Making Sense of a Changing Economy

Technology, Markets and Morals

Edward Ne

ROUTLEDGE

MAKING SENSE OF A CHANGING ECONOMY

'Economists know a lot about economics but not much about the economy'

Conventional economic theory and policies are increasingly perceived as irrelevant and out of touch. While the economic system continues to change 'rapidly, the dominant theories which guide economic policy have largely remained unchanged for the last fifty years.

In *Making Sense of a Changing Economy,* Edward Nell presents an unorthodox and original view of the current state of economic theory and policies. Deriding the general trend for 'econobabble', he explains the reason why economic theory and policy now seem anachronistic. In so doing, he provides a clear and sharp explanation of how the economic system actually works. The book is divided into four parts covering all the major economic principles. The understanding of economic theory is simplified by placing it within real-life contexts, while technical and more difficult topics are explained in separate appendices. Coverage includes:

- a guide to the function and rationale of the market, including an analysis of the Keynesian versus monetarist debate;
- management of the system and possible alternatives;
- markets and morals—the Machiavellian versus the traditional code;
- outlook for the future—current controversies, the environment, and the transformation of consumption and production.

Professor Nell employs a lightness of touch and wit that makes the book entertaining throughout. The result is an enjoyable and accessible read which requires minimal prior knowledge of economics. The book will be a valuable guide to those who find conventional economics texts formidable or irrelevant.

Edward J.Nell is Malcolm B.Smith Professor of Economics at the New School for Social Research.

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PREFACE

This book is intended for anyone and everyone with a genuine interest in the important and alarming economic issues of our times. I say ‘genuine’ interest, because it takes hard work just to understand what these issues are, let alone to assess the different proposals for dealing with them. So this book is not for the casual consumer of sound bites. But its not only for students and scholars—it is addressed to everyone who cares about what is happening to the economy. Anyone who has ever taken an economics course ought to be able to follow the argument—even if, perhaps especially if, they found that economics course less than inspiring. One of the goals here is to explain why the conventional wisdom in economics is out of touch. To do that it will be necessary to range far afield at times, touching on issues in Philosophy and Politics, as well as Economics. The borders between disciplines are as porous as those between nations—but crossing one of these borders without proper documentation may be just as dangerous! The reader will have to judge.

Economics aspires to be a scientific subject, and some familiarity with the technical language is necessary. I have tried to define all such terms, and show how they are used, whenever they come up, but it may be useful to consult a good basic textbook, from time to time. The crucial sections to note are those that explain the basics of supply and demand and prices, on the one hand, and the adjustment of the whole economy through savings, investment and the multiplier, on the other. But be careful! *Understand,* but don’t be too quick to *believe,* what the textbook says. It should be there, readily at hand, not only for consultation, but also as an example of what can go wrong in thinking about the economy, since it is an important part of the argument here that the textbook approach can be misleading on many important issues!

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KEY TERMS

Aggregate demand

This refers to the level of demand present in the economy as a whole, at a particular time. Demand refers to 'effective' demand, that is, desire backed by money. Normally, aggregate demand is taken to equal the sum of the spending on Consumption plus Investment plus Exports minus Imports plus Government.

Balance of trade; balance of payments; exports and imports

'Balance of trade' refers to the difference between what is bought from other countries (imports), and what is sold to them (exports), during a specific period of time. When imports exceed exports, a trade deficit results. The balance of trade refers only to the exchange of goods, whereas the balance of payments takes into account all transactions between countries—goods, services and financial transactions.

Banks and banking

In the US, the Glass-Steagall Act has separated banks into two broad types: commercial banks and investment banks. Banks serve as 'intermediaries', by channeling the surplus funds of savers to borrowers. Commercial banks do this by accepting deposits and granting loans, earning a profit on the difference between the rate they pay out on deposits and that which is charged for loans. Such loans are primarily for current business purposes. Investment banks raise money for corporations and government agencies by issuing bonds and stocks; such funds are capital funds. In recent years, however, the distinction between commercial and investment banks has become increasingly blurred; both types of banks now engage in practices that were once the exclusive domain of the other.

Business cycle

Refers to the ups and downs of the economy over time, i.e. contractions and expansions of GDP. The term 'cycle' implies that there is some regularity to such occurrences, as opposed to the (neo)classical view that recessions are simply random events. The character of the business cycle appears to have changed over time; in the nineteenth century price fluctuations were the chief concern; in the twentieth century changes in output and employment have moved to the foreground.

Capacity; capacity utilization

Refers to the maximum amount of output that the economy could produce if all of its resources (land, labour, capital, etc.) were being fully utilized. Capacity utilization is a specific measure of the former, usually expressed as a percentage of maximum capacity, a concept which has proved difficult to define precisely.

Capital

Refers to a particular configuration of legal rights and relationships establishing control over the means of production and claims to the output of those means, thereby giving rise to valuations of both outputs and inputs. 'Capital' may refer to the heterogeneous collection of inputs, or to the *value* of that collection, or it may refer to a fund of purchasing power, or to the value of a claim to a stream of payments generated by some production process. These are not three separate definitions—goods, funds, stream of payments— they are three phases or stages in the regular turnover of capital, as funds are converted into productive goods, which are used to generate a stream of earnings from the sale of output.

Credit and finance; financial markets

Credit is a device whereby individuals and businesses can consume more than their present income would allow, by borrowing against future income. The price of credit is measured by the interest rate. Mainstream theory views the interest rate on credit as representing an individual's preference for present versus future consumption. In other words, the greater the desire to consume now versus the future, the higher the interest rate consumers will pay for that privilege. Credit can take many forms, the most common of which is bank loans. Finance refers to the ability of firms to raise funds to pay for investment and production; credit is only one form of finance.

Financial markets refer to the array of markets where financial assets are traded, including credit instruments.

Consumption; consumption function

Outlays by households and businesses for goods and services. The consumption function analyses the relationship between income and consumption. It is typically assumed that as income rises, consumption rises; in other words, income and consumption are positively related. However, this relationship is not proportional; as income rises, consumption will tend to rise by a smaller and smaller amount.

Deficits; government budgets

Deficits simply refer to an excess of expenditure over income during a specific period of time. A government budget deficit, for example, occurs when the government spends more than it receives in the form of taxes in a given year. This can result from an excess of spending, a shortfall in taxes, or some combination of the two. The Government does not separate capital and current expenditures; hence a ‘budget deficit’ may reflect capital spending. The Government does not calculate capital gains on its assets, either, nor does it revalue its assets to reflect inflation. The deficit should tell us whether the Government is increasing or decreasing its asset position; moreover, we should be able to learn whether the Government is stimulating the economy or holding it back. As conventionally measured, it answers neither question.

Dynamics and statics

Statics, or comparative statics, refers to a type of economic analysis in which various positions of equilibrium are compared to one another after a dis-equilibrating change in one of the variables under study. For example, two equilibrium positions can be compared after a change in the money supply. However, static analysis says little or nothing about how, or if, the economy moves from one equilibrium position to another, which is the central concern of dynamic analysis.

Economic growth

Refers to the increase in GDP from year to year, expressed in percentage terms, as a rate.

Employment; unemployment

In simple terms, the percentage of the work force who have jobs. Unemployment therefore represents the percentage of the work force without jobs. It is important to note that official unemployment figures only count as unemployed those who are willing and able to work, and are actively seeking employment. Workers who have given up looking for work, or who are employed part-time when they would like to have a full-time job, are not considered 'unemployed'.

Equilibrium

A fundamental theoretical tool in mainstream economic analysis, used to describe a situation where the system is at rest, i.e. there are no forces pushing the system toward further change. This conception of equilibrium derives from nineteenth-century physics. Equilibrium canalso be used to describe a situation where prices adjust so that supply and demand are equal, and therefore all markets "clear". In such a situation, sellers are able to sell all that they want at the market-clearing price, and consumers can purchase all that they wish to consume. Macroeconomics draws on a different conception of equilibrium, a kind of hydraulic concept, in which 'injections' of purchasing power just balance 'withdrawals'.

Free trade (see *protection*)

An economic doctrine dating back to the mercantilist period, based on the idea of comparative advantage. The essential point is that if there are no barriers to exchange between nations (tariffs, quotas etc.), then all nations will be made better off by specializing in the goods that they are best at producing and exchanging them with other countries, rather than trying to produce at home all the goods that they need. Free trade is the driving force behind recent trade agreements such as NAFTA, the US-Canada Free Trade Agreement, and GATT (the General Agreement on Tariffs and Trade). Free trade means that a country gives up control over its balance of payments; hence it may be forced to adopt austerity to protect the value of its currency.

GNP; national income

Gross National Product is the supply corresponding to aggregate demand. It is a statistical measure designed to reflect the dollar value of the goods and services produced and sold by a given country in a particular period, usually a year. National income is the mirror image of GNP—since all sales constitute income to someone, we can measure GNP by either adding up the value of all goods sold or by adding up the value of all incomes earned in the process of producing those goods and services. Thus, National Income will consist of wages, salaries, bonuses, profits (distributed as dividends or held as retained earnings), capital gains, rents, commisions etc., interest, and any other payments that are made for productive services. Transfer payments are not included.

Households and firms

Households are simply the individual economic units in the economy. A firm describes any business enterprise, whether organized as a corporation, partnership or proprietorship.

Inflation

A rise in the average level of prices, as measured by indexes such as the Consumer Price Index (CPI) or GDP deflator. Both the CPI and the GDP deflator measure inflation by comparing the current level of prices to the price level in some base year, chosen periodically. The CPI measures the change in prices for consumer products only. The GDP deflator is broader, encompassing the prices of raw materials and inputs for manufacturers and businesses, as well as consumer prices.

Infrastructure

Basically, all the items that help make our economy more productive—highways, schools, hospitals etc. Since private investors may have difficulty reaping the benefits of investment in such projects, the state of our infrastructure is usually dependent on government spending rather than private investment. It follows that cuts in government spending tend to weaken our infrastructure and indirectly curtail our overall economic prosperity.

Investment

The addition to the nation's capital stock: goods, machinery, technology etc. Note that the economist's definition of investment differs from the standard definition. Economists are only concerned with the increase in the nation's ability to produce goods and services; therefore, the purchase and sale of existing assets is not considered 'investment'. For example, putting your savings into stocks and bonds only serves to transfer wealth from one party to another, without increasing the nation's productive capacity.

Just price

A theory of price formation descended from the Middle Ages, based on ethical values and 'justice'. As the market system of production extended its reach over society, moral philosophers and theologians grappled with the ethical implications of trade and commerce upon everyday life and spirituality. The basic idea of a 'just' price was that it would allow both parties to a transaction to benefit equally, so that neither was taken advantage of. 'Just' prices were ethical, or fair. In practice, however, just price came to mean simply the conventional price established by the market, generally believed to be equal to the direct and indirect labour embodied in the good or service.

Macroeconomics

The branch of economics dealing with aggregates such as the rate of unemployment, inflation, GDP growth etc. It studies the economy as a whole, rather than its individual parts—firms, households etc.

Margin

A 'marginal unit' is the last unit added to a particular stock, such as the labour force, the money supply, etc. Economists typically study changes at the margin, such as a one-unit increase to the existing capital stock, rather than analysing the entire capital stock.

Marginal productivity; marginalism

Marginal productivity theory holds that as more resources are applied as inputs, output will increase, but at a diminishing rate. That is, marginal products decline. This is held to provide a basis for the theory of wages and prices. No one would pay a worker more than the worker could produce, i.e. more than the marginal product, what one more worker will add to output. Competition will push the wage down to that level. Similarly, price will be governed by marginal cost; no one would sell for less, and competition will push price to that level. The theory that develops these ideas fully is known as 'marginalism'.

Markets

Institutions that bring together buyers and sellers of a particular good or service. Not necessarily a physical location; the money 'market', for example, isn't an actual place where people buy and sell money, as is the case with the stock market.

Market-clearing

A result that occurs when supply and demand are equal, such that all supplies are demanded and all demands are fulfilled. When markets clear, there is no tendency for further change and the system is said to be in equilibrium.

Microeconomics

The study of the individual units that make up the economy and their behaviour—households, firms etc.

Multiplier

A multiplier relationship occurs when a change in one variable leads to a succession of further changes in other variables, producing a 'ripple' effect. For example, an initial amount of investment spending provides income to someone, who in turn spends that sum, providing income to someone else etc., leading to a cumulative expansion of income in the economy as a whole. The end result is a multiplied increase in economic activity beyond that of the initial investment.

Money

Not simply what we put in our wallets. Economists have a more precise definition for the green stuff—they call it 'currency'. In economic jargon, 'money' usually refers to currency and purchasing power held in checking accounts, or 'M'. Furthermore, 'money' is not what we make at work; this is called 'income' by economists. Money should also not be confused with 'wealth'; when non-economists say that an individual has a lot of money, what they really mean is that they are 'wealthy'.

Monetarism

The doctrine of economics developed by Milton Friedman, and which was the driving theoretical force behind the period of high interest rates and attempted control of the money supply during Paul Volcker's reign as Chairman of the Federal Reserve System in the early 1980s. The basic conclusion is that inflation is the result of an oversupply of money, and therefore limiting growth of the money supply is the ultimate cure for inflation.

Neo-classical

A broad, catch-all term used to describe economists and economic theories that are based on the notion of supply and demand, Say's Law, and marginal productivity theory. In general, neo-classical economists are in favour of free markets, arguing that the economy will correct itself in the long-run if government and other obstacles are removed.

Optimal; optimizing

Optimal outcomes are the best that can be attained under given circumstances. Optimizing is a method of studying the choices consumers and firms make in economics. Since agents are assumed to be 'rational', we can make the further assumption that they will always choose the course of action that provides them with the optimal outcome. For example, in consumer choice theory, optimizing allows us to predict that consumers will choose the good that provides them with the most 'utility', or satisfaction. This allows for the development of theories of how consumers actually behave.

Principal-agent

Refers to a fiduciary relationship where one person or group acts on behalf of another, as 'agent'. It is typically used to refer to the 'principal-agent problem', whereby agent(s) tend to act in ways that are contrary to the interests of the principal(s). For example, in a corporation, the managers of the firm are supposed to act in the best interests of shareholders, as their 'representative agent'. However, many studies have indicated that agents frequently take actions that are detrimental to the needs of the principals.

Production function

Describes the relationship between the number of workers employed and aggregate output in the economy. It is typically assumed that as the volume of employment rises, the level of output rises also, but at a diminishing rate. In other words, while higher employment increases output, each additional worker adds less to output than the previous worker. In economic jargon, increasing employment is subject to diminishing returns. Mathematically, the first derivative is positive while the second is negative.

Productivity; productivity growth

Productivity is the relation between output and input in some time period; the phrase usually refers to labour productivity. Productivity growth is the annual rate of increase of labour productivity, reflecting technological improvements or improvements in labour organization.

Protection

Establishing trade barriers to protect domestic industries and jobs from foreign competition. Widely believed to permit or encourage inefficiency, although there is little evidence to support this. However, protection clearly does permit a country to adopt an expansionary stance without fear of creating a balance of payments crisis.

Rate of interest; rate of profit

Basically, the price that is paid for the use of money. If you are a lender, the rate of interest is your compensation for providing someone with the temporary use of your surplus funds. Since all rates of interest in the economy tend to move in the same direction, economists frequently speak of 'the' rate of interest, even though in reality there are numerous different rates of interest. The rate of profit refers to the profit made (or expected) on a particular project, relative to the initial investment, expressed as a percentage. Economists frequently use rate of profit and rate of interest interchangeably since, in equilibrium, the two will be equal. This is because borrowers will only borrow if they believe that the rate of profit, which is what they make on the project, is at least equal to the cost of borrowing the money, represented by the rate of interest.

Real wages/money wages

Real wages are the amount that workers receive in terms of its ability to purchase goods and services. Money wages are simply the face value of the income received by workers, not adjusted for the price level of goods and services.

Rent; rent-seeking

Feudal rents were originally per capita payments owed in virtue of status, like tithes. They only later became attached to particular plots of land. Differential rents—sometimes called 'Ricardian rents'—arise because of differences in the fertility of different lands or in the productivity of equipment. (Both plots of land or pieces of equipment produce the same good for the same price, both pay interest at the same rate; the more productive land or equipment can charge rent.) Monopoly rents are based on monopoly control of a desired resource or needed asset. 'Rent seeking' behaviour refers to activity designed to establish monopoly control.

Savings

Savings represent individual income that is not consumed, i.e. spent on goods and services. Savings are typically deposited in accounts at financial institutions, which can then be lent out to firms and others who need to borrow. According to orthodox theory, a higher rate of savings is therefore necessary for investment to increase.

Stability

This can be used in two ways in economics. One usage refers to the stability of equilibrium. In this sense, a stable equilibrium would exist when the forces of competition or supply and demand tend to push the variables of the model back toward equilibrium after a disequilibrating disturbance. An unstable equilibrium would tend to push variables farther and farther away from equilibrium, so that the equilibrium would never be regained. Stability can also be used to refer to functional relationships, such as the demand for money. The basic idea is that the demand for money is based on a number of factors, most of which aren't subject to frequent and drastic fluctuations. As long as money demand is stable, predictable relationships will develop, which can be used as a basis for policy recommendations.

Supply and demand

The basic idea that prices and quantities are determined by the free interaction between producers' desire to supply a particular product and consumers' desire to purchase that product. In general, producers will increase quantity supplied as price rises, while consumers will demand less. If the quantity supplied by producers at a given price exceeds the quantity demanded by consumers, the price will fall, as producers attempt to eliminate inventories of unsold goods. The converse holds for an excess of quantity demanded over and above the quantity supplied. Eventually, a price will be arrived at for which supplies and demands are equal, and thus prices will have no tendency to change further.

Transformational growth

Theory developed by the author which recognizes that the way the economy functions changes over time. By implication, any economic theory must incorporate these changes if it is to offer a realistic assessment of economic life. Hence, the principles of economics—the basic theory of how markets work—are likely to be different in different eras. In particular, S&D is a plausible account of nineteenth-century market adjustment, while simple

Keynesian theory describes the advanced world in the post-War era. This theory is in direct contrast with most orthodox approaches to studying the economy, which are basically ahistorical—they treat the economy as essentially unchanging over time, and economics as a science devoted to discovering timeless truths.

INTRODUCTION
Economics at the Alumni Club

It was late; the cocktail hour was over and people had begun to settle in at the dinner tables, while the speakers gathered at the podium. I had been delayed by some small departmental crisis, typical of academic life. Standing in the wide doorway, I checked out the large round tables one after another, hoping to find former room-mates. Ignoring the mural, its struggle to be quaint a lost cause, showing life at P……n thirty years ago—as glowingly remembered by loyal alumni. Should I sit down? Would the dinner be worth it? Would the wine be drinkable? (… European conferences; the older Universities have excellent wine cellars.) Activity at the speakers table had increased; mikes were tested, and then the group was called to order. We were to hear how the Crash had happened, what to expect next from the economy, why we were declining, straight from the horses' mouths, the men who knew how the system worked… I decided to stay.

These evenings fade into one another. The speakers are always different, the speeches always the same: America's decline, hopes for rebirth, which will come when virtue is restored in the family, righteousness to public life—provided we curb our extravagance, cut deficits and government spending, so we can save enough to get accumulation going again. It can be embarrassing to listen to these speeches. (Always by men, none of my classmates were women; they came to the University later, after much opposition.) Yet it can also be illuminating. 'Econobabble', one might call it. A set of clichés, phrases, and postures designed to sound important and appear profound, but which can be easily mastered by anyone with a minimal education. The need to tighten our belts, the dangers of deficits, the importance of sound finance, and of saving, the need to provide adequate incentives, the rigours of competition and the efficiency of markets—the litany goes on.

Yet econobabble can be too easily dismissed. These are the ideas according to which the country is run—tidied up and made presentable and well-seasoned with self-congratulations. Of course, not every after-dinner speech is the same, even if delivered in econobabble. Businessmen are chiefly interested in profits; academics and economists tend to put the well-being of the public first. There can be major conflicts, although sometimes they go together. But taking this into account, the major problem is that these speeches—and the ways we talk about the economy generally—simply don't connect with how the system works. It's not just wrong facts, or misunderstandings of technical details. That would be no surprise, and nothing to worry about. It's a question of the whole picture, the *vision* of the economy and how it works. Free markets, efficiency…everyone will be better off. It all works automatically: supply creates its own demand. The picture that underlies econobabble is what is disturbing, because it shows that the vision guiding our political discourse is dramatically out of focus.

FINDING A TABLE

By now, the room had largely filled up, and as I looked around there didn't seem to be any seats left at the dinner tables. Nor had I spotted any of my former room-mates. I stood off to one side, near the door to the kitchen; it was noisy but I had an unobstructed view of the podium. The introductions were being made. The main talks would be after dinner; now each speaker whetted our appetites. A first speaker, for example, having dined on taken-over firms for lunch, told us how he had cut unprofitable routes from his airline. If the customers weren't there, you didn't do it. Sales, not prestige, not tradition, was what mattered. You had to be hard-headed, and you couldn't count on building up sales by cutting prices. Sometimes that worked, sometimes it didn't. You had to know whether the customers were going to be there.

Common sense, I thought; business should design its operations to appeal to the markets where the sales are expected to be. What else would you do, after all? But that is not what most of the textbooks say; they'll tell you to design operations to be the cheapest, and they won't even notice a possible problem. There is something to be said for plain common sense.

I wasn't the only one without a seat. An organizer and his wife were also high and dry—an old friend with a new job, retired early from telephones and now working for anti-pollution. And not alone; a number of other classmates were involved in environmentalist projects. He arranged a table for us; at dinner he drank sparingly. Once fat, now trim. Wife the opposite—and smoked, too. I looked around the room; only wives—well, women—seemed to smoke. Or to be fat. No one drank hard liquor. Fish first, good. But then rubber chickens. Why bother to jog if you ate rubber and drank sulphites? Mass production, for all its real benefits, certainly came with costs.

THE MAIN COURSE OF EVENTS

The platform stirred again, as plates were removed and mouths opened for business. New introductions and the conqueror of airlines, successor to Howard Hughes, took the floor again. No Jane Russell, no outlaws. Not even a spruce goose. But then, with eloquence, we heard that the cause of our problems was too much wasteful consumption, too little saving. American companies are soft; they squander money on Lear jets and executive suites. The country is the same; everyone has a VCR and nobody works hard or saves. If there is no saving how can there be growth? The other speakers nodded sagely and agreed. American executives didn't save and they didn't take hard decisions, either. American management was run by committee; everyone got along with everyone else, and no one rocked the boat. The result: no innovation, no dynamism. The whole country was going soft. Business had given up on competition.

And why not? I thought, as I had so often on similar occasions. Wouldn't you? Competition was war; dangerous, unpredictable, and a source of unending stress. Business leaders celebrate its virtues, but in practice keep it at a distance. Now an interruption from another panelist, a venture capitalist. The problem is the shortage of venture capital. Correct this and competition will be restored through the dynamics of American ingenuity, operating through the free market. Incantation, rather than analysis? After all, why has the free market failed to provide enough venture capital? Perhaps because moneyed wealth does not enjoy the risks of competition? Could that be? Just as business itself unfailingly moves to restrict competition?

Is this so hard to understand? Consider what we see in the health clubs every day: There's too much stress in life. Which is the reason for all the jogging and carrot juice. Why not make a deal? Competition is right up there with apple pie and the Fourth of July, but in practice no one wants it. Yet the panel nodded solemnly, and Venture Capital subsided, pleased. An economist once said the only people who really like competition are economists who write textbooks. A metaphor for the modern economy: the textbook writer who lavishes praise on competition, hoping to edge out the competing books and establish a monopoly.

Too much welfare, too much government regulation, the speaker continued, too much government spending—a familiar litany, but in recent years a new element had emerged—especially in regard to the military. Weapons waste. This is where our savings go—and it's mostly garbage. First, the Cold War is over and we'll never use it; if we negotiate a deal with the Russkies, we'll never need any of it. And God help us if we ever did have to use it, because the stuff won't work. It's not the right stuff; it's the wrong stuff. Contracts awarded non-competitively, compliance improperly audited, and whistleblowers booted; the whole military mess is a waste, and it is dragging down the rest of the economy. We've squandered our savings.

I could agree with a lot of that, I thought, but is military spending the only 'waste'? What about packaging? Advertising? The waste of our best talents in protracted lawsuits, or in blowing speculative bubbles in the financial markets? What about the neglected and under educated kids in the cities, or for that matter, in the suburbs? And why do speakers on these occasions invariably go on about 'savings' all the time? Savings is just not-spending-on-consumption; there s no magic in that. *Investment* is what counts. It is a mystery why so many people believe that more not-spending-on-consumption will encourage more spending on investment. If people are buying *fewer* consumer goods, why build a new factory to make *more* consumer goods? After-dinner speakers often started from common sense: markets are indeed the key to progress and prosperity. But almost invariably there would follow a disastrous move: the country is just like a household or a business. You and I should not run ourselves into debt—so neither should the country. You and I should not overspend, so neither should the country. Spending on what you don't need is waste, for us, so it must be for the country, too.

This is the hardest point, probably in all of economics. The system as a whole is not just the projection of its parts onto a larger screen; it is not the household or the firm writ large. It is a different *kind* of system; it works according to different rules. And there is no obvious reason why this should be so. Even worse, at one time—and not so long ago—it wasn't so, and the system as a whole *did* (more or less) replicate the workings of the household. The word 'Economics', in fact, is derived from the ancient Greek for household management. How to explain all this? Write a book!

ADDITIVES IN THE FOOD FOR THOUGHT

More wine; more, but not better. And dessert, cake made with white sugar, whipped cream from the can. Now, wait a minute, just where do all these derogatory judgements come from? Let's be superior and show that we have taste? Are we being a little defensive? Well, perhaps. But consider this: the richest school in the richest country in the world has a dinner and the chickens are rubber, the wine has additives and the whipped cream is from a can. The point is plain enough—mass production is why we became the richest—but the taste of the additives and the rubber shows why we are slipping now. The dinner may say more, more eloquently and more to the point, than the speakers. Pushing dessert away, I turned towards the podium.

Now, black hair slicked down, peering through rimless glasses, impeccably dressed financier, of New York and Paris, was presenting elegantly phrased thoughts about international flows of funds and the causes and consequences of the twin deficits, those of government and foreign trade. The government deficit absorbed private savings and so drove up interest rates, attracting foreign funds, which drove up the dollar, which created the trade deficit. Very simple. So we need to save more, and spend less, especially on the part of the government. We can't afford welfare, we can't afford extravagance, certainly not on the part of the military, which should set an example of efficiency. We can't afford to shell out money for the poor and the homeless, much as they need it, shameful as their plight is, unless we can curb some other forms of spending— such as the military or Star Wars. Or Social Security.

It sounded good, especially delivered with a slight foreign accent, which lent authority and an air of European sophistication. It's what we've been hearing recently from the Chairman of the Federal Reserve, and from the Clinton Administration. It is also completely and obviously wrong. A quick look at the figures will show that there is simply no correlation between larger deficits and higher real (that is, inflation-adjusted) interest rates. To take the most obvious case: the largest deficits in relation to GNP in the twentieth century occurred during World War II, when real interest rates were near zero or even negative. In the 1950s and early 1960s, GNP grew faster than debt, so deficits fell in relation to GNP. But during a good part of this period, real interest rates rose. In the 1980s and 1990s deficits/GNP and real interest rates have sometimes moved together, sometimes in opposite ways. There s no reliable or systematic pattern. Yet the Clinton Administration built its economic policy on reducing the deficit in order to bring down interest rates! It did bring the deficit down—but as of late 1994 and early 1995 interest rates are going back up!

It should be added that the rest of the argument is no better. It went: high interest rates lead to a high dollar, which cuts into exports and creates a trade deficit. High interest rates relative to those in other countries will tend to attract an inflow of short term capital, and this will tend to drive up the dollar —sometimes. Other factors are also involved. A high dollar will cut into exports. But high interest rates will tend to cut domestic investment and create a slump at home, which will tend to reduce imports. So the total effect on the trade balance may not be at all clear-cut. But these are technicalities. The issue is the *vision* of the economy. According to the after-dinner speakers, deficits are dangerous. They are one of the major causes of our problems. By contrast, a better focused vision of our system will tell us that the deficits are a symptom, an effect not a cause, and that they are not only not particularly dangerous, but kept within limits they actually serve a useful function.

The next speaker continued the litany. Governor of our neighbouring state, the one where it's dangerous to breathe and the rivers are firetraps, he told us of the need to cut government spending, to bring budgets under control. Tough decisions had to be made; priorities had to be clear. Unless the budget deficits were controlled, the country would spend itself into ruin. At present we were heading, as a country, for bankruptcy; governments were out of control, consumers were piling up debt, firms were doing so even faster, and as for banks, the whole system was on the brink. The problem was a moral one; as a people we had lost sight of the old virtues, the eternal verities, 'neither a borrower nor a lender be/for a loan oft loses both itself and friends / and borrowing dulls the edge of husbandry'. Miss Shipley, too, had stressed that, in 9th grade, not realizing that Polonius was a pompous old fool, and his advice to his son was meant as a parody.

Instead of making things better, the Governor's prescription—and his successor s even more—could only make them worse. Cut back on government when rivers are catching fire? To say nothing of centre cities. Reduce taxes instead of solving problems? This was being part of the problem, not part of the solution. How could that be? The Governor was smart, had been a fine student, and after a flirtation with the teaching of history, had spent the whole of his adult life in public service. Like the banker and the take-over artist, he knew his trade; he knew how the world worked well enough to rise to the top. Like them, and like his successor, he started out his remarks from eminently common-sense premisses. Good, clear, sharp observations about politics and money. How could he, or they, be wrong? How could people who run the system not know how it works?

BORN IN THE USA MEANS BORN TO RUN

Well, for one thing, you get to the top by knowing how to climb a pyramid, not by knowing how it was made or what mysterious forces it contains. I remembered my trip to Egypt, my second year at Oxford. It was not long after Roger Bannister had broken four minutes on the track in Cowley; everyone was doing a 'four-minute' something or other. Art Buchwald defined the track for a 'four-minute Louvre': main entrance—*Mona Lisa—Winged Victory—Venus de Milo*—and out. Now we were going to try a four-minute Great Pyramid—a race, we agreed, that would prepare us for corporate America. Real training. We were perhaps more right than we knew—it's not just corporate America, it's the same in the academic world, too. Everything seems to depend on how skilfully you can climb the Great Pyramid. (Don't try a four-minute pyramid; the rock crumbles unexpectedly as you get near the top, and its a long, steep fall to the bottom. More training for corporate America!)

But preparing for the climb, and all the mountaineering skill in the world, doesn't tell you anything about what to do when you finally get to the top. Witness Ronald Reagan. Or, for that matter, some CEOs of major companies. To reach the top personal political skills are needed; to govern, knowledge and wisdom. Knowledge of how the system works, and how it can be made to work better. Wisdom to know when and how and for whom to make it work better. None of this is learned or needed in the scramble up the ladder. Indeed, one of the worst things you can do is show that you know more about how things work than the boss does.

Yet this is only part of the story. After all, once at the top someone smart enough to have made it there should surely be able to figure out how things work. Why not? In previous eras the reflections of active leaders—at least the smart ones—told us how the system worked.