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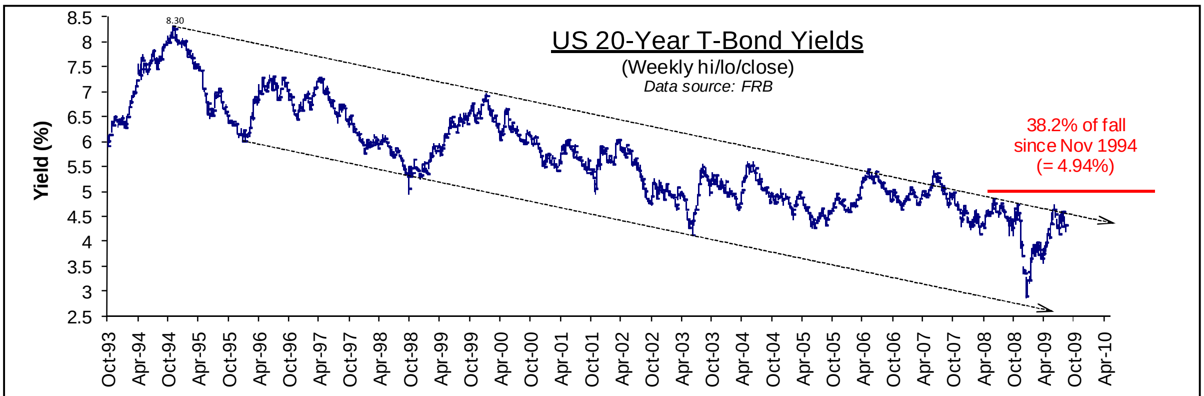
Change only ever comes out of crisis

The *Sunday Times* this week reported the hostile debate on fiscal spending between the economist Paul Krugman and the historian Niall Ferguson. The question is whether the recent surge in government spending should be maintained to stave off depression (Krugman) or whether it needs to be curtailed to avoid inflation (Ferguson). The vitriolic and personal nature of the dispute suggests that the argument is not just about the correct economic policy in the face of an economic disturbance; it seems also to be about the role of politics. The left-wing Krugman favours high levels of government penetration into the economy, whereas the right-leaning Ferguson prefers individual freedom; Krugman (as a follower of Lord Keynes) believes that unfettered individualism causes instability, while Ferguson (as a student of history) suggests that too much government results in lower productivity and more inflation; Krugman (reading between his lines) thinks that private sector behaviour will not change; Ferguson (explicitly) believes it is subject to evolutionary forces.

A polarisation of political views (including the emergence of fundamentalist attitudes) is inevitable during the disruptive end-phase of a 35-year infrastructure cycle. But what the polarisation specifically highlights – and what Niall Ferguson is pointing to – is the fact that the economics profession does not have a theoretically rigorous explanation for panics and crashes, which are still regarded as random accidents. However, it can be demonstrated that most major falls in asset markets have a cyclical component. For example, big equity price falls have occurred regularly during the last stages of a 35-year cycle since the late 18th century – ie, 1797, 1832, 1869, 1907, 1937, 1974, and (now) 2008. Unfortunately, economics does not yet recognise the validity either of rhythmic cycles or of the collective drive towards end-cycle excesses from which a collapse emerges. Nor does it recognise that government is neither an independent nor a gifted agency in the process.

It is likely that a paradigm shift in economic theory will eventually emerge from the ongoing sense of crisis that will colour the 35-year output cycle that is just starting. First, the economy will no longer be stimulated by a swarm of innovations. Second, the 54-year Kondratyev price cycle will no longer be generating a benign disinflation. Third, the cycle reversal mechanism that snapped into action in 2007-09 will limit the economic advance because the private sector will (a) persistently try to reduce its debt, and/or will (b) be crowded out of the financial markets by the public sector's borrowing needs. Timings can only be tentative, but *Helmsman's* economic confidence model therefore suggests a weak economic advance between now and 2014 (with an interruption in 2011-12) that will be accompanied by rising commodity prices. Within this process, the T-bond market will be the ultimate arbiter on the Krugman-Ferguson dispute. The rise in yields since last December has only signalled that the financial panic is over; and they could rise further without triggering a catastrophe. But when yields retrace more than 38.2% of the fall since November 1994 (see chart), they will start to lock into feedback with a government funding crisis and deteriorating inflationary expectations.



Comment: It's not what academic economists think, but what markets know, that triggers change.

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