GRIGORY YAVLINSKY

Translated by Antonina W. Bouis

realeconomik

The Hidden Cause of the Great Recession (And How to Avert the Next One)

"An important contribution to understanding the interplay between social norms and modern economy."—George Soros

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To my children

PREFACE

There is no crisis for people who play Bach.

—From a conversation at the conservatory

It would have been pointless to write a book like this just three years ago—one simply couldn't hope for a positive response. But the situation is different now, largely because of two changes. The first is the financial crisis of 2007–2009, which made at least some of the educated public more interested in understanding the underlying fundamental problems of the current world economy.

Second, and this could be more significant, the current debate on economic policy of U.S. President Barack Obama's administration provides more room and opportunities for serious discussion than before.

Before these changes occurred, any debate on such issues would in principle have been consigned to oblivion, so there was only one option—to wait for the opportune moment.

The title and subtitle, *Realeconomik: The Hidden Cause of the Great Recession (and How to Avert the Next One)*, reflect the central idea of this book: the cause of the crisis is that at the core, modern capitalism is concerned with money and power, not ideals, morals, or principles. I use the word *Realeconomik* as an analogue to Realpolitik, a pejorative term for politics that masquerades as practicality while in fact comprising the cynicism, coercion, and amorality of Machiavellian principles.

Contemporary economists might not accept some of the ideas proposed in this book. I could not have published these ideas even in the first half of 2008 without being considered at best retrograde or at worst an ignoramus. Even now I have little hope that the opinions of contemporary trendsetters in economics and business have changed. However, it is possible that what is variously described as the "Great Recession of the early twenty-first century" or the "longest U.S. slump since the 1930s" will make at least some of these people consider seriously the argument of this book.

Unfortunately, the reasoning you will find here has become unfashionable. In the 1950s, when the world was still extricating itself from the ruins of World War II, the ideas I wish to discuss were more a part of public discussion. Today, many will find them politically incorrect, if not seditious. An entire generation of Western politicians, businessmen, and economists has come of age without ever thinking seriously about the relationship between morality and economics or ethics and politics.

If we turn to eastern Europe, in particular early in the post-Soviet age, such discussions were out of the question. It was generally accepted that business should be measured only by profits. Politicians who succeeded communist-era leaders (and who largely had been a part of the communist ruling class) proclaimed the transition from totalitarianism to market democracy yet actually adopted the most unprincipled and cynical view of the nature of politics, driven by the all-encompassing conviction (learned in their communist past) that in a market capitalist society only profits mattered—the central idea of Realeconomik.

In this book I do not seek to make any moral judgments: I aim instead to be descriptive and analytical. My goal is not to moralize, but rather to indicate those areas that are usually not discussed in public—to write what many people think but may prefer to keep to themselves. I have tried to be more or less impartial, though one may perceive judgment behind many of my words. I have no intention of condemning anybody as mean or immoral: in no way do I consider myself a man who has the right to judge my fellow human beings. Anyway, that's not my task.

I aim to formulate a number of thoughts about what I perceive to be the underlying causes of the global economic, moral, and political crisis at the beginning of the twenty-first century. Testing some of the ideas contained in this book will surely require several years of solid academic work. Nevertheless, I accepted the kind offer of Yale University Press to publish it now, because time moves so swiftly in our modern world that I feel the urgency to state clearly the things that I believe to be crucial to understanding the events unfolding before our eyes.

The underlying premise of this book is that the nature of the Great Recession is not only economic—or perhaps not even attributable mainly to economic factors. Neither is it the product of mere complacency and negligence of duty on the part of authorities and top-level managers in the private sector, as some experts insist. Rather, the underlying fundamentals and causes go deeper—to such things as general rules of society and the logic to which they are subject, encompassing the issues of individual and social values, moral guidance, and public control, as well as their evolution over the past several decades. These issues are much more serious and have a greater impact on economic performance than is customarily believed.

Academic researchers and governmental decision makers should not lose sight of the fact that even comparatively sophisticated ways of responding to this crisis, as proposed by many, such as writing new, stringent rules, exercising more public control over their enforcement, imposing taxes on some kinds of financial operations, and the like will not resolve fundamental problems, which are not simply economic. Far less will be achieved by simply "pouring money on the crisis," even if it is accompanied by exposing the banking secrets of thousands of officials and businessmen.

There are no ready-made solutions to these problems. However, I hope this book will provide a fresh perspective for anyone concerned about another bursting bubble, persistently high unemployment, the "new normal" (economic stagnation in a low-growth, low-inflation environment), financial volatility, sharply rising poverty rates (even in industrialized nations such as the United States), and social unrest, or the possibility of something more catastrophic.

My book is not a clarion call to change everything instantly. At the same time, the ideas discussed here could and should become the cornerstone of modern policies in developed countries that could help overcome certain disturbing political, economic, and social developments of the past twenty-five years.

I have structured this book to include a number of ideas and observations that reveal the key traits of the modern Western economic and political system from the perspective of various changes of the past two or three decades, both in the essence and character of business activities and in their political and ideological underpinnings. Those changes can tell us much about the global economic decline.

I am ready to accept criticism, as some shortcomings of this book are obvious to me, too. However, the urgency of the problem persuaded me not to let perfection be the enemy of the good. Comprehension of the key provisions should not require extensive scholarly references or an array of empirical evidence.

It is difficult to talk about the economy from the perspective of morality, as the very concept of morality seems to be devoid of established content, is subject to broad interpretation, and is often rather elusive. But those difficulties seem insufficient reason to exclude morality from economic analysis and research. It is essential to treat the issue of morality seriously and extensively to provide a meaningful perspective for economic processes and their consequences, especially in the framework of long-term analysis.

I realize that treating moral sense as an economic phenomenon is a complex enterprise sure to be widely challenged, and I address this subject extensively elsewhere in the book. Nevertheless, I must begin with the premise that there exists a code of simple and well-known, almost universal, informal rules of behavior. These rules are essential to the efficient functioning of market mechanisms and need to be constantly maintained, if not enforced, by public institutions. Consequently, public neglect of these rules in business, as well as in regulating activities, may lead—and to a large extent has already led—to serious deficiencies in economic mechanisms, first and foremost in the financial sector.

I believe this premise is of utmost importance, and that may excuse my desire to share with the readers my personal impressions and findings. The latter originate not only from my research but also from daily experience of mixing with people who consider the relation of politics and business to morality an issue unworthy of serious consideration. The viewpoint of these people reflects the cynical attitudes common in the West, and it also represents a psychological vestige of the hypocritical totalitarian past in the Eastern Bloc countries. This worst-of-both-worlds combination often produces the atmosphere I call Realeconomik: undisguised cynicism that can lead to lawlessness, corruption, and even violence as a means to resolve political and economic disagreements.

Certainly I understand the difference and draw a clear line between personal codes of behavior and the much more complex ethics in public policy. Nevertheless, that line is neither absolute nor insurmountable: a politician who maintains ethical principles in his private life is likelier to implement them in politics, though the degree to which he can do so may be limited by the results achievable. If sticking to principles dooms a policy to failure, that policy is flawed; achieving positive results without compromising principle is the true art of politics, an art sadly neglected.

In this book I hope to demonstrate the need to rearrange our economic mindset to allow more room for values and guidelines to govern the behavior of economic agents. If I succeed in drawing public attention to this need, I will consider my mission fulfilled.

REALECONOMIK

CONTENTS

Introduction

At first nobody can diagnose a serious illness. However, by the time everyone can see it, it's too late.

—Experienced physician

The financial meltdown of 2007–2009 prompted me to write this book. While there have been lots of theories and discussions about the crisis, they primarily centered on the surface issues, or those not far beneath. Causes have been discussed, too, but largely the immediate and simple ones, which explain many things but not all that matter. Being an observer of developments rather than an interested participant in stock exchange gambling, I longed for answers to questions more about the deeper meaning of market disorders than about how particular markets function (and malfunction), and I couldn't find answers that satisfied me.

But the crisis served as a convenient starting point. The questions it raises are not new—they have been in the air for quite some time, and every now and then they were raised for consideration. The global economic slowdown brought them to light—probably for a brief time only, as they will again fall off the radar of scholars, practicing businessmen, and politicians once the Great Recession is past and stability resumes.

So I have no intention to present yet another personal view of "hot issues" about the global slump; rather, I think of this book as an attempt to find answers to the bigger questions elicited over the past several decades, questions that will confront us for a long time to come. But because the crisis triggered my curiosity, the first set of questions relates to its character and its causes.

Standard economics textbooks describe business cycles of various natures and durations, of various degrees of severity and corresponding consequences. Cycles happen, and there is nothing unusual about them. But if that's the case, why is there so much fuss about this particular instance of financial market disorder—why has it been ascribed nearly catastrophic dimensions?[1] If, on the contrary, this case is so particular and special, why has it been addressed with the standard set of policy measures regularly used in business cycles?[2]

If everybody agrees that the reasons for this crisis are not confined to cyclical factors, then what are those extraordinary reasons? As no one has been able to provide plausible explanations aside from vague "policy failure," there must have been quite a lot of these unusual "failures" to produce a convulsion of such magnitude. If so, why did economic and monetary authorities, market regulators, rating agencies, and other experts make so many wrong choices?

If the gravity of the situation with American subprime mortgage loans was apparent to professionals more than a year before the dramatic decline in the stock markets began in the summer of 2008, why was it allowed ultimately to develop into a freeze in international financial relations and a perceptible recession in many parts of the world economy?

Speaking more generally, why do all those malfunctions, declines, and crashes happen when they do, and why do they almost always come as a surprise to recognized economic gurus? (Of course, many experts maintain post facto that they foresaw everything that occurred and even more, but such claims are no more useful than the observation that a broken watch indicates the correct time twice a day.)

Extending the inquiry still further, why do as many elements in the operations of a market economy remain mysterious as was the case a hundred years ago or more, even though economic theory has in the past century far overtaken economy and business in complexity? Why do stock market analysts, drawing on constant improvements in technical and fundamental analysis software, still resemble astrologists, with the accuracy of their forecasts depending mostly on the scope of possible interpretations? If the financial authorities are in possession of various tools to regulate credit, price movements, investments, and consumer activity with mathematical accuracy, why does it transpire that those tools fail when needed most, because computations are made on the premise that most variables do not vary? What is the practical value of tools that fail worst when needed most? And why must investors and taxpayers bear the cost of their never-ending updates?

Other questions offer no evident or convincing answers. In developed economies even severe recessions are rarely accompanied nowadays by deep reductions in revenues and volume of business activity: two-digit negative growth rates for leading market economies have come to be viewed as largely theoretical scenarios. Inflation, which devalues savings and fixed incomes, as a rule does not exceed a few percentage points and, if we are to believe statistics, falls almost to zero in adverse market conditions. However, if this is the case, it would be logical to assume that losses by some people should be offset, even if at a discount, by gains for other people. If a large number of people, companies, and even entire branches of industry and areas of the economy incur extensive revenue losses and asset impairments during crises, then these losses should result in significant gains for other people—yet for some reason we never hear of such profits.

So if there are no winners, or virtually no winners, doesn't this mean that precrisis estimates of aggregate revenues and assets had been artificially inflated as a result of incorrect or fraudulent data? If so, why do not more experts decry such grossly incorrect estimates? Why do they instead unfailingly speak of the coming recovery and again advise people where to invest whatever money they have left after the last meltdown, instead of addressing the issue of what went wrong before and during the crisis, and whom the people who suffered losses might blame (aside, of course, from themselves)?

Searching for answers to these and other similar questions, I couldn't find a consensus in the general discourse. However, if there is no visible cause, then there must be a hidden one. Certainly one can come up with various explanations, including quite elaborate and exotic ones—intervention by extraterrestrial forces, say. But I think there is a single reason that sheds light on all my questions. It looks like a hidden cause because few people are inclined to see it or talk about it. Most are reluctant to dwell on the subject because it leads to conclusions that are unflattering at best.

But before turning to this subject, I'd like to make some other explanatory remarks. As I said earlier, the slump has brought to light many unpleasant truths. Most of them, however, have deeper roots and implications.

The alarming signs and signals are not unique to the crisis but raise much bigger issues.

So I could not help asking myself questions of yet another nature.

What is the modern meaning of utility, which is one of the cornerstones of the mainstream theory of modern capitalism, and what is the meaning of the human needs that represent an essential condition for economic goods to possess utility? How should we define utility, and who is in the position to do the defining? Why do we have to buy a certain set of goods and services, and how could we know their actual utility and their costs of production? Who actually sets the price for all these goods and services, and how is the price set? Do we really have to pay it, and if so, why? And what, under current conditions, is the real meaning of the notion of productivity, which is also central and essential to the modern theory of capitalism? How can it be measured, and does it bear any practical sense?

Private property, we are told, is the basis and the most essential element of a capitalist market economy. If there really has been a "manager revolution," allowing executives de facto to prevent the formal owners of industrial assets from disposing of their property and also the income that it generates, thus stripping any practical meaning from the formal right to private property, the question arises: Why is there so little debate on this issue, and why are no allowances made for this revolution when practical policies are proposed to invigorate economic growth? Why is it presumed generally that firms and banks act as if they are being operated for the benefit of their shareholders, maximizing their current and future value?

The transition to a capitalist market economy of former Eastern Bloc countries added greater social complexity; society was divided along new lines, with greater gaps between strata. That development posed yet another set of questions. What laws and rules govern the distribution of income and property under modern capitalism? Why do new gaps arise for no obvious or convincing reason, and how does that inequality correlate with the notion of fairness and justice—if indeed those qualities are to be applied to the subject?

Why did the financial sector grow to such size and complexity? What lies beneath this expansion? Have financial technologies made some real progress, such that financial products have become more convenient or safe? Or maybe what has happened is a kind of intellectual alchemy, bordering on deceit? Why is it that amid an impressive flood of financial services being advertised, there are so few people who boast that they have benefited from them?

The mantra of much present-day economic thinking is that the new economy emerging to replace its industrial predecessor is knowledge-based and oriented toward innovation. But questions remain unanswered here as well: What do the innovations accomplish, and how do they relate to the welfare of society, to the public interest? What is understood by the public interest, and who evaluates and formulates it? Who makes money from "intellectual innovation"? Who pays for it, and why? And how does this transaction affect the distribution of income and property on a global scale? What basic logic, if any, governs these processes?

It may seem not logical, but thinking over these and other more fundamental issues—as well as considering what lessons might be drawn from the slide into the Great Recession—has brought me to a single conclusion: when no clear visible reasons explain a phenomenon, hidden causes may exist. Perhaps the hidden cause is too complex and arcane to discover, but perhaps it is right beneath the surface, willfully ignored rather than obscure.

Now I come to the topic that forms the nexus of this whole book, and to the main message that I hope my readers will take away. To have a viable, effective, and efficient economic system, we must reject the mindset that drives Realeconomik, the notion that "Homo economicus" bases his judgments on purely rational, narrowly economic considerations.

The ability to secure the information essential for making economically rational decisions is limited. Moreover, this limitation becomes more pronounced as economic life becomes more complex, as the utility of goods and services offered to consumers becomes less self-evident and requires more and more expertise. On the contrary, a greater role arises for irrational considerations, like passions and desires, and for accepted rules and values, motives and constraints that constitute what we define as ethics or morality.

These rules and values and the motives and constraints that arise from them are rarely granted prime importance in discussions of economic behavior, and often they are simply dismissed as irrelevant. However, they provide a simple and plausible explanation for much around us and answer many questions I have raised.

The financial decline that unfolded in 2007–2009 has numerous contributing factors, some related to business cycles, some to structural changes in the financial sector, and some to wrong decisions by relevant authorities or private institutions. Nevertheless, as I hope to show, many questions stemming from this crisis will remain unanswered if we stay within the realm of analysis of relevant decisions as right or mistaken, competent or poorly worked out, ignoring their ethical and social background. To avert yet another outbreak of financial instability, we should not limit ourselves to the mere indication of policy failures or incorrect risk assessments. We must confront the spread across the financial sector and related industries of tolerance for dubious and overtly misleading practices. We must hold governments and lawmakers accountable when they yield to financial sector lobbies and hand out undue favors. We must not tolerate the irresponsible indifference by authorities and experts on whose opinion they rely to a dangerous accumulation of risks in the financial system.

Moreover, the "hidden" factor of moral weakness, when put in the right perspective, may help to give a coherent picture of the inner logic of modern capitalism and its current evolution, as well as a satisfactory explanation of the dangerous changes in the economic world over the past several decades.

The structure of Western economies has undergone a visible and possibly irreversible shift in favor of the financial sector, while increasing the share of the costs of various intellectual (or pseudointellectual, as is often the case) components in the products of other sectors. This shift may have certain objective and natural driving forces behind it, like the increasing importance of knowledge for production activities, or the preponderance of complex links between economic agents requiring greater specialization. But in parallel to those forces we can see business in these sectors becoming less transparent, increasingly seducing those engaged in it into misleading and deceitful behavior. We can also see people in these sectors using their advantageous positions to extract royalty payments from their clients as fees for intellectual assets created by past generations, which they have groundlessly privatized. Finally, they openly manipulate consumer psychology, using not only aggressive and coercive advertising but blatant deception disguised as mysterious "innovations." All this has been made possible by the passivity of politicians and the open collaboration by members of the intellectual elite.

Ethical considerations also come into play, as I hope to prove, in the modern trend in international economic policy of dividing the world into zones characterized by great differences in the levels of economic and social