

NEOLIBERALISM, SOCIAL FRAGMENTATION AND WORLDWIDE DEPRESSION

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**Institute for Theoretical and High Energy Physics, University of Paris 6
Working Report**

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Working Report (2009)

First release: 10 May 2009

Present version: 6 September 2009

Ami, entends-tu le vol noir des corbeaux sur nos plaines ?

[My friend, do you hear the dark flight of the crows over our plains?]

—Maurice Druon, Joseph Kessel, *Chant des Partisans* (1943)

“I think that there is a small experiment which we may try tomorrow, Watson, in order to throw some light on the matter.”

—Sir Arthur Conan Doyle, *The Adventure of the Shoscombe Old Place* (1927)

Preface

In mid-2006 the Chinese government announced that it was in the process of drafting a new labor law which would give greater power to the All-China Federation of Trade Unions (ACFTU). The new law would give to labor unions the right to collective bargaining on such matters as wages, working hours, bonuses, work safety, insurance benefits. In the past, existing labor laws have not been really enforced. WalMart, Disney, McDonald's and Adidas have been singled out for using contractors that violate China's labor laws. In 2006, Microsoft China, McDonald's, PricewaterhouseCoopers (a financial consulting firm) and many other foreign companies were not unionized.

Hoping to head off some of the new rules, representatives of some American and European companies began an intense lobbying campaign to persuade the Chinese government to mollify the draft. They hinted that if the new law was passed they would remove some of their factories to countries where wages were kept down¹.

This example illustrates fairly well the main issue faced by the world economy. If on one hand wages in developing countries are prevented from going up in spite of huge increases in productivity, if on the other hand companies move their business from high wage countries to low wage countries, this will set the conditions for downward oriented wages, a process that some US lawmakers designate by the expression "race to the bottom".

This is not mere speculation. It is true that in China wages went up substantially and that living conditions have improved but this is hardly true in many other places. Mexico is a case in point. After 30 years of industrial investment in the *maquiladora* border zone the living conditions in this area remain very difficult. At the same time the decisions made by US companies to establish their new factories beyond the Mexican border has weakened the demand for labor in the United States and has therefore contributed to depressing American wages.

Evidence provided in the following chapters suggests that the previous process which eventually lead to 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

¹More details on this question can be found in the following articles published by the New York Times and available on line : 13 October 2006, 10 April 2007, 30 June 2007, 11 September 2008.

in following decades. The mid-1970s also marked the beginning of a huge inflow of immigrants (in large part of Hispanic origin) into the United States. It was also around 1975 that the number of strikes began to fall sharply denoting an erosion of the bargaining power of American unions.

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 take it to task². 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 agenda³. 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 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

²See 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.

³Even such lucid and renowned economists as Paul Krugman and Joseph Stiglitz put little emphasis on the transformations which took place in the labor market and union legislation. As we will show, these changes preceded deregulation and Reaganomics. A suggestive summary of Paul Krugman’s perspective can be read in one of his New York Times articles entitled “Reagan did it” (1 June 2009).

mechanism a substantial part of consumption and growth was achieved through an increase of the outstanding Treasury debt⁴. 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 further (as is quite possible on the basis of the exponential growth of the number of cases so far) it will be a further hindrance to international trade. However, the example of the influenza epidemic of 1918 suggests that this should not have a big impact on economic growth. Indeed, from 1917 to 1918 there was a 9% increase in US Gross Domestic Product. 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.

- 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.

⁴In 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.

- 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 predictions⁵. 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 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 shares⁶.

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.

⁵These predictions rely on observed quantitative regularities rather than on mathematical models. The reasons for this are explained in Roehner (2008 b).

⁶At 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.

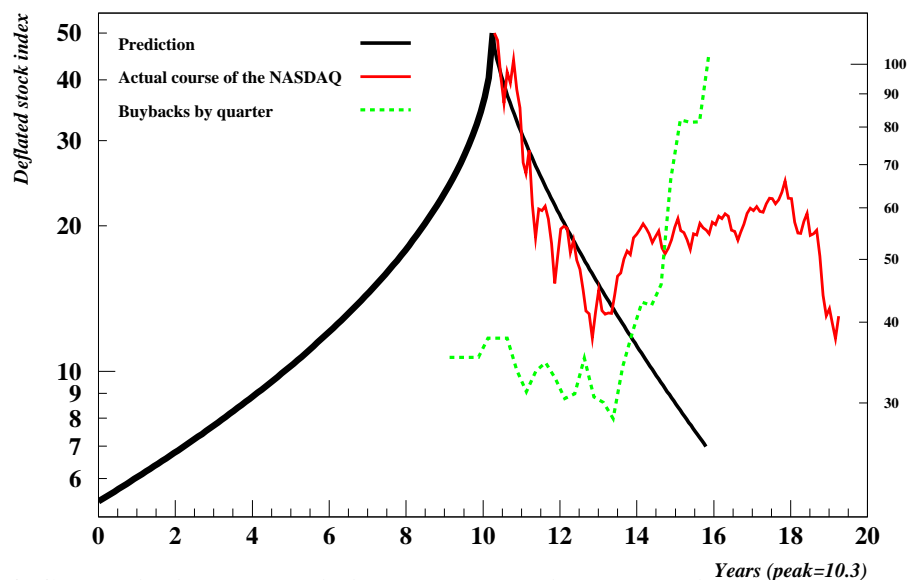


Fig. 1 NASDAQ Composite index: prediction compared with observation. Year 10 on the horizontal axis corresponds to 2000; the downturn occurred in March 2000 which corresponds to 10.3. The prediction covers the interval 10-16 that is to say 2000-2006. Made in May 2000, it was published in January 2001 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.*

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 out⁷. 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

⁷For 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.

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 accounting, 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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Paris, 10 May 2009

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Comments are welcome

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Chapter 1

Neoliberalism: an overview

Neoliberalism

Broadly speaking, neoliberal policies tend to encourage free trade and to reduce the role of government which is why they are often referred to as free-market policies. Among the consequences of such policies one can mention the following effects.

- Privatization may lead to control by foreign companies; this point is discussed later on in connection with Latin America and Eastern Europe.
- Because free-trade is also interpreted as free circulation of manpower, huge amounts of cheap labor become available in industrialized economies which in turn depresses wages and reduces the incentives for technical innovation in production processes. A side-effect of cheap labor imports is to erode the role of unions. For instance in the US private sector the unionization rate decreased from 30% in the 1950s to about 8% in 2008.
- Because taxes are seen as an hindrance to free-market mechanisms the neoliberal agenda requires sharp cuts in tax rates for both households and companies and light tax rates for financial revenue. Needless to say, such policies mainly benefit to the wealthiest people. This reduction in income redistribution led to an erosion of social solidarity. A subsequent chapter will discuss this point in greater detail.
- In industrialized countries down-sizing of the role of the government leads to under-investment in basic infrastructures such as roads, bridges, dams, dikes, public transportation facilities.

From a methodological perspective it is often helpful to consider cases in which the effects that one wants to study appear most clearly. The emirate of Dubai epitomizes many of the positive as well as negative aspects of neoliberal policies. One can mention: massive imports of cheap labor, negligible tax rates for Emiratis and companies, non-unionized workforce, a bold project of creating in the middle of a desert a metropolis based on tourism and financial services. It will be interesting to see how Dubai weathers the economic crisis⁸.

⁸The sociological consequences of this project are described and analyzed in an article published in the British newspaper "The Independent" (Hari 2009).

**Table 1.1a Occurrences of the term “neoliberalism”
in newspapers: number of articles per month in 2000 and 2008**

Newspaper	2000	2008
Britain		
Guardian	1	4
The Independent	0.08	0.6
<i>Average</i>	0.54	2.3
France		
Figaro	not available	0.8
Le Monde	1.7	2.5
<i>Average</i>	1.7	1.6
United States		
Christian Science Monitor	0.08	0.08
New York Times	0.0	0.4
Washington Post	0.2	0.5
<i>Average</i>	0.09	0.3
<i>Global average (3 countries)</i>	0.8	1.4

Notes: According to the definition given on Wikipedia, the term “neoliberalism” is most often used by critics of the doctrine. Proponents prefer to use the terms “market economy” or “market liberalism”. This observation is indeed confirmed by the data given in the table in the sense that “neoliberalism” is used more often by left-wing oriented newspapers than by right-wing papers. However, beyond this left-right difference there is also a clear difference between countries: the frequency is markedly higher in Britain than in the United States.

The word “Reaganomics” was mainly used during the two terms of president Reagan (1981-1989); after 1990 the word was used less than once a month in the New York Times.

Source: The data have been obtained by using the key-word search engines available on the websites of the newspapers.

Roots of the neoliberal program

As shown by the tables below, the word “neoliberalism” has not been much used in the past and is still sparsely used at the time of writing.

The first occurrence of the word “neoliberalism” in the New York Times was in 1983 (6 October, section B, p. 8). Before 2000 it was used once every 5 months, and between 2000 and February 2009, about once every three months⁹. Instead alternative expressions have been used. For instance, on 27 February 2009 there was an article entitled: “Obama’s budget plan sweeps away Reagan ideas”. The article refers to the fact that after two decades during which taxes on high income brackets had been lowered, the budget for 2010 was planning tax increases on the top 1%. Yet, “Rea-

⁹Incidentally, a similar keyword search for the Venezuelan newspaper GloboVision gave 3 occurrences per month in 2008. Given the frequency with which the expression is used by President Hugo Chavez one would have expected a higher rate of occurrence. However, as we are not familiar with the political orientation of the papers in this country it is difficult at this point to draw a reliable conclusion.

**Table 1.1b Occurrence of the word
“neoliberalism” on the Internet**

Language	Word	Number of websites [million]	Normalization factor [100 million]	Normalized number of websites
English	neoliberalism	2.3	1.8	1.3
French	neolibéralisme	4	0.8	5.2
German	neoliberalismus	0.4	0.3	1.3
Spanish	neoliberalismo	1.8	0.5	3.6

Notes: Because the number of existing websites depends on the language, the numbers of relevant websites must be normalized in some way to make them comparable. As normalization factors we used the number of websites obtained for the keyword “economics” expressed in the respective languages that is to say: economics, économie, Wirtschaftswissenschaft or Ökonomie, Economia. In terms of normalized numbers there seems to be a marked difference between French and Spanish websites on the one hand and English and German websites on the other hand.

Source: The data have been obtained by using the Google search engine.

gan’s ideas” were not limited to tax policy; they brought about many other changes such as deregulation, reduction of the role played by government agencies, reduction in social welfare programs and so on. Many of these ideas had been advocated by economist Milton Friedman who became a close adviser to president Reagan.

Before being implemented by president Reagan, neoliberal ideas had been introduced and applied in Latin American countries. One of the first experiments carried out by the so-called “Chicago Boys” was conducted in Chile after General Pinochet’s coup in September 1973, that is to say about 8 years before President Reagan began to implement a similar program in the United States.

Although the word “neoliberalism” may be fairly new the notions that it covers are not. The main ideas of the neoliberal creed have been a permanent and central theme in the program of the American Chamber of Commerce and of the National Association of Manufacturers for decades. For instance after the election of president Roosevelt fierce campaigns were conducted by these organizations against his “socialist program” (an expression frequently used at the time) and in favor of a “free-enterprise” agenda. The participation of business in the war program was seen as an opportunity to regain some of the lost ground.

As an illustration, one can mention the following declaration made on 17 September 1942 by Lamot DuPont, then Chairman of the Board of the DuPont Company ¹⁰ :

¹⁰This excerpt of DuPont’s speech before the resolution committee of the National Association of Manufacturers is cited in Selden (1943, p. 99). The primary source is not given specifically for this excerpt but it is indicated that the whole section is based on the following sources: Lobby Investigation Report (senator Blake); Committee on Education and Labor (La Follette Committee), Senate Report No 6, part 6; Investigation of Concentration of economic power, Temporary National Economic Committee (TNEC) monograph 26.

“We will win the war by reducing taxes on corporations, high income brackets, and increasing taxes on lower incomes, by removing unions from any power to tell industry how to produce, how to deal with their employees or anything else, by destroying any and all government agencies that stand in the way of free enterprise.”

It took about 40 years for the objectives outlined by Lammot DuPont to be fully realized. Naturally, these goals were not specific to American business but were probably shared by corporate leaders in other industrialized countries. What was really new with the version of neoliberalism which emerged in the late twentieth century is the fact that, mainly thanks to the Chicago School, it became an economic theory as well as a political program. So many Nobel prize awards were bestowed on neoliberal economists that the Chicago School became the center of mainstream economic theory and policy. In spite of the fact that the present crisis has clearly shown that markets do not regulate themselves, the neoliberal conception will probably remain the mainstream paradigm for many years until being replaced (if ever) by an alternative vision which will take years to emerge and spread.

Neoliberalism and the financial crisis

In his testimony of 23 October 2008 before a House Oversight and Government Reform Committee, Alan Greenspan declared:

“It was the failure to properly price such risky assets that precipitated the crisis. In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year [i.e. 2007] because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today. When in August 2007 markets eventually trashed the credit agencies’ rosy ratings, a blanket of uncertainty descended on the investment community.

It would probably be a mistake to think that the present crisis will bring down the neoliberal ideology. Basically, this ideology is the expression of corporate interests. The mathematical models mentioned by Alan Greenspan were largely *ad hoc* models set up with the objective of obtaining “rosy ratings” from rating agencies.

It can be noted that Lammot DuPont (1880-1952) was a staunch supporter of the anti-New Deal “American Liberty League”.

In this respect one should recall that what makes a model scientific is *not* the fact that it is expressed through mathematical formulas. Mathematics is only a language which by itself does not carry any truth. What makes a model scientific is the way it has been tested in various conditions. Let us give two illustrations.

- Galileo's law of free fall was stated by him in plain language but it was based on extensive experiments and it provided the starting point of classical mechanics.
- The fact that Einstein's theory of gravitation uses sophisticated mathematical tools does not have any implication as to its truth. Nowadays it is accepted by most physicists because during 90 years it has been tested in various experiments and astronomical observations and was found to stand these tests with success.

There can be little doubt that it will be possible to revise these models in a way which makes them more consistent with the present business situation but without calling into question the "free market" assumptions on which neoliberalism relies. As a matter of fact this is the direction indicated by Greenspan. He does not suggest any oversight of derivatives markets by the Securities and Exchange Commission. Instead he suggests that simply by adequately changing risk parameters in financial models they will again be working as well as they have been working during the past three decades. It is likely that most investors wish to keep a system which has been so profitable. According to the New York Times (4 March 2007), during the three decades up to 1999 Mr. Soros's fund returned more than 30% a year on average. This represents an overall multiplication by a factor $1.3^{30} = 2620$.

In the same article, one also learns that in managing the money of King's College of Cambridge University from 1928 to 1945 (less than two decades) John Maynard Keynes earned the College an average annualized return of 13%, i.e. an overall multiplication by $1.12^{18} = 9.0$. This is certainly a good performance especially during a period of time marked by the Great Depression and the war, but nevertheless between 30% and 13% there is a big difference.

When Alan Greenspan speaks of the collapse of the intellectual edifice of financial mathematics he has mainly in mind the pricing system. It is quite possible that exotic financial products had been priced too low, a problem which can probably be remedied by changing a few parameters in the pricing models.

In contrast the failure of the *risk management* edifice calls into question the soundness of sophisticated hedging methods. To explain this point let us start from a concrete example. The University of Harvard relies on its endowment (i.e. its capital assets) for paying the salaries of faculty and staff members and for its extension programs. This endowment which amounted to \$37 billion on 1 July 2008 is the largest of any US university. Yet, in the 3 months between July and October 2008 it had shrunk by 22%. The endowments of other universities experienced a similar

fate with declines of 13% and 11% for Yale and Princeton respectively (New York Times 22 Feb 2009). One of the main justifications for introducing a broad set of new financial products was to provide more flexibility and efficiency in hedging operations. These new hedging tools, it was claimed, would allow fund managers to avoid major losses even in the case of unexpected changes. Such hedging strategies were particularly suited for university endowments for which the main goal was to protect the underlying capital in a long-term perspective. The large losses experienced by Harvard, Yale and Princeton show that hedging and risk control did not work. Needless to say, the same observation can be repeated for the management of many other funds from money funds to pension funds. In all these cases Greenspan's "infectious greed" argument does not apply because these managers did not (and by law were not allowed to) pursue risky strategies; their duty was to use hedging and diversification strategies to protect their capital against any financial upheaval. Yet, it seems they were let down precisely by the sophisticated tools designed to provide protection.

Neoliberal ideology and social fragmentation

In a general way the implementation of neoliberal policies results in increased social fragmentation. In subsequent chapters we will illustrate this fragmentation by describing examples from the economic, financial and social spheres. One may wonder how this connection between neoliberalism and social segmentation can be explained.

As a first possible explanation one may mention the underlying economic theory. The classical and neoclassical view of economics is based on the notion of *individuals* making rational decisions in order to maximize their utility function. Collective factors, such as for instance interactions between employees or "herd effects" in times of financial panics, are not taken into consideration. Thus, one can hardly be surprised that neoliberal policies result in processes of social fragmentation.

It can be noted that the axioms of neoclassical economics are implemented in a fairly selective way. The existence of monopolies or oligopolies is certainly at odds with neoclassical principles. Yet, nowadays this issues are almost never mentioned by the proponents of free-market. Monopolies such as Microsoft or oligopolies such as Boeing and Airbus are well accepted. This omission is all the more surprising when one realizes that the decade from 1995 to 2005 has been marked by a huge number of mergers and acquisitions which markedly increased economic concentration ¹¹.

¹¹The wave of bailouts in the fall of 2008 also resulted in increased concentration because many failed firms were bought up by competitors.

The lack of attention given to this question stands in contrast to the scrutiny that it received during the period of the New Deal¹². Similarly, questions about lobbying groups which received so much attention in the 1930s are almost never mentioned nowadays. Do such lobbying groups not interfere with a “rational allocation of factors”?

Neoliberalism and privatization

The two major characteristics of neoliberal programs are (i) privatization of profit generating activities (ii) transfert to the state that is to say to tax-payers of the social cost (e.g. the consequences of social disaggregation) of neoliberal programs.

The first characteristic can be illustrated by the case of Argentina. Between 1990 and 1995, 121 state-owned (or state-controlled) companies have been sold off to the private sector. Railroads, subways, oil companies, water and sewage networks, telephone networks, national airlines were placed on the auction block¹³.

After privatization the workforce in many of these sectors was drastically reduced.

- In railroads: from 87,000 in 1991 to 5,200 in 1995.
- In state petroleum: from 52,000 in 1990 to 6,000 in 1995
- In the federal administration: from 874,000 in 1989 to 200,000 in 1994.

What was the result of this policy? Between 1990 and 1998 the Gross Domestic Product per capita at constant price expressed in US dollars increased from \$2,738 to \$8,000 (Wikipedia, article “Economy of Argentina”, an average annual growth rate of 14%, Well, quite remarkable one might think. But let us look at the evolution of unemployment:

	1984	1989	1992	1994	1995	1998
Unemployment rate	4.4%	8.1%	7.0%	11%	18%	12%

Source: 1984-1995: Keeling (1997); 1998: Wikipedia, article “Economy of Argentina”.

How can one reconcile such contradictory results? The answer is very simple.

(1) In 1990 the exchange rate of the Argentinian peso was 1 peso = 0.49 US\$; then, in 1993 in the course of the dollarization process it was set somewhat arbitrarily at: 1 peso = 1 US\$. Such an artificial rate did not hold very long however. In 2001 it fell back to 1 peso = 0.31 US\$.

Now, if instead of expressing the previous GDP growth in US\$ (which inflated it by a factor 2) we express it in peso (still at constant price), one gets an average annual growth rate of 4.5%. Still not bad! But this is not the end of the story. Between 1990

¹²See for instance the “Investigation of Concentration of Economic Power” by the Temporary National Economic Committee.

¹³Keeling (1997)

and 1998 the current account balance in percentage of GDP was: -2.3%. In other words, 2.3% of the growth was financed through increased public debt. Thus, the “true” average growth rate was only 2.2%. It must be added that these years were characterized by a high inflow of (mainly short-term) capital, otherwise the current account balance would have lead to greater difficulties.

In short, the privatization process lead to dismal results in economic terms. As one knows it also led to the financial crisis of 2002. The scenario in Argentina was not not very different from the one which developed in the wake of he huge privatization wave of the Soviet economy and lead to the financial crisis of 1998. The East European countries had a similar experience:

- In Poland the average annual growth rate of GDP (adjusted for inflation) over the period 1999-2007 was 4.1%. Yet, in spite of such a high growth rate unemployment stayed at an average level of 17% (TradingEconomics Website). It is well known that during this decade a large number of Polish workers went working in Britain, Ireland and Iceland. Had they remained at home the unemployment rate would have been higher.

- Hungary and the Czech Republic show a similar pattern, albeit with lower unemployment levels. Over the period 1999-2007 both countries experienced average growth rates of GDP (adjusted for inflation) of the order of 4%. Yet, the unemployment never fell under 7%.

It is usually considered that with a growth rate of 2.5% to 3% an economy is stable in terms of unemployment. With a lower growth rate unemployment tends to rise whereas with a higher growth rate it tends to fall¹⁴. Thus, when a economy growth rate is about 4% over a decade and nevertheless the jobless rate does not decline, this signals that there is something wrong. The most common explanation is that the GDP was inflated by financial profits (for instance due to a housing bubble) itself triggered by an inflow of short-term capital.

In other words, the Argentina syndrome can be observed in more or less severe forms in many countries which have undergone a large-scale privatization process.

The promotion of neoliberalism

In May 2008 the University of Chicago set up the project of establishing the Milton Friedman Institute. This is a \$200 million project and the majority of the funds will be raised from alumni and business leaders. An initial set of donors at the \$1 and \$2 million level will be invited to become members of the Milton Friedman Society. The initiators of this project claim that the Institute will be a center for path-

¹⁴Unless it is already at a low level around 3% which characterizes the residual unemployment due to the temporary state of joblessness in the process of shifting from one job to another.



Fig. 1.1 The future home of the Friedman Institute at the University of Chicago. The project of the Milton Friedman Institute was launched in May 2008. The university provided half a million dollars in seed money and is seeking \$200 million in private donations of \$1 million or more. The building aimed for the Institute currently houses the Theological Seminary. One of the main purposes of the Institute will be to host outstanding young scholars, post-doctoral fellows, visiting researchers in order (in the words of George Pratt Shultz) “to prepare them to lead enterprises in all sectors and thereby strengthen market-oriented economies”. In August 2008 more than 100 tenured faculty members have signed a petition opposing the institute. Critics say that they are concerned the institute will be a partisan organization.

breaking research. Can such a claim really be trusted? Can one seriously think that the sponsors would be happy if this research leads to the conclusion that free markets do not regulate themselves and need some kind of supervision to ensure long-term sustainability? In this connection one should keep in mind the well-known sentence by Upton Sinclair: “It is difficult to get a man to understand something when his salary depends upon his not understanding it¹⁵.”

As we will see in this chapter and in the next, neoliberalism has far reaching implications not only in finance but also in the economic and social spheres. In the last chapter we will examine if there is a way out of the neoliberal ideology. If it ever happens it will probably be a rocky and arduous road.

As an illustration one can consider the case of railroad privatization. Such experiments in Argentina, Britain and the United States ended in failure. In Britain privatization resulted in security failures which lead to many accidents and eventually to partial re-nationalization. In 2006 Network Rail, a state-backed organization took over the private company Railtrack. As a result, taxpayers faced unlimited fine for the errors that led to the Ladbroke Grove disaster in which 31 persons died and 400 were injured (“The Independent” 1 November 2006). Yet, three years later and in

¹⁵This statement was quoted by former Vice-President Al Gore during his decade-long campaign against carbon dioxide emissions.

spite of such clear evidence, privatization of national railroads is still on the agenda of the reforms promoted by the European Commission.

Chapter 2

Triumph of neoliberalism in economics

State power and cracks at grass-root level

At the end of the twentieth century the United States was not only the world's only superpower but also a highly successful nation in terms of scientific innovation, cultural creativity and ideological dominance. These achievements largely contributed to the quasi-universal acceptance of the neoliberal creed. Let us give a closer look at such achievements.

- In the decade 1901-1910 the United States won only 2 Nobel prizes (including one for Peace to President Theodor Roosevelt) which represented 3.2% of the prizes awarded. In the decade 1919-1928 the American share doubled to 7.8% but remained modest with respect to other industrialized countries (e.g. Germany: 22%, France: 12%, UK: 12%). If we now move up to the decade 1981-1990 we see a situation where the United States completely outranks all other countries; its share of Nobel awards has jumped to 49% while the share of Germany which comes in second position is only 8.2%. The situation is almost the same in the decade 1999-2008 with a share of 52% for the United States and only 8.0% for the UK which comes in second position.

Moreover, in all academic ranking of world universities (whatever the criteria used) there is an overwhelming proportion of American universities in the top 50.

- With corporations such as Microsoft, Google, eBay or Wikipedia¹⁶ the United States is in a monopolistic situation for the computer and Internet industry. There is a similar situation in agribusiness and biotechnology where firms such as Monsanto enjoy a near monopoly.

- The American film industry and TV channels are present worldwide¹⁷. It is probably not an exaggeration to say that the world news are shaped by American news agencies. Election decreed as fair by the State Department and the US medias will be seen that way worldwide; similarly, no matter what actually happened, elections said to be marked by widespread fraude will be seen that way worlwide. Needless to say, in the first class of countries one will likely find allies of the United

¹⁶The founders of Wikipedia make the claim that their foundation is based on international cooperation which is probably true; nevertheless, close to 100% of its donors are American, at least for those who are not anonymous as is the case of over 50%.

¹⁷For instance in the cafeterias or meeting places of many Japanese universities there is a wide TV screen which exclusively broadcasts CNN programs.

States (e.g. Afghanistan, Egypt, El Salvador, Mexico, Iraq after 2003) while the second class would include countries (such as Iran after 1979, Serbia under president Milosevic or Venezuela under president Chavez) which oppose the United States.

In the same spirit, massacres committed by troops of allied governments (e.g. El Salvador, Guatemala, South Korea in 1980 or Thailand in 1976 and 1992, Turkey against Kurds) will be almost completely ignored while on the contrary massacres (even if of much smaller magnitude) in contentious countries will be pinpointed¹⁸.

This ability to shape the world opinion became of even greater importance in the Internet era which is marked by a globalization and uniformization of public opinion.

- The American industry has more world class brands than any other country, e.g. Coca-Cola, Disney movies and recreation parks, MacDonald fast food restaurants, Starbuck coffeehouses, Nike and so on. General Motors and Ford are present through their subsidiaries in many countries worldwide¹⁹.

- In terms of military capability the United States enjoys an overwhelming domination. In 2007 the military spending of the United States which reached \$500 billions represented 45% of the world total and was about 10 times the spending of China which came in second position. With the advances made in Eastern and Central Europe during the past 20 years the network of American military bases (over 700 worldwide) is more extensive than ever.

- During the whole period of the Cold War the United States was able to suppress Communist movements worldwide. It is true that the Vietnam War marked a setback but this failure remained isolated in the sense that there was no domino effect. Toward the end of the 1980s a clever policy was able to win over several East European countries and to outmaneuver the Soviet Union. As a testimony of the wide support the United States was able to gather even without the approval of the UN Security Council, it can be mentioned that 38 countries took part in the occupation of Iraq in 2003. Of these, there were 18 East European countries but only 3 from Latin America; whereas most of the 18 stayed until 2008, the Latin American countries were among the first to withdraw their troops in early 2004.

In short, by 2000-2009 the United States was highly successful in what can be called high end achievements. Yet, at grass-root level the picture was fairly different. Top level research is thriving but high school education is struggling. Although Ameri-

¹⁸Countless other examples could be given. Some specific episodes are described in Herman et al. (1988). Although this study focuses on American medias, its argument also holds for the media of many other countries. This kind of bias does not apply only to the news but also to the presentation of historical episodes. Although such a disregard of factual evidence may appear chocking to a scientist or an impartial historian, it must be realized that this is not a moral issue but the result of an asymmetry in competing forces.

¹⁹The non-military aircraft division of Boeing has tried a similar operation by sharing the manufacturing of the 787 Dreamliner among half a dozen countries. This policy in which the core company provides only the design has made the success of Coca-Cola for decades; it is obviously more difficult to implement for complex products such as cars, ships or aircraft.

can corporations were highly profitable for decades the real wages of their employees had been declining since 1975. The worldwide extension of US armed forces is unparalleled but at the same time it has become a separate, closed-off and self-sufficient entity within the American society. Although foreign US policy leads the world the relations between the federal government and several of the 50 states are becoming increasingly strained. The same is true also for interstate relations.

An issue which surfaced with the depression is the tax shelter status offered to companies by some states. For instance Delaware holding companies are shell subsidiaries to which companies transfer ownership of things like trademarks or patents. Delaware does not tax the income collected from such assets. Apart from Delaware, corporations are also allowed to establish such shell subsidiaries in Nevada and Wyoming. Although this system has been used for decades it really gathered momentum in the 1990s. Squeezed by the depression, more than 20 states are pushing to collect taxes that corporations are avoiding in this way (New York Times 29 May 2009).

Such a picture would not be surprising in the case of a dwindling colonial empire when falling income from colonial possessions brings about a fiscal and social crisis. Such was more or less the case of the UK after World War II. In the present case, we are facing a completely different and, to my best knowledge, fairly unique situation.

A frozen political landscape

We mentioned the ability of the United States to condition and control international news. This does also apply to domestic news. The data which will be presented in the following sections are rarely alluded to in American medias, and are not often discussed by researchers or citizens. To accept such data would mean to admit that the fruits of economic growth have not been shared equally and that the American faith in steady progress and improving living standards no longer squares with facts. Quite understandably, there is some reluctance to raise such issues. But because these facts are virtually eliminated from the public debate, any change becomes unlikely. In short, the strength of big media corporations and the capacity of lobbying groups to control Congress bars any move that would modify the current power structure.

In a following chapter we compare the challenge faced by President Roosevelt in 1933 with the similar challenge faced by President Obama in 2009. We will come to the conclusion that the drastic turnabout which took place in 1933 can no longer occur in 2009. In spite of being dominated by the Democrats, the Congress is unwilling to provide to President Obama the strong support that was given to President Roosevelt. The American political situation appears frozen. A confirmation is provided by a statistic about the success rate of members of Congress who sought re-election:

from 1978 to 1998, their average success rate was 94%; in 1998 it reached 98.3%; in November 2004, 394 of the 401 members who sought re-election won, a percentage of 98.2%; 83% of the House races were won by a margin of 20% or more. comparison the re-election rate in European countries is about 60%.

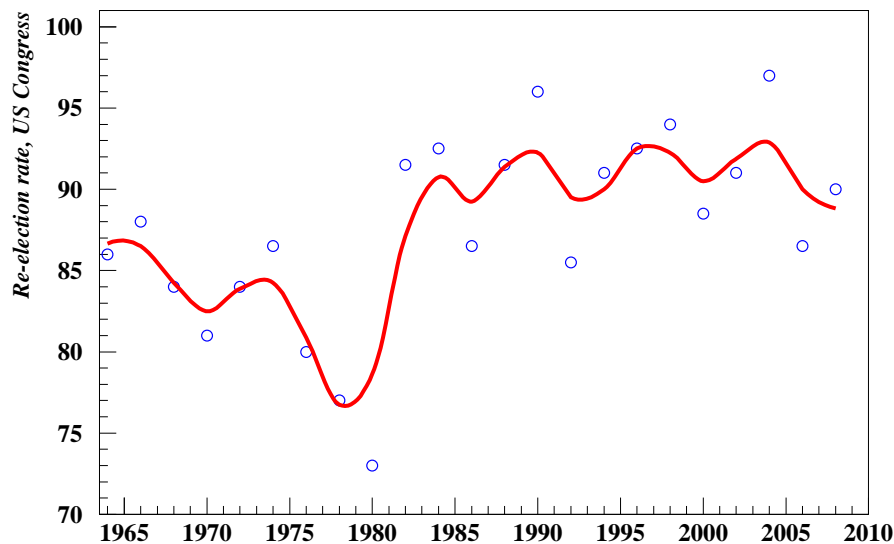


Fig. 2.1 a US Congress: re-election rate. After 1980 the re-election rate of Congressmen who sought re-election jumped to a level of about 92% and, apart from temporary fluctuations, remained at that level thereafter. The data points correspond to averages of the percentages of the House and Senate. The curve is a three-point moving average. The main factor in this evolution is a steady increase in the number of so-called safe seats. These are seats for which the winner wins by a margin of over 20% which means that there is in reality only one serious candidate. *Source:* <http://www.opensecrets.org/bigpicture/reelect.php?cycle=2006>

Three main factors may explain this situation²⁰: (i) At the election of 1998 incumbents outspent their challengers by an average ratio of 5 to 1. The advantage in terms of funding enjoyed by the incumbent candidate was similar in subsequent elections except perhaps in states with public financing for elections. (ii) Nearly a quarter of the candidates seeking re-election did not have a serious opponent; this explains why the average victory margin was as high as 43% (iii) Gerrymandering (i.e. redefinition of the boundaries of electoral districts) has led to an ever increasing number of “safe seats”. At the election of 2002 391 of the 435 House seats were considered as safe seats (in 1992 there were only 314).

If in addition one takes into consideration the fact that the politics implemented by the two parties are not very different, one comes to realize that the voters are not given a real choice. We come back to this point in the last chapter.

Income inequality: the watershed of 1975

²⁰Research and Reports (<http://www.bettercampaigns.org>)

First we consider four graphs which document a major change in the income pattern.

- The first graph shows that there was a drastic change around 1979. In the 3 decades before 1979 the growth of earnings was shared fairly uniformly by all income groups. As a matter of fact, the lowest income group benefited slightly more than the highest income group. It can be recalled that prior to 1980 the marginal tax rate in the highest tax bracket was 70%; subsequently it was lowered to 35%.

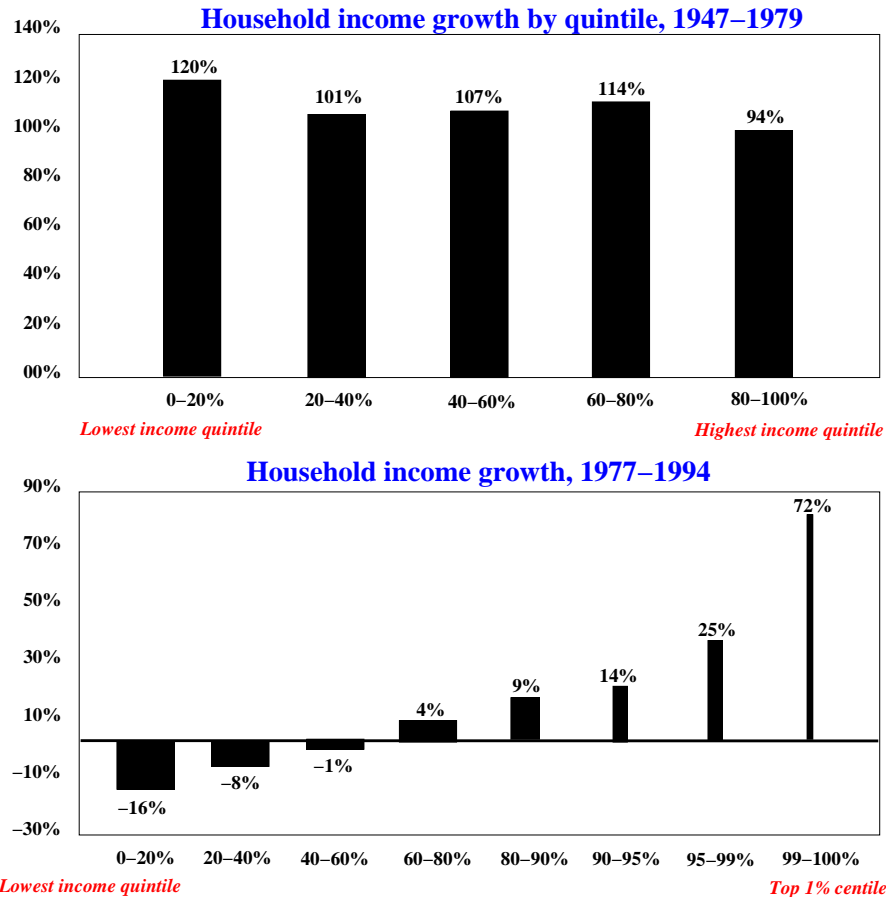


Fig. 2.2 a Change in the income pattern in the United States. The data refer to real (i.e. adjusted for inflation) incomes. After 1979 substantial income increases were confined to the highest income groups and particularly to the top 1%. *Source: “Wealth and Democracy” by Kevin Phillips (2002, p. 138), primary sources: Economic Policy Institute, Congressional Budget Office.*

- The second graph presents basically the same evidence. We see that between 1965 and 1978 the income of workers and chief executives progressed at the same pace but after that the two lines separated. The earnings of chief executives doubled while the income of employees stagnated. Note that in the following 20 years the growth of executive pay was even faster. As an illustration, in 2007 Barclays paid its president more than \$40 million (The Independent 9 November 2008). In relative terms such levels of earnings are similar to the income of dukes and princes in former times.

Moreover, executives are prepared to go at great length to keep such privileges even

to the point of putting their company at risk. This can be illustrated by the following story. The article of the Independent cited above mentions that Barclays shunned aid by the British government to avoid being forced to curb bonuses. Instead the bank preferred to solicit the (hypothetical) aid of Middle Eastern investors. This was in November 2008. In the following months Barclays financial situation continued to deteriorate and on 13 June 2009 it was announced that it was selling its Global Investor division (BGI) to US finance giant BlackRock for \$8 billion. Under this deal Barclays' president, Bob Diamond, will personally get \$26 million while 200 BGI's executives will share a \$1 billion windfall; this represents an average of \$5 million for each executive. In short, the deal resulted in breaking up Barclays, in transferring the control of one of its essential divisions to the ownership of a US corporation (a move which is hardly in the interest of Britain), but at least Barclays' executives were showered with hefty bonuses²¹.

By the way, the previous episode also shows that in spite of the troubles experienced by Citigroup, Bear Stearns, Lehmann, AIG and other American financial institutions, the US financial groups remain the world leaders. With \$27 trillion under management, BlackRock will be the strongest investment manager in the world. The fact that it is working for the Federal Reserve in managing the portfolio of mortgage assets it received from Bear Stearns as collateral, suggests that the financial crisis of the fall of 2008 brought about a closer association of major US financial companies with federal institutions such as the Federal Reserve and the Treasury.

The two previous graphs were taken from a book by Kevin Phillips entitled "Wealth and Democracy". It is interesting to note that Phillips was a close adviser of President Nixon.

- The third graph compares wage level and strike frequency. We see that after 1975 real wages decreased while at the same time the number of strikes fell dramatically. But this evolution started already after World War II. Several Laws were passed in Congress which strengthened the position of employers and at the same time curtailed the rights of unions. Because this policy was to some extent shelved during the second term of President Eisenhower and because collective labor contracts with employers were usually signed for a duration of 5 years, the effects of this legislation were felt only progressively. Since 1970 there has been a dramatic decline in the number of strikes. Real wages reached their maximum in 1973. After this date the largest part of GDP growth was absorbed by the growth of non-salary earnings (e.g. income from financial assets, real estate profits, etc.) the share of

²¹The article of "The Independent" (13 June 2009) which reports this story was entitled "Diamond in line for 22 million pounds as Barclays sells BGI. The article says that although in the short-term the \$8 billion from the BlackRock deal will enable Barclays to improve its equity ratio, in the long-term the remaining group will be highly exposed to the risks of volatile earnings.

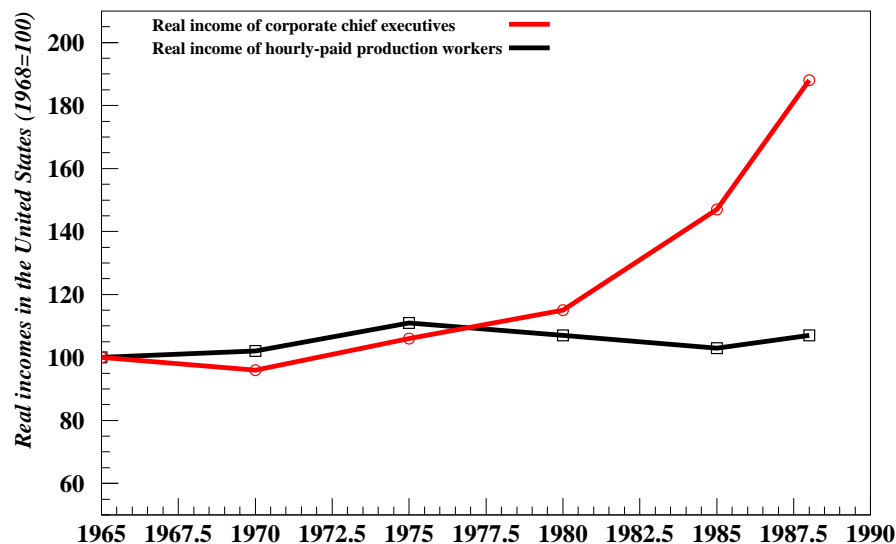


Fig. 2.3 b Increasing income inequality in US corporations. The graph refers to real (i.e. adjusted for inflation) annual incomes. A growing gap developed after 1979 which comes in confirmation of the previous graph to suggest that there was a deep change in US income patterns in the mid-1970s. In 1999 the average (pre-tax) compensation of the chief executives of the 200 largest US firms was \$8.3 million which represented 419 times the wage of the average factory worker; in 1980 the ratio was 42. *Source: Adapted from “Wealth and Democracy” by Kevin Phillips (2002, chart 3.22); primary source: “The Economist” June 1989*

which increased from 35% in 1950 to 55% in 2004.

- The fourth graph provides a comparison between the United States and three other industrialized countries. It shows that with the possible exception of the UK which presents a similar (but less marked) trend the other countries do not show the same evolution.

Ownership by “absentee landlords”

Between 1947 and 2000 the assets of American mutual funds as a proportion of GDP has been multiplied by a factor of the order of one hundred²². Mutual fund giants such as Fidelity Management and Research (FMR), Vanguard Group, Capital Research and Management or State Street, are the major shareholders (with percentages over 5% and up to 15%) of many large American corporations.

The term “absentee landlord” became widely used in the 19th century in relation with English owners of large Irish estates. “Absentee” refers to the fact that these owners spent most of their time in London or in vacation resorts of the French and Italian Riviera. More fundamentally, it refers to the fact that they were only interested in short-term financial returns. Because they had no knowledge of and no interest in the problems of their estates they were reluctant to spend money on investments that

²²More details can be found in Roehner (2006, p. 270).

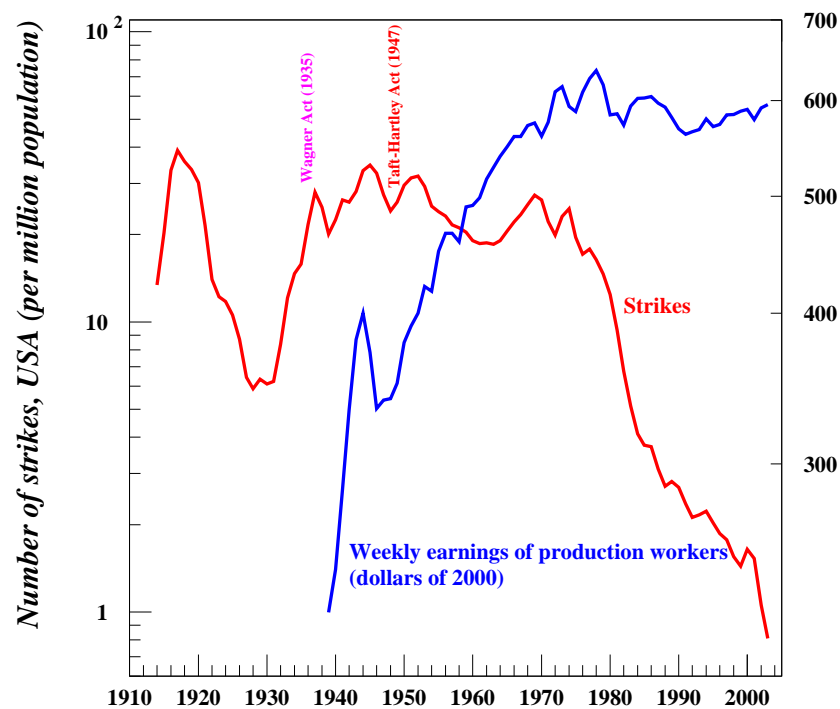


Fig. 2.4 Consequence in terms of earnings of the loss of influence of American labor unions. The Wagner Act was not the first pro-union law of the New Deal era nor was the Taft-Hartley Act the last anti-union law in the decade following 1945. The Wagner Act in fact replaced (and extended) the labor legislation contained in the “National Industrial Recovery Act” (NIRA) of 1933 after the latter was declared unconstitutional by the Supreme Court in 1935. The Taft-Hartley Act was passed in June 1947 shortly after the Loyalty Executive Order (No 9835 of March, 1947) which submitted all federal employees to a loyalty oath. It was followed by numerous indictments of union leaders based on the so-called “Thought Control Smith Act” (1940), by the McCarran Internal Security Act (September 1950), the McCarran-Walter Immigration and Nationality Act (1952) and the Communist Control Act (August 1954). Under the cover of fighting Communism, these laws in fact considerably weakened labor unions. *Sources: Statistical Abstract of the United States; Website of the US Department of Labor.*

would have brought a return only in the long-term. The stewards who managed the estates had of course a better knowledge but they were powerless as far as investment decisions were concerned.

The situation is similar for holding companies, mutual funds or private buyout companies. Their interest in the companies that they own is restricted to immediate financial returns²³. Moreover, because of their lack of empathy they are in the same position as Stanley Milgram’s instructors (see Roehner 2007, chapter 8) who inflicted

²³This situation is plainly apparent in economic and financial newspapers. Very little attention is given to the technical issues faced by companies. Ninety percent of the content is devoted to questions about mergers, acquisitions, changes of top executives, stock prices, bond issuance and other financial issues. Moreover all these topics are considered in a highly compartmentalized way. Thus, until recently it was not realized that problems in the real estate sector can have an impact on financial markets. Even nowadays it is hardly ever realized that the main engine of an economy is the income earned by employees. If this income is depressed through large scale imports of cheap labor there can be no sustainable domestic demand.

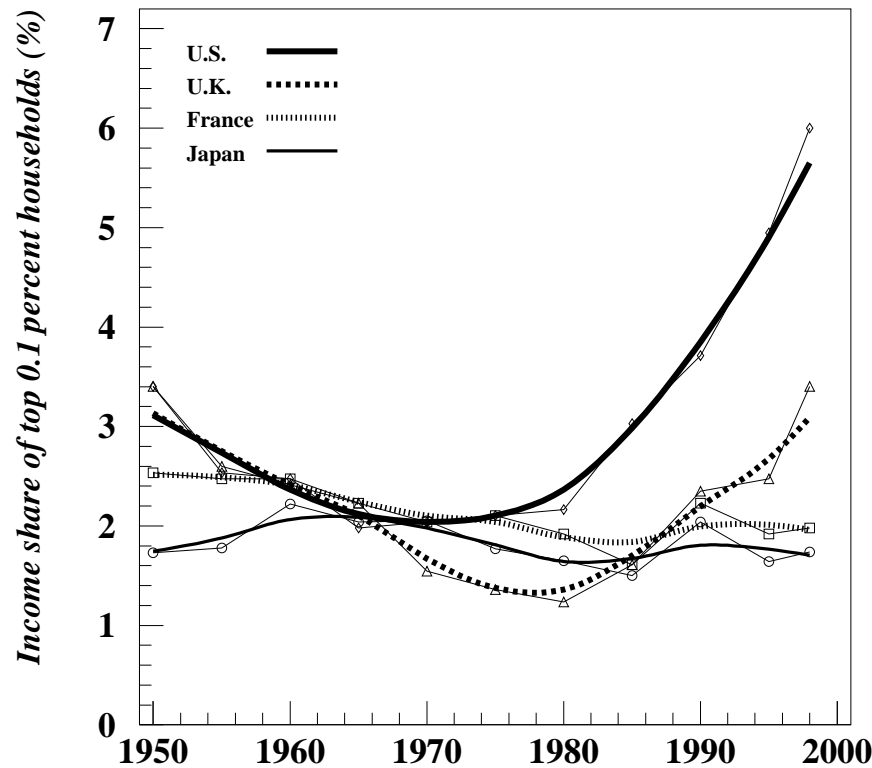


Fig. 2.5 Income inequality in several countries. Vertical scale: share of national income earned by the 0.1% of the households with highest income. The data are based on incomes reported to the fiscal administration; they represent incomes before the payment of income taxes and exclude capital gains. The thick curves are moving averages of the data points. Under an egalitarian distribution of income the top 0.1% would earn 0.1% of national income. According to the present graph their share is 20 larger in 1970 and 60 times larger in 1998. Sources: US, UK, France: Piketty and Saez (2003); Japan: Moriguchi and Saez (2004).

painful shocks on their subjects without much hesitation.

This can be illustrated by the attitude of employers with respect to fatal accidents in the workplace. According to an investigation performed by journalists of the New York Times (Barstow 2003) it appears that over the period 1982-2002 there were 2,197 cases in which fatal accidents were due to *deliberate* violations of safety laws by employers²⁴. Even more revealing of the *Zeitgeist* which prevailed during this period is the attitude of the federal government.

- Only 1,242 of these 2,197 deaths were ever investigated by the federal “Occupational Safety and Health Administration”. Moreover, in 93% of the cases that were investigated, OSHA declined to seek prosecution.
- Former OSHA officials say that those who were pushing for prosecution were hardly ever rewarded and in some cases they were penalized.
- When Congress established OSHA in 1970 it decided to make it a misde-

²⁴The total annual number of fatal workplace accidents in the same time interval was about 5,000.

meanor²⁵ to cause the death of a worker by willfully violating safety laws. The maximum sentence, six months in jail, is half the maximum for harassing a wild burro (small donkey) on federal lands. As a result, the average prison term per worker's death was only 5 days.

The fracture between management and workforce is not only harmful for employees, it also results in poor global efficiency. This means that in the long term such a system can hardly survive if competitors are allowed to emerge.

Even though the previous observations point to a deepening of the divide between employees and employers in recent decades this should not be interpreted as a steady and linear trend. There was already a broad divide in the 19th century which to some extent narrowed in the first half of the 20th century. As an illustration of the turn of mind which prevailed in the early 20th century one can cite the following excerpt from a Federal report on industrial relations²⁶:

The lives of millions of wage earners are subject to the dictation of a relatively small number of men who are totally ignorant of every aspect of the industries which they control, except the finances, and are totally unconcerned with regard to the working and living conditions of the employees in those industries.

Weakened national solidarity

One of the main roles of government whether at federal or state level is to improve collective living conditions for instance by providing schools, roads, bridges, police. Strengthening national solidarity is another important function of governments.

In the past decades two factors contributed to reducing this role.

The first factor was the influence of the neoliberal ideology. As one knows it proclaimed that the role of government should be limited to its most basic functions (army, diplomacy, police) and that the poor should care for themselves or be helped by non government organizations. Such a narrow conception of social solidarity was already prevalent in 19th century England. Revealing of this orientation was the institution of the workhouses. In order to get shelter and meals, poor people had to carry out absurdly useless tasks such as breaking stones. Similarly in India during periods of famine men, women and children had to break stones in order to get relief. For more details see Nash (1900) and Longmate (1974).

The second factor was the erosion in tax-income at both federal and state level. This

²⁵As opposed to a felony, a more serious criminal act. Petty theft, prostitution, vandalism, public intoxication are misdemeanors.

²⁶The excerpt is from the "Final Report of the Commission on Industrial Relations" and is cited in Boyer and Morris (1955). As a case in point the report includes the copy of a cable addressed by J.P. Morgan from his castle at Aix Les Bains (France) as to the necessity of a low wage scale.

erosion can be attributed to the change in tax rules (also brought about by the same ideology as already discussed). However one must also mention the development of tax havens.

In a report issued in 2005 the “Tax Justice Network” estimated that global tax revenue lost to tax havens exceeded \$255 billion per year²⁷. Actually, when compared with the budget of the United States which is of the order of 2,000 billions, 225 billions is not a big amount. The main point is rather that there has been a rapid development of tax havens during the past 20 years and that this evolution will continue unless the government of the United States changes its stance on this topic. The position of the Obama administration on this important topic will be discussed in a subsequent chapter.

²⁷The source is: “The price of offshore”, Briefing paper (March 2005). It is true that this figure was contested by the “Center for Freedom and Prosperity”. However, the fact that this organization was created to lobby legislators in favor of market liberalization and offshore financial centers suggests that it cannot entirely be trusted.

Appendix A: Possible scenario for the economic crisis

In this appendix we describe a scenario which shows why and how the triumph of neoliberalism may be connected with the financial crisis. It is quite by purpose that we make this point in an appendix. One should keep in mind that there can be no scientific explanation of single events. In other words, this scenario can neither be proved nor disproved. Depending on their turn of mind, some readers will find this scenario plausible or on the contrary unlikely. The only way to get closer to a scientific perspective is to find and compare other realizations of the mechanisms which were at work in this crisis (more on this in a subsequent chapter).

Before describing the scenario let us list the main characteristics of neoliberal policies²⁸.

- Privatization of profitable public services
- Lower tax rates for companies and affluent people
- Deregulation of existing markets and abstaining from regulating new markets (Internet, new financial products)
- Liquidation (or disabling) of federal agencies concerned with environment issues, with health hazards in workplaces or with the control of financial transactions
- Facilitating rather than opposing economic concentration by fusion, acquisition and buyout
- Outsourcing
- Substitution of short-term employment contracts to contracts providing long-term employment guarantees
- Globalization of financial markets, including (to say the least) a great tolerance for off-shore banking and tax heavens²⁹
- Globalization of labor markets; for industrialized countries this meant importing cheap labor.
- Discarding unions; it may be recalled that unionization is banned at Wal-Mart, the largest US company in terms of number of employees.
- Drawing higher education and research into the field of market economy. This in particular implies markedly increased tuition fees.

A possible scenario would consist in the following steps.

²⁸As all lists of this kind this one is fairly subjective; other people with different interests and backgrounds would list other items.

²⁹The position of market liberals on tax havens can be assessed fairly clearly by the opposition generated by candidate, president-elect and then president Obama when he claimed that he would attack tax evasion and tax havens; see for instance on the Internet the comments made by Bob Bauman calling the legislation planned by the new administration a “pernicious legislation” and even using the terms “more fascist powers”. It can be recalled that president Roosevelt was frequently accused of organizing a fascist state. In a cartoon that appeared in the New York World-Telegram on 12 November 1935, a businessman writes on a wall: “The New Deal is a combination of George III [who fought Americans in the War of Independence], Hitler, Mussolini, Stalin”.

(1) During World War II the financial aid provided by the United States took a form which was very different from what it had been during World War I. Through the Lend-Lease Act a total of \$50 billion (equivalent to nearly \$700 billion at 2007 prices) worth of supplies were shipped to the Allies: \$ 31 billion to Britain, \$ 11 billion to the Soviet Union, \$3 billion to France and \$1.6 billion to China. No repayment of these supplies was required. From an economic point of view Lend-Lease amounted to huge subsidies to the American industry. This was followed by the Marshall Plan. The funds provided to European countries had to be used to pay imports of American products. On the contrary during the First World War the United States made loans to the Allies whose repayment create endless problems after the war. After 1950 the policy of lavish credit supply continued through a succession of small wars (Korea, Cold War military expenses, Vietnam, Iraq) which amounted to subsidized orders for US companies. This set the scene of a world in which money supply and credit were plentiful. The way the Federal government responded to the financial crisis was again by increasing the money supply.

(2) In the late 1960s American companies experienced an erosion in profitability to which they responded in two ways: by investing abroad in countries where salaries were lower and by limiting wages in the United States through imports of cheap labor.

(3) Confronted to an unlimited supply of imported labor US workers and unions became increasingly unable to win strike contests. As a result the number of strikes plummeted and wages began to decrease (as documented in a graph given above).

(4) In the decades after 1975 the share of wages and salaries in the US GDP decreased steadily from 76% to 45% with a parallel increase of capital gains (e.g. appreciation of stocks or real estate) and corporate profits.

(5) As the US economy could hardly be driven by exports (there was a substantial deficit of the commercial balance in part due to the relocation of factories abroad) the only possible engine was domestic consumption and because of dwindling salaries consumption had to be propped up by cheap and easy credit. Thus, the scene was set for the financial crisis.

(6) Deregulation of traditional financial sectors and non-regulation of new financial products (derivatives, collateralized debt obligations, and so on) had created the tools for generating abundant credit.

(7) In 1994 (Orange County bankruptcy), 1998 (Long Term Capital Management bankruptcy), 2001 (Enron Corporation bankruptcy), 2002 (Global Crossing and WorldCom bankruptcies) there had already been serious crises which showed the risks of derivatives trading. In most cases the problem was surmounted by increasing the money supply.

(8) The real estate boom of 1996-2007 was yet another episode of economic

growth based on an abundant supply of money. It was made possible by cheap loans and in return housing equity provided collateral value for consumption-oriented loans.

(9) Then, in mid-2007 “something” happened (that we do not yet understand) which changed the attitude of major mutual funds and investment funds with respect to the sophisticated financial products that they had welcomed for almost two decades. Of course, credit crunches had already occurred in the past in the wake of the crises mentioned above, but not to the point of affecting almost all financial sectors (bonds, short-term loans, long-term loans, mortgages). In other words, this was something new, perhaps not in nature but certainly in scale.

A mechanism which may explain the severity of the credit crunch that began in 2007 would be a growing divide between the strategic interests of investment funds (such as Fidelity, State Street Corporation, Vanguard Group, Washington Mutual Investment Funds, Wellington Management Company, Capital Growth Management) and investment banks. It may be that the rush toward financial products of ever increasing complexity and opacity eventually run against the interests of such funds by depriving them of the market control that the sheer amount of their capital assets would otherwise give them. The fact that up to 2009 the crisis caused the failure of several big banks but was much less disruptive for investment funds would lend some support to this interpretation. Further confirmation may emerge as the crisis unfolds.

Chapter 3

Triumph of neoliberalism in society

The concept of social capital was developed by Harvard political scientist Robert D. Putnam. In his book entitled “Bowling alone” he suggests that the more people have opportunities to meet one another the “healthiest” a community is. The main problem is to define terms such as “healthiest” and “social capital” in a fairly objective way³⁰. Needless to say, more work is required to better understand the role of social interaction. The triumph of neoliberalism in many countries provides a unique opportunity to analyze the effects of a drastic change in social interaction. Why?

In the previous chapter we have already emphasized that neoliberalism is based on an individualistic conception. Not surprisingly, therefore, loss of social solidarity is one the most obvious consequences whenever neoliberal policies are implemented. How does such a loss of social solidarity affect our societies? The answer is not obvious because many effects are indirect rather than direct. It may seem that free-market policies do not prevent people from taking part in bowling associations, in bridge clubs or in astronomy workshops. Yet, if people must work longer, if the ultimate rational and pervasive purpose of our societies is to maximize the consumption of goods, then of course such activities will hardly be encouraged.

In the present chapter we discuss some effects of social fragmentation that can be observed in present-days societies. In some instances, such as the changing trends in education, the connection with neoliberal reforms will be fairly clear. In others fields such as infant mortality or homicide rates this connection will be less obvious. Many of the views put forward in this chapter are presented tentatively.

Leveling off in education trends

The next graph highlights abrupt changes in educational trends. The lowest line refers to the percentage of high school graduates, the other to the percentages of PhD degrees conferred annually.

How can we interpret this graph?

The stagnation in PhDs may have several causes but a fairly obvious factor is the

³⁰That is what we tried to do in a recent study entitled: “Maximization of interaction as an evolution principle for social systems” (2009).

inability of middle-class families to pay such long studies.

According to an article published in the Wall Street Journal (4 September 2009), in 2008 66% of college students had to borrow to pay for college and their average debt load was \$23,180 by the time they graduated. Since 1996, the number of students who had to borrow for college increased from 58% to 66% and the average amount that they borrow increased 33% from \$13,100 to \$23,180. Needless to say, this situation is very different from the situation experienced by the generation of post World War II veterans for whom the cost of their college education was paid by the federal government.

Most of these loans were so-called federal-student loans which means that their interest rate was lower than private, non-subsidized loans but even with a low rate the capital must be repaid nonetheless. In fact, there was a major change in federal aid. Around 1980 most of the aid was in the form of grants, around 2005 most of the funding went to providing subsidized loans.

The average of \$23,180 covers a broad variety of situations. The article cited above mentions the case of a 30-year old lawyer who has to repay \$175,000 from his 7 years in college and law school. Studies in law, business and medical schools are among the most expensive.

For the 34% who did not have to borrow their tuition and accommodation expenses were mostly paid by their families. Of course, even for those who had to borrow the funding provided by their families was also essential because tuition is about \$15,000 a year which means a total of \$60,000 or \$75,000 depending on whether the degree is obtained in 4 or 5 years. Adding the cost of accommodation one arrives at a total which is some 4 or 5 times the amount of \$23,180 which is borrowed.

The decrease in high-school graduates may be related to another effect namely the high inflow of uneducated immigrants.

Abrupt increase in the trend of incarceration rate

Sharp upturn in the mid-1970s

The next graph documents a rapid increase in the incarceration rate after 1975. The homicide rate is showed mainly for the purpose of comparison. It is true that the homicide rate was high in 1972 when incarceration began to pick up but it was also high in 1932. It is probably a general rule that crime tends to increase when economic conditions become difficult. In the years after 1932 the homicide rate decreased by itself (without a jump in incarcerations) as economic conditions became better.

In recent years incarceration rates continued to increase even after homicides had

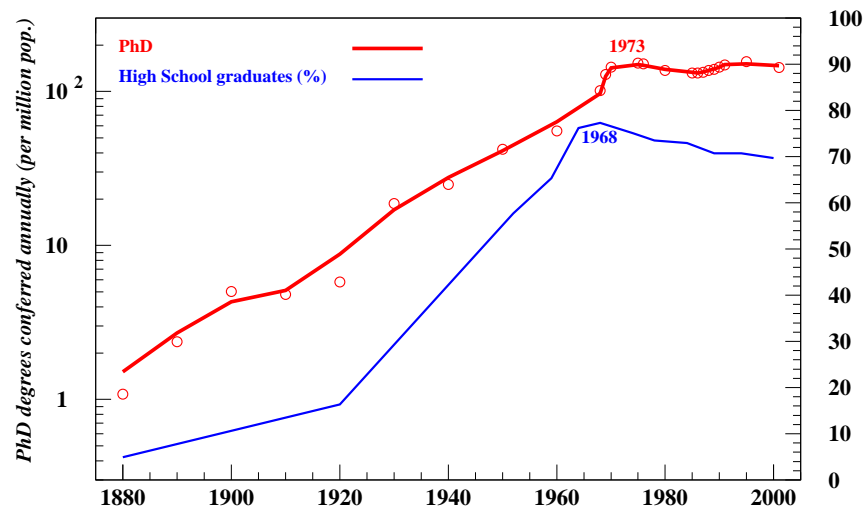


Fig. 3.1 Number of high school graduates and PhDs in the United States. A marked change in the trend of both curves occurred around 1968-1975. These changes suggest that two transformations took place simultaneously: (i) A contraction (at least relative to total population) of the upper middle class who previously had furnished a large part of PhD graduates. (ii) A widening of the poorest segment whose children leave school without graduating. It can be observed that in contrast with high school and doctorates, the proportion of Bachelors has continued to increase albeit at a rate that is smaller than during the decades before 1970. *Sources: PhD: Statistical Abstract of the United States; high school graduates: Barton (P.E.) 2005: One-third of a nation. Policy Information Center Educational Testing Service.*

fallen back to their level of the 1960s. Another possible factor may be the privatization of many state prisons. Constructing and managing prisons has become a business whose “customers” are the inmates.

Privatizing prisons and bribing judges

As one knows during the past three decades there has been a steady move in the United States toward the privatization of prisons at state and county level. The rule according to which inmates should be detained in the state in which they were tried and sentenced has given way to a more flexible scheme which allows prisoners to be sent from one state to another. In this way some states such as Arizona have become home of large prison facilities which hold prisoners from state as far away as New York State.

In a system in which private companies are remunerated on the basis of the number of inmates held, it seems natural that in order to maximize profit they would favor full occupation. Once a new facility for 1,000 inmates has been built by company *A* it would look forward to seeing it working at full capacity. Like the director of an hotel the manager of a private prison will try to increase the occupation rate.

How can he do that?

A fairly efficient method to fill a newly built facility is to obtain the closing of for-

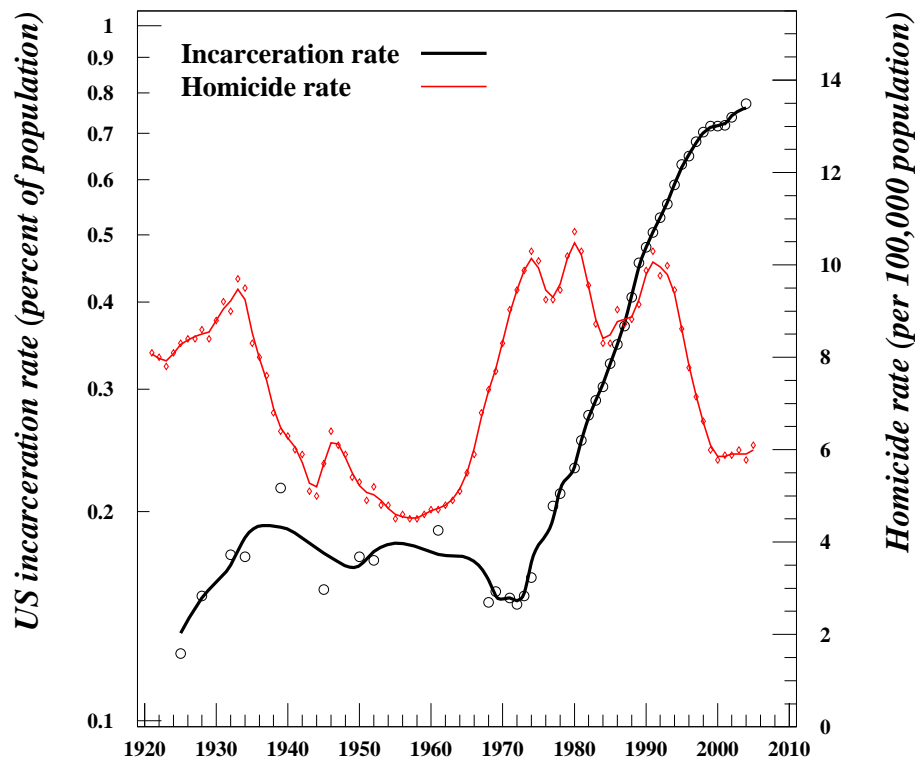


Fig. 3.2 Rate of incarceration and homicide rate. The marked increase in the rate of incarceration after 1975 resulted in a reduction in the homicide rate which began around 1990. Between 1930 and 1955 the homicide rate fell fairly steadily; this fall seems to have little or no connection with the (small) increase in the incarceration rate that occurred between 1925 and 1935. It should probably be attributed to the improvement of living conditions during the New Deal era. In 2008 the average cost of housing a single prisoner was \$ 46,000 a year (i.e. \$ 3,800 a month, a figure which is higher than the median personal income of full time workers in the United States (The Independent, 15 February 2009). *Sources: Statistical Abstract of the United States, various years.*

merly existing state or county prisons. This can be done under various pretexts: the old prison is no longer in line with existing regulation, its operation would be too costly in coming years, and similar arguments. Of course, to be credible such arguments must be brought forward by state officials not by the managers of the private facility.

Once a good occupation rate has been reached it must be kept at this level in forthcoming years which means that prisoners who are freed must be replaced by new inmates. That can best be achieved with the the judges' collaboration. As a result one should not be surprised to see that judges are becoming a target of bribery schemes. The following story illustrates some of these mechanisms.

The story of two bribed Pennsylvania county judges

On 26 August 2009 there was a short article in the "International Herald Tribune"

whose title was: “2 ex-judges in kickback case withdrew their guilty pleas”. At first sight this title was not very clear and the rest of the article was hardly clearer but because my attention was already focused on this bribery problem I made a thorough search on the Internet and in the articles of the New York Times by using the names of the two judges as key-words, namely: Mark A. Ciavarella and Michael T. Conahan, both of Luzerne County³¹ It revealed that this case was a perfect illustration of the mechanism explained in the previous section. Here are the main elements of this bribery scandal.

- **Election campaigns** Conahan ran the first time for Luzerne County judge in 1993 he announced that he would refuse to accept campaign contributions from lawyers and law firms. Instead he had to borrow \$180,000 to fund his election campaign. When he started his 2003 campaign he had to repay \$235,000 in loans. However he was able to pay it off thanks to donations from lawyers and law firms, thus reversing the promise made in his 1994 campaign.

- **Association with a detention center developer** In January 2002 Judge Conahan became President Judge which gave him control of the courthouse budget. At about the same time he came in touch with Robert K. Mericle, a developer of private detention centers. Eventually two private detention centers were built by the company Pennsylvania Child Care. By the end of 2002 Conahan eliminated financing of the county juvenile detention center thus clearing the way for the operation of Mericle’s new detention centers. At the same time Conahan signed a secret agreement which pledged that the county would pay \$1.3 million in annual rent on top of the tens of millions specified in the official contract for the operation of the detention center.

- **Red flags** When the county financial controller leaked a state audit that described the lease of the detention center as a bad deal, Judge Conahan issued a ruling to prevent other documents getting out.

Another red flag was the fact that between 2002 and 2007 the percentage of the trials in which juvenile defendants appeared without a lawyer was 10 times higher in Luzerne county (50% against 5%); in the same interval, about 25% of the over 6,000 trials ended with the juveniles being sent to detention center, a percentage 2.5 times higher than in the rest of Pennsylvania. The judges were able to increase the incarceration rate by pressuring probation officials to recommend detention over probation. A case in point is eight-grade Chad Uca who was sentenced to 3 months of detention for shoving a boy at school and causing him to cut his head on a locker (Chad Uca had no prior offenses).

A third red flag was the fact that the two judges were spending much of their time at

³¹In 2008 Luzerne County had a population of 312,000 residents: White: 95%, Black: 3%; in 2007 the average annual household income was 20% lower than the same figure for the whole of Pennsylvania.

their Florida Condo together with their developer friends.

- **Indictment** The two judges were charged in January 2009. It appears that over the 6 years during which the scheme was in operation they received about \$2 million in kickbacks. In February 2009 they agreed to serve a term of 7 years in prison but their sentence will be set only at a later date; at the time of writing (August 2009) the inquiry was still under way. In March they were dismissed from the bench. Mr. Mericle was also indicted. He agreed to pay \$2.5 million to fund local children programs; he faces up to 3 years in prison.

- **The strange attitude of the State Supreme Court** In May 2009 the State Supreme Court decided that “in order to help the youths move on with their lives” all documents related to their convictions should be destroyed. By doing so the Court would limit the ability of the youth to get a more equitable trial and would forbid any further investigation of the judges’s corruption.

In July the Court said that the records of the 400 youths who are already plaintiffs against the judges would be preserved. The other 6,000 would be destroyed.

On 12 August 2009 Judge Arthur A. Grim who was appointed by the Pennsylvania Supreme Court to investigate the case said that there would be no public benefit in retrying the cases and he recommended therefore that such retrials should be dropped.

What should one retain from this case?

(1) Strange as it may seem, it is customary for law firms to fund the election campaigns of judges, just in the same way as companies and lobbying groups sponsor the campaigns of congressmen and presidential candidates.

(2) Observation shows that the bribery mechanism that one would expect on the basis of profit maximization does indeed occur.

(3) So great is the power of judges that they can continue their malpractices even in the face of numerous red flags and incriminating evidence. In the present case it took 6 years and all the efforts of the Juvenile Law Center of Philadelphia to end this scheme.

(4) By deciding to destroy incriminating records, the State Supreme Court gave the impression of trying to end any further investigation, a behavior that suggests that more persons could be involved.

Other bribery cases

Is the case of Luzerne county exceptional or instead is it just the tip of the iceberg? Here is at least one other example. The source is the website of “Private Prison Watch” (4 July 2009)

The Willacy County (Texas) Adult Correctional Facility is a 540-bed prison which

was built in 2002. The Management and Training Corporation, a Utah-based private prison operator, was awarded a \$43 million contract to operate the jail after it was constructed.

- In January 2005, two Willacy County Commissioners Israel Tamez and Jose Jimenez resigned their posts and plead guilty to accepting \$10,000 in bribes from construction companies connected to the project in return for their votes in favor of the project.
- In March 2005, a third south Texas official, David Cortez, pled guilty to funneling at least \$39,000 to several Willacy County commissioners from an unnamed company involved in the jails development.
- In late May 2005, Willacy County sued two of the companies involved in the contract, “Corplan Corrections” and “Hale-Mills”, in state district court claiming that the companies bribed the commissioners to win the contract to build the prison.
- In November 2006 David Cortez was sentenced to a three-month term of imprisonment.

The forces that push up incarceration rates

Actually, if one wants to understand the mechanism that leads to ever higher levels of incarceration rates the bribery matter is probably of secondary importance. The real engine is provided by the shared interest that many parties have in building new prisons and in keeping high occupancy rates. This is best expressed by James Parkey, the President of Corplan Corrections, on the first page of the company’s website (31 August 2009).

“Years ago, I saw the need and the opportunity corrections centers represented. Small towns were dying, losing jobs and sources of income. Yet, some of these small towns were in ideal locations to qualify for federal and state requirements for detention centers.

We approached County Judges, Mayors and City Councils and, to our delight, there was enormous interest in building a prison. Many prisons bring 150 to 400 new jobs to a community. Now, there are many more communities wanting detention centers than are available. But if your community qualifies, Corplan Corrections will make it possible for you. We may even be able to show you how your community can qualify.”

Among the services provided by “Corplan Corrections” the website cites the following.

- We work with State and Federal officials, have a good rapport with political leaders and often fly to D.C. or State Capitals to make projects move forward
- We will meet with your city and county leaders and with the “Public” to help educate and “sell” the project to your community.

Among the advantages of such projects the website mentions the following.

- Additional jobs and additional sources of income for city and county.
- Increased security for our nation and cities.
- Political benefits.

It is of course not surprising that projects in which so many parties have an interest are indeed implemented. However, before closing this discussion we must also ask who may possibly oppose them.

Clearly, we can discard illegal immigrants and other potential inmates of such detention centers whose opinions bear little weight in the debate. Apart from them, the only group who might object are the citizens whose taxes will fund the projects. Yet, in communities in which there is an increasing feeling of insecurity (due to increased segmentation of social groups) there will probably be a consensus in favor of more detention facilities; especially if such project can be financed through long-term loans (which were easily obtainable until the credit crunch of 2008). Thanks to cleverly designed loans the burden of higher taxes could be postponed to future years just as was the case for home buyers during the real estate boom.

Change in the trend of infant mortality

Fig. 3.3 shows the evolution of infant mortality that is to say mortality between birth and one year of age. Infant mortality is a kind of synthetic indicator of various social conditions such as the health of the mother, her working conditions, the healthiness of the home and so on. This graph shows the US rate relative to a sample of three other industrialized countries chosen fairly randomly. Surprisingly, in the present case the change in the trend occurred as early as 1950. It is in the 1960s that the rate became higher than in the reference countries. In 1975 the ratio was equal to 1.45 but there is no change of trend as in the previous graphs.

Increased segmentation of the American society

Why should one focus on social segmentation?

It was already mentioned that the federal tax rate was greatly reduced for rich people in the late 1970s that is to say approximately at the time when many trend changes took place. The increase in income inequality is a sign of greater social segmentation.

The changing attitude of the federal government was certainly an important factor. During the New Deal it can be said that the Federal Government sided with the workers and the middle class. It is in his famous address of 7 April 1932 (that is to say at the beginning of his first electoral campaign) that Franklin Roosevelt

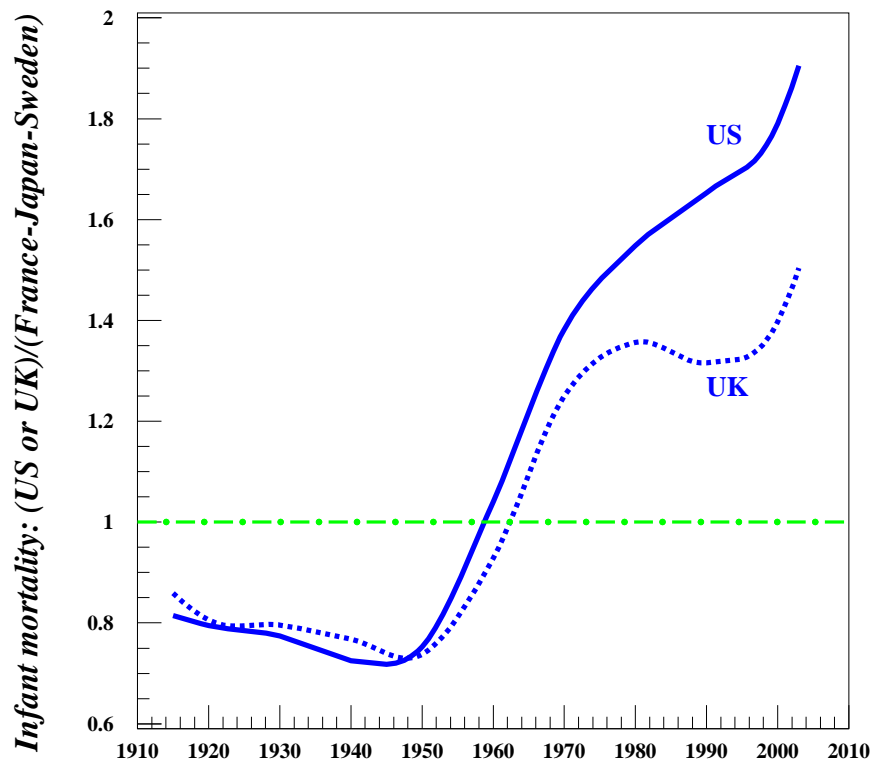


Fig. 3.3 Ratio of infant mortality rate in the US (or UK) to the rate in three other countries. Infant mortality refers to the mortality of babies between birth and one year of age. Because this variable reflects health care and living conditions in all social strata, it is considered a significant indicator of social welfare. The graph shows that in the 1950s there was a change in the trend. The new trend displays a growing gulf between the US (as well as the UK albeit to smaller degree) and other developed countries. *Sources: Statistical Yearbooks of the respective countries.*

introduced the notion of the “Forgotten Man”:

“These unhappy times call for the building of plans that rest upon the forgotten man at the bottom of the economic pyramid.”

This was not only rhetoric but was matched by sweeping reforms. Many of them were blocked by the Supreme Court especially during Roosevelt’s first presidency. For years the Wagner Act which gave so many new rights to workers and unions was not accepted as law by the employers because they expected it to be nullified by the Supreme Court.

However, such an explanation would suggest that the whole matter depended upon the personality and political choices of American presidents. In short Roosevelt versus Reagan. It would be a very anthropomorphic explanation.

It might be tempting to attribute some of the changes that we listed above (i.e. lower

educational achievements, higher infant mortality) to the increase in income inequality. Strictly speaking that would be a mistake however. Indeed, it is rather the fact that real wages stagnated or decreased which made living conditions more difficult for low income people. If all incomes had been increasing (even though at different rates) that would have made greater inequality almost bearable.

A closer inspection shows that the segmentation due to income inequality is only one (albeit a major one) of many symptoms of segmentation in the American society. From the perspective of physics it makes sense to examine the degree of segmentation for we know that greater segmentation basically means less overall interaction. Listing segmentation factors is a fairly indirect method for assessing interaction strength but it has the great advantage of being easy to use.

Persistence of the Black-White divide

One might think that in the wake of the Civil Rights movements the divide between African-Americans and the rest of the country progressively narrowed. Complete integration can be considered to be achieved when the statistical indicators of the minority population become the same as those of the total population, that is to say same average income, same infant mortality, same percentage of college graduates and so on. Here we examine one of these indicators, namely infant mortality. Fig. 3.4 shows that instead of decreasing the gap rather increased. This is a surprising result because for other aspects (e.g. access of African-Americans to higher education) the gap narrowed.

Perhaps is this outcome in some way connected with the factor that we examine in the next section

“White flight”

For over 5 decades a phenomenon commonly referred to as “White flight” has lead middle-class people to move from city centers to distant suburban areas. This phenomenon has transformed many city centers (e.g. Atlanta, Cincinnati, Detroit) into distressed areas.

In fact, rather than a *White* flight the phenomenon is more a move away from *poverty*. Indeed, it concerns all middle-class groups whether White, Hispanic or Black. This point is explained in an article by Jago and Roehner (2006).

Gated communities

Simultaneously, the development of so-called “gated communities” has provided a new form of self-chosen segregation. Gated communities are private areas in which new owners are accepted only if they fulfill certain conditions. In large-scale gated areas like retirement communities, there may be local stores, restaurants and busi-

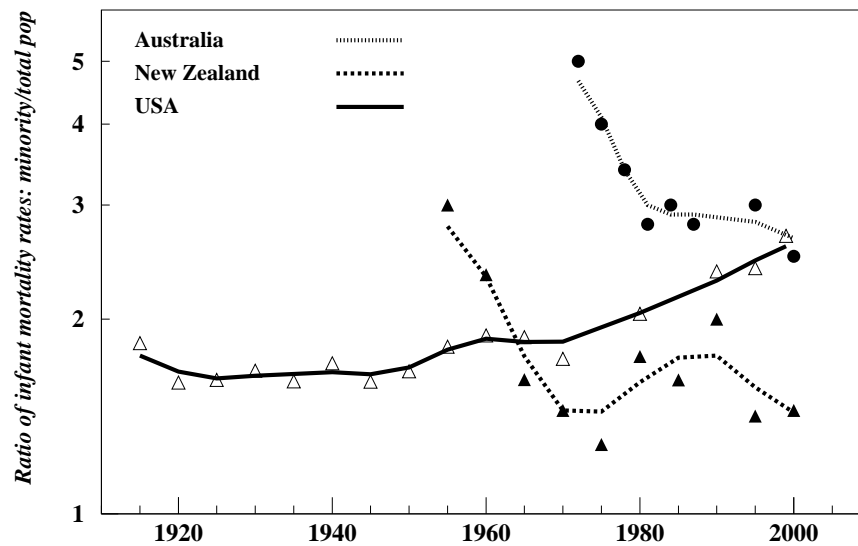


Fig. 3.4 Ratio of infant mortality rate of the minority to the total population for three countries. The purpose of the graph is to assess the progress in the degree of integration of the minority. Somewhat surprisingly, in spite of the success of the Civil Rights movement, there was little progress in the United States (at least in terms of infant mortality). *Sources: Statistical Yearbooks of respective countries.*

nesses all within the secured area of the complex. As this notion is fairly difficult to define precisely the statistics provided by the American Housing Survey are uncertain. However, an Internet key-word search (performed in mid-November 2008) shows that the expression “gated Community” is used quite commonly as a commercial argument by property developers. Here are the results obtained for different key-words:

- “gated community”: 3,870,000 websites found by Google
- “exclusive gated community”: 137,000 websites
- “upscale gated community”: 25,300 websites
- “charming gated community”: 4,600

The self-sufficient world of US Armed forces

Since the end of World War II military and veterans live in a world where many services are provided by the army: homes, stores, schools, hospitals, sport installations, vacation resorts, funeral services. In short, the personnel of the US armed forces lives in a kind of huge gated community.

The root of this privileged status can be traced to the Servicemen’s Readjustment Act of 1944 (also called GI Bill). Its main objective was to provide college education for the 14 million World War II veterans. Tuition was paid directly by the government to the chosen institutions of higher education. The veterans also received one year of unemployment compensation. In addition they were eligible for low interest, zero

down payment loans to buy homes and start businesses. Although the GI Bill served as a blueprint for subsequent legislation regarding the Korean or Vietnam wars those later bills were more restrictive. Nevertheless, they contributed to create a section of the American society which is a world in its own and they gave great influence to veteran associations such as the American Legion.

Deepening gap between employers and employees

In the private sector the unionization rate dropped from about 30% in the 1950s to 8% in 2007. As noted earlier, the role of labor unions has declined *in spite of* a fall in real wages. In other words the sharp decrease in the number of strikes can hardly be interpreted as an expression of satisfaction.

From the perspective of social segmentation it can be observed that the unions provided a bridge and means of communication between employees and employers. Their quasi-disappearance has cut off this link. In a sense the present trend can be seen as a return to the situation which prevailed during the 19th century. We do not yet see the high level of confrontation between workers and employers which marked this century but it is probably in the making.

Aging and underfunded transportation infrastructures

The Penn Central's bankruptcy in 1970 was the final blow to long-haul private-sector passenger train service in the United States. The troubled line abandoned most of its remaining passenger rail service, causing a chain reaction among other railroads. The federal government stepped in and, in 1971, created Amtrak, a virtual government agency, which began to operate a skeleton service on the tracks of Penn Central and other US railroads. After private-sector reorganization efforts failed, Congress nationalized the Penn Central under the terms of the "Railroad Revitalization and Regulatory Reform Act" of 1976. A subsequent attempt to create Comrail in 1987 lead to failure in 1999.

In short, there remain only few (fairly obsolete) lines for passenger transportation by train in the United States. As a result, transportation by car (including buses) and by air became the two most common forms of transportation.

The nation-wide bus system operated by the Greyhound company is efficient but it is slow and for some reason it is little used by middle-class people.

A good part of the road infrastructure is aging and deficient: 13% of bridges in the United States (i.e. about 80,000) share the same "structurally deficient" rating as the bridge that collapsed in Minneapolis in August 2007. In addition, an equal number are "functionally obsolete". Of course, to make sense of such data one would need to compare them with similar data in other countries.

Decline in the membership of social organizations

According to the website of a Christian organization that tries to encourage social gatherings³², in the late 1960s and early 1970s there has been a drop of about 40% to 50% in membership in all sorts of organizations: the PTA³³, the Elks Club, the Kiwanis Club, the League of Women Voters and the NAACP.

In “Bowling alone” Robert Putnam documents the loss in membership of many civic organizations. Putnam uses bowling as an example. Although the number of people who bowl has increased in the last 20 years, the number of people who bowl in leagues has decreased.

Putnam found that in time of economic depression as for instance in the 1930s, membership in social organizations experienced a marked decline.

Lack of communication between employees

Almost no indicators are available that could give information on the level of social cohesion among employees. There are even few qualitative assessments. The following testimony describes the evolution of interaction among Boeing employees. It was published in the Seattle Times on 30 July 2009³⁴.

“I recently worked for Boeing as a contractor on the 747-8. Before that I was in the IAM as a assembly mechanic on the 747 for 10 years starting in 1979. In between, I worked for many Boeing suppliers. When hired by Boeing back in '79, I was fully trained by experienced senior mechanics before being allowed to work on my own. When I recently returned to Boeing as a contract mfg engineer, I was shocked by how much this great company had changed over the last 2 decades. Gone where the experienced people. Foreign contractors were everywhere. **No one was communicating** and contractors hired to temporarily help **were shunned by the SPEA direct workers**. There is something very wrong at Boeing. Things have changed. In the 80's, Boeing was constantly cited as one of the best managed companies in America. No one is saying that now. Boeing workers hate their management and management has lost control of the workforce. Working at Boeing was a horrible experience and I left them.”

³²<http://www.sccquest.org/gatherings/fall05.htm>

³³• PTA: “Parent-Teacher Association”, a voluntary organization bringing together parents and teachers.

• Elks Club: “The Benevolent and Protective Order of Elks” (also often known as the “Elks Lodge” or simply “The Elks”) is an American fraternal order and social club founded in 1868. It is one of the leading fraternal orders in the US, claiming over one million members.

• “Kiwanis International” is a global organization of volunteers headquartered in Indianapolis, Indiana. It comprises approximately 8,000 clubs in 96 countries with over 260,000 adult members (2008). Kiwanis emphasizes service to children and youth.

• NAACP (pronounced N-double-A-C-P), the “National Association for the Advancement of Colored People” is one of the oldest and most influential civil rights organizations in the United States.

³⁴This comment contains several acronyms; here are possible meanings: IAM=Integrated Area Management, mfg=major functional group, SPEA=Service Platform Engineering Associates.

What is described is a lack of interaction among workers on the one hand and between employees and management on the other hand. Hiring temporary workers (who presumably earn smaller wages than permanent workers) is a hidden form of outsourcing. It may be cost effective but it is also a sure recipe for bringing about bad working relations. It is probably because the adverse impact of worsening labor relations cannot be easily assessed that management may expect the hiring of temporary workers to be a satisfactory solution.

At the time of writing (8 August 2009) and in spite of the fact that the “Dreamliner” was scheduled to make its maiden fly only in 2010, Boeing was planning to establish a second production line in South Carolina. The first production line is in Everett in the state of Washington which is the historical cradle of Boeing. For the management of Boeing one of the main advantages of the move would be that, in contrast to the plant in Everett, the one in South Carolina would be union-free. That would at least suppress the hostility between unionized and non-unionized employees.

Chapter 4

Triumph of neoliberalism in finance

“**Hoarding** has immobilized about \$1.5 billion [representing 18 billion in dollars of 2000] of the national gold supply and has caused drastic deflation and credit contraction. A dollar hoarded destroys 5 to 12 dollars in potential credit. A nation-wide pledge was given to President Hoover by business organizations to convince their membership that investment in government bonds are as safe as the government itself and that with the creation of the Reconstruction Finance Corporation [on 22 January 1932] there is less likelihood of bank failures.” (New York Times 7 February 1932 p. 1)

“**Credit crunch** pinches struggling companies. Corporations are in the grip of the worst credit crunch in a decade. The credit crunch is a collision between a slowing economy and the go-go days of just a few months ago, when it looked like almost any loan to a business was safe. The ability to raise cash has dried up for all but the most financially sound companies. It is likely to get worse before it gets better.” (USA Today, 5 January 2001)

The excerpts of these articles, one written during the Great Depression the other published during the recession of 2001 show that:

- Credit contractions are a major characteristic of most depressions and recessions.
- Credit crunches start unexpectedly and abruptly; this is particularly clear in the second excerpt. It was also true in February-March 1933 when a new wave of hoarding swept the United States in the weeks preceding the inauguration of President Roosevelt. (see below for more detail)

During the past two decades there have been (at least) 4 credit crunch episodes, namely: 1994, 1998, 2001-2002, and finally the one which started in August 2007 (more details below). Yet, the previous crises were much less serious as the last one. Of prime importance was the fact that the tricks implemented by the Treasury (e.g. injecting liquidity in banks, buying shares, lowering the Federal Reserve interest rate) which seemed to work so well in all previous crises, did not prevent big banks (such as Sears or Lehman Brothers) and financial institutions (such as Fannie Mae and Freddie mac) from facing bankruptcy. In other words, one should not ask why there was a crisis but why it turned out to be so severe.

In this chapter we examine the changes brought about in the financial sector by the neoliberal agenda. We will make this part fairly short for two reasons. (i) Much has already been written on the financial aspects of the crisis (ii) Because financial transactions involve many technicalities for which the required data are not always available, it is difficult to reach reliable conclusions.

Financial instruments are tools which can serve different purposes. Ultimately, of course, the main objective is to secure a high return rate, but this involves many different steps.

- Finance can be a powerful control tool. This is clear for holding companies. In this form of ownership a variety of firms are bought up, aggregated to larger corporations or partitioned into smaller companies and sold. Most often, this kind of strategy is dictated by the perspective of short-term financial profit.
- At macroeconomic level one can mention the requirements imposed on indebted countries by international organizations such as the World Bank or the International Monetary Fund. Usually, to get new loans, indebted countries were compelled to reduce budget deficit either by compressing expenses or by selling and privatizing profitable state-owned companies.
- Macroeconomic constraints often go hand in hand with control over the state's monetary policy.

Because such mechanisms are of ever increasing importance, we devote several sections to them. This leads us to a broader discussion of how countries can influence one another.

Aggravating factors

It can be argued that neoliberal reforms made the present crisis more serious than previous ones. Among the aggravating factors, one can list the following.

- The deregulation of existing financial markets that began in the 1980s compounded by the refusal to regulate in any way the new derivatives markets which came into existence after 1985 created an opaque world (largely based on deceit and graft as we will see); this was an important factor in the collapse of confidence in the summer of 2007.
- Over the past 25 years the number of tax havens has more than doubled to around 70 worldwide. Over the same period the volume of bank deposits held offshore in tax shelters has risen to \$ 11 trillion (The Observer 17 November 2002, Business section, p. 3).
- According to the recommendations of the Basle Committee, the debt-to-equity

ratio³⁵ of banks should not exceed 11 which corresponds approximately to a capital adequacy ratio³⁶ of 8%. Nevertheless, major British or American banks had a ratio which was substantially higher: the median debt-to-equity ratio of UK banks was 33 with a range from 18 to 65 (Financial Times 12 Dec 2008). In 2006, that is to say at least one year before the fall in their stock prices began, the average debt-to-equity ratio of the five major Wall Street Investment banks was 25, the highest was Morgan Stanley at 31, the lowest Merrill Lynch at 21³⁷. Even these inflated figures do not truly represent the level of indebtedness of banks because they were able to upload much of their debt to Special Purpose Entities that is to say basically straw institutions which they controlled but whose debt did no longer appear on their balance sheet, a technique that was also used by Enron Corporation with the consequences that one knows.

The present crisis is often referred to as the “subprime crisis” but this expression is inadequate and misleading. Subprime loans were also made during previous housing booms yet without the devastating consequences that we have seen this time. This statement can be illustrated and supported by several observations.

- The run on “Northern Rock”, a major English bank involved in mortgage loans, occurred in September 2007 that is to say at a time when UK housing prices were still in the up-going phase. Even US housing prices had at that time declined by only 5.8%. This suggests that the crisis was more a financial crisis than a housing crisis.
- What we wrote about credit card laxness at the beginning of chapter 3 (of the edition published in January 2001) became even more pronounced in subsequent years. Between 2000 and 2006, even though Americans’ real income was essentially stagnant credit-card borrowing rose by about 30% ; between 2003 and 2008 the profits of credit-card companies jumped 45%. Since credit-card companies, unlike most lenders, are allowed to change the terms of their loans at any time, people who borrowed money at, say, 9% may be required to pay 17% some time later. (The New Yorker 16 March 2009, article entitled: “House of cards”).
- During the real estate crisis of 1990-1995 housing prices in the west and north-east of the United States fell by about 40%, yet without major consequences for Fannie Mae and Freddie Mac the two big government sponsored entities. There

³⁵An important point is how equity should be estimated? For banks the standard definition is: $\text{equity} = \text{assets} - \text{debt}$. As an example, consider a bank who holds the following assets (in million of euros): (i) Cash: 10 (ii) Government bonds: 15, (iii) Mortgage loans: 20 (iv) Other loans: 55; and whose debt to depositors is 95. then the equity would be: $100 - 95 = 5$. In this example the debt-to-equity ratio would be $95/5 = 19$ and the equity-to-assets would be $5/100 = 5\%$. For publicly traded banks shareholder equity (that is to say stockmarket capitalization) can also be a fairly straightforward measure of equity. However, in times of panic when share prices of banks are in free fall such a measure becomes less reliable.

³⁶The capital adequacy ratio is the ratio of equity to an estimate of the assets at risk. In our previous example the risk for cash and government bonds would be considered zero, the mortgage loans at risk may be considered 50% of the total, while for “Other loans” 100% may be considered at risk. This gives a total amount at risk of 65 and a capital adequacy ratio of $5/65 = 7.7\%$.

³⁷Source: Company Annual Reports, SEC Form 10k

was only a 20% fall in their stock prices. On the contrary, during the present crisis their stock prices began to fall sharply in October 2007 at a time when real estate prices had fallen less than 7% and they were put in conservatorship (a status similar to receivership for banks) one year later in September 2008. At that time US real estate had experienced a fall of 9.1% that is to say much less than during the crisis of 1990-1995.

- Even banks which had no exposure to US mortgage securities (e.g. the Icelandic banks) experienced great problems which lead to their nationalization.
- By the end of 2008 for funds and other financial institutions the most “toxic” assets were OTC derivatives (OTC=Over-the-Counter) assets that is to say derivatives which were not standardized products issued by an exchange but products designed, created and sold by banks on a private basis.
- The globalization of financial risk sharing explains that the failure of a major American or British bank had worldwide consequences. Although the previous housing boom (and bust) was also shared by several industrial countries (Britain, France, Japan, Sweden, the United States) the bank failure remained confined. For instance, the failure of the Saving and Loans thrifts did hardly affect financial institutions outside of the United States.

These factors gave rise to numerous sale abuses. They all shared one common feature, namely that during a period which lasted several years and in some cases extended over several decades, such sales brought huge profits³⁸. In the following paragraphs we describe such a case in more detail.

Abusive sales of loan insurances This case is described in an article published in the English newspaper “The Independent” (17 March 2009); it illustrates how customers were deliberately misled by financial institutions. This problem was aggravated by the fact that regulatory agencies failed to take corrective action.

During the real estate boom in Britain well established financial institutions³⁹ sold protection insurance along with real estate loans. These insurances were supposed to cover house buyers in case of repayment difficulties due for instance to unemployment or illness.

There were two main abuses in these insurance contracts:

(i) the premiums (to be paid along with loan repayment) were very high compared with average market prices; it was estimated that their cost was five to ten times higher than what it should have been. For a mortgage a typical annual premium was about 400 pounds.

³⁸With rates over 50% and in some cases, such as the one described below, over 500%.

³⁹They are *not* identified in this article; however another source names: Alliance & Leicester, Barclays, the Lloyds Banking Group which includes Lloyds, Halifax and Royal Bank of Scotland, Regency Mortgage Corporation.

(ii) the contracts contained conditions which in practice would prevent any claim. For instance, people were warned that any pre-existing health problem would invalidate the guarantee even if the claim was made for a reason not related to health problems. Thousands of complaints have been filled (at a rate of 800 per week) in 2008-2009.

The Financial Service Authority (the British financial watchdog) did not take any action until early 2009. This is all the more revealing because the problem was identified by the FSA as early as November 2005 (see the FSA press release of 5 November 2005 particularly the section entitled “FSA calls on industry to improve sales practices urgently”). Some institutions were fined (e.g. a subsidiary of HSBC in January 2008 and Alliance & Leicester in October 2008) by the FSA⁴⁰. Yet no decisive action was taken until February 2009 when the FSA prohibited the selling of loan insurances in which the premium is paid in total at the start, the so-called single premium contracts⁴¹.

Many of the problems listed above have been identified by lucid economists or even by the media. For instance the hefty bonuses and “golden parachutes” (bonuses for executives who leave a company after it experienced serious problems) doled out to top employees have raised protests in newspapers since 2001 but without any real effect.

Similarly, the Sarbanes-Oxley Act of 30 July 2002 tried to correct some of the abuses revealed by the Enron bankruptcy. On account of what happened in 2007 and 2008 (which had many similarities with the Enron case in terms of opacity and deceit) it seems that this law was largely ineffective.

This episode suggests that the problem will not be solved just by passing new laws. Unless the balance of power between reforming forces and lobbying groups changes, little will be achieved.

In summary, it can be said that the crisis which began in July 2007 was not qualitatively different from previous crises. Credit crunches, subprime mortgage crises, real estate downturns or collapses in some derivatives markets had occurred in the past. What was new was the fact that these problems occurred simultaneously.

Greater segmentation

The changes that we described in the previous section may seem fairly diverse. Yet they have one common characteristic. They brought greater segmentation in financial

⁴⁰These fines were in the million pound range whereas the earnings from single premium insurances were in the billion pound range.

⁴¹More specifically, in such policies the entire premium is added to the loan as a lump sum and interest is charged on it.

markets in the sense that the “distance” between the agents who subscribed a contract and the institution supposed to carry out the service described in the contract increased sometimes to the point of leaving the realization of the contract suspended in thin air. Several examples of such segmentations are given in a very interesting book by Frank Partnoy (2003).

- Remember that credit default swaps are a kind of insurance against the default of a borrower. Because there were no disclosure requirements it was often impossible to know who ultimately held the contract (on the secondary market the contract could be sold just like a bond) and would fulfill the service specified in the contract⁴².

- In a sense structured finance and securitization are modern versions of a fairly common practice namely transferring the rights to payments owed by borrowers. As an illustration let us consider the case of General Motors which grants low interest loans to its customers. When the rights to such car-lease payments (i.e. what the car owner will repay each month) are transferred to another company or investor (let us call it C) this becomes a securitization process. For General Motors the big advantage is that these loans can be taken off its books.

There is a downside however. General Motors has some information regarding its customers which may allow it to estimate their capacity to repay the loan. Ideally, one may think that this information can also be transferred to C . Yet, observation shows that a good deal of information is lost in the process. For instance, C may be a financial company which has not working understanding of the specifics of car-lease loans. The result will be that the ability of car buyers to repay their loans will become an abstract financial notion. The link between the quality of the debt and the financial situation of the debtors has been severed.

Of course, this problem is amplified when the rights to payment are resold by C to another company D , by D to E and so on.

- Following the bankruptcies of Enron (end of 2001) or WorldCom (July 2002), the bankruptcy fillings showed that these companies had several hundred creditors. Twenty years earlier companies of similar size would have had at most a dozen creditors (Partnoy 2003, p. 377). This was the direct result of the fact that new financial tools allowed risk to be spread on a larger scale. But again this resulted in loser links between borrowers and creditors.

These three examples illustrate a general trend toward greater segmentation. Similar trends have been described in previous chapters in the social and economic spheres.

In the last two sections we listed a number of factors which explain at least quali-

⁴²In the case of a bond this can hardly happen because the persons who ultimately hold the bonds when they come to maturity know which institutions have issued the bond and they will demand payment. For CDS one has the opposite situation in the sense that the last holder has to pay for the defaulted loan.

tatively why the present crisis is more serious. However, one has to recognize that qualitative explanations are not really satisfactory. The real goal would be to be able to predict the *magnitude* of the crisis. To do this, one has to rely on a comparative analysis of other major crises with the handicap that there are of course only few crises of such a magnitude.

How can one follow the buildup of a speculative episode?

Speculative price peaks for stock or housing prices can be identified fairly easily.

Stocks

For stocks it is well known that in a long-term historical perspective the time-average of the ratio of share prices to annual dividends⁴³ which are distributed to shareholders is on average around 20. Once the average price-to-dividend ratio of a stock market becomes higher than 30 or 40 and continues to increase one can be almost certain that such a situation will sooner or later become unstable and lead to a downturn. Although it is difficult to predict at what point the downturn will occur⁴⁴ one can be almost sure that it will happen.

Real estate

In real estate markets the analog of the price to dividend ratio is the ratio of the price of a house or an apartment to the annual rent. It turns out that the long-term historical average of the price to rent ratio (PRR) is also in the range 15-20. During speculative episodes prices usually increase much more quickly than rent levels which means that the PRR will go up. During a speculative episode, housing prices can double⁴⁵ which implies (if we assume that the rent did not increase faster than the consumer price index) that the PRR may have jumped to about 35. Another illustration was provided by Hong Kong between 1993 and 2001. From 1993 apartment prices were multiplied by 2.3 In this case data for rent changes are available and they show that the PRR increased from 15 to 25. After the downturn of 1998, both the price and the PRR fell back to their initial level of 1992⁴⁶.

Can this level of 20 for the PDR or PRR be given a more intuitive interpretation? A PRR of 20 means that the annual rent represents $1/20=5\%$ of the price. In other words, the yield of the investment will be 5%. What gives a special importance to

⁴³The so-called price-to-earnings ratio (or PER) is also commonly used; however, if one wishes to consider this question not from the perspective of the company but rather from the investors's point of view, then it is more natural to use the price to dividend ratio (PDR).

⁴⁴One can remember that just before the downturn in March 2000 the PER of the NASDAQ market was close to 200.

⁴⁵In London between 1996 and 2007 housing prices adjusted for inflation were multiplied by 3. This is a fairly exceptional case however.

⁴⁶A graph of these variables can be found in Maslov et al. (2003, p. 1443).

this figure is the fact that the long-term historical yield of investment grade bonds is also about 5% ⁴⁷. On the basis of this 5% yield of bonds, the 5% yield of shares or apartments can be seen as a result of an arbitrage process. When the yield of real estate falls below 5% investors may prefer to hold low risk bonds (for instance Treasury bonds). In other words, the 5% yield will represent a kind of (long-term) equilibrium state. For a while the speculative episode may feed itself on capital gains, but capital gains are inherently unstable in the sense that any price fluctuation may be amplified and bring about the collapse of the bull market.

Pushing the question somewhat further one may wonder what reason may explain the fact that the long term average of bond yields is of the order of 5%? If one admits that the inflation rate is low enough to be neglected in our calculation, then an interest rate of 5% will provide an annual return of 5 cents on an euro. To get a return of 100 cents on an euro will take 20 years. If the inflation is not low enough to be neglected but not over 2% then it may take about 30 years to get a return of 100 cents on a euro. In short for a 20- or 30-year bond the total of the coupon payment will be almost equal to the capital. Twenty or thirty years represents the time length between two generations. At this point it is difficult to give a more accurate justification of this connection. One can only speculate that in a virtual population in which the time length between two generations is 2 years the “natural” interest rate would be 50% rather than 5%.

Coming back to the financial crisis, one may wonder what insight can be gained from the previous considerations. There were two major components in this crisis, real estate speculation and derivatives trading.

- For real estate the situation is fairly clear in the sense that there were recurrent price peaks as shown in Fig. 4.1.

The mechanism outlined previously provides a fairly natural explanation for the succession of these episodes. Everytime that for some reason (low interest rate, substantial rent inflation⁴⁸) there was an acceleration in real estate trading this opened the way for a new speculative episode. It can be noted that this graph is restricted to the West of the United States; this is because prior to 2000 the real estate markets in different regions of the United States were not synchronized; thus the national price average does not show a clear pattern as does Fig. 11.1. By the way, the synchronization which came about after 2000 was certainly a factor which made the crisis more serious.

Bonds

⁴⁷As the price of investment grade bonds, that is to say low risk bonds, is usually not very different from 100, this means that the coupon rate is of the order of 5%. For more details see Macaulay (1938).

⁴⁸For instance, the rapid development of the buy-to-let market was an important factor in the London housing bubble. It pushed up prices but at the same time it depressed rents which resulted in a low return and a high PRR.

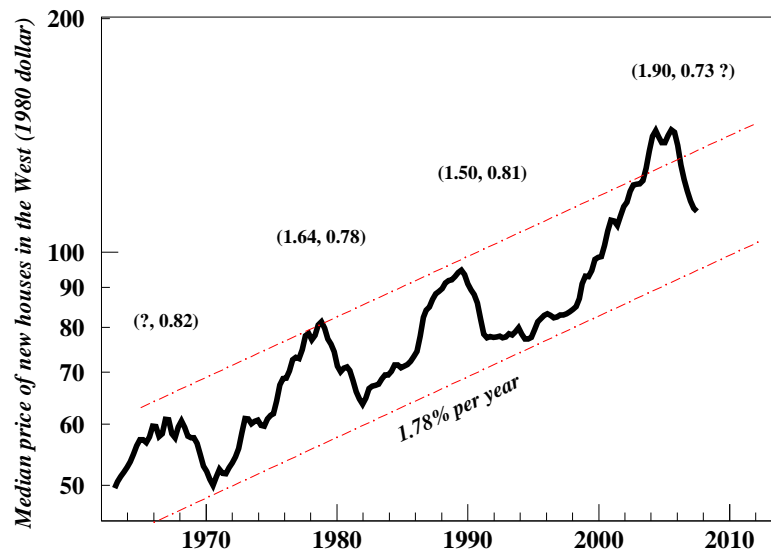


Fig. 4.1: Median price of new houses in the West of the United States. The two numbers above the peaks give the amplitude of the peak (the ratio of peak price to initial price) and the amplitude of the fall in the downgoing phase (ratio of trough price to peak price). The whole curve has been smoothed using a three-year centered moving average. The value 0.73 for the last peak is based on a prediction made in Roehner (2006, p. 179). *Source: U.S. Bureau of Census*

For bonds the analog of the price to rent ratio is simply what is called the yield which is defined as the ratio of the nominal rate of the bond (also called coupon rate because this percentage is printed on the bond's coupons) to the price of the bond on the secondary market (it is called "secondary" to emphasize the difference with the "primary market" when the bond is offered to investors for the first time).

For investment grade bonds the price usually remains confined within fairly narrow limits (e.g. 95 to 105). For this reason neither the price nor the yield are good indicators for stress in bond markets. A better indicator is the difference between the yield of corporate Baa bonds and the interest rate of Treasury bonds (of same duration). This indicator is referred to as the corporate bond - Treasury spread. Moody's rating scale which range from AAA for the most secure (e.g. Treasury bonds) to C corresponding to a bond almost in default is divided into two classes: the upper class from AAA to Baa corresponds to investment grade bonds while the lower class from Ba to C corresponds to speculative grade bonds. Thus the Baa – Treasury spread is an estimate of how more uncertainty Baa bonds carry as compared with Treasury bonds.

The graph below shows that every time there was stress in financial markets (for insistence as a result of a series of major company failures) the spread became larger. The peak which occurred in the fall of 2008 was particularly high. Over the period 1962 to 2008 the highest peak had been in early 1983 when the spread reached 4%.

The fact that the peak of fall 2008 was 2 percentage points higher underlines the gravity of the present crisis. In early 2009 the spread was narrowing but this does not necessarily mean that it will not climb again in coming months. For instance during the period 1980-1984 there were several ups and downs: in mid-1980 the spread reached 3%, then it decreased to 1.5% ((mid-1981) before climbing to 4% and then falling to 1.2% in mid-1984.

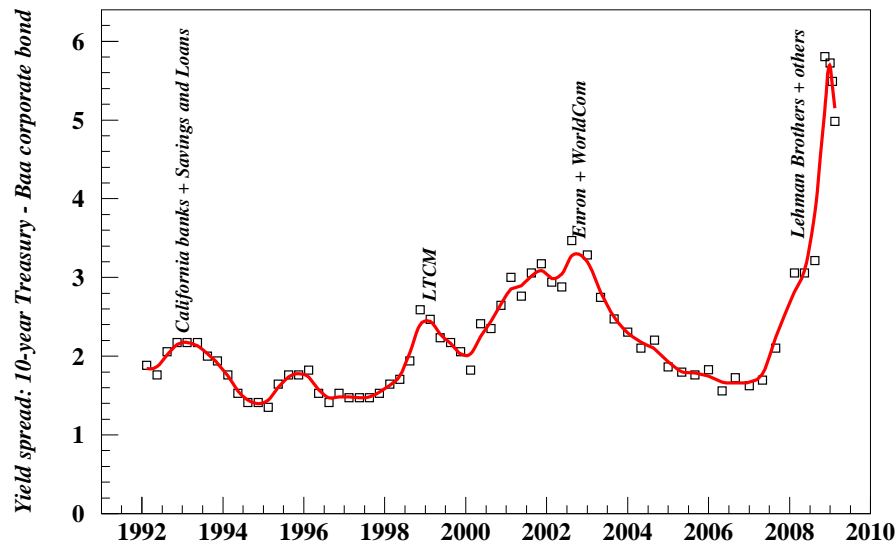


Fig. 4.2 Spread of investment grade bonds over Treasury bonds. The spread is the difference between the yield of Baa corporate bonds and the yield of 10-year Treasury bonds. As Treasury bonds can be considered a securities with no uncertainty, the spread represents the equivalent in terms of yield of the uncertainty attached to Baa corporate bonds. The graph for speculative grade bond yields minus 10-year Treasury yields has the same shape. It reached 20% in the fall of 2008 and then declined to 16% in early March 2009. *Sources: Graphs and data for spread (Internet)*

Derivatives

A common feeling is that the present crisis has been aggravated by distrust in complex derivatives. Thus, a natural question is whether one can find an indicator which would permit to estimate the degree of speculation that prevailed in the derivative market. This not an easy question however.

There are many sorts of derivatives and they are traded in many different places especially if one includes over-the-market derivatives. In addition, because many of these products are fairly new there are few good sources. This is why it is difficult to get a clear picture of the return of such transactions. Although it is possible to give some quantitative elements, it will be seen that they raise additional questions.

As is well-known there was a multiplication by 10 in total world derivatives outstanding contracts during the 10 years from 1998 to 2007. How should one interpret such a rapid development? One factor was certainly that derivatives were were prof-

itable especially in the 1990s. But why were these products so profitable? After all they were only traded by trained persons (e.g. fund managers, hedge fund traders); why were they willing to buy at a price which gave a return of 30% (or even higher) to sellers. This is hardly the mark of an efficient market. One reason may have been that trading in complex derivatives allowed pension funds or insurance companies to make (in a oblique way) transactions in risky products they were not allowed to make by law. Thus, one can understand that to some extent they were willing to overpay the derivatives.

According to another “theory”, the huge increase in the volume of transactions was a parade against the decline in the profit rate of individual transactions. But before such a thesis can be accepted one would need at least some data documenting the decline of profit rates in the course of time. It is true that the ratio of market values to notional amounts fell from 3.1% in 2001 to 2.2% in 2007 (Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007, 19 December 2007), but this cannot be considered as a convincing proof of a fall in the rate of profit.

Spreading neoliberalism: overlords and vassals

According to the Collins online dictionary a tribute is a payment made by a state to another, usually as an acknowledgment of submission. In feudal societies it was the amount of money paid by a vassal to his lord.

Dollarization

A modern version of the tribute is the seigniorage paid to an overlord country *A* by a country *B* who uses the currency of *A*. *B* is usually either a small country who is politically under the influence of *A* or a country which experienced economic troubles (e.g. high inflation rates or inability to repay its debt) and had to ask for the help of *A*. The notions of seigniorage, full dollarization, unofficial dollarization, full currency board that will be explained in this section provide an insight into the international implications of free capital markets at the level of central banks and national currencies. But first of all, in order to make this more concrete let us give an illustrative example.

Dollarization in Ecuador

- March 1999: Ecuador is in trouble. The country’s 39 commercial banks, the targets last week of huge withdrawals by depositors who feared the banks were on the verge of collapse, had to close until the situation improves. Earlier austerity moves had frozen salaries of public workers and ended subsidies on gasoline. Since January 1999 the value of the sucre, the national currency, has fallen in dollar terms by more than 40 percent, with most of the decline occurring last week. President Mahuad, a Harvard-educated lawyer, plans to increase the value-added tax from 10% to 15%, a measure that has drawn strong opposition from the Chamber of Commerce whose president declared: “You do not build a

country with more tax increases”.

There had been speculation that the president might follow the path taken by Argentina and decree either parity between the sucre and the dollar or outright “dollarization,” in effect abandoning the sucre altogether. He did not take such a step, but said it is possible he may do so later.

(New York Times: 13 March 1999)

- **Ecuador, January 2000** In 1999 the economy contracted more than 7% and the country defaulted on about half of its \$13 billion foreign debt. From Jan. 5, 1996, through Jan. 14, 2000 the Ecuadorean currency declined 88% against the dollar President’s Mahuad’s decision to abandon the currency, the sucre, in favor of the dollar won the support of banks and many business groups. The essence of the government’s program is to replace the sucre, named for Ecuador’s national hero, Marshal Antonio Jose de Sucre, with the US dollar.

Yet, in the rest of the country there is little support for this decision. Even the military, which has supported Mr. Mahuad in past crises, has offered only lukewarm support. The president of the Central Bank, his top two deputies as well as the bank’s assistant manager resigned to protest the president’s decision.

The new currency plan is a major setback for the International Monetary Fund. An agreement was in sight for a \$250 million loan. After the president’s decision the managing director of the IMF, Michel Camdessus, issued a terse declaration.

Apart from Panama whose currency is the dollar since 1903, many Latin American nations already rely on dollars, to one degree or another. In Peru customers in many supermarkets can pay in Peruvian soles or in dollars. According to a World Bank official, in Argentina, a lot of the costs of dollarization have already been incurred, so the step to full dollarization would not be great. According to an economist full dollarization eliminates devaluation risk, and, consequently, will likely result in interest rates which are both lower and less sensitive to crises elsewhere.

Dollarization means that the interest rate will be set by the Federal Reserve in the same way as the interest rate in the eurozone will be set by the European Central Bank. Alan Greenspan, the chairman of the Federal Reserve, made clear that the monetary policy of the Fed would *not* take into account cyclical differences between dollarized countries and the United States. For instance an interest rate hike, intended to slow expansion of the American economy, might send Ecuador into recession.

In times of conflict the United States may use the dollar as an economic weapon, withholding currency from an intractable government to bend it to Washington’s will. Indeed, the Bush administration took just that step against Panama as part of its effort to overthrow General Manuel Noriega.

Seigniorage is the difference between the production cost of coins and bills (which is low especially for bills) and the revenue obtained by the central bank by selling the currency to banks. In other words it is the revenue generated by issuing new currency. In the case of Ecuador, seigniorage represents \$30 million a year. With dollarization in effect the Ecuadorean government will have to buy the dollars from the Federal Reserve. (New York Times: 11 January 2000, 12 January 2000, 18 January 2000)

- The collapse of the Mahuad government began on 21 February 2000 when Indian protesters marched on the national Congress in Quito. A military unit assigned to guard the building instead stepped aside, allowing Mr. Vargas and his supporters to enter and proclaim the overthrow of Mr. Mahuad and the dissolution of Congress. Deposed president Mahuad was replaced by the the vice-president, Mr. Noboa who also favors dollarization.

(New York Times: 23 January 2000)

The episode of the shift to the dollar in Ecuador clearly suggests that such a move may not be welcomed by the population. Yet, for different reasons the period 1999-2001 seemed a good time for the dollarization of Latin American countries.

(1)) The euro was introduced in banking and foreign exchange transactions in

January 1999 and for the general public in January 2002. This set an example which, quite understandably, the United States were tempted to follow by creating an integrated American market in which the dollar would be universally accepted. NAFTA (North American Free Trade Agreement) came in effect in 1994. In this respect, one should recall that between 1946 and 1956 the United States greatly encouraged the formation of a political and economic union in the wake of the formation of NATO which was itself a response to the Warsaw Pact⁴⁹.

(2)) The crisis of 1997-1998 in South-West Asia and in Russia has shown the devastating effects from speculation in currencies especially for small economies (one may recall that China was little affected). Dollarization has many drawbacks but one cannot deny that it provides a protection against speculation.

(3)) Back in 1999 just before the decline of the NASDAQ market American prosperity was at a peak. This was the time of the “New Economy”. As a result, the free-market ideology advocated by US economists was still in favor with most Latin American economists and political leaders. The collapse of the Argentinian economy was still in the making. Ecuador had shifted to dollarization in 2000, El Salvador in January 2001, and it was expected that Argentina, a much larger economy, would soon follow suit. As observed in an article published in the New York Times on 25 November 2000, these events reflected “a growing trend in Latin America to embrace the dollar as official tender”⁵⁰. Indonesia explored setting up a currency board based on the dollar in February 1998 but was convinced not to do so by the International Monetary Fund (New York Times 20 February 1998).

In January 1999, Rudiger Dornbusch, an economist at the Massachusetts Institute of Technology made the following observation: “In this environment it is increasingly ridiculous to argue that every country must have its own central bank. Currency sovereignty is the right to have stagnant growth”. The same article also says that Argentina was better positioned than its neighbors to rebound quickly, in part because outside investors have faith that if they invest they will not face the risk of devaluation before they get their money back. At that time some Brazilian economists were considering whether to follow Argentina’s lead by linking the real to the dollar. (New York Times 2 January 1999).

One year later Professor Steve H. Hanke, an advocate of dollarization who served as a senior economist on president Reagan’s Council of Economic Advisors, observed: “The only way to extinguish the frequency and reduce the magnitude of recurring

⁴⁹The formation of an European Defense Community was energetically encouraged by Secretary of State John F. Dulles. To no avail eventually.

⁵⁰The article notes that “El Salvador’s decision to adopt the US dollar as its currency won immediate support from the United States Treasury Department”, an attitude in sharp contrast with the neutral wait-and-see attitude about dollarization in Ecuador one year earlier.

currency crises is to put these little half-baked central banks out of business.” (New York Times 23 January 2000).

**Table 4.1 Articles about dollarization
in the New York Times (1981-2008)**

	1981 – 90 article/year	1991 – 2000 article/year	2001 – 05 article/year	06 – 08 article/year
Dollarization	1.0	2.7	1.8	0.31
Currency board	0.2	9.1	3.0	0.30

Notes: The table shows that both dollarization (i.e. adopting the dollar as national currency) and the establishment of currency boards (a milder version of dollarization) attracted US interest in the period 1991-2005. After 2006 these issues were dropped.

Source: The data have been obtained by using the key-word search engines available on the website of the New York Times.

Currency board

Hong Kong did it in 1984. Argentina in 1991. Estonia in 1992 and Lithuania last year. Soon, El Salvador and Jamaica might do it. Brazil is studying it. And even Mexico sees it as a possible path to financial stability.

“It” is the adoption of the currency board.

Last year, Lithuania pegged its lita to the United States dollar and has seen its foreign exchange reserves increase by 10 times. A currency board makes sense for Mexico because of its economic integration with the United States through the North American Free Trade Agreement. (New York Times: article of 5 February 1995 entitled “A Strong Leash for Currencies on a Rampage”)

Under the currency board system a country establishes a peg with an anchor-currency (e.g. dollar, euro or yuan). Countries that adopt such a system abandon monetary sovereignty to the central bank of the anchor-country which means that interest rates and supply of money are decided abroad. The sole responsibility of the country is to defend the value of the local currency at the fixed exchange rate, which can only be changed by Congressional action (in the case of a currency pegged to the US dollar). In short, the only difference with dollarization is that the country nominally retains its currency and the central bank (which becomes a completely passive institution) still receives seigniorage revenue by selling coins and bills to banks.

For obvious reasons the US administration has been very reluctant to openly advocate currency board systems. Yet, because their adoption strengthened the power of the Federal Reserve, it was regarded with favor by neoliberal economists as attested by the following excerpt from an editorial published in the “National Review” (22 December 1997):

Instead of abdicating responsibility, Treasury Secretary Robert Rubin should be promoting American interests.

- First, he should press the self-strangled Asian economies to adopt market-liberalization measures (as, indeed, Taiwan is doing).
- Next, he should endeavor to restore long-term monetary stability in Asia. Ideally, that would mean persuading smaller Asian economies to adopt a full-scale currency board, in effect unifying their currencies with the dollar. That would be better than IMF loans pegged to tax hikes.

The tone of the article of 1994 cited at the beginning of this section suggests that the multiplication of currency board pegged on the dollar is seen as a favorable development by the author⁵¹.

The aftermath of the Argentinian collapse

The decade 1990-1999 marked the high tide of the adoption of the neoliberal agenda in Latin America under leaders such as Carlos Menem (Argentina) who introduced a de facto dollarization in 1992, Fernando Collor (Brazil), Patricio Alwyn (Chile), Carlos Salinas de Gortari (1988-1994), Ernesto Zedillo (1994-2000), Vicente Fox (2000-2006), three successive presidents of Mexico⁵², Luis Alberto Lacalle (Uruguay), Carlos Andres Perez (Venezuela). In June 1990 US President George H. W. Bush announced the “Enterprise for the Americas Initiative” with the goal of achieving hemispheric free trade by 2000. NAFTA (North American Free Trade Agreement) which came into force in 1994 marked the first major step in that direction.

The collapse of the economy of Argentina was a watershed. The implementation of the neoliberal agenda had begun after the military took power in March 1976. On the agenda were wage freezes, deregulation, free trade, privatization⁵³, endless borrowing (and escalating foreign debt). For a while de facto dollarization (1991) lowered inflation, attracted foreign investors and boosted growth. Argentina became a show-piece of neoliberalism and globalization. As the IMF’s star pupil, the country received huge credits (in the early 1990s it was the world’s fourth largest recipient of foreign funds). But the debt-driven economy began to crash in 2000.

⁵¹The article goes on to say that “after the Hong Kong dollar was pegged to the United States currency calm was restored and capital flight arrested”. Well, this was written in 1994, but in the fall of 1997 a huge wave of speculation tried to break the peg between the Hong Kong dollar and the US dollar. This episode suggests that currency boards are not a sufficient safeguard against speculators.

In an article published on the website of the Cato Institute (4 June 2003) Professor Hanke goes to the point of recommending an “orthodox currency-board rule” for China (PRC). Under such a proposition supply of money and exchange rates would be fixed mechanically without leaving any room for monetary policy.

⁵²Salinas was a graduate of Harvard, Zedillo of Yale, Fox of Harvard; Fox had also been an executive and President of Coca Cola Mexico from 1964 to 1979. These personal links with the United States translated into friendly diplomatic relations; it is also an illustration of the importance of universities like Harvard, Columbia and Yale as “nurseries” of heads of foreign governments.

⁵³On 6 September 1992 the New York Times ran an article entitled: “The big push toward privatization in Argentina”

In a sense the mechanism of the crash was not very different from what happened in 2008 in Britain, California, Dubai, Iceland, Ireland and East European countries: credit scarcity slowed down the debt-driven economy and led to the failure of over-leveraged banks; this, in turn, brought about withdrawal of funds invested on a short-time basis and pushed unemployment to high levels. During the Argentinian crisis unemployment reached 22%.

Historical roots

The first attempt to establish a currency board seems to have occurred in 1849 in the British colony of Mauritius in the Indian Ocean. In 1912 the system was extended to Western Africa and in particular to Ghana and Nigeria with the creation of the West African Currency Board.

Such systems in which the monetary policy of a country is under the control of another was not confined to colonies, it was also used when countries defaulted on their debt. In such cases one (or several) representatives of the creditor nation got a seat (and a de facto veto right) in the central bank committee of the debtor nation. Such a procedure can be seen as an adaptation to the case of a whole country of the receivership procedure which is used in the United States for bankrupted companies. In the receivership procedure an administrator who represents the creditors takes the direction of the board until the company is able to emerge from bankruptcy.

Such a system was used recurrently by Britain and the United States in Latin America. Several cases of this kind are described in an interesting and well documented book by Nearing and Freeman (1926).

Foreign economic aid as a control tool

As one would suspect, foreign economic aid is rarely granted with no strings attached. Aid programs run by the US Agency for International Development (USAID) or by other government or semi-government organizations are often suspended when a country falls out of favor with the Department of State. This can be illustrated by the following example.

On 18 June 2009 the board of the “Millennium Challenge Corporation”, a US government development fund, announced that it would cut \$62 million from a program for Nicaragua. In its comments, the organization cited concerns about democracy and free market economy. The aid had been granted back in 2004 when current President Daniel Ortega was in the opposition. One remembers that the Sandinist government of president Ortega had already been a target of US covert operations (support to the guerrilla war waged by the anti-Sandinist Contras) in the Reagan years before it left power after the elections of 1990. The suspension of the aid interrupted construction work on three highways and hurt many Nicaraguan people. It

was announced that Venezuela would provide replacement aid through the “Bolivian Alternative for the Americas” (Xinhua News Agency 20 June 2009).



Fig. 4. a: Logo of the US Agency for International Development. Following in the footsteps of the Marshall plan, the USAID was created in 1961 by the Kennedy administration. With an assistance of \$18 billion in 2004 granted to Iraq, the USAID has been a major partner in the occupation of this country. In 2008 the USAID had a budget of about \$40 billion.



Fig. 4. b: Logo of the Millenium Challenge Corporation. Created in 2003 by President Bush, this organization (also referred to as the Millenium Challenge Account) grants aid to countries selected on the basis of neoliberal criteria. The organization has a budget of about \$2 billion.

Countries which are granted aid by the MCC are selected on the basis of set of indicators among which is the “Trade Freedom” indicator created by the “Heritage Foundation” and the Wall Street Journal; in so doing, the MCC contributed to promote the neoliberal agenda in the poorest countries.

It is clear that other countries than the United States also have programs of foreign economic assistance, but through their sheer magnitude the programs run by the United States dwarf all others. Together with the monetary policies that we discussed above, these programs shape the political orientation of the poorest countries. In the next section we discuss other ways and means aiming at the same objective.

Other forms of oversight and control

The establishment of a currency board gives a country *A* control over the monetary policy of a country *B*. Of course, other forms of oversight and control are possible particularly in the political, cultural and social spheres. The question is of interest for our purpose in so far that it helps to explain how the neoliberal agenda has been adopted on such a large scale and in a relatively short time span. The thesis that we present below could be discarded as being nothing more than a new version of conspiracy theory. Of course it is very difficult (perhaps even impossible) to separate exogenous influence from endogenous factors. What makes it possible to test this thesis in a scientific way is the fact that we can study it on *many different cases*, thus it becomes possible to identify regularities and to make predictions. If these predictions turn out to be correct, it will show that the thesis may hold some truth.

The phenomenon has its roots in the years after World War II. In the wake of the

American occupations that took place in many defeated countries as well as in a few Allied or neutral countries⁵⁴ the State Department was able to favor the emergence of governments, political parties, newspapers, radios (and later TV channels) who were both anti-Communist and friendly to American interests. In defeated countries such as Germany or Japan this was done through the tight control imposed on the governments which emerged during the occupation and behind the curtain of censorship. The purges performed in Germany and Japan offered an excellent opportunity to select people and ensure their lasting loyalty. In countries such as South Korea (or the Philippines) which were liberated countries this was done under the cover of martial law and military administration established to counter the Communist threat⁵⁵.

The occupations lasted about 6 years⁵⁶. It should be noted that this was a much longer time span than in previous conflicts. After the defeat of France in 1815 and 1871 the foreign occupation lasted only 1 or two years and during this time there were very few (if any) attempts to control the French administration.

How was it possible to extend the post-war control to the period after the occupation. An obvious answer is that even after the occupied countries regained their independence, they remained dependent on the presence of American troops for their defense. This was of course the case in Germany, Japan and South Korea but also in Britain, France (until 1967), Italy and Turkey. It is well known that in Japan the Liberal Democratic Party (LDP) has been in power almost continuously since its formation in 1955. It is also known that from the 1950s through the 1970s, the American Central Intelligence Agency spent millions of dollars in attempting to influence elections in Japan to favor the LDP against more leftist, less pro-American parties, such as the Socialists and the Communists, although this was not revealed until the mid-1990s when the New York Times exposed it⁵⁷.

In fact, to invoke the influence of the CIA is to take a narrow view. The bottom line is that a country which relies on another for its defense must follow the lead of the latter at critical junctures. This was the gist of the partnership between vassals and their overlord.

An episode which occurred in France in 1946 is quite revealing in this respect. During a crucial political meeting for the formation of a new government a motorcyclist delivered a message from General Billotte, deputy Chief of Staff, which said that “a

⁵⁴e.g.: Germany, Iceland, Italy, Japan, South Korea, Turkey.

⁵⁵This is true for South Korea but even in the Philippines there were guerrilla groups which fought the domination of big landlords. In China a similar struggle took place which however had an opposite outcome.

⁵⁶More details can be found in Roehner (2008), a book about the occupation of Japan.

⁵⁷Source: [http://www.fact-archive.com/encyclopedia/Liberal_Democratic_Party_\(Japan\)](http://www.fact-archive.com/encyclopedia/Liberal_Democratic_Party_(Japan)) Of course, such actions were not limited to Japan. For an enlightening description of the influence of CIA agents (i.e. nationals who were serving the objectives of the CIA in exchange for money or for support in their professional or political carrier) in Latin America see Agee (1975)

Socialo-Communist government would be seen as a threat by our Allies; as a result they may consider reducing their commitment to guarantee our security” (Demory 1995). Similar pressure was applied during the crisis which preceded the return to power of General de Gaulle in 1958 at least until this return was eventually endorsed first by President Eisenhower and finally by the State Department. There are similar examples in Germany, Japan and the United Kingdom. For instance since the end of World War II the UK has been relying on US-made Polaris and Trident missiles for its nuclear submarines. Moreover, the information sharing agreement between British and US intelligence agencies translates into an unequal partnership because of superior means and funding on the American side⁵⁸.

In countries such as Austria, Germany, Italy, Japan or South Korea which were occupied by Allied forces⁵⁹ two of the most effective means to maintain a lasting influence beyond the occupation period were the following.

(1) One of the first objectives of the occupation forces was to identify, investigate, neutralize and control the intelligence and counter-intelligence agencies of the defeated countries. Subsequently, when the country emerged from occupation status and tried to built up a new intelligence structure the close links established with American (or British) intelligence ensured that this structure would have close links with US intelligence. But this was an asymmetric relation which bordered on outright dependence. This point is illustrated in an article by Siegfried Beer (2003, section “Intelligence cooperation or dependence”). Beer’s article concerns Austria but there is little doubt that the same situation prevailed in other occupied countries⁶⁰.

(2) It often comes as a surprise that German or Austrian people who had played a substantial role during the Third Reich nevertheless came to occupy important positions in the post-war era in organizations controlled by the US. As is well known German people had to fill in questionnaires (called “Fragebogen” the German word for questionnaire) In the American Occupation zone, the requirement to complete Fragebogen extended to all those over the age of eighteen⁶¹. This gave the Allies an extensive data base about positions occupied by Germans in Nazi or military organizations. Moreover, records of war crime trials was another source of information. Needless to say, that information could be used by the Allies to exercise pressure on individuals. Incriminating information could be “forgotten” or “withheld” for pliant people or it could be “reactivated” for the purpose of embarrassing persons who had a tendency to go in the wring direction. In other words, the existence of self-

⁵⁸Other ways and means for keeping a handle on public opinions are described in Roehner (2007, p. 145-149).

⁵⁹Naturally, a similar argument can be made for countries occupied by the USSR but in order to get a clear insight into these cases one must be able to read Russian.

⁶⁰Beer writes: “There can be absolutely no doubt about the fact that the beginnings of Austrian intelligence after World War II were marked by heavy, almost intolerable dependence on foreign influence.

⁶¹In the British zone only candidates for public or semi-public jobs had to complete it; by December 1946 about 1.5 million Fragebogen had been completed.

incriminating files provide a means of control

As illustrations one can mention (i) Kurt Waldheim who was Secretary General of the United Nations from 1972 to 1981 and President of Austria from 1986 to 1992 but whose military activities in the Wehrmacht unexpectedly came to the attention of the medias in 1986. (ii) Otto Schulmeister who as editor of “Die Presse” and “Wort und Wahrheit” was an important figure in post-war Austrian journalism. In 2009 it was revealed that over two decades he had been working for the CIA; it is claimed that in exchange his activity during the Third Reich were kept under the rug.

During the Cold War it was relatively easy to keep right-wing governments in power under the requirement of fighting Communism. After 1990, a new strategy had to be defined. As far as one can know, it relied on supporting pro-western youth groups. Such youth groups were established in Belarus (Zubr), Georgia (Kmara), Kyrgystan (Kelkel), Russia (Nat-Bols of Edward Limonov), Serbia (Otpor), Ukraine (Pora). In the case of the Otpor youth group this can be illustrated by the following excerpts from the New York Times.

American assistance to Otpor and the 18 parties that ultimately ousted Milosevic is still a highly sensitive subject. But Paul B. McCarthy, an official with the Washington-based “National Endowment for Democracy” is ready to divulge some details. Of the almost \$3 million spent by his group in Serbia since September 1998, he says that Otpor was certainly the largest recipient. Money went into Otpor accounts outside Serbia and McCarthy held a series of meetings with the movement’s leaders in Podgirica, the capital of Montenegro, in Budapest [in the north of Hungary] and in Szeged [in the south of Hungary near the Serbian border].

At the “International Republican Institute, another Washington group financed by AID [USAID: United States Agency for International Development, closely related to the Department of State.] an official says that some of the \$ 1.8 million the Institute spent in Serbia in the last year was provided direct to Otpor. (NYT, article by Roger Cohen (2000)).

The fact that the opponents to Milosevic received \$ 25 million in American aid between July 1999 and August 2000 (NYT 23 September 2000) does of course not prove that this money played a “crucial” role in the uprising⁶². A more convincing test is provided by the fact that the article of 23 September described *in advance* what would indeed happen two weeks later on 5 October. The article explicitly says that whatever the results of the election, they will not be accepted by the population, that “angry voters will take to the streets”, and that the same “people power” which spelled the end of the Marcos regime in Manila in 1986 will similarly bring down Milosevic. The article recognizes that the crucial factor would be the attitude of the police and army. According to a subsequent article (NYT 9 October 2000) it was

⁶²As a matter of fact for *single* events it is impossible to prove anything regarding the respective roles of exogenous versus endogenous factors; it is only for a collection of events that a scientific assessment can be made. The larger the sample of events under consideration, the sharper the proof can be made.

Velimir Ilic, mayor of the town of Cacak, who was in charge of infiltrating the police with paratroopers of the Yugoslav Army and young policemen from Cacak.

After such groups won political contests, pro-American governments came to power. In the case of Serbia, William D. Montgomery US ambassador to Croatia made no mystery of this objective when he declared “We hope the new generation of leaders will come from Otpor’s ranks. That would be a fair return on America’s investment in the movement.” (NYT 26 Nov 2000)

Privatization and economic return

Once these governments were in power different reforms were introduced which strengthened the ties with the United States: privatization of state owned companies, training of the police and army by American instructors, establishment of bases especially for the US Air Force. One of the clearest illustrations is provided by Georgia, but a similar trend was observed in Poland, the Czech Republic, Romania or Kosovo.

It can be argued that privatization was the most important part of that program. A case in point was provided by the fate of the Prime minister in Slovakia. In 1989, Vladimir Meciar was chosen as Prime minister of the Slovakian part of Czechoslovakia by the new political party “Public Against Violence” (Verejnost Proti Nasiliu, VPN). In 1992 with his Czech colleague Vaclav Klaus he was at the origin of the division of Czechoslovakia into two separate countries. But in contrast to Klaus who was an “ardent free-market reformer”, Mr. Meciar was a hard-line nationalist and opposed to the privatization of big state-owned companies (New York Times articles of 2 January 1993, 13 February 1994). The article of 1994 was entitled “Slovakia is balking at privatization”. Less than 3 months later Mr. Meciar was ousted from his position as prime minister with the support of the movement OK’98.

Role of US armed forces

It is not immediately apparent why armed force should play a role in this scenario. However, history shows that economic and financial domination is often accompanied by military occupation, especially in fairly weak countries. The most obvious example was the concession system in China which lasted almost one century from around 1850 to 1949⁶³. Although the objectives of the western powers and Japan were said to be commercial, their presence gradually became a military occupation. Thus, the great powers had substantial naval forces in China; in the 1920s the British and US forces had 55 and 30 vessels respectively totalling 13 cruisers, 24 destroyers and 23 gunboats (Source: NYT 11 April 1927 p. 2). The same scenario repeated itself in other areas. The United States have had a permanent or temporary military

⁶³Strictly speaking the western powers who held concessions formally renounced them in 1942 but the US military presence ended only in 1949.

presence in many Latin countries. Its worldwide military network comprises about 700 bases and installations. The last developments occurred in Central Asia (after 1992), former Yugoslavia (after 1999), Afghanistan and Central Asia (after 2001), Iraq (after 2003).

As an illustration, Fig. 4.3a presents the Bondsteel base in Kosovo. Although formally part of the NATO force in Kosovo, it is for all main purposes an American base. The other occupying powers, namely Britain, France, Germany and Italy did not build similar bases in their respective occupation areas.



Fig. 4.3 a: Aerial view of camp Bondsteel in Kosovo. The camp was built after the action of NATO against Serbia in June 1999. *Source: Wikipedia, entry “Camp Bondsteel” (public domain).*



Fig. 4.3 b: The five occupation zones of Kosovo. KFOR entered Kosovo on 12 June 1999 after the adoption of UN Security Council Resolution 1244. *Source: Wikipedia, “KFOR” (public domain).*

What is the purpose of such a base? A partial answer was provided by Defense Secretary Donald Rumsfeld during a visit to Camp Bondsteel in June 2001. He explained to the troops: “My view is we don’t spend in you, we invest in you. You are not a burden on our economy, you are a critical foundation for growth”. One month later, on his first trip abroad, G.W. President Bush also visited Camp Bondsteel. What then is the *economic* role of such a base? It is often said that it has something to do with the protection of the oil pipelines which cross this area, but such an argument is obviously inadequate. It does not make sense that the best way to protect pipelines is to build a base with about 7,000 troops. Two other responses can be offered:

- The existence of this base guarantees that the government of Kosovo will remain friendly to US interests.
- It can provide support to other US troops in the area for instance in Afghanistan or Iraq.

However these reasons are not very satisfactory either. (i) Kosovo is a very small country whose independence is not even recognized by the whole international community. (ii) The United States has already large bases (e.g. in Dubai or Kuwait) which are much closer to Iraq than is Camp Bonesteel. In short, we must recognize

that at this point we do not have a clear understanding of the connection which exists between the economic objectives of the US government and its military strategy. Ultimately, one could of course argue that as the construction and logistics of the base was outsourced to Brown & Root Services, a subsidiary of Halliburton, the decision to build it was the result of lobbying pressure, a process of which there have been other illustrations in the past⁶⁴.

Role of domestic military forces

Complementing the establishment of military bases there are often training programs of the armed forces and police of vassal countries by the overlord country. This kind of influence appeared in its clearest form in many Latin America countries between 1950 and 1990 and also in countries such as Afghanistan (after 2001), Egypt, Georgia, Iraq (after 2003), Pakistan, South Korea, Thailand or Turkey. In such countries where the army and police were trained by American advisers and funded by the US government they have frequently become the strongest organized forces in the country⁶⁵. During the last four decades, whenever instability or leftist influence threatened, the government of such countries was routinely taken over by the military. As we know, this happened recurrently in many Latin American countries as well as in Pakistan, South Korea, Thailand or Turkey. In a sense, in such countries there have been successful implementations of the scenario which was planned (and carried out unsuccessfully) in China⁶⁶ and Vietnam. On the whole, the successes of such policies were much more frequent than the failures.

The future

Will the present economic crisis result in a weakening of this kind of influence? It is unlikely. The cost of running such operations is fairly low especially when compared to the cost of US armed forces; therefore the funding of such programs will not be much affected by the crisis.

If the economic situation becomes more difficult it can become tempting to extract more economic advantages from countries which are ruled by pro-American governments. In this perspective, toppling local dictators (e.g. Milosevic or Saddam Hussein) can be seen as a means for replacing them by governments who are friendly to

⁶⁴For instance the decision taken by President Gerald Ford with the approval of Congress to vaccinate the *whole* American population after only *one* case of swineflu was detected in January 1976 was clearly unreasonable; but in spite of being opposed by many experts and denounced in many New York Times articles, it was taken nonetheless and was at least partially enforced in the fall of 1976. Interested readers can find more details on the Internet and in the archive section of the New York Times.

⁶⁵Shortly after its inauguration the Obama administration was planning to spend about \$ 2 billion a year over the next 5 years to build an Afghan armed force (army and police) of about 400,000. This funding would represent twice the budget of the Afghan government.

⁶⁶During World War II there was an extensive training program of Nationalist troops by American advisers. This operation pioneered a strategy that would be re-enacted many times in the post-war era.

US interests and willing to concede economic privileges to American corporations. There have been many historical examples of this kind in Latin American countries. Naturally, the United States is not the only country that pursues similar objectives. A clear illustration was given by the economic exploitation of China through the concession system (which prevailed from the mid-19th century until 1942 and was followed in November 1946 by an unequal economic trade agreement with the United States) in which almost all western countries took part. What makes the United States special is: (i) its unparalleled expertise in implementing such policies (ii) its worldwide dominance. Such policies complement the neoliberal agenda in the field of foreign relations in the sense that free trade and open door policies are necessarily to the advantage of the dominant partner.

Although in recent years this policy was very successful in Eastern Europe, one may argue that it was less successful in Latin America. Indeed, in the wake of the economic crisis in Argentina governments were elected (for instance in Bolivia, Brazil, Venezuela) which openly questioned the neoliberal agenda and pledged to keep American interests at bay. Will this be a lasting trend. It is still too early to know for sure.

Why does privatization offer inroad opportunities to foreign companies?

In many Latin American countries the privatizations carried out by liberal governments in the 1990s left major national companies in the hands of foreign corporations, especially in promising sectors such as telecommunication, water distribution, electricity production and distribution, oil production and distribution and so on. A similar scenario took place in Eastern European countries. Such an outcome was of course hardly surprising because Western countries could rely on a sophisticated banking sector which enabled them make competitive bids. However, this gave rise to what can be called an absentee landlord system (see Roehner 2007, chapter 8) which resulted in under-investment and mismanagement. Eventually such policies generated much public discontentment.

An illustration of the absentee landownership to which privatization leads is provided by Mongolia. Although the country experienced a democratic revolution in 1989 the former communist party remained in power until 1996. The program of the party which came to power included the privatization of 60% of all state property. What were the results⁶⁷?

- The country's largest government owned bank was bought (a 76% ownership by a consortium from Connecticut and Switzerland for \$ 12 million.
- Another major Mongolian bank was bought for \$ 7 million by a Japanese group

⁶⁷The following information is based on an article from the New York Times (21 October 2003) entitled: "In Mongolia, a tilt toward a free market"

but it is managed by American executives. It was renamed XAAN.

- In 2000 the government handed management of a Mongolian bank called Ag Bank to the US Agency for International Development which outsourced it to a Washington consulting firm⁶⁸.
- Over the following two years (i.e. 2004-2005) other privatizations were planned, for instance the national airline, the largest petroleum importer, the nation's largest insurance company.

At the end of the privatization process most of these companies will be in foreign hands and owned by Western companies which have very little knowledge about Asia and more specifically about Mongolia. Such links are even weaker than between English landlords and their Irish estates back in the 19th century. The lessons learned from historical episodes suggest that in the long run absentee landlordship is an inefficient form of management. Yet, such a system can hold on for a long time if it is backed by state power. In the case of Ireland the system lasted for over three centuries.

Abstentee ownership in Eastern Europe in the next decade

The pro-democratic revolutions in Eastern Europe can be seen as a repetition of what happened in Latin America in the two decades 1982-2002. In the previous decade (1972-1982) several Latin American countries (e.g. Chile, Argentina, Uruguay, Bolivia) had been ruled by military dictators. Several of them were already pro-American and willing to implement neoliberal reforms; such was for instance the case of Augusto Pinochet in Chile who had direct contacts with Milton Friedman and other advisers from the University of Chicago. Once brought down, these dictators were replaced by civilian governments which were also pro-American and neoliberal. As a result many public services (in banking, telephone, water distribution) were privatized which often brought them under the control of foreign companies.

In many cases these experiences were disappointing in the sense that they resulted in price increases while at the same time the foreign companies did not fulfill their promises regarding long-term investments in basic infrastructure. As already mentioned, this outcome lead to a rejection of neoliberalism and to a more guarded attitude with respect to foreign companies. In a sense, the crisis of 1997-1998 had similar results in Asia.

It is not unreasonable to expect a similar evolution in Eastern Europe. At present (early 2009) many of the governments which came to power in recent years are

⁶⁸Since, as is well known, the USAID has close links with the Central Intelligence Agency this decision had certainly a political significance.

much more pro-American and neoliberal than their electors⁶⁹. Once the failure of neoliberal policies will become apparent, it can be expected that people will reject them as they have done in Latin America.

Of course, such a statement assumes that electors will be given a real choice. If the main parties in fact propose more or less the same program (as was the case with “New Labour” in Britain) then a growing gulf will develop between voters and the political parties supposed to represent them.

Previous speculative crises

In many respects the crisis which started in July 2007 was just a repetition of similar episodes that occurred in the past. As illustrated by Fig. 4.4 speculative bubbles have occurred repeatedly since (at least) the nineteenth century.

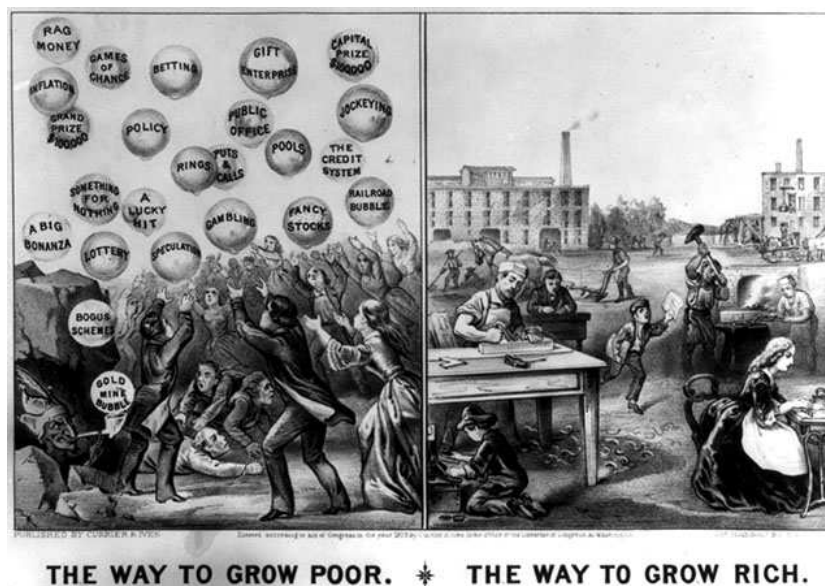


Fig. 4.4 The way to grow poor; the way to grow rich. This lithography was created in 1875 by the American artists Nathaniel Currier (1813-1888) and James Merritt Ives (1824-1895). It makes probably reference to the burst of a housing and railroad bubble in the fall in 1871 which lead to a financial panic in the fall of 1873. Between 1857 and 1880 the firm Currier & Ives created about 7,500 images. *Source: Lithography by Currier & Ives, 1875. Library of Congress Prints and Photographs Division, reproduction number: LC-USZ62-662 (public domain).*

Previous “subprime crises”

More specifically, previous crises have already featured many of the issues that we have seen in the present crisis, e.g. sharp downturn in real estate prices (see Fig. 3.1),

⁶⁹In Poland and in the Czech Republic this was revealed by several surveys on crucial issues such as the war in Iraq or the installation of anti-missile facilities; government policies were disapproved by a wide margin (60% or more).



Fig.4.5 Effect of free-trade on French farmers.

This is the cover page of a French newspaper dated 30 November 1884.

On the left-hand side it shows a farmer facing a dire condition as a result of the fall in wheat prices. The poor “Jacques Bonhomme” (which is the archetype name of French peasants) shows his empty wallet while rats and mice eat the grain that is stored in the sacks in the background. He summarizes his situation by saying “Ça va mal” (I’m in trouble).

The price fall and the slump in sales were due to imports of cheap wheat from producers such as Argentina, Canada, Russia or the United States where extensive farming allowed lower production costs. Between 1880 and 1885 the average annual price of wheat in France fell from 23 franc/hectoliter to 16 franc/hectoliter, a 30% fall which implied a drop of same size (or larger if sales also declined) in the income of French wheat producers.

On the right-hand side the picture shows that wealthy people on the contrary benefited from free-trade. It is not exactly clear why the cartoonist targeted especially the Comte de Paris who personified the former reigning family.

As other European countries faced the same problem, a consensus eventually emerged which by the end of the century led to higher tariff rates. This protectionist reaction became even stronger after 1925 when overproduction once again produced a slump in grain markets.

If one replaces “cheap wheat” by “cheap labor” this cartoon describes fairly well the situation faced by working people in western countries nowadays (2010). The price of what they sell, namely their working skills, has fallen as a result of the import of cheap labor. As a parallel of the slump in sales there is an enduring high level of unemployment in many industrialized countries.

Source: *Bibliothèque Nationale de France*.

no-documentation loans⁷⁰, adjustable rate mortgages⁷¹, boom in mortgage-backed securities, tightened lending standards which led to a credit crunch (New York Times 18 February 1984 p. 1, 14 Jan 1990). The mortgage delinquency rate rose to 4.15 percent of total loans outstanding in the fourth quarter of 1994⁷², collapses of mortgage insurers⁷³.

On 11 October 1967 a new expression made its first appearance in the columns of the New York Times, namely the expression “mortgage backed securities”. The beginning of the article summarizes fairly well what was the purpose of these securities: “The Federal Government’s chief mortgage man hopes for mortgage market”. Indeed, back in 1967 there was no integrated *national* mortgage market in the sense that because of regional surpluses or shortages of credit, mortgage rates used to differ by as much as 2% between cities (NYT 22 Jan. 1984). In other words there were local credit crunches which lead to high credit rates. This lack of integration was due to insufficient communication links between local markets.

It can be recalled that there was a similar situation in commodity markets before the advent of railroads. Back in the early nineteenth century in France wheat price differentials in distant cities were of the order of 50% (more details can be found in Drame (1991))⁷⁴.

Even booms in mortgage-backed securities had been experienced many times in the 1970s and 1980s. In an article of 1977 one can read: “One of the fastest-growing innovations in the credit markets this year has been mortgage-backed securities” (New York Times 20 November 1977, p. F5). Detailed articles published in the New York Times (Arenson (1979), Berg (1984)) explain how mortgage-backed securities work and delineate some of the problems that may arise.

According to a figure given in Wikipedia (article “Savings and Loans crisis”) the Savings and Loans crisis of the early 1990s cost taxpayers about \$150 billion which represents 2.5% of the GDP of 1992. Transposed to 2008, 2.5% of GDP would represent about \$300 billion. At the time of writing (March 2009) the cumulative amount of successive bailout plans for banks represents (at least) one trillion dollars that is to say three times more than the cost of the previous real estate crisis. This shows once again that the burst of the housing bubble is only one of the components

⁷⁰Which means that loans were attributed to persons who did not show any official document to back their income statements.

⁷¹Which includes loans whose interest rates were artificially low during the first initial years and were set to increase sharply in the following years.

⁷²The delinquency rate includes loans that are at least one payment past due but does not include loans in foreclosure. At the end of the third quarter of 2008 the delinquency rate stood at 7.0% of all loans outstanding; the percentage of loans in the foreclosure process was 3.0 percent (Mortgage Bankers Association).

⁷³Such as the failure of TMIC, a large mortgage insurer in February 1988 (New York Times 3 March 1988).

⁷⁴The situation was basically the same in other European countries and it had dramatic consequences in times of dearth.

of the present crisis.

Regulation, self-regulation or no regulation at all

The article of 1979 about mortgage-backed securities mentioned above put great emphasis on the necessity of regulation. In 1979 real estate activity reached a peak (at least in the West) and there was much talk about possible federal regulation. Not surprisingly, in order to avoid federal regulation mortgage dealers claimed that they would be able to introduce self-regulation. The “Government National Mortgage Association” was skeptical. One of its executives made the following comment.

“We still have some doubts about whether it is possible to put together an effective self-regulation program. It is necessary for Federal agencies to consider alternatives to self-regulation in case the program is not put into place or is not effective”.

Responding to this concern a mortgage dealer at Salomon Brothers declared:

“We have been given a chance to self-regulate; I believe it is a last chance. If we don’t get something in place very soon, the game is over”.

In fact, in the following years free-market ideology gained greater momentum with the result that no effective regulation, whether federal or industry-based, was ever introduced.

A highly profitable business

Back in 1983-1984, mortgage trading had already become a very profitable business which is quite remarkable because interest rates were fairly high at this time. In his article of January 1984, Eric Berg gives the following illustrations.

- The rise of the mortgage market has produced a bonanza for Wall Street. Nearly every major house has expanded its mortgage-trading activity. For example 40% of the net income of Salomon Brothers in 1983 was provided by mortgage-related commissions and trading profits.

- In January 1984 the Savings and Loans industry was still recovering from a difficult position due to a depressed housing market from 1979 to 1982. The rapid growth of mortgage-backed securities to a total of \$253 billion or 14% of the \$1.7 trillion in mortgages outstanding gave them the possibility to jettison old, low-paying mortgages even sometimes at losses of as much as 50%. In other words, the mortgage-backed securities market enabled some savings and loans to stave off bankruptcy.

- One of the problems of the mortgage industry has been the possibility given to home buyers to pay off their loans early. Freddie Mac addressed that problem by creating “Collateralized Mortgage Obligations” which reduced the risk of prepayment.

All these observations suggest that the main financial innovations for mortgage mar-

kets had already been introduced in the early 1980s and were at that time working fairly well. In other words, the tools were probably sound and it is rather the abuses to which they gave rise which brought about the problems which lead to the financial crisis.

Chapter 5

State intervention: myth versus reality

In this chapter we examine the intervention of states in the economy, a topic which is closely connected with the question of Keynesianism. Whereas the field of application of Keynesian policies is usually restricted to macroeconomic policy, in this chapter we extend it to include strategies at microeconomic level. We will show that few markets are completely free of state interventions.

The fact that the field of state intervention is much broader than what is usually understood by the expression “Keynesian economics” is also emphasized by the fact that, apart from Keynes himself, many economists took an active part in developing these ideas. For instance, the Japanese economist Takahashi Korekiyo (1854-1936) was called Japan’s Keynes. About half a century later the French economist Edmond Malinvaud (born in 1923) proposed a new synthesis between neo-classical and Keynesian economics.

Regarding the discussion of state interventions there is actually a paradox in the sense that while being shunned and frowned upon by mainstream economists, state intervention and Keynesian policies are being extensively used by most governments.

In one of his columns in the New York Times (25 July 2009: “Why markets can’t cure healthcare”) the economist Paul Krugman pointed out that the production, sale and consumption of health care cannot be organized as a free market. His argument can be summarized as follows.

A significant number of Americans believe that the answer to our health care problems is to rely on the free market. Not so. There are two strongly distinctive aspects of health care.

One is that when you need health care it can be extremely expensive. Very few people can afford to pay major medical costs [such as surgery] out of pocket. This tells you that health care must be largely paid for by some kind of insurance.

The second thing about health care is that you cannot trust HMOs [health maintenance organizations that is to say big companies which act as providers of health care services] because for such profit-making institutions your treatment is their cost [which means that they will deny treatment as far as possible].

The key point in Krugman’s argument is that there can be no free market for health

care. The airliner market that we consider in this chapter is a very different market. and one in which there is fierce competition between big companies such as Airbus and Boeing. It is tempting to think that a market in which there is so much competition is a free market. Not so. In fact, as we will see, state intervention in many different forms plays a key role in this market. Moreover our argument and conclusion will be seen to apply as well to the market of many other products. Basically, this covers the markets of all products for which the design and construction phase is long and costly. One can mention for instance telecommunication satellites, nuclear power plants, high speed trains, refinery plants, tanks, submarines.

Naturally, this does not mean that all other markets are free markets. To create a new soft drink is neither long nor costly. Yet this market is dominated worldwide by the Coca-Cola monopole. In short, even markets which at least in principle could be free are not because of a trend toward ever greater concentration. This, however is another story. In this chapter we have a more limited objective.

In the first part we consider the micro-economic level. It will be shown that in many important economic sectors such as aeronautics, nuclear power plants, railways which require long-term investments, government actions and subsidies *necessarily* play a major role. This will be illustrated here by the example of the airliner industry. In the second part we consider the macro-economic level. It will be seen that since 1945 Keynesian economic stimulation has been used on a permanent basis by the US government as well as by other industrialized nations.

In short, even in our time dominated by the neoliberal ideology, governments continue to play a major role. Yet, there are two areas from which the US federal government has really withdrawn, namely the regulation of financial markets and of labor relations. It is well known that through chronic underfunding the US Security and Exchange Commission was made almost powerless. The same is true for other federal organizations which were created during the New Deal and in particular those in charge of controlling the implementation of labor regulations. The consequence was a quick deterioration in the bargaining power of unions and consequently in the earnings of workers.

In the last part I briefly describe some of the networks which supported neoliberal ideas and allowed this conception to become accepted worldwide. At the time of writing (10 November 2008) it is the sole economic paradigm not only in the United States from where it originated but also in the Scandinavian countries, in the European Union and in Japan. from the European Union to Japan or to China.

Japan's Keynes

The era of economic reform which followed the Meiji Revolution was largely impelled and monitored by the central government. In other words it was an exercise in Keynesian policy which occurred several decades before the Keynes offered a rational for such policies. That reform was much in line with what was done in France under Napoleon III or in Germany under Bismark.

Korekiyo Takahashi was born on July 27, 1854, in Tokyo (at this time still called Edo). At 13 he was sent to study in the United States. He returned to Japan about two years later shortly after the Meiji Restoration. Subsequently he became a Christian. Takahashi's successful career in the administration started in 1881 (at the age of 27) in the newly established Ministry of Agriculture and Commerce. By 1900 he was a vice-governor of the Bank of Japan. He held the position of Minister of Finance 6 times between 1913 and 1936. On 26 February 1936 he was murdered (along with many others) by radical officers. By his clever (Keynesian) policy Takahashi was able to shield Japan from the shock of the Great Depression. Incidentally, it can be mentioned that the portrait of Takahashi appeared on a 50 Yen banknote issued by the Bank of Japan in 1951.

Keynesianism is usually considered in the framework of macro-economic policies, but in the first part of this talk I will show that the issue of state intervention is already present at the micro-economic level.

Role of government subsidies at micro-economic level

My point here is that in some sectors state intervention at micro-level is absolutely essential for the completion of the technical challenges faced by the industry. Obviously, it would have been impossible to carry out the Apollo program without federal funding. Similarly, although less evident, the construction and commercialization of the first jet airliner would have been an ill-fated endeavor without federal funding. An important word in this statement is “commercialization”. Even if a jet airliner could be built without subsidies, it would have been too expensive for airlines to buy it. Consequently, the very notion that a “free-market” can exist for items necessitating heavy initial investments is a proposition which is not supported by available evidence.

I will explain that point in more detail for the case of the aeronautical industry. We will see that as a rule military aircraft opened the way for similar civilian aircraft.

Civilian aircraft follow the design of military aircraft

The Boeing B-377 Stratocruiser was an airliner version of the Boeing Stratofreighter which in turn was the transport version of the B-29 Superfortress and of the B-50. The Stratocruiser first flew on July 8, 1947. Here are some of the specifications of

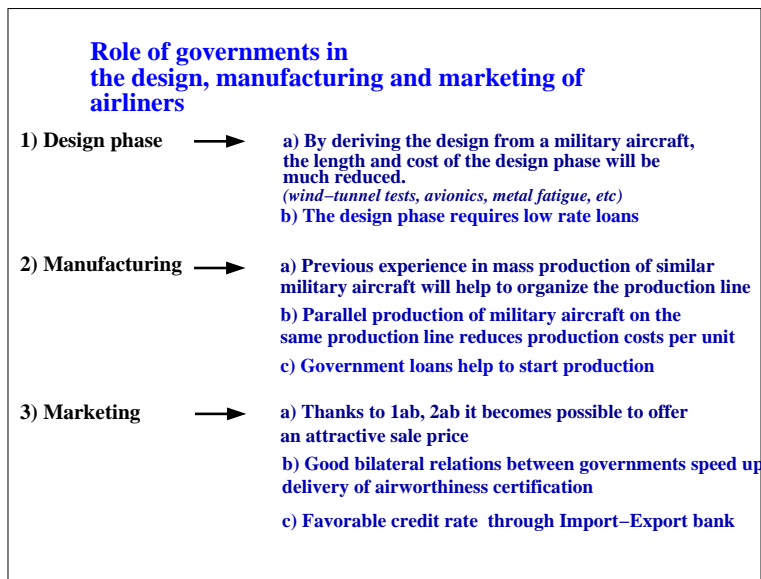


Fig. 5.1: Role of government in the design, manufacturing and commercialization of airliners

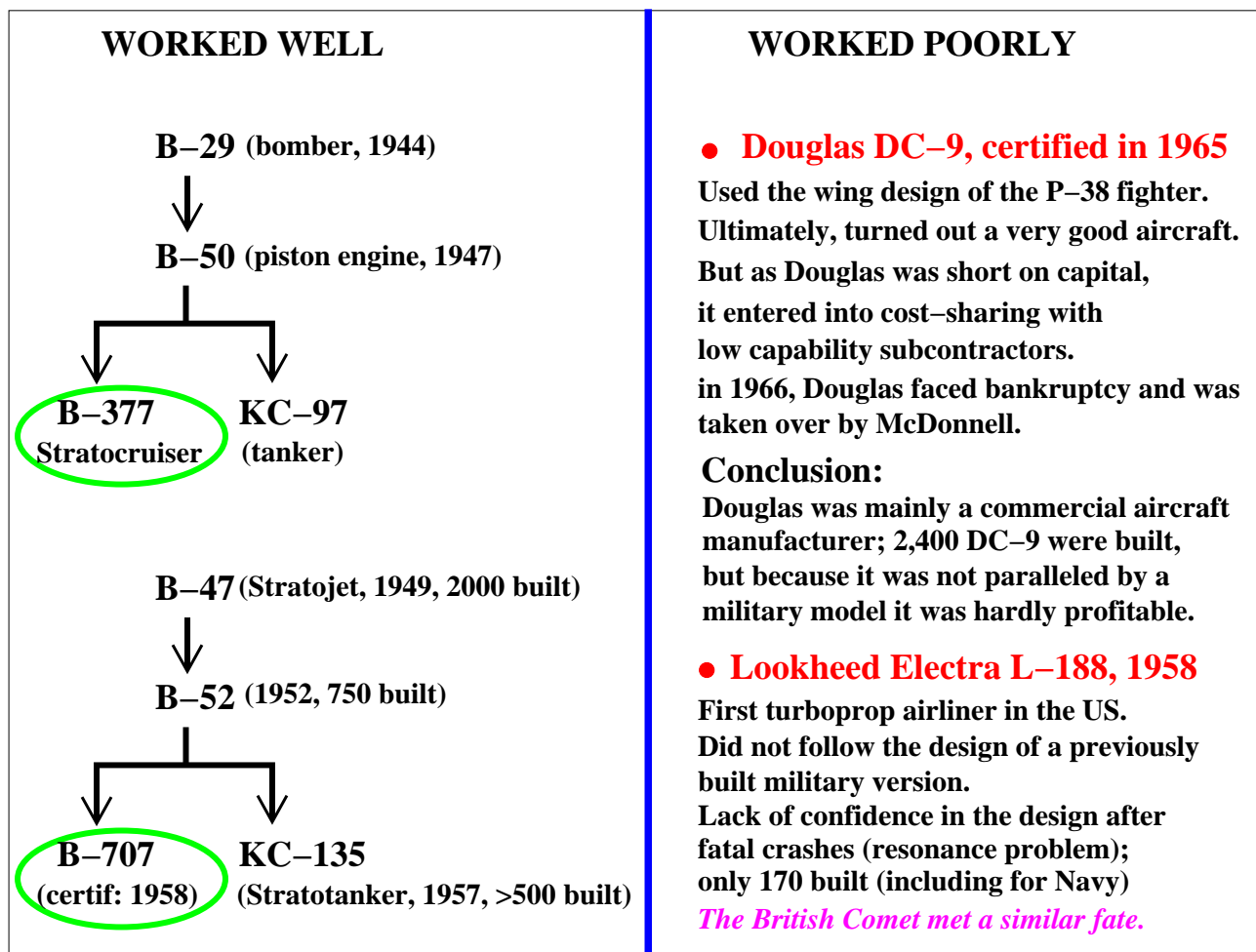


Fig. 5.2 Comparison of successful and unsuccessful airliners.

these aircraft.

B-50 (military)



Fig. 5.3: Boeing C-97 Stratofreighter and Boeing 377 Stratocruiser. The commercial 377 was basically a civilian version of the C-97 and its tanker version KC-97. Federal funding received for the development of the military versions allowed a substantial price reduction of the commercial version. *Source: Wikipedia (public domain).*

Wingspan: 43.1 m; length: 30.2 m; height: 10.0 m

Max takeoff weight: 78,470 kg; Maximum speed: 636 km/h

Boeing Stratofreighter (military transport)

Wingspan: 43.1 m; length: 33.7 m; height: 11.7 m

Max takeoff weight: 79,370 kg; Maximum speed: 603 km/h

Boeing B-377 Stratocruiser (airliner)

Wing span 43.0 m; length 33.6 m; height: 11.7 m

Max takeoff weight: 67,133 kg; Maximum speed: 603 km/h

As can be seen from these data and from the photographs the civilian Stratocruiser was almost identical to the military Stratofreighter which in turn was similar to the B-50. In other words the research, design and development cost of the Stratocruiser

was 100% covered by government funding.

The same observation applies to the Boeing B-707, the first American civilian jet aircraft. It was almost identical to the military KC-135 Stratotanker which flew 8 years earlier. The Boeing B-707 was even built on the same production line as its military version.



Fig. 5.4: Boeing B-47 Stratojet and Boeing B-707. The 707 was basically a commercial version of the Stratojet bomber; there was also a tanker version, the KC-135 Stratotanker. The B-47 was the first 4-engine jet in the world. It made its first flight in December 1947 about 7 years before the first flight of the 707. The latter benefited from its military precursor in terms of technical improvement and cost reduction. *Source: Wikipedia (public domain).*

The case of airliners which do not benefit from subsidies

If the price level at which airliners are sold is set by aircraft whose design was 100% covered by government funding, an obvious implication is that aircraft whose design costs were not (or only partially) covered by government funding should run into troubles. This is indeed what can be observed.

The Beechcraft Starship As a case in point one can mention the Beechcraft Starship, a business turboprop aircraft for 8 passengers. It was the world's first all-

composite business aircraft; 70% of its airframe consisted of plastic composite, a percentage notably higher than for the Boeing 787 (i.e. 50%). As observed by Max Bleck, the president and chief executive officer of the Beechcraft Company, the company had to master a new technology, create a database listing the mechanical properties of the raw materials it was going to use (resins, fabrics, tapes) and train its workforce. All without subsidies. What was the result?

The program cost \$300 million and lasted 13 years from 1979 to 1992 when the first commercial flight took place. Each aircraft eventually cost \$5 million, about \$1.1 million more than planned initially and about twice as much as similar (aluminium) business aircraft. In addition, the final version of the aircraft had an over-weight of one ton (22% of its empty weight); as a result its seating capacity had to be reduced from eight to six passengers. Naturally, under such conditions the aircraft attracted few customers. From the 53 which were built, only few were sold, the others were leased.

In short, we have here the example of a fairly small company which takes up a major technical challenge without any help from the state. Although many difficult technical challenges were overcome the resulting aircraft is too expensive for the market⁷⁵.

In a more general way the troubles can be of different kinds.

- A too short design phase could result in a flawed design; this was the case of the Lockheed Electra. It flew for the first time in 1958 but suffered from lack of confidence in its design after a series of accidents.
- If the design phase is long enough to produce a good aircraft but the profit margin on the sales may be too low to allow the company to reimburse the loans made during this phase. This is what happened with the Beechcraft Starship as we have seen and also for the Douglas DC-9. Certified in 1965 it turned out to be an excellent aircraft (about 2,400 DC-9 were sold) but Douglas run into financial troubles, faced bankruptcy and was taken over by McDonnell.
- The Concorde, the first (and so far only) supersonic jetliner was a very innovative design which did not follow a military design. As a result, its price was set at a level which dissuaded all airlines (except British Airways and Air France) from buying it. In the early 1970s the price of a Concorde was about twice the price of a Boeing-747 (\$60 million as compared with 30 million). But this high price resulted largely from the small order book, a question that will be discussed subsequently.

Government support is important not only in the design phase but also in the production and marketing phase. If two aircraft are very similar their production lines can

⁷⁵Such a commercial disaster would have led the company to bankruptcy if it had not been taken over by Raytheon (a much bigger company) in 1979-1980.

be organized in the same way and the experience acquired in the production of the military model will prevent many glitches in the production of the civilian model. At the marketing level the availability of low-interest loans through the US Export-Import bank (or similar institutions in other countries) will facilitate the sales.

Extending the argument

The argument that we have developed for the airliner industry also applies to other items which have both a military and a civilian usage. That is the case for helicopters, jet engines, rocket engines, spacecraft, radars, and so on. For items whose design requires a great deal of technical research but have only a civilian usage (such as nuclear power plants), the available evidence shows that their design is supported by government and their profitability is guaranteed by government regulation which ensures a stable sale price for the electricity which will be produced during the first years of operation of the plant.

Other ways in which states help national companies

Apart from the question of financial subsidies there are other issues in which the attitude of the state is crucial. Let us give four examples.

The Vickers Viscount

During World War II the United States developed enormously its aircraft industry. But so did also Britain, Germany and Japan. Germany, as we know, was able to produce jet aircraft fighters even before the end of the war. Yet, 10 years later by 1955 the United States had an almost complete monopoly over the production of commercial airliners. What happened during these 10 years?

During the occupation period Germany and Japan were not allowed to develop aircraft; this interdiction concerned military aircraft as well as commercial airliners. What about Britain?

The United States started to develop a jet bomber, the Boeing B-47, as soon as the war ended. It made its first flight in 1947 and entered service in 1952. Yet, the first jet airliner, the Boeing B-707 made its first commercial flight only 6 years later, in October 1958⁷⁶. On the British side two commercial airliners, the Comet and the Vickers Viscount⁷⁷ were ready to fly much earlier. How can one explain that they had so little commercial success? Because the Comet had some technical problems

⁷⁶How can one explain this long delay? Boeing began the program was launched in 1952 and the B-707 made its first flight in May 1954. These are fairly normal development times, so the real question is actually why the program was not started sooner. A possible explanation is that Boeing was kept busy by the orders that followed in the wake of the Korean War.

⁷⁷The Viscount was not a jet but it was powered by a turboprop engine which made it very similar to a jet aircraft.

which may provide a possible explanation, let us concentrate on the Viscount. Two reasons may explain why it attracted only few orders in the United States: (i) The long delay in its certification by American Aviation authorities. (ii) A campaign of detraction waged in the United States. On 6 April 1957, Mr. J.H. Carmicheal the president of Capital Airlines (the only US company who had ordered Viscount by this time) declared that “a vicious and unethical campaign of detraction was being waged in the United States against the Viscount.” He said that the campaign had been carried out since Capital Airlines first began using the aircraft in June 1955. However, he did not identify the source of the attacks. In spite of these attacks the Viscount was reasonably successful; 400 planes were produced but it was of course a much smaller aircraft than the B-707. Yet, it was also the last successful airliner produced in Britain (if one excepts the Airbus planes which were co-produced with France and Germany).

The Concorde

This section documents how the commercialization of the supersonic Concorde was blocked by American authorities.



Fig. 5.5 A British Airways Concorde airliner flying in formation with “Red Arrows” from the Royal Air Force Aerobatic Team. The show took place at the Golden Jubilee of the Queen in June 2002. In contrast to the Boeing 377 and 707 the Concorde did not follow the design of a military aircraft but its development was subsidised by the British and French governments. *Source: Wikipedia, entry “Concorde” (public domain).*

In 1972 the aircraft had received 74 orders mainly from Middle Eastern companies. At first the United States responded to the challenge by a similar project. The project was attributed to Boeing but Boeing gave it a low priority. How can one understand this lack of interest in a project that promised to be a major technical innovation? It may be related to the fact that Boeing lost a contest to build a supersonic bomber. Being unable to repeat the operation that led from the KC-135 to the B-707, Boeing knew that its profit margin on a civilian supersonic airliner would be found inadequate by its shareholders.

Then, on 3 December 1970 that is to say 21 months after the Concorde’s first flight and subsequent to Boeing’s loss of interest the US Senate banned all civilian su-

personic flights on American land routes, an action that virtually cut the wings of the Concorde. By the same vote the Senators required supersonic aircraft to be less noisy at every stage of operation than other jetliners. Six months later, on 20 May 1971 (that is to say well before the rise in oil prices) funding for a supersonic airliner was dropped by Congress. Then, not surprisingly, on 27 October 1972 United Airlines cancelled its option-orders for 6 Concorde and other companies made similar cancellations.

Whereas the aircraft had obtained its airworthiness certificate in October 1975 the ban of the US Congress was lifted only in February 1977, immediately to be replaced by a similar ban from New York City which was lifted only in November 1977 that is to say more than 2 years after certification. Landing in New York was a crucial issue because this was the Concorde's most profitable route.

Are the US certification agency and Boeing too close?

It is often said that an aluminium aircraft is protected against lightnings by the so-called Faraday shield effect. A Faraday shield is an enclosure formed by conducting material (or by a conductive metal mesh) which blocks out external electrical fields. For an aircraft, this is only one part of the story, however. It is true that the inside of the fuselage of an aluminium aircraft will be protected thanks to this effect. But another important problem is how to prevent sparks in the wings which contain the fuel. Basically sparks will appear at any place where there is a gap between two parts between which a high electric potential may appear.

How can this protection problem be solved for aircraft that have a graphite composite airframes like the Beechcraft-Rayton Starship or the Boeing 787 Dreamliner? Of course, composite parts have been used in commercial aircraft for a long time. Already in 1975 a program was started to manufacture a composite stabilizer for the Boeing 737. But the "Starship" and the "Dreamliner" were the first aircraft in which more than 50% by weight of the airframe was composite⁷⁸.

The protection of the fuselage can be ensured by inserting a conducting mesh between the outermost composite layers to act as a Faraday cage and protect the occupants. The protection of the wing tanks is a more difficult problem. In 2002 the Federal Aviation Administration (FAA) which is in charge of the certification of airliners established a new set of rules for the protection of fuel tanks. According to these rules there should be three protection layers on all fuel tank fasteners especially those inside the tank. After conducting an extensive series of tests Boeing's engineers concluded that the Dreamliner will not be able to meet these requirements⁷⁹.

⁷⁸The figure was 70% for the Spaceship and 50% for the Dreamliner (50% composite, 20% aluminum, 15% titanium, 10% steel, 5% other).

⁷⁹Article entitled "FAA too loosen fuel-tank safety rules benefiting Boeing's 787, Seattle Times 8 February 2009. The

In January 2009 the FAA announced that instead of requiring three protective layers it would allow some parts to have just one. The point which is of interest from the perspective of the present discussion is that the move by the FAA has stirred intense opposition *inside* the FAA office. In a declaration delivered on 3 February 2009, the national union representing about 190 FAA engineers called the new policy “an unjustified step backward in safety”. Only the future will tell us who was right, but what is worth noting is that the “FAA management contradicted its own technical staff in arguing that the rules could be relaxed”. It was said that the FAA engineers who raised safety concerns were simply removed from the team developing the new policy. A Boeing internal document reviewed by the Seattle Times shows that the company had a team “to assist FAA in wording of interpretation” of the lightning rule for the 787 as far back as August 2004, just 8 months after the new jet program was launched.

By submitting foreign aircraft to protracted reviews (as was the case for the Comet, Viscount and Concorde) and by easing rules for domestic companies the FAA certainly distorts free-market rules. To suggest that this should be avoided would be a fairly naive view. Most of the FAA engineers are former Boeing engineers which implies that the two organizations have close relations. As a matter of fact, such a situation is the rule rather than the exception. Similar situations and scenarios can be expected in other countries as well. What makes the case of the American FAA more important is simply the fact that the rules that it sets tend to become the norm worldwide.

Anti-trust inquiries

The second case is taken from the software industry. Ten years ago an anti-trust inquiry was opened against Microsoft on account of its monopolistic position. It is clear that such a procedure can be conducted with more or less energy and determination. It is the Department of Justice that is to say the US government which initiates this kind of procedure and determines up to which point it should be pursued.

In conclusion, the notion that there can be a “free” market independent of any government interference is a fiction which is not consistent with available evidence. It can exist in the mind of some economists but it does not exist in reality (at least not for the items that we considered).

Answers to objections

Boeing 747

Spaceship got its certification in June 1988 which means that it was not concerned by this rule.

You may object that some innovative aircraft such as the Boeing 747 were built without being preceded by a similar military design. There are two answers to this objection.



5.5 Lockheed C-5 Galaxy military transport aircraft and Boeing 747 airliner. Wingspan (W), length (L) and height (H) of the two aircraft are as follows: W: 68m, 60m L:75m, 70m H: 19m, 19m. They made their first flight in June 1968 and February 1969 respectively. One of the main differences in their conception is their wing design: high-wing for the C-5 vs. low-wing for the 747. *Source: Wikipedia, entries “Lockheed C-5” and Boeing 747 (public domain).*

Once a company is as large and profitable as Boeing was in 1966 (when the design phase of the 747 started) it is in a better position to make the big investments required by such a new design. * In fact the 747 also benefited from research on military aircraft. It resembles the C-5 Galaxy military transport aircraft (e.g. same cockpit located well above the rest of the fuselage; front-door for the cargo version). It is true that the C-5 was produced by Lockheed and not by Boeing, but Boeing took part in the military CX-HLS (C means “Cargo”, X means that it is a research design, as for the X-15, and HLS means “Heavy Logistic System”.) which opened the way for both the C-5 and the 747; incidentally, the two aircraft became operational almost simultaneously in December 1969. Another important aspect concerns the engines.

The so-called High-bypass turbofan engines which equipped the 747 were developed in connection with the CX-HLS project.

Airbus A320

Delivered in 1988, the A320 pioneered the use of digital fly-by-wire control systems in a commercial aircraft. With more than 3,800 aircraft of the A320 family built (2008), it was the second best-selling jet airliner after the Boeing 737. Is this a counter example for the argument developed in the previous section? Not really. Two reasons may explain why this innovative aircraft could be sold at a price which made it a commercial success.

- The fly-by-wire control system was developed for the Concorde albeit in analog rather than digital mode.
- Airbus benefited from low-interest loans from the European governments which took part in the program. As a matter of fact, this fact was used by Boeing to claim that Airbus enjoyed an unfair advantage.

Airbus A380

In 2007 when it made its first commercial flight, the A380 was the world largest aircraft. In its charter version it could carry 853 passengers whereas in its 747-400 version the Boeing 747 could take only 524 passengers. As for the A320 its development was supported by low-interest government loans and once again Boeing claimed that it was the “most heavily subsidized airplane in history”, thereby forgetting the huge amounts of funding it received from the Department of Defense.

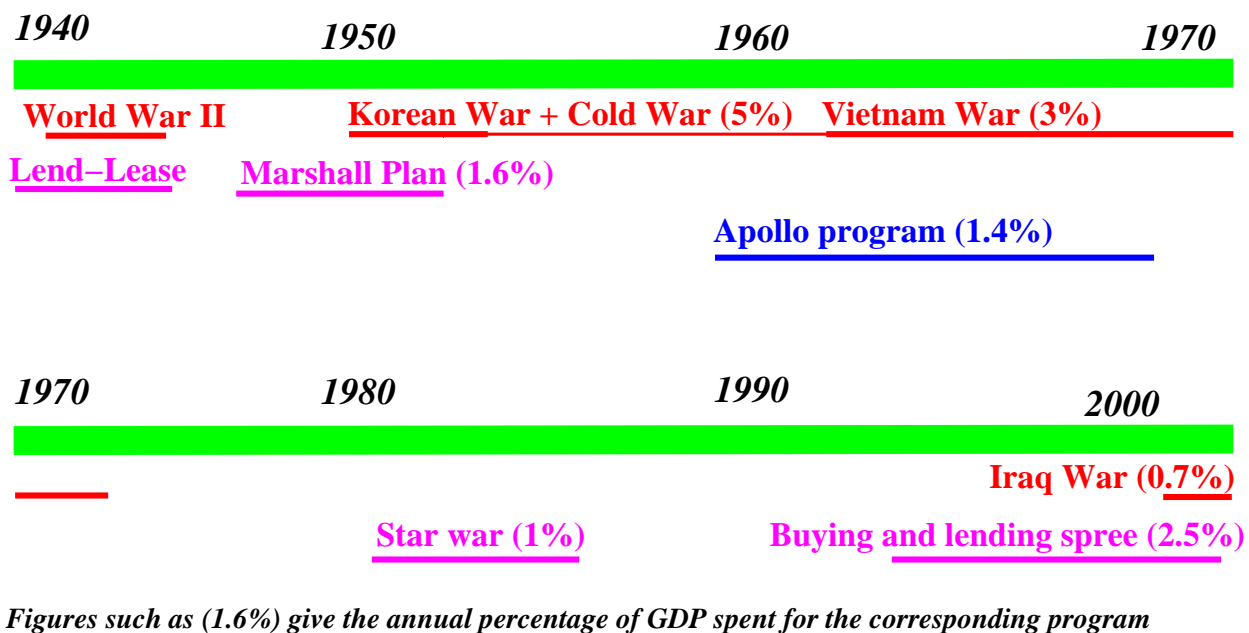
Role of government subsidies at macro-economic level

This part of my talk will not be new for you. We all know that government spending can be used to encourage or prop up some industrial sectors or areas. However, often we do not realize the magnitude of this effect. For instance, people rarely think of World War II, of Lend-lease (during World War II), of the Marshall plan, of the Korean, Vietnam or Iraq wars in terms of subsidies to private companies. Yet, all these episodes involved big government spendings most of which translated into sources of income for American companies.

I will just illustrate that point by three examples.

- One might think that during World War II only industries in the military sector profited from defense expenses. This view is too narrow however. During WWII millions of American people were submitted to loyalty investigations for instance before they could get a job in a company working for defense. A substantial amount of these investigations were carried out by the investigation departments of credit companies. This is illustrated on the slide.

Keynesian stimulation in the United States by subsidising private companies



- The expenditure of the US Federal Government has been about 20% of GDP over the past 50 years; Reaganomics did not change that. Such a federal budget gives ample means of economic intervention. For the sake of comparison, in 2007 that ratio was 11% in Germany, a country with a similar federal organization.
- Powerful federal institutions (such as the Treasury, Import–Export Bank, Fannie Mae) give the Federal Government the possibility to help US Corporations in many ways.
- The main idea of Reaganomics, Thatcherism and neoliberalism is to reduce government spending and stop its interference with market forces. Government spending has remained unchanged, we have seen, has there been a change in its interference? Answer is: YES

Fig. 5.6 Wars provide recurrent opportunities for governments to subsidy private companies.

- The financial aid provided by the Marshall plan had to be used for purchasing American goods.
- Since the end of the 1990s more and more services of the US Army have been outsourced to private companies: transporting troops to Iraq (or taking them back

There is at least one field from which the US government has withdrawn which is the organization and regulation of the relations between workers and unions on one hand and management on the other hand.

The New Deal had given many rights to unions but in the decades after the Taft–Hartley Act of 1947 the clocks were progressively turned back.

What effects would one expect from that withdrawal?

Employers have always been well organized in a number of associations, such as the Chambers of Commerce or the National Association of Manufacturers (NAM). If unions are not allowed to organize in a similar way, they will obviously be at a disadvantage.

Thus:

- **if sympathy strikes are prohibited,**
- **if employers are authorized to recruit temporary workers during strikes,**
- **if bankruptcies can be used as a last resort means to overrule the unions, then, of course, one would expect the weight of unions to dwindle.**

Is this expectation confirmed by actual observation? Answer is: YES as will be seen in what follows.

Fig. 5.7 Government role in regulating the relations between employers and labor. Employers can fire employees whereas the opposite is not possible. Thus, the balance of power is naturally tilted. If in addition, the government sides with the employers by cancelling most of the regulation introduced by the New Deal, then employees will be subdued and their unions crashed and suppressed.

to the US) is done by American airlines; basic services such as breakfast, lunch, dinner, household services, construction of bases and so on are provided by private companies. In addition, numerous security companies (a list available on the website [globalsecurity](http://globalsecurity.com) lists about 25) protect Iraq's oil pipelines or official American services in the so-called Green Zone.

Withdrawal of the federal government

In the two previous sections we have seen that the Federal Government remains very active in providing subsidies at both micro-and macro-economic level; this is reflected in the fact that the Federal budget represents about 20% of a country with a federal structure similar to the one of the United States represented only 11

However, there are (at least) two fields from which the federal government retreated, namely the regulation of financial markets and the relations between unions and employers. These two fields had received considerable attention during the period of the New Deal.

The Security and Exchange Commission had been created in 1934 but during the past two decades it was made almost powerless by chronic underfunding, e.g. there was almost no increase in its personnel in spite of the fact that the variety and the volume of financial operations had greatly increased. During the time he was Chairman of the Federal Reserve from 1987 to 2006, Alan Greenspan remained adamantly opposed to any regulation of derivative markets.

President Roosevelt wanted to provide a “decent standard of living” to all Americans; this is what he summarized under the expression of a “Economic Bill of Rights”. He realized that this can only be achieved by improving the bargaining position of the unions. The Wagner Act signed in July 1935 was an important step in this respect. In the first few years of the Wagner Act many employers simply refused to recognize it as law because the United States Supreme Court had already struck down a number of other statutes passed during the New Deal. After the Taft-Hartley Act of 1947 the pendulum began to move in the opposite direction. The powers of the federal services in charge of controlling how the regulations protecting the rights of workers were implemented were progressively curtailed.

The key-point in this question is the fact that employees are naturally and strategically at a disadvantage with respect to employers. They have influential (and well funded) associations such as the National Association of Manufacturers. They have most of the medias on their side. Consequently, if the government also sides with them, employees will face certain defeat in any social conflict. If employers can recruit temporary workers during strikes, if bankruptcies (under Chapter 11) can be used as a last resort means to overcome the opposition of unions and workers to salary and benefits cuts, if labor is plentiful because of an influx of immigrants, then of course the unions will lose one battle after another. Eventually, the balance of power will become so defavorable to them that strikes will become useless.

The results of such an evolution can be seen on the graph of Fig. 2.4 which shows real weekly wages as well as the number of strikes. By 2005 strikes have become almost inexistant and the real wage is lower than in 1975.

The promotion of the neoliberal agenda

In the field of economic studies the neoliberal agenda is currently being promoted by a network of websites (see chapter 6 of my book: “Driving forces”). How are these websites funded and who subsidizes the conferences that they organize in costly hotels? Nobody knows because, in contrast to political parties, such associations do not have to publish their funding sources .

However, there have been organizations such as the Mont Pelerin society promoting

this agenda well before the Internet era and in fact since the time of the New Deal.

Table 5.1 provides a link between the presidents of the Mont Pelerin Society and Nobel prize winners; it suggests that such associations have been able to shape the field of economics in a very effective way.

Table 5.1 The Mont Pélerin Society

The [Mont Pélerin Society](#) was the main organization for promoting neoliberal ideas among economists. It was founded in 1947 by Friedrich Hayek.

Of the 23 economists who served as president of this society between 1947 and 2004, 5 became Nobel prize winners shortly after the end of their terms as president as can be seen from the following table.

Presidents of the Mont Pélerin Society who won Nobel Prizes

Name	Term as president	Nobel prize
F. Hayek	1947 – 1961	1974
M. Friedman	1970 – 1972	1976
G. Stigler	1976 – 1978	1982
J. Buchanan	1984 – 1986	1986
G. Becker	1990 – 1992	1992

Notes:

- The French economist Maurice Allais (Nobel prize in 1988) attended the first meeting of the Mont Pélerin Society and was one of its founding fathers but he did not serve as president.
- Three other prominent members of the Mont Pélerin Society were Ronald Coase, Vernon Smith and Erik Lundberg. Coase and Vernon became Nobel laureates in 1991 and 2002 respectively. Lundberg was a Swedish economist who held the following positions: (i) President of the Swedish Bank (ii) Member of the Nobel Committee for Prize in Economic Science from 1969 to 1979 (iii) Chairman of this committee from 1975 to 1979.

One must keep in mind that economics is still a field in which significant empirical tests of theories⁸⁰ play a very modest role. Consequently ideological reasons and plausibility arguments play a prominent role. As an illustration one can mention the fact that the books written by Friedrich Hayek contain almost no empirical data and, to our best knowledge, the statements which are made have never been tested on real data. Whereas the Nobel prize in physics has always been awarded to discoveries which had stand the test of experimental observation, in economics this has rarely been the case.

⁸⁰We would not label the standard econometric methodology of model testing as being “significant”. A model should be tested in a *great variety of situations* and not just in one as is the standard procedure.

By awarding Nobel awards to neoliberal economists, the Bank of Sweden (“Sveriges Riksbank”) which instituted the Prize in 1968 promoted this political philosophy at the expense of other possible orientations. Moreover, by rewarding so many untested theoretical investigations the Nobel Committee can hardly be said to have contributed to making economics into a more scientific and reliable discipline.

Chapter 6

Is there a way out?

It was said that Reaganomics was a Trojan horse for the rich. Under the cover of a new tax policy, tax rates on top brackets were drastically reduced from 70% to 35%. In a book published in 1986, David Stockman, Ronald Reagan's budget director, writes that the main purpose of the tax reform was to bring down the tax rate on upper income brackets and that to make the reform palatable as a political matter it had to be presented as a new bold economic approach called supply-side economics⁸¹.

In previous chapters we pointed out that the main themes of neoliberalism (which is the global version of Thatcherism and Reaganomics) include many demands which have been on the corporate agenda for decades. If we accept this assumption it must be possible to find other historical episodes during which neoliberal policies were either dropped or re-introduced after having been abandoned for a while. It is the purpose of this chapter to present and briefly discuss such episodes. We will describe five episodes.

(1)) The crisis of 1893-1897. This crisis is interesting because it has some similarities with the present crisis. It started as a financial crisis, became an economic crisis and ended in what is called the progressive era which was marked by a kind of New Deal. It was the time of Theodore Roosevelt's "Square Deal"⁸².

After World War I the decade of the 1920s was again a period of frenzy and speculation marked by an advance of neoliberalism.

(2)) The transition from the neoliberal agenda to the New Deal agenda in 1932-1933 in the wake of the Great Depression.

(3) The resistance against the implementation of New Deal policies in the period 1933-1938.

(4)) The post-war period after the death of President Roosevelt in 1945 (at the beginning of its fourth term) and the end of the war economy was marked by a series of defeats for unions and labor. After 1947 with the buildup of the Cold War the

⁸¹In contrast Keynesian policies rely on stimulating demand and consumption and because lower-income earners spent a much larger proportion of their income than high-income earners they recommend to lower tax rates for cash-strapped households. Supply-side economics relied on the development of entrepreneurship and on the implicit assumption that "a rising tide will lift all boats".

⁸²In many respects T. Roosevelt's Square Deal prefigured F. Roosevelt's New Deal. In 1906 he convinced Congress to create the "Interstate Commerce Commission" to regulate interstate railroad rates. It was the first true federal regulatory agency.

progressive forces who had supported the New Deal suffered even greater blows. The economic effects of these setbacks were not immediately apparent because globally it was a period of great prosperity. For instance real wages continued to increase for about 20 years.

(5)) At the beginning of his term in the spring of 2009, president Obama gave several signals which suggested that neoliberal policies were no longer favored. At the time of writing (April 2009) it is still too early to say if these signals will open the way to new policies. However, the evidence currently available suggests that the president has opted for going along with business lobbies rather than to oppose them.

Situation in 2009

Before examining these episodes, it may be useful to have a brief look at the situation in 2009 that is to say at time of writing.

In many respects the world in which we live has become more unipolar. The term “unipolar” is usually used to describe the post-1991 world which is dominated by one superpower. It is not only politically that our world has become unipolar but also socially and economically. In the field of economic research Marxist or Keynesian conceptions have been swept away. In western countries the medias (newspapers, radio, television channels, Internet) are dominated by a few huge companies and even the few (more or less) independent companies which remain are following in the footsteps of the big corporations. As a case in point one can mention the French newspaper “Le Monde”. Twenty years ago, it was trying to provide a fairly independent and objective view; nowadays, it follows other medias in their most frenziest campaigns even at the cost of relaying news of most doubtful reliability.

Yet, there are nevertheless some signs of resistance to the new order. The problem is that for the time being this resistance takes the form of refusals and rejections, not of counter-paradigms. This is illustrated in Fig. 6.1.

Crisis of 1893-1900

The depression which began in 1893 had some common characteristics with the depression which started in 2008.

- In 2008 many US banks had to be bailed out by the government. In 1893 many banks and railroad companies had to be bailed out by the government. For instance on 16 August 1893 the Northern Pacific Railroad was placed in the hands of receivers (after having been declared in bankruptcy) *for the third time*. By February 1994 one sixth of the railroad mileage had passed into the hands of receivers (NYT 27 Feb



Fig. 6.1 Billboard against Wal-Mart in the United States. The background sentences in blue say: “More traffic, rising crime, local job loss, tax payer subsidies for health care”. The last contention refers to the fact that the wages paid by Wal-Mart are low enough for health care coverage to be provided by “Medicaid”, which is a federal program for low income households.

This photograph was taken on 19 June 2005 on Staten Island which is located about 10 km to the south of Manhattan. Around this time there were also programs on the television channel PBS (Public Broadcasting Service) which exposed some of the adverse social and economic consequences of Wal-Mart management methods in the United States, for instance the fact that it prohibits unions and employs illegal immigrants; in the second case this was laid on local managers who, allegedly, acted without explicit approval from Wal-Mart headquarters.

1894 p. 4).

- In 1894 as in 2008 the situation of many banks was beleaguered by recurrent writedowns. An article of the New York Times of 13 August 1893 observes: “Commercial bank directors are not hopeful. A good deal of the paper is reputed worthless”. Two months later one reads the following judgment: “The most reckless and unscrupulous methods may be pursued by the directors of a bank until the institution has been plunged into bankruptcy” (NYT 25 Oct 1893 p. 4).

- As can be seen from Fig. 6.1 the initial increase rates of unemployment were fairly parallel for the two depressions.

Needless to say, it would be pointless to compare the two depressions in a global way. What would make sense is to compare *specific aspects*. For instance it could be interesting to compare the evolution of delinquent mortgages in the two episodes. It is not possible to develop such studies within the framework of the present publication, but we intend to do so in a subsequent paper.

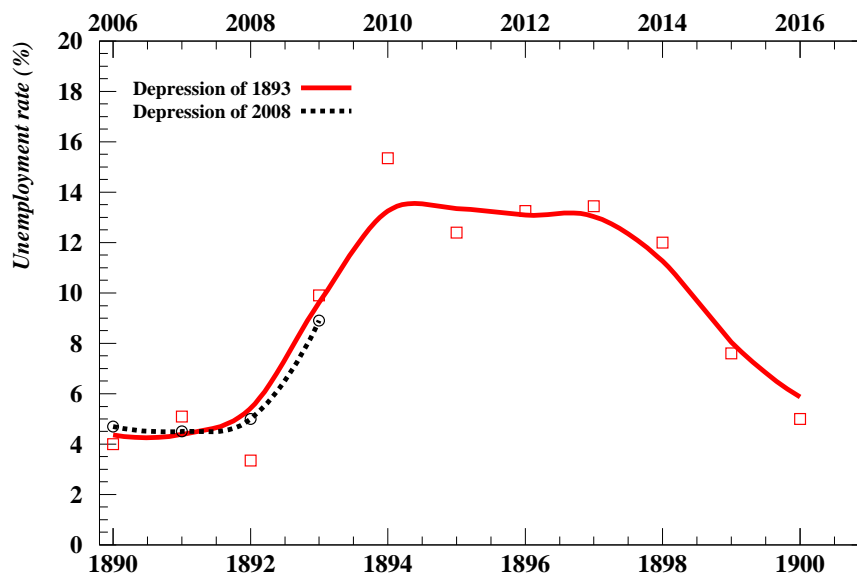


Fig. 6.1 Unemployment in 1890-1900 on the one hand and in 2006-2009 on the other hand. As explained in the text the depression of 1893 had several common points with the depression of 2008. A 3-point moving average was used to smooth the curve for the depression of 1893. *Source: Unemployment data for 1890-1900 are from Lebergott and Romer series cited in Wikipedia, entry: “Panic of 1893”.*

1932-1933: Runs on banks, closing of the Stock Exchange

President Roosevelt’s inauguration took place on Saturday 4 March 1933. The New York Stock Exchange closed on Friday night⁸³ and remained shut until Tuesday 14 March. During these 10 days there was also a banking moratorium which means that most banks were closed. This, in a nutshell, illustrates the dramatic circumstances under which the new administration began to work.

Chronology 6.1 Events before and after President Roosevelt’s inauguration on 4 March 1933

Runs on banks and hoarding of currencies have been common features since (at least) mid-1931. However, in 1931 and 1932 only small amounts of gold were sent abroad. On the contrary the new run on the banks which started in mid-February 1933 resulted in a huge outflow of gold.

As always it is difficult to say what triggered this movement. Was it a reaction of defiance against the reforms planned by the new administration or was it a panic due to deteriorating financial conditions?

In response to this situation President Roosevelt took drastic emergency measures in the first days after his inauguration. Hoarding of gold was forbidden under threat of heavy penalties. The prohibition against holding gold was only lifted by President Gerald Ford.

1932, Feb 4 President Hoover appealed to the country to cease the hoarding of

⁸³At this time the NYSE was normally open on Saturday; the only weekly closing day was Sunday.

currency, as a patriotic move toward loosening credit. Hoarded funds were estimated by the President at \$ 1,300 million every dollar of which, he said, meant the destruction of from \$ 5 to \$ 10 of credit.

(*NYT 4 February 1932, p. 1.*)

1932, Jun 4 Wall Street celebrated the advent of a \$100 million pool established by New York's largest banks. The pool should begin to function this week. The money is to be invested in sound securities, stocks as well as bonds. As a result, over the last two days there was one of the wildest advances in the history of the Stock Exchange.

(*NYT 4 June 1932, Financial and Business section p. 5F.*)

[This investment pool can be put in parallel with the stimulus plans that were adopted in late 2008 and early 2009. \$100 million of 1932 would represent \$1.5 billion of 2008. The amount involved in present-day stimulus plans had been at least 500 times larger.]

1933, Feb 13 Situation in real estate. Efforts to help the real estate situation which is one of the worst problems now besetting the United States resulted this week in the formation of the "Realty Stabilization Corporation" for New York city which is to borrow \$100 million from the "Reconstruction Finance Corporation" in order to finance mortgages.

(*Times 13 February 1933 p. 19.*)

1933, Feb 15 With more **bank failures** there has been a recurrence of hoarding by nervous people. All the banks in the state of Michigan have been closed for one week which means a moratorium for all business transactions.

(*Times 15 February 1933 p. 19.*)

1933, Feb 27 Runs on banks in different parts of the United States increased in number. Ten states have already enacted moratorium legislation. Congress has amended the "National Bank Act" so as to allow national banks under condition of approval by the Secretary of Treasury to withhold from depositors (for a period of 6 months) all but a small fraction of their balance.

Hoarding did not confine itself to currency (as was the case in last year's crisis) but also resulted in the hoarding of gold. This is probably due to the feeling that there will be a depreciation of currency.

(*Times 27 February 1933 p. 19.*)

1933, Mar 2 Injection of public money into the financial system. The "Reconstruction Finance Corporation" was formed in February 1932 to protect banks, insurance companies, railways and other corporations in difficulty by the use of government credit. The amount of the advances that it was called upon to make

has exceeded all expectations; it totaled \$2 billion [in dollars of 2000 this would represent about \$28 billion]. Among the factors which brought about this crisis one can mention:

- (i) Prices of shares and land were pushed to heights out of all relation to any return which could be expected from them.
- (ii) American banks lent money freely and themselves embarked upon highly speculative operations.
- (iii) Everyone was encouraged to speculate on margin that is to say with borrowed money.

(Times 2 March 1933, p. 13.)

[When one reads the factors to which the Times ascribes the financial crisis which lead to the Great Depression it is tempting to draw a parallel with the current crisis.]

1933, Mar 4 The New York Stock Exchange closed on this day which is a Saturday whereas in normal times it used to be open on Saturdays. It will remain closed during 10 days that is to say until the end of the Banking moratorium on March 15.

(Farrell 1972.)

[Similarly, there were high expectations after the inauguration of president Obama in January 2009.]

1933, Mar 4 Americans are a people of invincible hope. But seldom can their eagerness to see a new President inaugurated have equaled that of this year. It is a delayed realization of what they have been carrying in their hearts since last November.

(NYT 4 March 1933, p. C12.)

1933, Mar 4 Excerpt of the inaugural address of President Roosevelt. “Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men. Faced by failure of credit they have proposed only the lending of more money. Stripped of the lure of profit by which to induce our people to follow their false leadership, they have resorted to exhortations, pleading tearfully for restored confidence. They know only the rules of a generation of self-seekers. They have no vision, and when there is no vision the people perish.

The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit. Happiness lies not in the mere possession of money; it lies in the joy of achievement, in the thrill of creative effort. The joy and moral stimulation of work no longer must be forgotten in the mad chase of evanescent profits [...]

There must be a strict supervision of all banking and credits so that there will

be an end to speculation with other people's money. [. . .]

In the event that the Congress shall fail to take one of these two courses, I shall ask the Congress for broad Executive power to wage a war against the emergency, as great as the power that would be given to me if we were in fact invaded by a foreign foe."

(<http://www.historyplace.com/speeches/fdr-first-inaug.htm>.)

[It is not uncommon for a president to make similar pledges. Because the "practices of unscrupulous money changers" have never been very popular in any country, it is an easy way to rally a broad support. What differentiated President Roosevelt from his predecessors is that these promises were seconded by acts. During the first "Hundred Days" 15 major laws were passed, among which one can mention the Farm Relief Bill, the Civilian Conservation Corps which would provide work to 250,000 young men or the law establishing the Tennessee Valley Authority to bring hydro-electric power and flood control to 7 southern states. Other laws addressed the problem of home mortgage foreclosures which was causing Americans to lose homes at a rate of 360,000 per year. In the last sentence the president warns the Congress that if needed he is ready to ask for special war time executive power.]

1933, Mar 5, 11 pm The President's Bank proclamation.

WHEREAS, there have been heavy and unwarranted withdrawals of gold and currency from our banking institutions for the purpose of hoarding;

WHEREAS continuous and increasingly intensive speculative activity abroad in foreign exchanges has resulted in severe drains on the nation's stocks of gold;

Because of this state of emergency the law of 6 October 1917 will again be put in force. Under this law the penalty for hoarding by natural persons is imprisonment for not more than 10 years.

(*NYT 6 March 1933 p. 1.*)

1933, Mar 6, 9 The two steps in the prohibition of gold hoarding.

(i) On March 6, taking advantage of a wartime statute that had not been repealed, president Roosevelt forbade the hoarding of gold or silver (in bullion or coins) under penalty of 10 years of imprisonment or/and \$ 10,000 fine.

(ii) On 9 March Congress incorporated the penalties of the wartime statute into the Emergency Banking Act.

(*NYT 6 Apr 1933 p. 16.*)

1933, Mar 27 For several past months there has been a substantial transfer of assets from New York to London which can be estimated at about \$ 160 million.

(*NYT 27 March 1933 p. 23.*)

1933, Mar 28 During February 1933 there has been an alarming drop of the gold reserves of the banks of \$558 million. In the first days of the Roosevelt admin-

istration, orders were sent to the Treasury (under the Emergency Banking Act) to compile a list of all persons who had withdrawn large amounts of gold in the last two years without apparent business reasons for doing so. The Treasury first asked the commercial banks through the Federal Reserve Banks to forward the list by March 13. Subsequently the deadline was extended to March 27.

What action the government will take toward the persons who have not returned their gold has not yet been announced.

It is expected that the government define what it considers to be hoarding after what a rule will be laid down by which the Department of Justice may prosecute hoarders.

(NYT 28 March 1933 p. 27.)

[On 27 March 1933, the Federal Reserve Banks had a store of gold of only \$503 million; this shows the magnitude of the withdrawal.]

1933, Apr 6 The amount of gold still in hoarding can be estimated to about \$1,000. How much of this is in foreign countries and how much is in the United States can hardly be known.

(NYT 6 April 1933 p. 1.)

1933, Apr 6 The executive order issued on April 6 affirms that the national emergency still continues to exist [in spite of the end of gold outflow] and sets out in more detail the government prohibition against hoarding. All persons are required on or before May 1 to deliver to a Federal Reserve Bank gold in coins and bullion or gold certificates now owned by them. They will receive lawful money in return.

The penalties remain as set by the President's first proclamation.

(NYT 6 April 1933 p. 16.)

[In the Donald Duck cartoon stories there is the character of dear Uncle Scrooge⁸⁴ (“oncle Picsou” in the French version) who swims in a pool full of gold coins. This character was created in 1947 at a time when it was still illegal to hold gold.]

1933-1938: Opposition to New Deal policy

In most historical accounts of how the New Deal policy was implemented one aspect is often under-reported, namely the bitterness of the resistance put up by business interests and in particular by the “National Association of Manufacturers” (NAM) and the “United States Chamber of Commerce” which were the two most powerful associations lobbying for business interests.

⁸⁴A scrooge is an ungenerous person; Ebenezer Scrooge was the protagonist of a novel by Charles Dickens.

As a matter of fact, pro-union regulations were not implemented for years because employees were expecting that they would be voided by the US Supreme Court in the same way as the “National Industrial Recovery Act” was declared unconstitutional in 1935. Resistance to the New Deal policy on the one hand and increasing popular support for the reforms on the other hand lead around 1935 to what is called the “Second New Deal”. It was markedly more pro-labor than the first New Deal.

There can be little doubt that by 2009 similar reforms would elicit even more powerful opposition. The greater concentration of newspapers, TV and radio channels in the hands of a few big corporations would make the struggle for public opinion more asymmetrical and unbalanced than in the 1930s.

As will be explained in the next section, the pendulum began to move in the opposite direction almost immediately after the death of President Roosevelt in April 1945.

1946: Anti-New Deal reforms after World War II

As a general rule, wars put workers in a better bargaining position for the simple reason that they bring about a shortage of labor. This was particularly true during World War II in the United States. Some 12.5 million American joined the armed services in a time when plants were operating at full capacity to fulfill war supply plans. The same effect had been observed during the Civil War and during the First World War. What made it particularly strong in World War II is the fact that President Roosevelt supported the advancement of the rights of workers.

Broken promises

On 11 January 1944 in a speech delivered in Congress President Roosevelt defined an “**Economic Bill of Rights for the American People**”⁸⁵:

In our days these economic truths have become accepted as self-evident:

- The right to a useful and remunerative job.
- The right of every family to a decent home.
- The right to adequate medical care.
- The right to adequate protection from economic fears of old age, sickness, accident, and unemployment.
- The right to a good education.

Many of these objectives were dropped within a few years. So radical has been the change in the *Zeitgeist* that by 2009 the very notion of a bill of economic rights seems somewhat weird and utopian. There is still much talk about “human rights” but what is to be understood under this expression seems to have been seriously squeezed.

⁸⁵This speech was made one year before President Roosevelt’s death.



Fig. 6. a Cartoon about opposition to the New Deal policy in 1935. The person who writes on the wall symbolizes the American Liberty League (which is written on his back) an association of business leaders who opposed New Deal policies. On the sheet of papers that he holds in his left hand are the following names: Judas Iscariot, Cain, Jesse James (famous American outlaw who has been portrayed as a kind of Robin Hood), the Jukes family (a family of outlaws who lived in the 19th century and was studied by an American sociologist), Jack the Ripper (pseudonym given to an unidentified serial killer active in London in late 1888), Public enemy No 1. Similar pictures drawing comparisons between President Obama and Hitler have been published in 2008 and 2009. *Source: Published in the New York World-Telegram, the cartoon was reproduced in Wolfskill (1962).*

Already during the war, in June 1943 Congress passed the repressive Smith-Conolly Labor Act, a forerunner of the Taft-Hartley Law, over the veto of President Roosevelt.

After the war business organizations tried to turn back the clock. The Cold War which began almost immediately after 1945 was instrumental in this respect. In fact,



Fig. 6. b Picture drawing a parallel between President Obama and Hitler (left) or Lenin (right). This is just one example of a series of pictures which offered a parallel between President Obama and Chancellor Hitler. The comparison with the previous figure shows that such a parallel is a fairly permanent element in the repertoire of the American right (in the sense the term “repertoire” is used in Roehner and Syme (2002)). The great difference with 1935 is that by this time President Roosevelt had indeed carried out an important program of structural reforms whereas in mid-2009 President Obama was still struggling to pass his first main reform plan namely the restructuring of the health care system. *Source: The picture has been reproduced on many websites, e.g. <http://scatterplotshooting.worldpress.com> or <http://snappedshot.com/plugin/tag/obama>. According to the inscription in the right-hand side margin the initial design was due to J. Michael Haynes (we were not able to locate this name on the Internet). Note that there is a typo in the sentence at the bottom of the poster.*

business began to advocate for an end to the New Deal even before the end of the war. The objections of the NAM were mainly directed against the Wagner Act and the Temporary National Economic Committee (TNEC).

One of the main activities of the TNEC. was to enforce anti-trust legislation and in 1942 the NAM published a massive refutation (830 pages) of the arguments of the TNEC (Scoville et al. 1942). In mid-1943 NAM officials called for a government commitment to a return to free enterprise in the post-war period (NYT 22 Jun 1943 p. 27). At the end of 1944, the NAM adopted a 6-point program whose themes were basically those of Friedrich Hayek’s book *The road to serfdom* (NYT 8 Dec 1944 p. 1).

The message against government intervention was repeated relentlessly in the late 1940s. Between 1946 and 1950 the NAM distributed 18 million pamphlets that pushed anti-New Deal, anti-union and anti-communist sentiments. A cartoon service serving more than 3,000 weeklies disseminated cartoons that humorized the NAM theses. For instance, the forgotten man that Roosevelt popularized in his speeches is represented as a tattered taxpayer. The NAM also produced radio programs (e.g. the Family Robinson) and movies and it run vast national billboard campaigns (Ewen 1996) .

As a sign of a burgeoning anti-union campaign one can mention an advertisement inserted in the New York Times of 25 September 1946 (p. 23) by the “Employers’ Industry Wage Scale Committee”. Covering about one third of a page, it was running the following headline:

**The Trucking Strike
is Affecting You
and every Resident of New York**

The arguments developed in the rest of the message were quite standard: (i) New York truck driver wages, it was said, were already 20% higher than in other cities [but the rent of apartments was probably also substantially higher in New York than in other cities.] (ii) The Union has rejected the proposals of the employers. (iii) It is the public which will eventually pay for the higher wages [curiously enough, this is rarely (if ever) mentioned in newspaper articles in relation with the salaries of top executives which, as is well known, have experienced huge increases in the past two decades].

In the same issue of the New York Times (p. 22) one can say a photograph of George L. Mueller, president of the “Powers Workers Union” as he was being led to prison after being sentenced to a term of one year for contempt of court. At the audience to the judge’s question: “Do you refuse to call off this strike as far as any authority of yours is concerned?”, he had answered “I do”. On this reply he was immediately sentenced for contempt.

One should recall that Secretary of Commerce, Henry Wallace was fired by President Roosevelt on 20 September 1946. Wallace who had been vice-president from 1941 to 1945, favored cooperation with the USSR which had also been the policy of President Roosevelt until his death⁸⁶. It was said that Wallace was the last New Dealer to leave the government. So, September 1946 was a real turning point.

Such pressure and campaigns proved indeed effective. The development of unions which had been so strong before and during the war was curtailed. A landmark date was 23 June 1947 when the United States Senate followed the House of Representatives in overriding Truman’s veto and establishing the Taft-Hartley Act as a law⁸⁷. It amended the Wagner Act (which Congress had passed in 1935) in a

⁸⁶In June 1944 together with Owen Lattimore he made a three-week visit to the eastern part of the USSR. Wallace relates his visit in a book entitled “Soviet Asia Mission” (1946) while Lattimore brought back a film and an article for “National Geographic Magazine” which was published in December 1944. Lattimore later became the target of an anti-Communist campaign.

⁸⁷Although President Truman expressed (fairly mildly) his opposition to the law, subsequently he used it several times

way which was favorable to business.

Moreover, while the prospect of universal, federally insured health coverage seemed close, the project was killed in Congress in November 1949.

The turning point of 1945 in foreign policy and the Cold War

In some political circles the Soviet Union had remained the main foe even though it was officially a close ally during the war. There had already been a “Red Scare” in the 1920s. During the 1930s a “House Committee on Un-American Activities” (HCUA) hunted down Communists and sympathizers, i.e. members of so-called front organizations.

In the weeks before the election of November 1944 at a time when the war was still in full swing there was quite a revealing incident that was mentioned by President Roosevelt in his radio address of 5 October 1944 (see below). Thirteen Republican Congressmen had mailed 3,116,000 copies of a speech in which they alleged that “the Roosevelt Administration is part of a gigantic plot to sell our democracy out to the Communists”⁸⁸. It can be said that the Cold War began soon after the death of President Roosevelt on 12 April 1945. Under President Truman, Secretary of the Navy James Forrestal who was strongly anti-Communist assumed an essential role. Starting in 1946 and in collaboration with the FBI, the American Chamber of Commerce published a series of anti-Communist brochures which were based on the assumption that the only objective of American Communists was to overthrow the government⁸⁹. The Taft-Hartley Law was a fruit of the Cold War and represented a landmark victory of business in its fight against the power of unions.

Document 6.1 President Roosevelt’s radio address of 5 October 1944

My fellow Americans:

I am speaking to you tonight from the White House [. . .]

I have just been looking at a statement by a member of the Congress, Representative Anderson, Chairman of the House Committee on Campaign Expenditures, about a document recently sent free, through the mails, by one Senator and twelve Representatives- all of them Republicans. They evidently thought highly of this document, for they had more than three million copies printed free by the Government Printing Office, requiring more than 18 tons of scarce paper, and sent them through the mails all over the country at the taxpayers’ expense.

to break strikes.

⁸⁸The article of the New York Times (4 October 1944, p. 14) which mentions this story says that the speech attacked the “Congress of Industrial Organizations” (C.I.O.) union but it does not allude to the attack against the Roosevelt Administration, probably an effect of self-censorship in war time.

⁸⁹The first titles were as follows: *Communist infiltration in the United States: its nature and how to combat it*; *Communists in the government: the facts and a program* (1947); *Communists within the Labor Movement, facts and counter-measures* (1947). Other titles followed subsequently.

Now let us look at this document to see what made it so important to 13 Republican leaders at this stage of the war when many millions of our men are fighting for freedom. Well, this document says that the “Red specter of Communism is stalking our country from East to West, from North to South” the charge being that the Roosevelt Administration is part of a gigantic plot to sell our democracy out to the Communists.

This form of fear propaganda is not new among rabble rousers and fomenters of class hatred who seek to destroy democracy itself. It was used by Mussolini’s black shirts and by Hitler’s brown shirts. It has been used before in this country by the silver shirts and others on the lunatic fringe. But the sound and democratic instincts of the American people rebel against its use, particularly by their own Congressmen and at the taxpayers’ expense.

I have never sought, and I do not welcome the support of any person or group committed to Communism, or Fascism, or any other foreign ideology which would undermine the American system of government, or the American system of free competitive enterprise and private property.

That does not in the least interfere with the firm and friendly relationship which this Nation has in this war, and will, I hope, continue to have with the people of the Soviet Union. The kind of economy that suits the Russian people, I take it, is their own affair. The American people are glad and proud to be allied with the gallant people of Russia, not only in winning this war but in laying the foundations for the world peace which I hope will follow this war and in keeping that peace.

Source: Website of the American Presidency Project.

The Taft-Hartley Law

Passed by Congress in June 1947, the Taft-Hartley Law nullified many of the rights that workers and unions had gained through the Wagner Act of 1935. In that sense it really marked a turning point in US labor relations. To make this point clear one must explain in some detail its main provisions.

- It required union officers to deny under oath any Communist affiliation. As a result, the 232,000 officers who signed the oath were in daily danger of employer-inspired testimonies which would expose them to perjury indictments and could send them to prison. There were several cases of this kind. One of them received broad public attention. In 1954 Clinton Jencks who had played his own role as a union leader in the movie “The Salt of the Earth” was indicted, convicted of perjury and sentenced to 5 years in prison. The conviction rested largely on the testimony of a paid informant for the Federal Bureau of Investigation who later recanted his story.

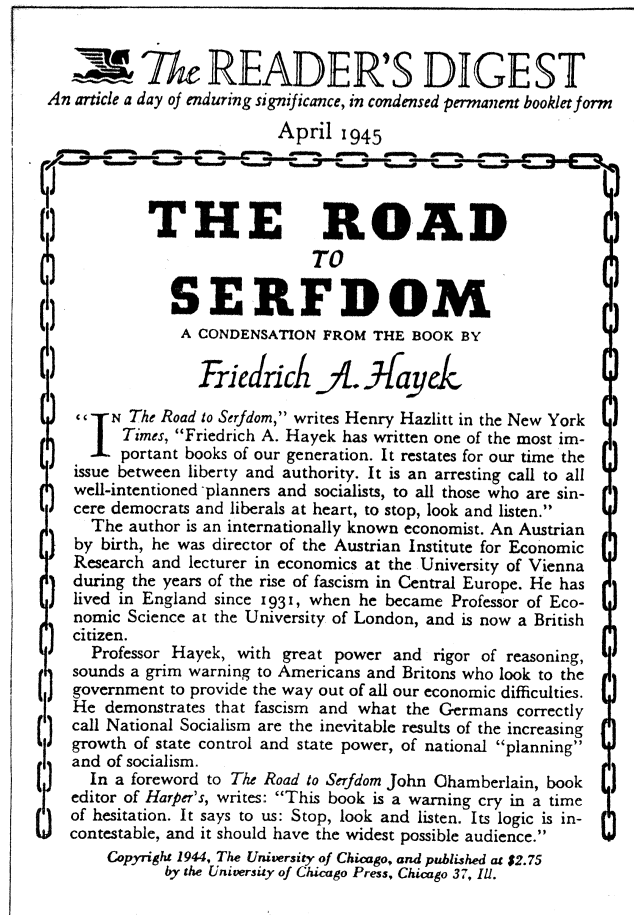


Fig. 6.2 Advertisement for the "Road to Serfdom". Hayek's book presents opinions but contains very little facts and almost no data. At that time the Reader's Digest had a circulation of one million copies. Published in 1944 jointly in Britain and in the United States, the book benefited from a worldwide advertisement campaign; for more details about this campaign see Roehner (2007, p. 117-119). As a matter of fact, it was part of a broader campaign destined to get rid of the reforms of the New Deal which had raised strong objections from business associations and their lobbying groups.

The case was taken up by the Supreme Court in 1957 in a decision which bared a system of prosecution based on paid informants.

- The law gave courts the power to fine unions for alleged violations, thus exposing them to million of dollars in legal expenses, fines and damage suits.
- The law established a 60-day cooling off period in which no strike could be declared.
- By outlawing mass-picketing it gave again employers the opportunity to employ replacement workers.

Union-bashing

In a review of a book entitled "Scandal in organized labor" Professor Lawrence Richards observes: "The association of unions with organized crime is perhaps the most idelible image of organized labor in American culture. Even Americans

who know nothing else about unions (indeed, precisely those who know little about unions, “know” about union corruption”. A natural question is: how did such a belief take root?

Two observations can throw some light on the answer.

- Such a belief is largely specific to the United States. In France, Germany or the Scandinavian countries no association is made between unions and organized crime.
- During the 1930s the LaFollette Civil Liberties Committee of the US Senate (as well as other commissions) conducted hearings of employers which exposed their unlawful behavior in matters of safety rules, union obstruction or agreements with competitors.

In the 1940s the wind began to turn. Columnists, radio programs and movies introduced and popularized the idea that union bosses were by and large gangsters or in league with gangsters. Scandals surrounding William Bioff or Jimmy Hoffa were exploited by anti-New Deal conservatives for union-bashing purposes. This is precisely the topic of the book that we mentioned above. Its author, David Witwer, focuses on a few select cases which were at the start of this evolution. He exposes the anti-New Deal agenda of the “Crusading journalists” who investigated these affairs; he explains how employers often encouraged the pressure of organized crime on unions and took advantage of it. Just to name a few, movies such as “On the Waterfront⁹⁰” (1954), “Armed and Dangerous⁹¹” (1986) or “Hoffa⁹²” (1992) contributed to create a strong association in the minds of people between unions, crime and corruption.

Although it is difficult to assess with precision the role played by such campaigns in the fall of unionization rates, one would expect that they had indeed some influence. The best proof of their effectiveness is provided by the fact that anti-union organizations are prepared to spend millions of dollars on such campaigns. From an Internet excerpt from the “National Journal” (31 July 2008), one learns for instance that anti-union front groups planned to collectively spend almost \$100 million in 2009 against the “Employee Free Choice” bill and those who support it; the contribution breakdown was as follows:

- Chamber of Commerce: \$25 million
- Coalition for a Democratic Workplace: \$30 million
- Employee Freedom Action Committee: \$30 million
- Freedom’s Watch: \$30 million
- Center for Union Facts: exact contribution unknown, but in the millions.

⁹⁰A longshoreman struggles to stand up to his *corrupt union bosses*

⁹¹A fired cop signs up as security guard and find he has joined a *corrupt union*.

⁹²About the fight of Attorney General Robert Kennedy against *corrupt unions* such as Jimmy Hoffa’s Teamster Union.

Will Obama's presidency mark a turning point?

Chronology 6.2 shows that on the basis of his first month in office President Obama intends to break away from the assertions of the neoliberal creed. This is particularly clear for the following issues: tax evasion and off-shore tax shelters, unionization, tax rate for the highest income brackets, federal aid to alleviate the cost of higher education. Yet, in politics intentions are not enough. Any substantial change must overcome the resistance power of the social and political forces who took advantage from the previous system. So the real question is rather⁹³: “Will President Obama and the Democratic Party commit themselves with sufficient energy to the objective of making such a change *really* happen?”

We try to answer this question at the end but before that, one can make three preliminary observations:

(1)) Proponents of neoliberalism are not willing to question the soundness of their model in the light of the present crisis. They did not do that after the failures of Enron, Global Crossing and WorldCom (which were early warnings of the problems which surfaced in 2007) and they will not do so either in the wake of the current crisis. The common position of banks and neoliberal think tanks is: “We are opposed to any form of federal regulation; whatever mistakes had been made will be corrected by the profession”. In short, the plan is to overcome the present crisis and to resume the activities which had been so profitable during the past decades. Actually this attitude makes sense from their perspective. This can be shown by the following simple calculation. It is said that the fund of George Soros had an average annual return of 30% between 1969 and 1999. Such a return represents a multiplication by a factor $K = 1.3^{30} = 2,620$. So even after a fall of 90% the multiplier is still equal to $k = 262$ which corresponds to an average annual return of 20%.

(2)) There is already a vocal opposition to President Obama's agenda but for the time being (March 2009) it comes from hard core of neoliberals such as the Rupert Murdoch medias, the Cato Institute, the Heritage Foundation and other neoliberal think tanks. On the contrary, the Hearst Press is showing moderation and understanding.

(3)) A major difference with the New Deal is that President Obama had been elected much earlier in the crisis. At the time of President Roosevelt's inauguration the country had already been in economic recession for 3 years and the unemployment rate was 25% of the civilian labor force (Historical Statistics of the United States p. 135). As a result there was a consensus that “something had to be done”

⁹³In the time of globalization it could seem bizarre to put so much emphasis on the policy of the United States. Yet, at the present time its influence is so overwhelming that even for large countries such as China or India their economic options are modeled on the US particularly as far as labor policy is concerned. A major US shift away from the neoliberal agenda would bring about a global turning point.

which even extended to business circles. Although this good will did not last very long, in the present case there is nothing of the sort.

If one adds to that the fact that the medias are much more powerful (especially due to TV) and more concentrated in a few hands that they may have been in 1933, one would expect that the groups who oppose any change will put up a more determined fight.

Chronology 6.2 Will there be a shelving of neoliberalism under the Obama administration?

Through decisions taken within a few weeks after his inauguration on a number of important issues, President Obama has shown that the changes that he promised during his campaign imply the calling into question of several of the axioms of the neoliberal creed. As illustrated in this Chronology this concerns in particular the following points: (i) Curtailment of tax havens worldwide (ii) Higher taxes on rich people (iii) Federal aid to students (iv) Halt to the privatization of Medicare.

2009, Jan 27 Against the stimulus plan (1). The Cato Institute mounted a full frontal attack against [President Obama's] stimulus plan.

(Excerpt from the website "Mike Norman Economics" ..)

[The stimulus plan (American Recovery and Reinvestment Act) was intended to be passed by Congress on a bipartisan basis. Incidentally, this is why it was found highly disappointing by progressive economists such as Paul Krugman. Nevertheless: (i) The plan passed with zero Republican support (ii) It drew fierce criticisms from neoliberal think tanks. (iii) On 29 January, the Cato Institute sponsored a nationwide advertisement campaign in newspapers against the plan.

For the President this may have provided a clear indication that it was futile to seek bipartisanship.]

2009, Jan 29 Against the stimulus plan (2). The Cato Institute purchased full-page ads in major national newspapers (e.g. the New York Times or Washington Post). After citing a statement made by Mr. Obama on 9 January (i.e. before his inauguration) which read: "There is no disagreement that we need action by our government, a recovery plan that will help to jumpstart the economy.", the message said: "With all due respect, Mr. President, that is not true." Below there was a short declaration which contained in particular the following sentence: "More government spending by Hoover and Roosevelt did not pull the United States economy out of the Great Depression in the 1930s." After these comments came a list of about 190 names, mostly professors who signed the declaration. The same advertisement was placed in 15 student newspapers on 11 February 2009.

(<http://wichitaliberty.org/economics/with-all-due-respect-president-that-is-not-true/>.)

[Incidentally, the US production of steel which was 15 million tons in 1932 had climbed to 53 in 1939 (and 83 in 1941, Historical Statistics of the United States p. 693); thus, to say that government spending by President Roosevelt did not pull the country out of the depression does not seem quite correct.]

2009, Feb 6 Executive Orders about the role of unions. President Obama signed an Executive Order, effective immediately, authorizing executive agencies of the federal government to require every contractor on large-scale construction projects to become a party to a Project Labor Agreement (PLA) with unions. This Executive Order, which specifically revokes contrary Executives Orders issued by former President George W. Bush in 2001 and reinstates a Clinton-administration rule, was immediately hailed by organized labor. The reaction of the business community, not surprisingly, was far different. The chief executive officer of the “Associated General Contractors of America” said that this order “has the unfortunate potential to limit contractors’ ability to compete for projects at a time when the government is reporting that over one million construction workers have lost their jobs.”

(<http://www.jacksonlewis.com/legalupdates/article.cfm?aid=1634>.)

[To the extent that this rule will apply to *all* contractors it is difficult to understand why it should limit their ability to compete. The real reason of the protest may be that this rule will strengthen unionization in a time when union-free companies have become the rule.

This is the fourth pro-labor Executive Order signed by President Obama since January 30th. Another order bars federal contractors from being reimbursed for expenses incurred in trying to persuade employees *not* to form a union. As a result of these orders most of the infrastructure projects funded in the \$787 billion stimulus plan will have union workers.]

2009, Feb 20 Fight against tax shelter abuses (1). Swiss law prohibits Swiss citizens from revealing any information covered by bank secrecy. This was confirmed when (on Friday night) the Swiss Administrative Tribunal ruled that UBS should *not* reveal to the American authorities the names of American clients having a secret account. Yet, shortly after this decision was released UBS announced that it had already transmitted the names of about 300 clients (in a total of 52,000 US customers). On Wednesday the bank had received an ultimatum that it had until Thursday to comply or face an indictment which would bar it from banking activity in the United States. One obvious question is: how were the customers selected whose names were transmitted? If they did not give permission they could rightly complain about discrimination.

(Tribune de Genève.)

[The importance of this information comes from the fact that the demand for the names of the clients had already been made in June 2008. See in this respect the following articles:

- (i) Wall Street Journal 14 May 2008: Two charged in tax case.
- (ii) Spiegel 20 May 2008: Europe, US battle Swiss bank secrecy.
- (iii) Bloomberg 1 July 2008: UBS may be forced to comply with a request by Federal prosecutors to reveal the names of US clients with secret bank accounts set up to evade income-tax.

Under the Bush administration, the matter was left pending. Nothing happened between July 2008 and 20 January 2009. Although UBS said it was cooperating with the IRS it did not release a single name. Then under the new administration the procedure was energetically reactivated.

It can be recalled that in February 2007 together with his colleagues Carl Levin and Norm Coleman, Senator Obama had introduced a bill, the “Stop Tax Haven Abuse Act” which contained much stricter regulation for both individuals and companies. The bill was not passed at the time but a similar bill may be introduced once again in 2009 with this time a better chance to become law.]

2009, Feb 26 Higher tax on rich people (1). Obama’s planned tax would hit highest earners hardest. Taking from wealthy people to support universal health care will create enmity between high income people and those less fortunate. It will fracture society.

(Excerpt from the website of the Cato Institute.)

[This statement should be compared with the observations presented in an earlier chapter which suggest that the past two decades were marked by a broad increase in social segmentation.]

2009, Feb 27 Higher tax on rich people (2). Obama’s budget plan sweeps away Reagan ideas. In a radical departure from recent history, the budget planned by President Obama would sharply raise taxes on the rich mainly by eliminating tax cuts which were enacted under former President George W. Bush. The top income tax rate for couples making more than \$ 250,000 would increase from 35 percent to about 40%. The tax increases would be delayed until 2011

(NYT 27 February 2009, San Francisco Chronicle 28 February 2009.)

[An increase from 35% to 40% represents a small change if one recalls that before 1980 the top rate was 70%.]

2009, Feb 27 Federal aid to students. If adopted the planned budget will markedly increase federal aid for students who want to go to college. Over the last three decades the cost of college tuition climbed while the pay of less-educated work-

ers declined. As a result the United States lost its standing as the country in which the largest share of young adults graduates from college.

(*NYT 27 February 2009.*)

2009, Feb 27 Taking control of Citigroup. The US government will swap the \$25 billion in preferred stock that it holds in Citigroup from a previous bailout into common stock. This will raise its share in the bank to 36%. To emphasize the significance of this decision it must be recalled that in contrast to common stock preferred stock does not carry any voting right. This conversion will make the Federal government the main shareholder of Citigroup. Although the current chief executive will remain in place for the moment, the boards of directors will be reshaped.

While this is not outright nationalization it comes close to it. In the wake of this decision the shares of the bank fell 39% to \$ 1.50.

(*Associated Press, 27 February 2009, article entitled “New Citi plan may serve as model but carries risks”.*)

[Financial support provided to banks under the Bush administration took mostly the form of purchasing “toxic” assets or preferred stock which did not give the Treasury any control over the banks decisions.]

2009, Feb 27 Budget plan draws broad criticism in the Murdoch medias. As an illustration one can mention the comments in the New York Post: “Obama’s budget schemes to drain staggering amounts of money from people who worked for it and steer it to people who didn’t. This isn’t the free market. It’s the freeloader market”.

(*New York Post.*)

[Even the Federal aid to help select students to pay their tuition is disapproved on the account that it comes on top of Social Security and Medicare which is said to be on “the verge of catastrophic collapse”.

The New York Post, one of the oldest American newspapers, belongs to the group of Rupert Murdoch.

This excerpt shows that five weeks after his inauguration, President Obama is already facing a fierce opposition at the forefront of which one finds the Rupert Murdoch medias (which include the Fox News TV channel, the “Weekly Standard” magazine and many others) and neoliberal think tanks such as the Cato Institute.

In contrast, the Hearst newspapers (e.g. Houston Chronicle, San Francisco Chronicle, Seattle Post-Intelligencer) are much more moderate and balanced in theirs comments.]

2009, Feb 28 The “Federal Deposit Insurance Corporation” (a government agency providing a kind of insurance to customers of failed banks) has been authorized



Fig. 6.3 Cover of the “Weekly Standard” of 9 March 2009. The “Weekly Standard” magazine belongs to Rupert Murdoch’s News Corporation. The titles of some of the articles published in this issue are quite revealing: “The Return of Big Government”, “Hey, Big Spender”, “A Ph.D. in Every Pot”, “Indefensible”, “Reports of conservatism’s demise have been greatly exaggerated”, “Unions are part of the problem, not part of the solution”.

to raise an emergency fee of 0.2% of deposits from the 8,305 federally insured financial institutions. In addition to this emergency measure the regular insurance premium will be raised to about 0.14%. In 2008 the average premium paid by banks and thrifts was 0.063%.

(Associated Press 28 February 2009, article entitled: “FDIC raising fees on banks.”.)

[During 2008 the FDIC rescued directly several small banks. In the case of large banks the FDIC mainly acted as a middle man. Thus, Washington Mutual (with assets around \$300 billion) was acquired by JP Morgan Chase for \$1.9 billion in a deal brokered by the FDIC. The capital of the FDIC is only about \$20 billion and would have been quickly exhausted if it had attempted large rescue operations.]

2009, Mar 3 Fight against tax shelter abuses (2). Bills against offshore tax havens were introduced by democrats in the Senate and House of Representatives. The Senate bill expands on one co-sponsored last year by then-Senator Barack Obama and Senator Carl Levin, who has sought a broad crackdown on tax dodgers. Texas Democrat Lloyd Doggett who introduced the legislation in the House declared: “These outrageous tax havens add to the soaring budget deficit and shift the tax burden to small businesses and families who play by the rules”.

(Reuters 3 March 2009, article entitled: “Foreign tax havens targeted in US bills”.)

[The article also notes that “a thriving business in tax evasion developed in recent years on Wall Street among consulting firms, hedge funds and other financial players.

Some purveyors even sought patent protection for their schemes. This shows that on this issue the Obama administration is intending to change the trend which prevailed in recent years.]

2009, Mar 4 Fight against tax shelter abuses (3). UBS wealth management executive Mark Branson, appearing Wednesday 4 March before a Senate Committee, said he objected to an Internal Revenue Service (IRS) lawsuit that seeks to force UBS to reveal the names of up to 52,000 US customers who may have concealed their accounts from tax authorities. He said that UBS cannot disclose information to the IRS that would put its employees at serious risk of criminal prosecution under Swiss law. He also said that as of 30 September 2008 47,000 American clients had failed to file special tax forms known as W-9s with the bank. UBS was supposed to require them to do so. So far, UBS has shut down 14,000 American offshore investment accounts but would not close their deposit accounts.

At the same audience IRS Commissioner Doug Shulman said the US government was taking unprecedented measures to combat offshore tax avoidance and promised that “much more is in the works”.

Senator Levin, the chairman of the Committee observed that banking secrecy is “part and parcel of a conspiracy to commit a crime under our law”.

Cloak-and-dagger tactics said to have been employed by UBS such as coded language in internal e-mails and memos or foreign shell companies were on display at the hearing.

(http://www.moneynews.com/streettalk/swiss_bank_tax_dodgers/2009/03/04/188504.html.)

[UBS’s refusal to disclose other names in addition to the 250 already transmitted has certainly been weighed carefully. In the worst case scenario it would mean the closing of UBS operations in the United States (25,000 employees out of a total of 78,000) but also perhaps in countries that may follow the American lead (e.g. Australia, Canada, Mexico). It can be hypothesized that the present decision was taken in agreement with the Swiss government and is based on the fact that the breaking of the secrecy rule would be more serious for Switzerland than a drastic contraction of the activity of UBS. The total assets of American UBS customers is estimated at about \$15 billion (Associated Press 4 March 2009, article entitled: “UBS says it had 47,000 accounts for Americans”). This figure is probably an underestimate because it is known that to open an account at UBS the minimum was \$1 million which on the basis of 47,000 customers would imply assets of (at least) \$47 billion.]

2009, Mar 10 Pro-union legislation. The so-called “Employee Free Choice bill” was introduced in Congress. The bill is meant to make it easier for employees to unionize because instead of a secret ballot, as is currently the practice, they

could simply sign a card supporting unionization. The business community is lobbying hard against the legislation with the leadership of Wal-Mart Stores and the US Chamber of Commerce. Wal-Mart is vehemently opposed to the legislation and its spokesman declared that the company feels certain that Congress will not pass this pro-union bill.

(Dow Jones Business News.)

[The real problem of unionization seems to be that in 25% of the unionization drives, pro-union workers are just (illegally) fired⁹⁴. Currently (2009) the penalty for firing pro-union workers is so weak that it does little to deter law breakers.

Whereas many Americans would probably agree that this is not fair, it is likely that the card check debate will not raise much public interest and even less approval. It must be noted that this legislation was already introduced in Congress in 2007 and defeated. In short, it does not appear to be a wise move to have chosen this battleground to start the all-important battle about the respective rights of employers and employees.]

2009, Mar 18 The Federal Reserve follows the UK and Switzerland in their policy of printing money. “The Fed is printing \$1 trillion of money, and using those funds to buy bonds. I think quantitative easing [the current way of referring to money printing] is the right way to go”.

(New York Times 20 March 2009, article by Paul Krugman.)

[After that announcement was made many analysts expressed their concern that the exchange rate of the dollar may slide and that, as a result, inflation may pick up in the United States with the possibility of a flight of money to more stable currencies. For the time being such fears seem unfounded. As far as the future is concerned, the outcome depends on how much dollars will be printed. One trillion could seem a big amount but compared with the deflationary process that results from the fall of house prices, it is in fact fairly small. In 2007 the total market value of US residential and commercial property was around \$30 trillion (22 for residential and 8 for commercial); thus, an annual price fall of about 20% results in deflation amounting to \$6 trillion. If annual quantitative easing comes to exceed this amount one may begin to worry about inflation.]

2009, Mar 29 Regulation plans of the financial system. The Obama administration wants to rewrite the rules of the game for the finance industry. This would

⁹⁴The ballot for unionization may be held if more than 30% of employees sign cards asking for it. But, according to current legislation, employers naturally get to scrutinize and challenge the signatures before the election can be called. This allows companies to use the current process to intimidate, coerce, and even blacklist workers involved in organizing those who signed the cards. In other words, the employer will know how employees are going to vote long before they step into the voting booth. Many employers resort to spying, threats, intimidation, harassment and other illegal activity in their campaigns to oppose unions. (<http://www.californiaprogressreport.com>, The Washington Independent 14 January 2009)

include forcing derivatives trading on to recognized exchanges, new oversight of hedge funds and additional powers to shut down large firms that threaten to destabilize the global economy.

Republican leaders signaled that they would not allow President Obama to bulldoze new legislation through Congress and called for time for reflection. The American Bankers Association immediately threw up objections to the plan. Analysts said that the planned regulation could curtail profitable trading opportunities.

(The Independent 27 March 2009.)

[At the time of writing (March 2009) there was much talk about regulation. However one should not forget that the Sarbanes-Oxley Act of 30 June 2002 already tried to establish enhanced standards for publicly traded companies and public accounting firms. This law was passed in the wake of the Enron and Global Crossing bankruptcies which revealed the broad extent of deceit and corruption. Its objective was to restore public confidence in US capital markets.

The very fact that this law was only mildly opposed by financial interests and their lobbying groups suggests that it was not taken very seriously. The crisis which erupted 6 years later indeed confirmed that opacity, deceit and graft were still widespread and pervasive. The Act established a new quasi-public agency, the “Public Company Accounting Oversight Board” (PCAOB) which was charged with overseeing and inspecting accounting firms. In following years very little was heard about this agency.]

2009, Mar 29 Prospects of a landmark pro-union bill. In the early 1950s about 35% of private-sector workers belonged to unions. Today less than 8% do. As a result, wages have lagged behind rising productivity. How President Obama and congressional leaders decide to craft pro-union legislation will determine the post-recession economy. Many expect this question to be a defining showdown of Obama’s presidency.

(Washington Post 29 March 2009, p. A05.)

[At the time of writing there are very few articles on this question. Yet, it seems clear that there can be no sustainable economic growth in the United States unless wages and salaries again begin to grow instead of declining as was the case during the past 30 years.]

2010 Rosy forecasts. The Obama budget forecasts that, despite the depth of the current recession, the economy will recover and grow by 3.2% in 2010 and then climb to an even more robust 4% in the three following years.

(Seattle Post-Intelligencer 26 February 2009.)

What should be expected in 2010–2011?

We have given a fairly detailed account of the first 100 days of the Obama administration. Let us now come back to the key questions addressed in this section: will there be a real break with the neoliberal agenda? Our flat answer is “No”. Why?

There is a considerable difference between the 100 days of President Roosevelt and the 100 days of President Obama. Between March and May 1933 15 laws were passed which represented *structural* changes. Between January and March 2009, the laws which were passed intended mostly to provide short-time relief; very little was done in terms of structural changes. The attempts which were made to introduce major breaks (e.g. in terms of tax havens or labor regulation) were not pursued with enough energy and did not materialize in major laws. In the weeks after his inauguration President Obama enjoyed strong public support which would have enabled him to make major breaks. He did not take advantage of this opportunity.

On several important issues President Obama backed down from the promises he made during his campaign, e.g. (i) regarding relief provided to home owners in bankruptcy: the finance industry was adamantly opposed to allowing bankruptcy judges to reduce the mortgage level. “When the time came to stand up to the banking lobbies the White House didn’t” wrote the New York on 4 May 2009. (ii) The introduction pro-union legislation has been given a false start as we explained above (iii) The struggle against UBS and other tax heavens seems to have been shelved. It is doubtful that these projects can be resumed later on especially once the strong public support of the first months has dwindled.

So, with the basic rules of the system practically unchanged what can one expect to happen?

Financial markets have very short time constants. They collapsed within a few months but they can also come back to life within a few months. As soon as credit will flow again the transactions which have been so profitable in the past (e.g. leveraged buyouts, mergers and acquisitions, initial public offerings) will be resumed.

For economic markets the time constants are much longer and recovery will take several *years*. Let us give an illustration.

During 2008, industrial production in developed countries fell by about 16%; how long will it take to return to the production level of early 2008? Since in past years the highest (sustained) growth rates were of the order of 4%, it means that it would take 4 years to regain the production level of early 2008. In other words even assuming steady, uninterrupted growth over the next 4 years, the production level of January 2008 will be reached again only in January 2013. If underlying problems such as income distribution are not solved in the meanwhile a recovery in the form of the

Japanese “lost decade” of the 1990s seems likely; this means a sputtering growth engine with “good” quarters being followed by quarters posting negative growth. Under such an assumption recovery may take much longer. In Japan the index of industrial production reached a level of 101.6 in 1991 and regained that level only in 2005, that is to say fourteen years later.

Some tests for the years to come

Will there be a way out of the neoliberal ideology in the years to come? There is no way to answer this question in a scientific way. However, it is possible to define some test-indicators which should allow us to see more clearly in which direction the world is heading.

Comparison between 1929 and 2008 in terms of synchronicity

Financial globalization progressed markedly between 1990 and 2008; therefore it is hardly surprising that the financial crisis assumed a worldwide extension in a matter of months. What is more surprising is how rapidly it affected the production sphere, a feature which is documented in Fig. 6.1c.

The severity of the depression which started in 2008 is not due only to its world-wide extension, but also to the number of sectors which experienced drastic declines within a few months. At the time of writing one can mention:

- Banking
- Residential real estate
- Office and commercial real estate. For instance, the market value of the Canary Wharf property, London’s financial hub fell 26% between December 2007 and December 2008 (The Independent 27 March 2009).
- Transport sector. For instance, the port terminal of Portland, Oregon which is a major hub for transpacific trade has seen a sharp reduction in activity. Trans-Pacific cargo traffic fell 32% in 2008 (Portland Business Journal 20 March 2009).
- Overproduction problems in the automobile industry spread fairly quickly.

Can one use Fig. 6.1 for predictive purposes?

Intuitively, one may be tempted to speculate that the more synchronous and widespread a crisis is, the deeper it will be and the longer it will last. be. Let us examine these points more closely.

- It is true that the downward momentum shown by graph 6.1c is impressive. The whole question, however, is whether this fall is due to exogenous or endogenous factors. As an example of the first kind one can mention the Spanish flue pandemic of 1918⁹⁵. Because it killed a substantial number of young people worldwide and

⁹⁵It is estimated that anywhere from 20 to 100 million people were killed worldwide, more than double the number

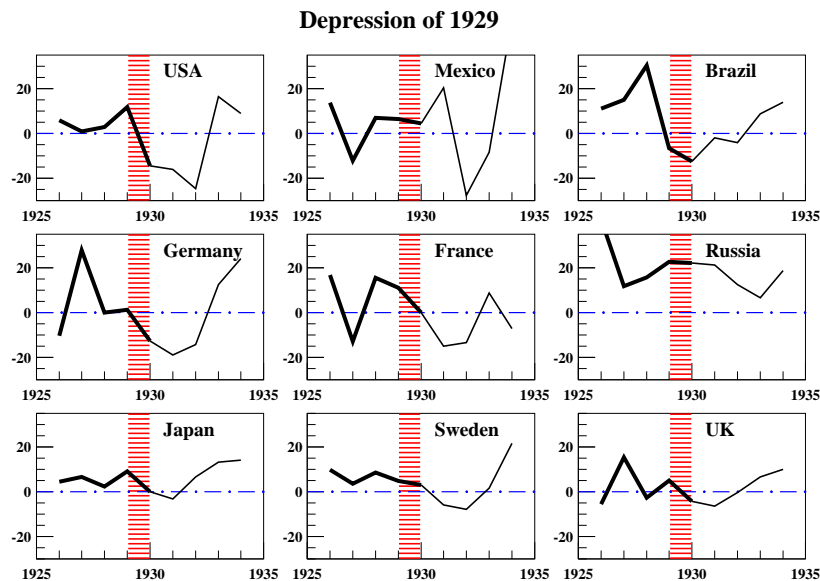


Fig. 6.4a Variation of industrial production in 9 countries before and after 1929. The graph shows annual variations expressed in percent. The zone delimited by the broad vertical line corresponds to the first year of the depression, i.e. the transition from 1929 to 1930. The graph shows that contrary to a common belief the Great Depression was not a worldwide depression. The UK, Japan and Russia were mildly or not at all affected. It can also be seen that during the 1929-1930 time interval, apart from the United States there were only two other countries (Germany and Brazil) where there were sharp negative growth rates. In short, the depression started with a low degree of synchronicity.

The fact that over 1929-1930 all the curves are going downward means that the *second* derivatives (i.e. the accelerations) were all negative. This has a simple interpretation. Once the depression had started in the United States, the reduction of US imports induced a slowdown in the activity of all main economic partners; this brought about reduced growth even in countries where growth rates remained positive. *Sources: Mitchell (1978), Mitchell (1982), Mitchell (1983)*

disrupted exchanges it certainly had a detrimental impact on economic activity. Yet, the epidemic lasted only a few months, basically from September to November 1918. As soon as it abated exchanges and activity were re-established and growth was resumed. Thus, in this case the impact of a sudden and global shock was neither severe nor short-lived.

- Fig. 6.1c shows that the impact of the current crisis is not only universal but also fairly strong. Annual falls of industrial production in the range of -10% – -20% are not common.

Is there a connection between the depth of a recession and its duration? In order to find out one can consider the case of the Great Depression in the United States. It is often argued (especially by proponents of neoliberalism) that the New Deal did not work because the industrial production resumed its level of 1929 only in 1939. In such a statement one forgets that the index fell from 124 in 1929 to 67 in 1932, a fall of about 50%. After the New Deal policy was started in 1933 the index grew steadily

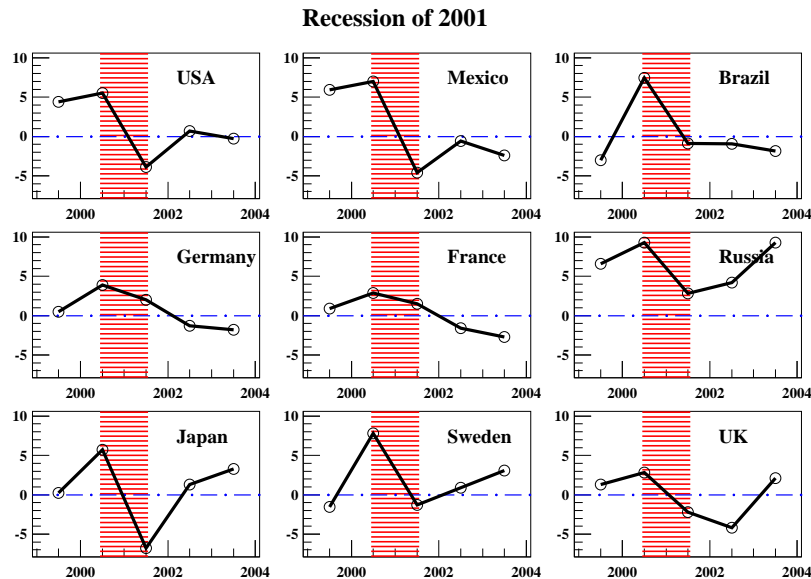


Fig. 6.4b Variation of industrial production in 9 countries before and after 2001. The graph shows annual variations expressed in percent. Compared with the graph for 2008 there are major differences in terms of amplitude and in terms of synchronicity. (i) The vertical scale shows that it was a recession of low magnitude; The three largest negative growth rates (US, Mexico and Japan) have a magnitude around -5% whereas in the next graph the three largest falls are much larger: -31% (Japan), -19% (Germany), -17% (Sweden). (ii) During the first year of the recession, industrial production continued to increase in three countries: Germany, France and Russia. Sources: Website of “Trading Economics”: <http://www.tradingeconomics.com>; Statistical Yearbook of Sweden; Historical Statistics of Japan.

(with the exception of 1938 which was marked by a decline) but it took of course some time to rescue the American economy from the abyss into which it had fallen. Even with an annual growth rate of 10% it would take 7 years to raise production from 67 to 124.

This example clearly suggests that depth and duration of a depression are two related variables because it takes time to recover the lost ground.

As an illustration, consider the case of Japan. During the golden decade 1981-1990 the average annual growth rate of Japan’s industrial production was 4.6% ; the highest annual rate occurred in 1988 with 9.7% ⁹⁶. Thus, to recover from the 31% fall which occurred in 2008 it would take $31/9.7 = 3.2$ years at the fastest possible annual rate and $31/4.6 = 6.7$ years at the fastest average rate sustainable over a period of several years.

Comparison with the Great Depression in terms of social interactions

In a previous chapter we documented the decrease in social interaction over the past decades. According to Harvard professor Robert Putnam economic depressions lead

⁹⁶The sharp drop of 1975 (-11%) was followed by a quick recovery but nevertheless the growth rate was only 9.2% in 1976.

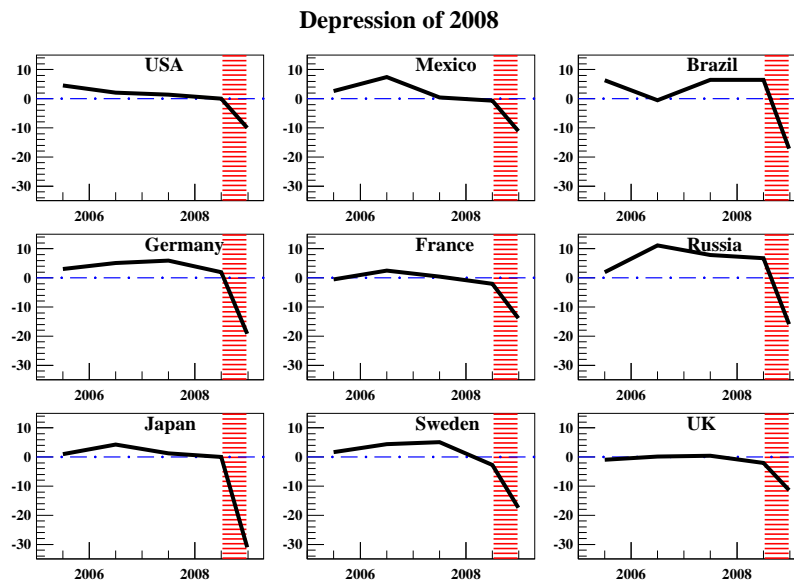


Fig. 6.4c Variation of industrial production in 9 countries before and during 2008. The graph shows annual variations expressed in percent. The depression started with a high level of synchronicity: all the falls are larger than 10%. It is probably the first time in the history of mankind that a severe recession started worldwide with such synchronicity.

Somewhat surprisingly, the falls are smallest in the two countries (UK and US) where the financial crisis originated. As of January 2009, the unemployment rate is almost the same (around 8%) in the European Union, in Russia and in the United States; the increase rate, however, is fastest in the US.

As a matter of comparison, the steepest annual decline during Japan's "lost decade" (1991-2001) was -7% which occurred from 1997 to 1998 and again from 2000 to 2001; in 1974 the oil shock brought about a fall of only 11%. (Historical Statistics of Japan).

China (which is not included in this graph because of the lack of data in the 1930s) had still a positive growth of about 8% in 2008, a rate which marked a substantial reduction with respect to earlier growth rates of about 15%. Sources: Website of Trading Economics: <http://www.tradingeconomics.com>

to even greater social isolation. He found that Kiwanis clubs, PTAs⁹⁷, and other social groups lost around half their members from 1930 to 1935.

Putnam believes that the effect would be more pronounced today. The Depression was a boom time for movies. Today movies are no longer cheap but TV provides a cheap substitute. Yet watching TV is an activity which contributes to social isolation.

Supply of labor

In the 19th century

Historically, it had always been a great concern for employers to be able to rely on an abundant supply of cheap labor.

⁹⁷ "Kiwanis International" is a global organization of volunteers headquartered in Indianapolis, Indiana. It comprises approximately 8,000 clubs in 96 countries with over 260,000 adult members (2008). Kiwanis emphasizes service to children and youth.

PTA: "Parent-Teacher Association", a voluntary organization bringing together parents and teachers.

Back in the 19th century as slave trade was progressively being abolished, British planters brought indentured workers from India to many parts of the British empire where they were needed to work on tropical plantations; one can mention for instance Fiji, Guyana, Jamaica, Kenya, Mauritius, South Africa, Surinam, Trinidad, Uganda⁹⁸.

Yet, except during the world wars, no attempt was made at that time to bring workers from the colonies to Britain or other European countries. Apparently, the supply of labor provided by Irish immigrants was deemed sufficient to support the industrial development in England and Wales.

After 1945

It is only after World War II that increasing numbers of immigrants from Jamaica, India or Pakistan entered Britain. In subsequent decades the globalization of labor supply became one of the main features of the new economic system. In 2009 this remains a crucial question because so long as supply vastly exceeds demand there can be no real improvement in real income and in working conditions. Yet, in all industrialized countries (with the possible exception of Japan) employers are still very committed to their demand for cheap labor and its corollary which is free immigration. For instance in 2009 the vice president of the US Chamber of Commerce declared that the business community remained committed to a significant guest-worker program⁹⁹ and welcomed an expansion of temporary worker programs. (New York Times 14 April 2009).

The European Union has long-term programs for recruiting foreign workers in sectors in which the supply is not sufficient. Needless to say, there would be another obvious way to increase the supply side, namely by raising salaries. If wages for night watchmen, nurses or construction workers were raised by 20% there is little doubt that the scarcity problem would be quickly solved¹⁰⁰.

This question arises even for highly qualified jobs such as scientific research. So long as experts in computer science, electrical engineering, mathematics, physics from countries such as China, India, the Philippines, Russia or South Korea are willing to fill positions in American industry and universities the average salary of PhD graduates will stagnate and the number of PhD diplomas earned by American students will continue to decline (see chapter 9 in this respect).

⁹⁸After these countries became independent in the 1960s, there have in several cases been rejection riots which lead to the departure of a sizable fraction of the Indian population.

⁹⁹Such programs are opposed by American unions because the immigrants are tied to one employer and cannot change jobs no matter how abusive working conditions are. In other words, such contracts are fairly similar to the contracts of indentured workers of the 19th century or to the labor contracts of foreign workers in countries such as Dubai or Saudi Arabia.

¹⁰⁰The argument that it would erode the competitiveness of these companies is pointless because these are domestic sectors which are not in competition with other countries.

In the same line, the development of post-doctoral programs has provided research institutions with a flexible, temporary and fairly cheap supply of scientific researchers from all over the world. But the downside is that highly trained scientists will have to wait until they are between 30 to 40 years old to get a permanent position, a situation which most of them do not happily accept ¹⁰¹ .

It is likely that denying permanent positions to young employees adversely affects birth rates. Indeed, does the ability to support a family in a sustainable way not appear as a reasonable precondition for getting married and raising a family?

Can the trend be reversed?

How can this trend be reversed? Before trying to answer this question it may be useful to recall Franklin Roosevelt's argument about using child labor in cotton fields (Address of the President delivered by radio from the White House, 7 May 1933).

Take the cotton goods industry. It is probably true that ninety per cent of the cotton manufacturers would agree to eliminate starvation wages, would agree to stop long hours of employment, would agree to stop child labor, would agree to prevent an overproduction that would result in unsalable surpluses. But, what good is such an agreement if the other ten per cent of cotton manufacturers pay starvation wages, require long hours, employ children in their mills and turn out burdensome surpluses? The unfair ten per cent could produce goods so cheaply that the fair ninety per cent would be compelled to meet the unfair conditions.

Currently, we have the same situation; it is no longer at national level, today it is at world level. So long as starvation wages are paid by 10% of the countries, those who pay decent wages will be faced with unfair competition and will be compelled to "meet the unfair conditions". This is the "rush to the bottom" scenario which has been described by many lucid American Congressmen.

The first idea which comes to mind is to re-introduce restrictions on cross-national migrations of workers. For historical, cultural and sociological reasons this was the policy followed in Japan. Yet, it would be very difficult to implement a similar policy elsewhere. For instance, to restrict the movements of workers between the countries that compose the European Union would run against the very ideas on which the European construction is based. In addition it would be almost useless because the companies would relocate their plants into Eastern countries where wage-levels are lower. NAFTA, the North American Free Trade Agreement, does not provide for free movements of workers but it makes little difference because US companies can freely establish their plants in the north of Mexico in the so-called *maquiladora*

¹⁰¹ Twenty years ago in France it was possible to obtain a permanent position in a research university at the age of 24; in 2009 one can apply at the age of 28 at the earliest; often young researchers are recruited after 30. The situation is similar in Germany or in the United States.

area¹⁰². The ability to shift production out of the country, and then sell the products back home, gives transnational corporations a crucial edge.

In short, unless there is a broad come-back of protectionism, that solution will not work.

Is there another solution?

Definitely yes. So far, all free-trade agreements whether on a bilateral basis or on a multilateral basis (e.g. under the European Union or World Trade Organization) contained rules which were designed for the benefit of companies but none which would improve the situation of people and workers. There were rules ensuring the free circulation of goods or prescriptions about the respect of patents, brands, intellectual property, but no rules about fiscal policies (regarding tax rates for corporations) or about the rights of unions.

As there were no rules about tax rates on the profit of companies, this brought about a race in which each country lowered its tax-rates in order to attract more foreign investments. But at the same time this deprived the governments of part of their receipts and made them unable to provide basic services (e.g. free education) to their population. As low wage countries have an inherent attractiveness, it would make sense to require tax rates on profit to be *higher* (for instance 5% higher) than in industrialized countries. That would have two advantages. (i) It would introduce a kind of balance between low wages and higher tax rates. (ii) It would provide resources to the governments of developing countries for improving infrastructure and education. Otherwise the conditions in these areas will not improve. The *maquiladoras* came in existence in Mexico around 1965 to take advantage of the low level of wages but more than forty years later there are still no unions in these companies. As a consequence, the condition of the workers has scarcely improved and these areas are still afflicted by third-rate infrastructures (in terms of water, streets, education) because the local government is too poor to make the required investments.

At present there were no rules in free-trade agreements about the basic rights of unions; as a result, the workers of low wage countries have been unable to improve their condition. The union-free plants established in the north of Mexico are a case in point. Thus, if the workers in developing countries cannot improve their condition, no equilibrium can ever be reached. There will be a race to the bottom, to ever smaller real wages until the economy comes to a standstill because there is no longer enough purchasing power in the system. As we already explained this is probably

¹⁰²The term *maquiladora* refers to an assembly plant set up in Mexico by a non-Mexican firm near the US-Mexican border. Starting in 1965 many non-Mexican companies were attracted by the low wages, special tax concessions and the proximity to the US market. They usually assemble parts manufactured elsewhere, and by law they must re-export 80% of their production. By 2000 the maquiladoras employed more than a million Mexicans, mostly women. The managers are usually foreigners, whereas the hourly-paid workers, who have little job security and few benefits, are Mexican.

what explains the debt driven economy that lead to the recent crisis.

What kind of rules could be included in free-trade agreements? To proclaim the basic right to form unions is not enough. Such a right is probably included in the constitutions of many countries. As we already explained, unions are powerless unless their rights are clearly stated. One may wonder why this is so.

- There is a fundamental asymmetry between employers and employees which comes from the fact that employers can fire their employees whereas employees cannot fire their employers. The following observations are merely consequences of this situation.

- “Company unions” (also called “yellow unions”) are run by the company managers and are not affiliated with an independent trade union. Such unions were popular in the United States during the early 20th century, but were outlawed under the Wagner Act of 1935¹⁰³). It seems fairly obvious that yellow unions are not the best way to promote the right of workers. Balanced free-trade agreements would forbid company unions just as the Wagner Act did.

- If employees can fire unionized workers they will be able to prevent the formation of unions. Similarly, if during a strike employers can hire replacement workers no strike can possibly succeed. As a result any union will be useless and will be deserted by workers. Thus, free-trade agreements should contain rules prohibiting unfair labor practices such as those that we mentioned.

- Whether or not free-trade agreements should contain minimum wage requirements is debatable. If the minimum wage in Romania was set at 2/3 of the minimum wage in France there would still be a strong incentive for business to relocate plants in Romania but it would be a first step in a process of convergence of average wage levels in the two countries. In case such a rule is omitted it may take several decades to Romanian workers for securing such a wage level through the normal bargaining process with employers. The weaker their unions are, the longer it will take.

Will the trend be reversed?

Needless to say, the previous proposals would be completely unacceptable for free-market apologists. As was already the case during the New Deal, any proposal which calls for an extension of the right of unions would be labeled by them as being a concession to socialism, a label which has become almost infamous¹⁰⁴. Unless there is a radical departure from the prevailing *Zeitgeist* such proposals will remain wishful thinking and vain hopes.

As a matter of fact, apart from such ideological reasons, there is an even stronger

¹⁰³Company unions are a mainstay of labor organization in Japan.

¹⁰⁴The social and economic record of Scandinavian countries where such policies were implemented certainly do not justify such a judgment.

reason for the continuation of the present trend, namely the fact that it is to the advantage of all parties involved, at least in a short-term perspective.

This can be seen easily on an example. Because the United States has not enough nurses for its hospitals it organizes the recruitment of Filipino nurses. What are the advantages for each party.

- It allows the nurses to earn higher salaries and perhaps to marry and settle in the United States.
- The money sent by the nurses to their family in the Philippines improves the balance of payment of the country which can be seen as a favorable feature by the Filipino government.
- This additional supply of labor keeps down the salary of nurses in the United States and improves the profit margin of hospitals. If in addition a part of this cost reduction is used to lower hospital prices, this will contribute to a reduction in the cost of healthcare, a feature viewed with favor by the US government.

In the long-term, however, this system has unfortunate consequences.

- It deprives the Philippines of a group of well-educated citizens. For those who settle permanently in the United States the money which has been invested in their education will just be lost. In short, such an immigration actually represents a drain of resources.
- By depressing wages in the United States this system contributed to the making of the depression which started in 2008. Indeed, as we already mentioned, it is the fall in real wages coupled with enduring high levels of consumption which lead to the indebtment bubble that brought about the crisis.

Neoliberalism and interaction

Another important feature of the decades 1988-2008 was the leveraged buyout (LBO) bubble.

In such an operation a firm A is bought by a financial institution B (e.g. a holding company, a mutual fund or a hedge fund) in large part with borrowed money. The objective of the buyer is to use the income generated by A to reimburse the loans. Naturally, if for some reason (e.g. a recession) A turns out to be unable to generate the cash-flow that was expected, both A and B will be in trouble.

As an illustration one can mention the fact that between 2007 and January 2009 the shares of the Blackstone Group (whose chief is dubbed “the leveraged buyout king”) tumbled 90%.

It is likely that the long-term consequences will be even more dreadful. The reason, once again, is because LBOs bring about a loosening of social interaction. Nowadays,

the debate about neoliberalism is obscured by purely ideological arguments. In an other publication (Roehner 2009) we have tried to analyze this issue from the point of view of network science. It turns out that efficient and creative systems are systems in which there is a high degree of interaction. The three previous chapters suggest that the implementation of the neoliberal agenda resulted in economic and social segmentation, in other words it weakened interactions and at the same time reduced efficiency.

To make this argument more compelling one should be able to *measure* interactions fairly accurately. This will require extensive (comparative) work¹⁰⁵. but we have the feeling that such a research program will shed new light on this problem.

From a purely qualitative perspective it is fairly easy to give historical examples which show that the kind of absentee landlord interactions that characterize holding companies leads to poor economic and social achievements. Within 10 years it will be possible to assess the performances of companies which were bought through LBOs. If our present argument holds they should be poorer than those of similar companies which did not undergone LBOs.

Insight about the future

Toward a new model?

The Chinese ideogram for the word “crisis” is formed of two characters: one (wei) represents “danger” and the other (ji) means a “crucial juncture” (a secondary meaning is “resourcefulness”). It may well be that for China the current crisis indeed represents a crucial juncture and perhaps even an opportunity. Why?

Before 2009 Chinese economic growth was largely based on massive exports¹⁰⁶ to which foreign companies contributed for about one half. However, in the course of time this may have become a sure recipe for stagnant wages. Indeed, many foreign companies came to China to benefit from low wages and threatened relocation if wages were increased. Stagnant wages compounded with a thriving class of Chinese entrepreneurs would soon have lead to an oligarchic system and a de facto alliance with foreign business interests.

This is not pure speculation.

- After all, this was already the power structure under the Kuomintang government.
- Moreover, the Latin American countries provide several illustrations of such an evolution. For instance, after the Mexican Revolution of 1910-1920, it took less

¹⁰⁵In physics it took more than a century to explore the interactions between molecules, atoms or nucleons.

¹⁰⁶In 2008 exports represented about 30% of the GDP of China.

than 50 years for an oligarchic political class to emerge which monopolized political power with the support and blessing of US business interests. Nowadays, Mexico seems to be torn apart by internal strifes much as China was during the concession era.

In the fall of 2008 the Chinese government has signaled its intent to develop the internal market. That, of course, means distributing higher salaries as was done in the United States during the New Deal era. If the present crisis lasts long enough (let us say more than 10 years) that move will perhaps lead to the development of a new interesting economic model.

In the Preface we mentioned that in 2006 the Chinese government was planning to introduce a new labor law which would give more bargaining power to unions and that this move was fiercely opposed by foreign companies. Was this law eventually passed over their objections? An honest answer would be “yes and no”. Yes, because the law was indeed passed in June 2007 and was introduced in 2008. But for labor laws even more than for other laws the main question is how they are implemented. So far, the contracts which have been signed are extremely favorable to the companies. The collective agreement signed at Wal-Mart is a case in point. Some local union tried to fight it but did not get much support from the All-China Federation of Trade Unions (ACFTU) and were easily defeated. Only the future will tell us whether this low-profile attitude of the ACFTU is intended to placate foreign corporations until further concessions can be gained or whether it means that the ACFTU wants to permanently side with the management, not only in foreign firms but also in domestic companies. If the new Chinese entrepreneurs gain sufficient influence in the government it is probably the second alternative which will be realized.

Suppose for a moment that the first solution will prevail. This would mean that a new economic model may evolve in China which would provide a credible alternative to neoliberalism. During the past decade China already was the only major country where unions have been able to move forward instead of retreating. Smaller countries such as France or Germany can hardly move against the main stream. Its size allows China to open a new road for economic development. The coming years will tell us if it will seize this chance or let it go.

Is there a way out?

When asking this question at the beginning of the chapter we had two issues in mind: (i) Is there a way out of neoliberalism? (ii) Is there a way out of the economic crisis which started in 2008? In the previous chapters we argued that these questions are closely connected.

Medium-term perspective

We observed that real wages in the United States have been stagnant or decreasing over the last three decades. Unless this trend is reversed there will be no sustainable growth in consumption and therefore no long-term increase in GDP. But this trend can hardly be reversed if economic policy continues to follow the neoliberal agenda¹⁰⁷. As we have explained, this agenda leads to increasing social and economic fragmentation which hampers economic efficiency.

This is why we devoted this chapter to examining if a change in economic policy is likely to occur under the Obama administration. Our conclusion was that there was a momentum for change but that it was just too weak. Perhaps, within two or three years there will be a “Second Obama” just as after 1935 there has been a “Second New Deal”? This, of course, is impossible to predict.

As was explained earlier, credit crunches occur suddenly but can end quite as abruptly. This opens the possibility that financial profit will again start to flow within one or two years. However, on the economic side the best we can hope for is probably a “lost decade” similar to what Japan experienced during the period 1992-2005. If during this lost decade there is a substantial change in the redistribution of national income, one can expect that the economic engine will start to run again.

Long-term perspective

At the beginning of this study we observed that the American political situation was basically frozen. Due to the high level of funds required to run a successful campaign the existing system tends to reproduce itself. Over past decades the percentage of safe seats at elections for Congress has climbed to over 83%. From an historical perspective, systems in which any evolution is blocked are not uncommon. As a matter of illustration one can mention two cases.

- Between 1830 and 1914 there have been numerous attempts change the political and economic system in Tsarist Russia. True, in 1861 serfdom was nominally abolished but this was a half-backed reform in the sense that the peasants had to buy-back their lands over a period of 49 years. True, a parliament was introduced in 1906 but it had little power and the Tsar had the power to dismiss the Duma and announce new elections whenever he wished. He made use of this right 4 times within 6 years. It can also be observed that these long awaited reforms were granted in the wake of two military defeats in the Crimean war (1856) and in the Russo-Japanese War (1906).

¹⁰⁷Proponents of neoliberalism may not agree on this point. But is this not what the last decades seem to show not only in industrialized countries but also in Latin America? In the coming years East European countries can be expected to follow the same unsuccessful path.

In the previous chapters we avoided discussing this issue from a theoretical perspective because we have the feeling that this would be a waste of time. Unless social interactions are included into the theoretical framework of economics it will remain wanting and incomplete.

- China and Japan were confronted to the expansionist policies of western powers in the mid-nineteenth century. In China, the turning point was marked by the Opium Wars (1839-1846 and 1856-1860), in Japan it is the arrival of the Black ships of Admiral Perry in July 1853 which heralded the beginning of a new era.

The interesting point is that the two countries responded to this challenge in very different ways. In Japan the Meiji Revolution (1862-1869) created a strong central government which was able to spur economic modernization. China's reaction to the challenge was much slower. While Japan was able to obtain the abrogation of the unequal treaties¹⁰⁸ in 1994, foreign encroachments in China expanded decade after decade.

Why was China's answer so much slower than in Japan? That is certainly an interesting question, but we can get a meaningful answer only by studying other similar cases. India, Mexico, Russia, Turkey offer other illustrations of this phenomenon.

In all above cases the transformation was brought about by exogenous shocks and these shocks were made possible by a state of military backwardness. Naturally, such a scenario is highly unlikely for a superpower like the United States. On the contrary, the United States is able to use its overwhelming military dominance to extract economic advantages from its vassal countries¹⁰⁹. In other words, from a comparative perspective the only meaningful cases are transitions that took place within a superpower. Needless to say, this condition narrows considerably the selection of possible cases. Even Britain at the height of its power in the mid-nineteenth century was not a superpower in the sense that the United States is today. It is true that the British fleet was by far the largest in the world but it is only through the introduction of aircraft carriers that naval forces have gained real effectiveness and capability for foreign interventions.

¹⁰⁸These treaties were unequal in the sense that they prevented Japan from levying more than token duties on foreign imports thus depriving the state of resources and subjecting the young industries to unfair competition.

¹⁰⁹By this term we mean countries which rely on the United States for their defense. Ever since 1945 it has been a permanent feature of US foreign policy to prevent its allies to develop nuclear weapons. It is clear that countries like Australia, Canada, Italy, South Korea or Turkey would have the technical capability to develop nuclear weapons (Germany or Japan are different cases because their constitutions prevents them from doing so).

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[A recapitulation entitled “How mortgage-backed securities work” signals two possible problems: (i) Mortgage bankers contract with Wall Street investment firms to sell them a pool of mortgages in 4 months. If for some reason activity slows down in the housing market they may not be able to supply the planned mortgages. To make sure that enough mortgages are sold to house buyers it is tempting to soften standard requirements (i.e. no downpayment or no-documentation loans) (ii) There is a similar problem at the other end in the sense that no down payments are required for the investors (insurance companies, credit unions) who buy mortgage-backed securities. If for some reason they slow their purchases Wall Street investment firms will not be able to sell their packages and will incur big losses.]

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[The article shows that in 1983 the secondary mortgage market (through which mortgages are resold as securities) was already well developed: the percentage of new and old mortgages resold as securities represented 60% of new mortgage loans.]

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[A French translation was published under the title: “La manufacture de l’opinion publique”. The book convincingly proves that the American medias reflect the positions of the Department of State. Such a demonstration is very easy to make. As a matter of fact, is it not fairly obvious that a similar claim can be made for the medias of all industrialized countries? For instance, the “Times” or the “Independent” certainly reflect the positions of the Foreign Office especially on issues that really matter for Britain.

A more unexpected observation is that in many countries the medias endorse the views of the *US Department of State* except when they run directly against their own national interest. Thus, in 1957 the French medias while subscribing to the anti-Communist stance of the State Department dissented on the the Alge-

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