Preface to the second edition

For the present edition four chapters have been added which form the fourth part at the end of the book[1]. Entitled “The triumph of neoliberalism”, the new part explains how the implementation worldwide of the neoliberal agenda paved the way for the present crisis.

As a matter of fact, the evidence provided in chapter 9 suggests that the present crisis already began to build up in the mid-1970s. It is around 1975 that (real) US wages reached a peak-level they would never regain in following decades. It was also around 1975 that the number of strikes began to fall sharply. The mid-1970s also marked the beginning of a huge inflow of immigrants (in large part of Hispanic origin) into the United States. The inflated supply of labor depressed wages and this had the consequence that consumption could be increased only by an unprecedented development of credit.

Perhaps the reader may think that to blame the prevailing economic system for the unfolding depression is a fairly common and all too easy temptation. In fact, the author did not wait until 2009 to question the neoliberal creed and to take it to task[2]. Moreover, it can be observed that even at the present time of writing there are but few voices in the media who establish a link between the roots of the crisis and the main tenets of the neoliberal agenda. Indeed, as we will see in chapter 9, the term “neoliberalism” is hardly ever used in major newspapers. As another illustration, one can mention that according to current polls conducted in Britain, the Conservative Party has a lead of 19 percent over the Labour Party. This clearly suggests that most people do not wish to establish any connection between the ideology of Thatcherism which still underpins the political agenda of the Conservative Party and the present woes of the British economy.

The most current attitude nowadays is to attribute the crisis to some errors

[1] They are numbered 9-12; the “old” chapters (1-8) have been kept unchanged.

[2] See for instance chapters 6 and 8 of “Driving Forces of Physical, Biological and Socio-Economic Phenomena” which was published by Cambridge University Press in May 2007.

and excesses; this notion is embodied in the expression "subprime crisis". That this expression is much too narrow is obvious from the fact that, as we will see, the policy of making subprime loans and packaging them into mortgage backed securities was already used during previous real estate booms and can hardly account for the catastrophic consequences seen in 2007–2008.

The policy which results from such a narrow conception is clear: bail out the defaulted companies, make credit flow again, restore confidence and the economic system will be up again for a new period of prosperity. This is to forget that the 1990s were a time of affluence only for those who were able to partake in financial profits. Wages, on the contrary, did hardly increase either in the United States, in Europe or in Japan.

To talk about a golden decade is also to ignore that between 1995 and 2007 economic growth in the United States was largely fed by an increasing deficit of the current-account balance (the largest component being the deficit on goods). By this mechanism a substantial part of consumption and growth was achieved through an increase of the outstanding Treasury debt[3]. As the deficit of current account was on average of the order of 3% of GDP, it means that once this spurious part of growth is discounted, the real growth was in fact fairly weak, of the order of 1% per year. The same argument also holds for other countries, for instance Britain. In spite of being a major oil producing country, Britain had an average deficit of current account of the order of 2.5% of GDP over the period 2004-2007.

If the influenza epidemic which appeared in March 2009 spreads worldwide, it will temporarily hinder international trade. However, the example of the influenza epidemic of October 1918 suggests that this should not have a big impact on economic growth. Indeed, despite the epidemic, the US Gross Domestic Product increased by 9% in 1918. The contraction which occurred in 1920–1921 had nothing to do with the epidemic.

The present crisis has been preceded by numerous warnings. From the failure of "Long Term Capital Management" (LTCM) in 1998 to the bankruptcy of Iceland in 2008, there have been many financial and economic crashes. What gave to these crashes the character of specific warnings is the fact that the companies and countries involved embodied the very essence of the free-market ideology.

[3]In this respect the 1970s also marked a turning point. From 1945 to 1975 the ratio of Treasury debt to Gross Domestic Product (GDP) fell from 120% to 35%; after 1980 it began to increase fairly steadily.

• Founded in 1994, LTCM was a US hedge fund whose board comprised two directors, Myron Scholes and Robert C. Merton, who shared the 1997 Nobel prize in economics. Highly leveraged, its operations were based on quantitative stochastic models. At first they were very successful with annual returns of about 40%. The wind turned in mid-1998. After losing $4.6 billion, LTCM was bailed out by a consortium of banks in an operation supervised by the Federal Reserve. The failure lead to an abrupt but short-lived stock market crash to which the Federal Reserve responded by lowering its interest rate.
In short, this episode prefigured in several ways the bailout of much bigger companies such as Sears or AIG ten years later. The scenario was very much the same: sudden and unexpected failure, bailout led by the Federal Reserve, stock market crash, lowering of interest rates and massive loans made to the banking system. There was a difference in scale however: in 2008 the losses were (at least) ten times larger than in 1998.
What made the failure of LTCM particularly ominous for the future was the fact that the sophisticated hedging procedures which were supposed to provide a shield against heavy losses simply did not work.

• Enron Corporation was awarded the title of "Most innovative US corporation" by Fortune Magazine in 2001 just a few months before asking for bankruptcy protection. Two months later, in January 2002, there was the bankruptcy of "Global Crossing" and in July 2002 the failure of WorldCom. What made these failures of particular significance is the fact that they revealed huge accounting scandals. In his book published in 2003, Frank Partnoy shows convincingly that in many other (more technical) ways these collapses prefigured the global financial crisis of 2007-2008. What makes his analysis particularly meaningful is of course the fact that it was published four years *before* the outbreak of the present crisis.

• Argentina used to be the International Monetary Fund's poster child. During the 1990s the IMF praised Argentina and used it as an example to show the rest of the developing world what sort of economic success could come from following the neo-liberal and free market policies of the IMF. By 1995, 90% of all state enterprises had been privatized. But prosperity lasted only so long as credit was abundant. In December 2001, Argentina plunged into a devastating economic crisis. Privatization policies also lead to lackluster performances in other Latin American countries.

• Britain, Hungary, Ireland and Iceland were acclaimed examples of the success of free-market policies. Yet again, in all these cases, the level of indebtedness was staggering and the financial houses of cards collapsed as soon as credit became scarce.

The comparative methodology that we advocate and use in this book often leads to testable conclusions and predictions[4]. Naturally, predictions are dependent upon the *ceteris paribus* condition (i.e. "all other things being equal"). This can be illustrated by the prediction regarding the evolution of

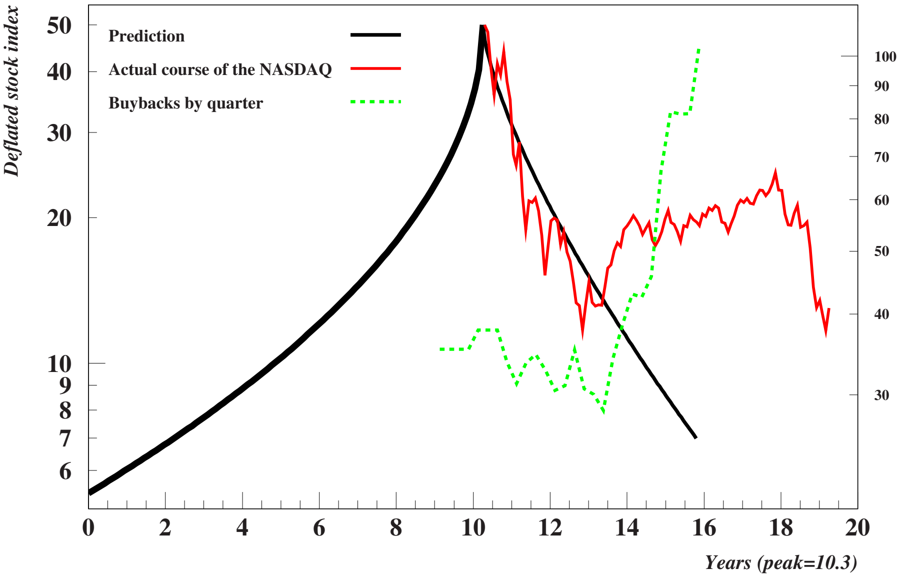

Fig. 1 NASDAQ Composite index: prediction compared with observation. Year 10 on the horizontal axis corresponds to 2000; the downturn occurred in March 2000 which corresponds to 10.3. The prediction covers the interval 10-16 that is to say 2000-2006. Made in May 2000, it was published in January 2001 in the first edition of this book (Fig. 7.12). The prediction is based on the common pattern of speculative price peaks observed on various stock markets since the mid-19th century. The main purpose of this graph is to illustrate the importance of the *ceteris paribus* ("all other things being equal") condition by showing that massive buybacks (which are basically unpredictable) can have a substantial influence on stock prices. The vertical scale on the right-hand side refers to buybacks expressed in billion of dollars; they tripled in 2003-2004. *Sources: NASDAQ: http://finance.yahoo.com/; Consumer Price Index: Website of the St Louis Federal Reserve; Buybacks: Press releases of Standard and Poor's.*

[4]These predictions rely on observed quantitative regularities rather than on mathematical models. The reasons for this are explained in Roehner (2008 b).

the NASDAQ Composite index in the years after the crash of March 2000 that was proposed in the first edition of this book and is recalled in Fig. 1. It was in agreement with observation for four years, from 2000 to 2003. Then, something unexpected happened. Many companies (e.g. IBM, Intel, Microsoft) started massive buyback programs of their own shares[5].

As another illustration, one can mention a prediction about real estate prices in the west of the United States which was made in mid-2005 and published in Roehner (2006). So far it turned out to be correct but it is clear that if in coming months (or years) there is a massive federal program to prop up house prices, the *ceteris paribus* condition will no longer hold. In this respect, the situation is exactly the same as in experimental physics when an unexpected exogenous factor interferes with the phenomenon that one tries to observe.

The previous examples show that one must be very careful in comparing theoretical predictions with observations. However, what makes the discussion of many economic issues quite unsatisfactory is due to a much simpler reason. It is the fact that the lessons of history are completely discarded. This point is underlined in the citation by Anna J. Schwartz that can be read on the first page of this book. As an illustrative example (see chapter 12 for more details), one can mention the fact that in 1893 one third of the American railroad companies had to be bailed out[6]. On account of such evidence should it not be clear that the privatization of railroads can hardly be a successful operation? When it was attempted by the government of Margaret Thatcher it turned out to be so successful that the private "Railtrack" company had to be re-nationalized in 2006 in the wake of a series of tragic accidents. Yet, in spite of such converging evidence, the privatization of European railroads is still on the agenda of the Commission of the European Union.

Apart from the loss in efficiency due to increased technical and economic segmentation, another adverse effect of privatization was amply demonstrated in the past decade. It can be called the "bonus-triggered doctoring effect". When the bonuses of executives are tied to specific levels of earnings, it is extremely tempting to do just about anything to meet (or appear to meet) the goal: cooking the books, playing down debt through off-balance sheet ac-

[5] At the same time there was a huge increase in mergers and acquisitions which is also known as a factor which raises stock prices, mainly because to make such operations successful share holders are offered more than the current market price.

[6] For one of these companies it was the third bailout in a row. As is well known, British and French railroad companies also faced similar problems.

counting, favoring short-term profit over long-term investments are some of the methods which have been used at Enron, WorldCom, Fannie Mae, Freddie Mac and numerous other companies. For listed companies this temptation is even stronger because many bonuses are paid in stock options (call options) which, to become profitable, require share prices to go up. Thus, shareholders must be cajoled in any possible way.

Yet, in current-day mainstream thinking privatization is still regarded as a miracle cure. How can one explain such a paradox? A clue may have been given by former Vice-President Al Gore when, during his lengthy campaign on the issue of carbon dioxide emissions, he observed that:

> "You cannot make somebody understand something if his (or her) salary depends upon not understanding it."

It seems that the same observation also applies to the agenda of neoliberalism. Tailored for the wealthy, this political philosophy has well served its purpose for many decades. Why then should it be questioned?

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