



## **The coming paradigm shift**

Political conflicts and economic dilemmas can usually be traced back to the assumptions that are being used. Socialism, for example, assumes the need to reduce inequality; free enterprise invokes the right to gain reward for effort. Keynesian economics assumes that the private sector is risk averse and makes mistakes; monetarism uses the concepts of rational behaviour and market clearing via price adjustments. In the 19th and early 20th centuries, political economics incorporated the assumptions of personal responsibility and the effectiveness of free markets. These assumptions were found wanting during the Great Depression of 1930-39, but theorists – both then and later – missed the fact that collective psychological misery was created by the appalling policy decisions of the period: world trade was enfeebled by the Smoot-Hawley tariff catastrophe (1930); the money supply was allowed to collapse (1929-33), and increasingly penal taxes were applied (1932-36). Despite all this, attention focused on the need for a more active role for government spending.

After the Second World War, therefore, government spending began to expand and, despite periodic consolidation, it went on expanding. However, the expansion seems to have gone through two distinct phases – one inflationary, the other disinflationary. One important variable has been supply-side innovation. Up until the late 1970s, genuine innovation was limited. Rising government spending accordingly became highly inflationary, and the inevitable financial crisis resulted in a very tight monetary policy. The subsequent period featured the infotech revolution and globalisation. A growing private sector therefore generated healthy tax receipts and downward pressure on inflation. Unfortunately, this encouraged governments to over-expand. Indeed, there was a short period in the middle of the last decade where the fading innovation impulse was masked by the direct and stimulative effects of rising government spending. But, when the business cycle turned down in mid-2007, the fragility of the situation was exposed and a catastrophic financial crisis emerged. The authorities responded with a very loose monetary policy.

Neither the crisis of 1973-74 nor that of 2008-09 changed the assumption that rising government spending was desirable. Nevertheless, policy-makers now have a problem: Keynesian spending programmes cannot offset the energy gap in innovation; governments cannot properly finance their social spending plans; and the private sector is still struggling with a gross misallocation of resources. Governments can either make spending cuts under their own volition or they can make such cuts in response to rapidly rising bond yields. It is a mistake to think that there is any other choice. It is also a mistake to think that the need to make the choice is confined to southern Europe.

The reality now is that the damage done to economic confidence by the 2008-09 financial crisis cannot be repaired using old methodologies. In fact, *Helmsman's* socio-economic model suggests that the drive towards a paradigm shift has already started. Western economies have entered the disruptive interval between the end of one era and the start of the next (see diagram – not available to non-clients). This interval, which prepares the psychological environment for change, lasts on average for 3-1/4 years, starts with weak growth, and then transits into an unexpectedly deep recession. It is then followed by a 10-year 'transition' cycle, whose volatility reveals the errors in the beliefs that informed the old era. In the next few years, therefore, academics and policy-makers will be confronted with the impotence of orthodox monetary and fiscal policies, and the aims of government – particularly in the EU – will increasingly be at odds with ability of tax payers and savers to provide the desired finance.

My fear is that, while southern Europe is being laid to waste by the madness of Eurozone politics, aggressive monetary easing by central banks will start to generate a major inflation. Economic stagnation and rising inflation are socially destructive. Indeed, if collective beliefs coalesce around the negative energies of scapegoating and aggression, global conflict could emerge. This is why political vision and leadership are now so important. Unfortunately, we are desperately short of both.

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