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**Capitalism and the Dark
Forces of Time and
Ignorance**
Economic and Political
Expectations

David Harrison

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Sevenoaks, UK

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PREFACE

The theme running through this book is how expectations of the future—a future about which we know very little—affect present-day economic activities, and in particular the function of investment. Expectations are precarious, and rise and fall in line with sentiment in speculative investment markets. When they rise too far, and collapse completely, the collapse in expected yields of capital assets precipitates an economic crisis, a full-scale depression if the investment comes to a full stop, and quite possibly a political crisis too.

Numerous authors have written about the inadequacies of modern economics since the 2008 financial crisis. To name a few, in chronological order: John Cassidy (*How Markets Fail: The Logic of Economic Calamities*) (2009) made the case early on against “utopian economics”, and the idea that markets are inherently rational. In *A Failure of Capitalism* (2009) and *The Crisis of Capitalist Democracy* (2010) Richard Posner described how the modern world had until the crisis of 2008 forgotten Keynes, and the lessons of the 1930s. In *Licence To Be Bad: How Economics Corrupted Us* (2019) Jonathan Aldred took to task fifty years of economic theory for undermining moral and ethical behaviour. In *Narrative Economics* (2019) Robert Shiller described how stories—not logic—propel economic events, and in particular events in finance. In *Radical Uncertainty* (2020) John Kay and Mervyn King explained how too much weight has been given to reasoning in terms of probability, and too little to situations where the future is completely unknown.

This book does not come, once again, to bury modern economics. It strives, instead, to praise some thinkers and their ideas which it suggests help explain the modern capitalist world, with its many and patent flaws. Rather than follow every twist and turn of how these ideas have been interpreted, adapted, or explained away by succeeding generations—which would make for a much longer work—it goes back to the root of some original concepts and applies them directly.

The starting point is Keynes's *General Theory of Employment, Interest, and Money* (1936). This is a complex work, and hardly an easy read, but I think it is fair to say that there is not one aspect of modern global capitalism, in all its maddening perplexities, which is not illuminated by it. Time and again, what seem to be today's unique problems, creating today's headlines, turn out to have been foreseen, or at least thought about, by Keynes. As he said in concluding the *General Theory*, it is the potency of ideas for the future which counts.

I have drawn in particular on Keynes's chapters dealing with the marginal efficiency of capital; the state of long-term expectation; the nature of capital; and the trade cycle. (I would suggest, in passing, that the marginal efficiency of capital remains a more useful concept, with greater explanatory power, than the efficient market hypothesis, of more recent and doubtful vintage.)

Since Keynes set such store by expectations in the face of an uncertain future, it is natural to examine what they are. In doing so it helps to consider the wider question of the nature of human knowledge, and the role played by expectations, developed over his many works by Karl Popper. In this way it becomes possible to see how the radical uncertainty which haunts capitalism—the dark forces of time and ignorance—might be illuminated by rationality.

Perhaps surprisingly, this book has a good word to say about Hayek too. Hayek's idea that prices transmit useful knowledge around the economy, like a telecommunications system, still seems to have much going for it—within its limits. Those limits are explored in the book, and were helpfully clarified by Hyman Minsky. And from Minsky there comes the concept of “money manager capitalism”—the form of institutional savings, developed in recent decades in the United States, from which many ills have arisen.

From a financial and economic crisis to a political crisis is but one short step, and many countries in the developed world have taken that step since 2008. When economic expectations collapse, it usually follows

that horizons shorten, politics turns inwards and the search for scapegoats takes over from reason and cooperation. This means that the question of putting capitalism on a more rational footing has become synonymous with maintaining the open society itself.

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Living in Truth

Abstract Contrasts Hayek's idea in 1945 that prices help create a rational economic order with the speculative financial order which emerged in the latter decades of the twentieth century.

Keywords Price signals · Enterprise · Speculation · Decentralised economy · Marginal efficiency of capital

PROFESSOR HAYEK'S KNOWLEDGE MACHINE

Towards the end of the Second World War the thoughts of many turned to the nature of post-war society. On the one hand, the *laissez-faire* free market economy had been thoroughly discredited by the crash of 1929 and the Great Depression of the 1930s. On the other hand, the Soviet-style Communist economy seemed incompatible with democracy. So should the economy of the future be planned or unplanned?

In September 1945 the economist Friedrich Hayek (1899–1992) put forward a bold new idea, with far-reaching consequences. Writing in an American economic journal, Hayek suggested a centrally planned economy could never work because no central planner could ever have all the knowledge to keep the economy running in the face of constant change. Instead, a *decentralised* economy would be better, with many

separate individuals responding individually to shifting circumstances of time and place, and making their own minute adjustments accordingly. Rather than trying to bring all knowledge into one place, and run the economy as if it were a planned scientific programme, subject to command and control, much more limited practical knowledge would suffice—provided this knowledge could get quickly to those who needed it, and at the right time and place.

How could this be done? Hayek's answer was through the price system. Like a system of telecommunications, price signals would carry instant messages of information from one part of the world to another, spreading useful and practical knowledge of changing circumstances to all who need it.

Suppose, said Hayek, that somewhere in the world a new use is found for a commodity like tin—or that a source of supply for tin is cut off. Those producers who use tin do not have to know all the details; all they need to know is that tin has become more expensive and they will have to economise. If some know of a new demand for tin, and switch resources to it, others will fill their place, the effects will spread rapidly through the whole economic system and influence all the uses of tin and its substitutes; the supply of all things made of tin, and their substitutes; and so on. And this entire chain of events will happen without most of those taking part in this process of change having the slightest idea about the original cause of it.

Hayek wrote of the “marvel” of the price system in bringing about all these adjustments, moving tens of thousands of people in the right direction, without any order being issued. And Hayek meant something deeper than just adjustments in the tin price. What is being brought together is real *knowledge*, dispersed non-scientific practical knowledge, beyond the reach of any individual (or any central planner) but knowledge of the kind necessary to allow society to function. By the price system a division of labour and coordinated use of resources based on an equally “divided knowledge” is all made possible. Hayek likened it to a telecommunications system, but the title of his article was “The Use of Knowledge in Society”. The problem he was addressing was nothing less than the best way to construct a rational economic order.

In September of 1945, when Hayek published his piece, the future shape of the post-war world was far from obvious. In 1944, only the year before, delegates at the United Nations Monetary and Financial Conference, meeting in Bretton Woods in the United States, had agreed a treaty setting out the rules for global financial cooperation and reconstruction.

In the spirit of the wartime alliance, even the Soviet Union sent a delegation. Weeks before Bretton Woods, the Allied landings in Normandy began the liberation of occupied Europe, and forces moved in gradually from the west as Soviet forces moved in gradually from the east.

In 1945 the immediate problem in Europe was not so much the rational order of society as its very survival. By the end of the war the scale of physical destruction was massive; civilian deaths and casualties were significant fractions of national populations; refugees and displaced persons criss-crossed the continent; and civil and political structures almost everywhere were broken.

Then in March 1946, speaking at Westminster College, Fulton, in the United States, Winston Churchill gave dramatic warning of a new iron curtain descending, from “Stettin in the Baltic to Trieste in the Adriatic”, east of which, in the Soviet sphere, Moscow-led Communist parties were taking control (speech, “The Iron Curtain”). In 1947, by now fearing complete economic catastrophe, the United States inaugurated the Marshall Plan, which, through the Organisation for European Economic Cooperation, aimed to revive the moribund European economies.

It was at this point that Hayek’s distinction between centrally planned and decentralised economies came into its own. The Soviet Union refused to allow countries under its control in central and eastern Europe to participate in the Marshall Plan. Instead, in 1949 it created the Council on Mutual Economic Assistance (CMEA or Comecon), to coordinate national economic plans across the Soviet region.

In western Europe, market economies were reconstituted along decentralised lines, first through national reconstruction and investment, boosted by Marshall aid, and then by integration of the individual national economies into a larger-scale European market. This process began with the sectors of coal and steel through the European Coal and Steel Community of 1951, and during the course of the 1950s and 1960s was extended to all other economic sectors through the launch of a European common market, via one of the two Treaties of Rome of 1957.

The object of this exercise was to merge separate national markets into one large European market “constituting a powerful unity of production” (as it was put in one of the founding documents), with an increased division of labour eliminating the waste of resources and allowing larger-scale industries to operate across Europe, without monopolies. It was accepted that this process would take time—decades—and to ensure the market

rules were obeyed a central institution—the European Commission—would need to enforce them, and also competition policy, and prohibit distorting subsidies by member states to their own industries. Over the years—and in fact to this day—the Commission and national competition authorities of the member states have worked together to ensure that producer prices are not distorted by anti-competitive behaviour. The enforcement of tough rules prohibiting price-fixing between competitors, and abuses of their market position by firms in a dominant position, has become the hallmark of European competition policy, to which companies all around the world pay careful attention.

All this falls under the heading of a decentralised economy, in the language of Hayek's 1945 article. There is no central plan in western Europe. There are instead the countless individual plans of tens of thousands of firms competing among themselves, producing according to price signals undistorted by anti-competitive behaviour, to encourage a better international division of labour.

Meanwhile, the Soviet-led centrally planned system of central and eastern Europe developed along very different lines. In the CMEA there was no role for decentralised prices. From the late 1940s onward most industry in central and eastern Europe came under the control of the state. Each country adopted a five, or six, year economic plan. Within these plans, the gap between known levels of production of goods and services was compared with the plan targets ("known demand"), and an estimate made how to fill the gap. Estimates were passed down to industry ministries, and within them down to industrial directorates, and eventually down to the enterprises under their control. Enterprises, for their part, drew up provisional plans for their own divisions and plants, which were passed back up the planning chain. The overall planning estimate was adjusted in the light of these reports, and the exercise repeated, sometimes only completed *after* the year to which the plan applied. Planning documents could run to thousands of pages. Hayek's price-signalling telecommunications system had no role to play: planning relied on quantities instead of prices, and the information moving through the system was slow, inaccurate and out of date, by no means getting to the right place at the right time.

Trying to combine each centrally planned economy in a regional European planned system made life even harder. Each centrally planned economy aimed to develop in the same way, favouring heavy industry by importing coal, iron ore, and staple foodstuffs while exporting iron,

steel, and machinery. The Soviet Union became the heart of the CMEA, controlling from Moscow a radial pattern of trade and economic activity across central and eastern Europe. Annual plans for cross-border volume flows of goods were drawn up by national state authorities, with planners in each CMEA member state implementing import and export quotas and fixing border prices, basing them on average world prices over a five-year period. Some limited specialisation emerged: the Soviet Union imported car parts from other CMEA countries and exported finished cars; Hungary had a monopoly on the production of buses; Romania the right to produce diesel locomotives.

The rigidities and inefficiencies of the CMEA system became gradually manifest over time. By the 1960s male mortality rates in central and eastern Europe began to rise, while continuing to decline in the west. A steep rise in global oil prices after the suspension of the Bretton Woods currency arrangements in the 1970s put ultimately fatal strains on European Communism, leading to its eventual collapse. The Soviet Union cut back on subsidised oil to other CMEA countries, and Poland, Hungary and the GDR in particular ran up enormous US dollar-denominated debts with international commercial banks to pay for imported western industrial and consumer goods. In 1985 Gorbachev arrived in power in the Soviet Union, with a policy of restructuring the Soviet economy. However, his attempts at reform, involving the introduction of market measures into the centrally planned economy, led to political liberalisation and the eventual secession from the Communist system by CMEA countries, and finally the dismantling of the Soviet Union itself.

In 1990 the newly elected first President of post-Communist Czechoslovakia, Václav Havel, surveyed the damage done by the experiments of the previous forty years. In his New Year's Day address on assuming office, Havel remarked how, when flying to Bratislava, he had looked out onto the industrial complex of the Slovneft chemical plant, plus a giant housing complex right behind it. The view was enough for him to understand that for decades statesmen and political leaders had not looked out of their own aircraft windows: no study of statistics could have enabled him to understand the legacy of forty years faster and better.

Havel's speech can be read as the epitaph on the centrally planned economy. The enormous creative and spiritual potential of the Czech and Slovak nations was being wasted: entire branches of industry were producing goods of no interest to anyone, while the things people needed were lacking. The state, calling itself a "workers' state", humiliated and

exploited workers. The outmoded economy wasted what little energy there was. A country once proud of the educational level of its citizens now ranked seventy-second in the world. “We have polluted our land, rivers and forests, bequeathed to us by our ancestors; we now have the most contaminated environment in all of Europe. People in our country die sooner than in the majority of European countries” (speech, “New Year’s Address”).

By the 1990s, after the collapse of Communism and the centrally planned economies of Europe, there could be no reasonable dispute: the decentralised western European economy worked much better, with prices signalling information rather than the state attempting to control it. As a dissident under the Soviet system, Havel had spoken of “living within the truth”; a simple statement of facts and realities in a Communist regime built on obfuscation and Orwellian doublespeak. In the end, truth prevailed.

So the second half of the twentieth-century vindicated what Hayek had suggested in 1945. Bringing together dispersed knowledge through the price system not only improved the division of labour but made an economy more energy-efficient and less polluting, with better life prospects for workers, producing goods and services that people actually wanted and needed. This lesson that the market system worked seemed of universal significance. Not just in Europe, but on a global scale, the better use of knowledge in society could surely make life better for everyone, everywhere, in a matter of time.

NOT A TIME MACHINE

By the first decade of the twenty-first century the largest markets in the world were not, however, in coal, or steel, or chemicals, or indeed anything that might be produced, or people might consume, or use. Instead, financial products based on underlying goods or services outstripped everything. Foreign exchange trading in currencies had risen to 73 times the value of actual global trade by 2010 (compared to a mere 11 times in 1980). The value of trading in oil futures grew from 20% of global physical oil production and consumption in 1980 to 10 times physical production and consumption by 2010. And there grew out of nowhere a market in devices known as “credit default swaps”, allowing two banks or other financial institutions to swap each other’s risk of default on the loans each made, or the bonds each held, for a mutually agreed fee. In a matter of a few years in the 1990s these devices

had evolved from specialised, bilateral, tailor-made agreements between two parties to mass-produced securities. The gross market value of credit default swaps peaked in 2008, with a total of \$5.1 trillion (roughly the same as half the GDP of the European Union).

Behind this market for credit default swaps there came another innovation in the United States: the creation of elaborate new securities based on pooling income streams from mortgages to house-buyers, with ratings based on the riskiness of packages of mortgages. These schemes worked beautifully so long as US house prices moved ever upward, but not when prices started to decline, raising the default risks of impossible-to-identify tranches of “sub-prime” securities, which rapidly became viewed in the market as toxic financial assets.

In 2007 a slide in United States property prices began, leading to a collapse in the market for mortgage-related securities, distress in the US financial sector, the bankruptcy of Lehman Brothers in 2008 and the near breakdown of the entire global financial system. This financial crisis became the worst since the crash of 1929, which had ushered in the Great Depression. Its repercussions were still working their way through the political economy of the developed world a decade and more later.

After the crash of 2008, it was noticed that credit default swap prices, measured in terms of spreads for major banks, had continued to move downwards, reaching a historic low in early summer 2007, so providing no warning at all of impending financial disaster. In other words, one of the largest markets in the world, trading in instruments to capture risk between the world’s most sophisticated and knowledgeable financial institutions, had been transmitting signals conveying little or no practical information.

The foreign exchange market, with enormous volumes of trading, far exceeding global trade in real goods and services, might equally have been expected, following Hayek’s logic, to convey useful knowledge on a grand scale. That was certainly what some in the market believed when global trading in currencies really took off, in the 1980s. As the head of one large US bank put it at the time, the old Bretton Woods gold standard had now been replaced by an “information standard”, based on the huge flows of information running through the trading rooms of the world’s global banks, carrying out a non-stop global plebiscite on the currencies issued by governments, and holding them to account. He likened it to a democratic process; as if absolute monarchs were being held in check by the universal suffrage of the markets.

But the results of this global plebiscite, expressed in prices, have been deeply puzzling. In the transatlantic area, bridging the two enormous market economies of the United States and Europe, responsible for about half the world's economic output, the dollar rose by 81% against the German mark in the period from 1979 to 1984; fell by 49% in the period from 1984 to 1987; and then rose by 12% between 1987 and 1988. In the twenty-first century, after the replacement of the German mark by the euro in continental Europe, the euro-dollar price has swung by margins of 15–25% *nine times* in the decade since 2007.

Needless to say, the US and European economies have not expanded and contracted like accordions in the space of ten years. Nor, in the 1980s, did the US economy almost double compared with the German, and then suddenly deflate to half its size. The dollar-euro exchange rate is sometimes called the most important price in the world. If so, it is hard to call whatever it is signalling useful or practical knowledge.

Or take Hayek's own example of the price of tin. As Hayek put it, instant messages conveyed by price signals would allow producers using tin to adjust their plans, and the supply and demand for tin and all its substitutes would move rapidly in line. The actual wholesale price of tin in recent decades, on the other hand, shows general stability in the 1960s (with a low of \$2163 per metric ton in May 1960), followed by a rapid increase in prices in the 1970s, a slow decrease in the 1980s and for the remainder of the twentieth century, and then massive volatility in the twenty-first century, with prices hitting an all-time high of \$33,265 in 2011 before slumping to below \$15,000 in 2016. This tin price pattern is typical of the prices of other basic commodities: crude oil prices have moved up and down in much the same way over these same decades.

So something seems to be missing from the Hayekian explanation of the world. His telecommunications system certainly still exists—information passes around the world today faster than ever, much faster than in 1945. And yet much of the information flashing through the global circuitry seems unreliable and untrustworthy, for anyone who wants to use it to make things, or plan for the future.

What exactly is the knowledge transmitted through the price system? Hayek was describing knowledge that is useful to producers, who need the minimum information about changing circumstances. This is what prices tell them. He linked it to the division of labour in the economy: divided knowledge—dispersed practical knowledge about processes and