those email rants that finds its way past your spam filter—you know the ones, written in bold and all caps. One struggles to avoid the conclusion that Roberts intended this book as a hymnal for angry nationalists, who tend not to care much for evidence, particularly if it comes at the expense of a good hunch.

In his own words, Roberts sets out "to show that offshoring is the antithesis of free trade and that the doctrine of free trade itself is found to be incorrect by the latest work in trade theory." That in itself implies a lot of lifting, but the objective is more ambitious still.

Roberts also intends to explain how globalism has eroded the efficacy of economic policy and destroyed the justifications for market capitalism; how jobs offshoring

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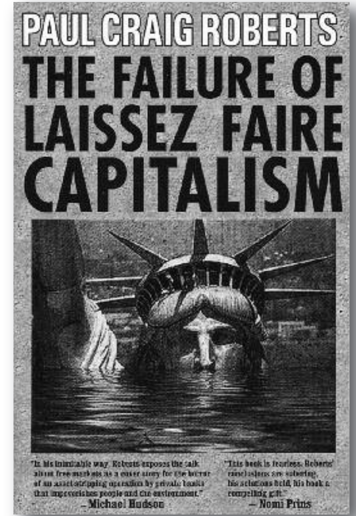
Giant Rethink



The Failure of Laissez Faire Capitalism and Economic Dissolution of the West: Towards a New Economics for a Full World,
by Paul Craig Roberts
(Clarity Press, 2013).

II. Roberts Is Correct!

Global investment bankers have fueled a bubble economy that has evolved into casino capitalism.

BY MICHAEL HUDSON

If today's economic system allocated resources efficiently, society would be living up to its technological potential. Financial management would dovetail with industrial engineering, enabling most people to enjoy the life of leisure and economy of abundance forecast a century ago. Our obesity problem would stem from overconsumption, not poverty. Or we would face the problem that Keynes warned about in the 1930s: prosperity leading to over-saving as consumption did not keep pace with income.

Where has the economic surplus gone if not to raise living standards for the 99 percent? Why are so many families falling deeper into debt even when working two or three jobs?

Technology is not to blame. Debt service is the main dynamic increasing costs. Bank loans and bonds are wealth to creditors, but carrying charges on this debt are growing faster than output and earnings can keep pace. Classical economists defined this problem as one of unproductive credit, and spent a century discussing how best to modernize banking to operate productively to promote industrial capitalism.

If lending provided borrowers with the means to pay, the credit system would be self-sustaining. But most bank credit is lent against property already in place, and increasingly for opportunities for rent extraction as governments privatize infrastructure to pay bondholders. Financial charges paid to banks and bondholders raise the economy's cost structure and absorb the rise in income. The economy shrinks as its growth in income is diverted to pay rentiers instead of being spent on goods and services.

Thorstein Veblen warned in the 1920s that financial engineering was diverting industrial capitalism onto a

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Michael Hudson is Distinguished Research Professor of Economics at University of Missouri, Kansas City. His last piece for TIE *was on Latvia ("Fading Baltic Miracle," Winter 2008). His most recent book is* The Bubble and Beyond *(2012).*

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and financial deregulation have wrecked the U.S. economy; how capitalism has been delegitimized by its failure to account for environmental costs and other externalities; how the European debt crisis is being used to subvert national sovereignty and to protect bankers from losses; and that Germany should leave the European Union and enter into an economic partnership with Russia.

All of these dragons to be slain in 175 pages!

The following passages (and page numbers) give a flavor of the book's random course:

- A massive new federal police agency, Homeland Security, was created in 2002 to protect Americans from a non-existent "terrorist threat" (p. 85).
- Today the President of the United States sits in the Oval Office in the White House and draws up lists of people to be murdered (p. 94).
- "Free trade" and "globalization" are the guises behind which class war is being conducted against the middle class by both political parties (p. 99).
- Globalism is a conspiracy against First World jobs (p. 131).
- The American economic elite hide their treason to the American people behind "free trade" (p. 143).
- The United States cannot afford the neoconservative dream of world hegemony and a conquered Middle East open to Israeli colonization (p. 157).
- Washington has no concern for the economic welfare of citizens or for their civil liberties or for those of its European puppet states. Washington serves the purposes of the interest groups that control it. These interest groups are committed to financial fraud and to war (p. 172).

The thread binding these disparate assertions—to Roberts' mind, at least—is that each is evidence of the failure of laissez-faire capitalism, which has been co-opted by elites to perpetrate a malicious plot against the global masses.

Like most manifestos, this book contains some nuggets of truth: unemployment, underemployment, growing wealth disparity, "too-big-to-fail," and other manifestations of crony capitalism are all legitimate problems that must be arrested and reversed. But there has been no failure of free trade; there has been no failure of laissez-faire capitalism. In fact, many of us are still trying to convince the world to try both.

Roberts has written more of a rambling op-ed than a serious book.

Roberts attempts to dismiss free trade as a mistake without elaborating. Instead he defers to a book often cited by protection-seeking lobbies in Washington, which posits that today's mobility of capital refutes Ricardo's theory of comparative advantage, and thus the "doctrine of free trade." Nonsense.

Roberts is guilty of perpetuating oft-repeated fallacies about offshoring and U.S. manufacturing decline.

Just because capital is more mobile today than it was at the beginning of the nineteenth century does not change the fact that different jurisdictions have comparative advantages by virtue of differences in their natural and man-made endowments. Comparative advantage is alive and well, but less so in the context of industries (English cloth and Portuguese wine), and more so with respect to the functions on global supply chains. China may have a comparative advantage in electronic assembly operations *vis-à-vis* the United States; the United States may have a comparative advantage in product design *vis-à-vis* Japan; and, Japan may have a comparative advantage in component production. Instead of trading wine for cloth, the modern set-up implies collaboration between U.S. engineers, Japanese manufacturers, and Chinese assemblers. But as countries' collective skill sets change, as well as their public policies, relative proficiencies will change too.

However, the current state of U.S. or global trade relations can hardly be described as "free trade." We are operating in a world of managed trade, where policy reflects a blend of business-driven, pro-export advocacy and business- and labor-supported anti-import measures. The centrality of politics to this endeavor makes us poorer, as resources are diverted from production and research and development to government affairs offices and K Street firms because the return on lobbying is found to be more profitable. Roberts is right to criticize this, but this is not free trade.

Regrettably, Roberts is guilty of perpetuating oft-repeated fallacies about offshoring and U.S. manufactur-

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ing decline, which has the effect of putting further distance between the real economic problems we face and their solutions.

He writes:

■ U.S. manufacturing has declined so much that, should its creditors permit, the time is not far off when the U.S. trade deficit becomes as large a share of GDP as its manufacturing output (p. 46).

■ Approximately half of U.S. imports from China are the offshored production of U.S. firms for the U.S. market (p. 49).

■ When an American firm moves production offshore, U.S. GDP declines by the amount of the offshored production, and foreign GDP increases by that amount. Employment and consumer income decline in the United States and rise abroad. The U.S. tax base shrinks, resulting in reductions in public services or in higher taxes or a switch from tax finance to bond finance and higher debt service cost (p. 52).

■ Some offshoring apologists go so far as to imply, and others even to claim, that offshore outsourcing is offset by "insourcing"… The Japanese produce [cars] in the United States [not] for the purpose of sending them back to Japan (p. 54).

So passively entrenched is the conventional wisdom that manufacturing vacated our shores long ago that most readers wouldn't question Roberts' assertions. But year after year, every year (with the exception of during formal economic recessions), the U.S. manufacturing sector has set new records with respect to output, value added, revenues, exports, and imports, and almost as frequently it sets new records for profits and returns on investment.

The metrics routinely and mistakenly cited as evidence of decline are manufacturing employment, which peaked in 1979 at 19.4 million workers, and manufacturing's share of GDP, which peaked in 1953 at 28.3 percent. But the decreases in neither reflect poorly on industry. Producing more with less, which is essentially the story behind manufacturing job attrition (and before that agriculture) is the answer to the essential economic problem of scarcity. The fact that manufacturing as a share of GDP has been shrinking for sixty years speaks not to declining manufacturing health, but to the rise of services, on which Americans now spend double their expenditures on manufactured goods.

Roberts intended this book as a hymnal for angry nationalists.

The fact that manufacturing as a share of GDP has been shrinking for sixty years speaks not to declining manufacturing health, but to the rise of services.

U.S. companies invest abroad for a variety of important reasons, but serving U.S. demand from those foreign locations is not prominent among them. According to Bureau of Economic Analysis data, over 90 percent of the value of output from foreign affiliates of U.S.-based companies is sold in foreign markets.

Moreover, offshoring is rarely the product of U.S. businesses chasing low wages or lax standards abroad. Businesses are concerned about the entire cost of production, from product conception to consumption. Foreign wages and standards are but a few of the numerous considerations that factor into the ultimate investment and production decision.

If low wages and lax standards were the real draw, the United States would not be the world's largest single country destination for direct investment. In 2011, the value of the stock of foreign direct investment in the U.S. manufacturing sector alone amounted to $838 billion, while the value of the stock of U.S. direct investment in foreign manufacturing sectors amounted to $589 billion. Those figures amount to a $250 billion manufacturing "insourcing" surplus.

These insourcing companies produced $649.3 billion in output, which was 5.8 percent of all private sector output; purchased $149 billion in new property, plant, and equipment, which was 14.4 percent of all non-residential, private sector capital investment; exported $229.3 billion of goods, which was 18 percent of the U.S. total; performed $41.3 billion of research and development, accounting for 14.3 percent of the total

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performed by all U.S. companies; and purchased 80 percent of their intermediate goods—nearly $2 trillion worth—from U.S. suppliers.

Contrary to Roberts' allegations of a zero-sum game, the performance of foreign affiliates and their U.S. parents seems to be positively correlated, improving or declining contemporaneously. In a forthcoming Cato Institute study, annual changes in affiliates' and parents' capital expenditures, output (value-added), total compensation, compensation per worker, and research and development spending are shown to move in the same direction in most years.

What Roberts really is assailing is crony capitalism—where vested interests capture the process and the levers of power. That, indeed, is problematic. But the solution is not more crony capitalism, which is enabled under the solutions Roberts suggests. The solution is to embrace globalization, which contains all of the incentives to foster smart policy at home. ◆

What Roberts really is assailing is crony capitalism.

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wrong track by shifting management to financial engineers. Along similar lines, Paul Craig Roberts' book describes how the financial and tax policies that enrich global investment bankers are impoverishing America's economy. Instead of promoting best-industrial policies, financialized globalization is turning into a race to the bottom. Shifting investment to low-wage economies overseas has led to U.S. unemployment. To make matters worse, the lowest-cost economies are those with minimum environmental standards. Their cost-cutting adds to global pollution.

The overgrowth of debt is much like environmental pollution. It requires increasingly heavy cleanup costs in the form of deleveraging. This causes debt deflation and imposes austerity, as we are seeing in Greece. The alternative is to write down debts. This involves writing down savings on the other side of the balance sheet. The political problem with such write-downs is opposition from the savers (also known as the 1 percent) that control economic policy.

In contrast to crashes in times past, that of 2008 did not lead to debt writedowns. The debts were kept in place. Packaged mortgages were transferred to the government's balance sheet ($5.2 trillion for Fannie Mae and Freddie Mac), or carried by the U.S. Treasury's $700 billion TARP and by the Federal Reserve's $2 trillion in reserves created in its quantitative easing program.

The underlying problem is that financial managers live in the short run. They can make fortunes most easily and quickly by asset stripping, speculation, and riding the wave of asset-price inflation. It takes longer to invest in plant and equipment and develop markets for new products. So financial managers aim simply to maximize the volume and price of financial claims on the economy's consumers, not build up tangible capital investment and expand employment.

This is not the familiar industrial capitalism pictured in economics textbooks. Most new investment is financed out of retained earnings, and companies now bypass the banks and issue their commercial paper directly in the money market. Banks are using their credit creation to fuel a Bubble Economy that is evolving into casino capitalism, making money on arbitrage (the $800 billion QE2 was invested largely in BRIC and Australian bonds and currency plays) and computerized derivative gambles.

Roberts describes how the financial and tax policies that enrich global investment bankers are impoverishing America's economy.

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The proliferation of debt is siphoning off a widening slice of household income to pay interest and other financial fees. For the corporate sector, cash flow is spent on interest for mergers and acquisitions, and for stock buybacks (increasing the value of management stock options). This decoupling of the financial sector's mode of "wealth creation" from industrial investment has inspired recent critiques of the idea that "increasing shareholder wealth" is the best way to promote new investment.

The problem stems largely from the modern focus of bank lending against collateral. The effect is to bid up prices for real estate, stocks, and bonds. But this does not provide borrowers with the means to pay—except out of "capital gains" when prices for the assets they buy are bid up by yet more credit extended on easier terms.

Debt leveraging was the essence of U.S. "wealth creation" from the 1990s to 2008. One consequence was to increase the price of financial assets and property relative to labor. Another was that instead of tangible wealth creation, what was built up was what economist Frederick Soddy called "virtual wealth": financial claims on property and income. Most of all, what was produced was debt. New homebuyers had to take on ever-larger mortgages in order to obtain housing. And as price/earnings ratios rose, pension funds had to invest more in financial securities to buy future income streams to pay retirees. Little "pension fund capitalism" took the form of direct investment. Most was used to bid up stock market prices.

The result of these trends is that our financial system has taken a detour that is leading to de-industrialization and polarizing economies between creditors and debtors. Personal savings, pension funds, and new bank credit are steered into speculation, building up wealth by inflating asset prices for real estate, stocks, and bonds on credit. The effect is to divert household income, business revenue, and state and local taxes to pay the financial sector instead of being spent on capital formation and consumer goods.

The overgrowth of debt is much like environmental pollution. It requires increasingly heavy cleanup costs in the form of deleveraging.

Some sector must bear the loss when the "real" economy is unable to meet the terms of the financialized economy. Today's great political question concerns who is to bear the losses from the tendency of the "miracle of compound interest" to mount up to the point where it outruns the economy's ability to pay—that is, to pay without imposing austerity.

Roberts wants to restructure banking to favor industry.

In the United States, the wave of foreclosures and austerity since 2008 has been slowed by the Federal Reserve and Treasury monetizing the negative equity shortfall. But Europe lacks a central bank able and willing to do this. The European Central Bank does not lend to governments, but only buys existing bonds in the market. This shifts Europe's financial losses onto taxpayers, shrinking economies by imposing fiscal deflation on top of debt deflation.

Paying the existing debt overhead—especially if interest rates rise—deters investment at the rate needed to provide full employment and maintain living standards. The effect is much like what Keynes described as over-saving, except that today's saving takes the form of paying down debt—the negation of a negation.

In contrast to Joseph Schumpeter's theory that industrial progress works by "creative destruction" of obsolete technologies, today's central banks and national treasuries insist that there is to be no such destruction where finance is concerned. Industry may be swept aside in insolvency, cities and nations plunged into austerity for the 99 percent, but there is to be no such loss for the creditor 1 percent. Bad loans and bad credit are not to be destroyed—only their indebted victims.

It doesn't have to be this way. Surveying the world's banking systems in the wake of the 1907 crash, the National Monetary Commission endorsed the German industrial banking philosophy in contrast to Anglo-Dutch merchant banking. Roberts' economic philosophy runs along similar lines, hoping to spur a debate as to how to restructure banking to favor industry rather than financialize and strip its surplus. ◆