REMAPPING DEBATE
Asking "Why" and "Why Not"

S&P: do what we want and no one gets hurt

Original Reporting | By Mike Alberti | Budget deficit, Markets

May 4, 2011 — In 1993, as the newly inaugurated Clinton Administration worried that rising interest rates could hamper the President's plan to stimulate the economy, Clinton adviser James Carville famously quipped: "I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."

Carville was expressing his frustration at those who, through their purchase and holding of U.S. Treasury bonds, wield — or are treated as wielding — substantial power to shape domestic public policy. In today's political and economic climate, several economists and social scientists are expressing similar frustration. Their concerns were amplified when the credit rating agency Standard and Poor's revised its outlook on U.S. government debt to negative from stable, a move that both S&P and many members of Congress used as ammunition to support calls for further cuts in government spending.

If the primary question being asked by policy makers is "how well are we reassuring markets" and not "how well are we serving the interests of our citizens," or if those policy makers believe that the answer to the first question provides a satisfactory proxy to answer the second question, these observers wonder whether political decision making in the U.S. can fairly be characterized as "democratic" at all.

Reassuring investors

In its report, S&P wrote: "The [more pessimistic] outlook reflects our view of the increased risk that the political negotiations over when and how to address both the medium- and long-term fiscal challenges will persist until at least after national elections in 2012."

For the next several days, officials rushed to make statements and appearances designed to satisfy bondholders that the deficit would be cut.

Treasury Secretary Timothy Geithner appeared on several television networks to reassure investors that Democrats and Republicans were close to a deal on the deficit. Members of Congress, from Charles Schumer to Paul Ryan, issued similar statements of their own.

This is hardly new. Officials have been explicitly trying to reassure bondholders since the government enacted a $787 billion stimulus package in order to limit the damage of the financial crisis of 2008. In May 2009, an official in the Obama Administration told Reuters anonymously: "Our deficit is going to increase sharply as a result of these measures, but once the recovery is fully, firmly established and the risks have dissipated we're going to walk back these measures and the deficit will decrease," adding that the U.S. is "attuned to the interests of our investors…and if the deficit issue comes up we're fully prepared to discuss it."

The official was speaking while Geithner was in China, on a mission to reassure the Chinese government that its holdings of U.S. debt were safe despite the stimulus package.

The impulse to reassure the bond market is said to be rooted in a fear that, if investors are displeased with public policy made by officials, they might pull their money out of the Treasury bond market. If enough of them did so, the argument runs, the U.S. would face a serious problem in financing its operations and paying the interest on its current debt.

There is substantial debate over whether investors would actually pull money out of the Treasury bond market (see sidebar).

WILL THEY FLEE?

Jamie Galbraith, an economist at the University of Texas at Austin, said that there was little chance that investors would flee from U.S. bonds, which for the foreseeable future will remain the safest place to invest, regardless of the deficit level.

L. Randall Wray, an economist at the University of Missouri at Kansas-City, agreed, adding that because the U.S. prints its own currency, there is no chance it will default on its debt.

"The people who argue that we need to cut the deficit because of the bond market either don't understand that or they don't want people to understand that," he said.

In that sense, Wray said, officials may be using the bond market as a way to stoke unfounded fears about the deficit in order to justify other agendas, like cutting social programs.

Whether those concerns are well-founded or not, said Arthur MacEwan, an economist at the University of Massachusetts, Boston, the focus on the perceived will of investors should raise red flags for citizens who are concerned about whose interests the government takes into account.

"The bond market is a formal way in which people with wealth can make their opinions about public policy known," MacEwan said. But since voters have no direct control over the bond market, he went on, when elected officials prioritize those opinions over the desires and needs of voters, "you end up with a fundamentally undemocratic situation."

Greg McAvoy, a political scientist at the University of North Carolina at Greensboro, wrote a paper in 1997 called “The Bond Market as a ‘New Institution’ in Macroeconomic Policy-Making,” in which he argued that the bond market has become increasingly influential since the 1980s and that “the encroachment of the bond market into policy-making has broad political implications, including the potential to alter quite significantly the preferences of policy-makers.”

McAvoy said that, while the bond market serves a vital economic function — serving as the mechanism through which the government can finance itself through borrowing — allowing the market to have too much influence over policy decisions “raises serious questions about the autonomy of democratic institutions to choose and pursue economic outcomes.”

One dollar, one vote

“What we normally think of when we think of democracy is the principle of one person, one vote,” MacEwan said. “So, we tend to think a lot about elections.”

But, MacEwan went on, while elections are a way of holding policy-makers accountable for their actions, a more accurate description of democracy is a system of governance in which the interests and well-being of the public at large trumps any and all competing interests.

Ha-Joon Chang, an economist at the University of Cambridge, agreed. “What democracy is for is to take care of everyone,” he said, “not just the financial markets.”

If the bond market can influence public policy to a point in which the perceived desires of bondholders can trump the perceived needs of voters, Chang said, that situation raises a troubling question: Who is serving whom?

Chang added that when private actors, who make their opinions known through consumption and lending, have more influence on officials than voters do, democracy becomes perverted: “To put it bluntly, you have a system in which it is not one person, one vote, but one dollar, one vote,” he said.

Different metrics

MacEwan argued that in order for a government to maintain its democratic integrity, the bond market must be viewed not as a determinant of public welfare, but as one of many tools that the government can deploy or manipulate in order to achieve its goal of promoting public welfare.

The first and most important step to take, MacEwan said, is “to recognize that what’s good for profits is not necessarily good for people.” He added that although there are many instances in which the de-

sires of investors do coincidently line up with the desires of citizens, that correspondence is just that: a coincidence.

Thus, for example, the interests of financial markets and the public would both likely be served if officials vote to lift the debt ceiling in the coming months. But, MacEwan said, the past two years are full of examples in which the desires of markets stand in stark contrast to the well being of the public.

"In everything from tax policy to monetary policy to environmental regulations, we see how the interests of the public and [the interests of investors] are not always the same," he said.

"Look at the way in which the tax arrangements for international investors get set up," MacEwan went on, referring to loopholes in the U.S. tax code which allow profits made by American companies overseas to remain untaxed. "By allowing them to avoid taxes, we are essentially giving them an incentive to invest and produce jobs abroad." While this may be profitable for investors and businesses, "it's terrible for the people who lose their jobs here."

Patrick Bond, a political economist at the University of KwaZulu-Natal in Durban, South Africa, pointed out that it makes little sense to judge policy decisions based on the perceived will of investors, because "their primary motivation is not the public welfare; it's to make money. If you had a relative who just cared about making money, would you want them watching your kids?" he asked.

Chang pointed out that the financial sector has harnessed both Democratic and Republican politicians to remove regulations the industry saw as harmful to its profit margins. For example, the Glass-Steagall Act had for decades prohibited depository banks from engaging in speculative activities. The Act was repealed in 1999, in large measure based on the argument that less regulation was needed to allow financial institutions to "innovate" and "thrive."

"Look what happens," Chang said, when you take away regulations designed to protect the public interest.

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John Weeks, a political economist at the University of London, said that he has been making that argument for a long time. "One common thing you hear is, 'well, the government might do stupid things, [and, by] telling you that you shouldn't be borrowing…they're doing you a favor.'"

“Even if that were true, it would still be undemocratic,” he added. “You’re not just for democratic processes…when they have a good outcome. Sometimes they have a bad outcome and you have to live with it. That’s what democracy means.”

Since financial markets are not an adequate proxy for public welfare, many economists and social scientists argue, it is imperative that the elected officials stop using the bond market as a primary metric of the well-being of constituents. That would require, MacEwan said, a fundamental change in that way that officials view their policy options.

Asking different questions

After the S&P report called for reducing the deficit by cutting spending, Sen. Charles Schumer (D-NY) responded quickly: “Now we just need to resolve how to do it.”

Dean Baker, co-director of the Center for Economic and Policy Research, observed that this response was not unusual. Catering to the perceived will of investors by reducing spending, he said, has become de rigueur for many Democratic and Republican officeholders — essentially, it is the only policy option on the table.

> Eric Tymoigne, an economist at Lewis and Clark College, used the United Kingdom not as an example of a happy ending, but of the deeply negative impact that excessive austerity can have on a fragile economy.

“If we stopped asking what’s good for markets and started asking what’s good for people, we could come up with a whole different view of what the government should be doing,” said Bill Mitchell, an economist at the University of Newcastle, in Australia. Regardless of the outcome in a particular situation, he said, the serious consideration of a variety of policy options would both encourage and reflect a better-functioning democratic process.

If “politicians would be primarily concerned with things like…wages, unemployment, living standards, accountability, [then] everything would be on the table,” Mitchell said.

For example, if officials were more concerned with depressed wages, Mitchell went on, they might be less concerned with the risk of inflation. Christina Romer, the economist and former adviser to the Obama Administration, recently provided another illustration. She argued that continued stimulus was necessary in order to help the economy recover faster and create more jobs. But Federal Reserve Chairman Ben Bernanke, despite the fact that inflation has been registering at levels below the Fed’s target, still cited fears of greater inflationary pressures in announcing last week that the Fed’s credit-easing policies would be coming to an end.

Chang added that the government is aggressively pursuing several new free trade agreements, which have been shown to increase the profits of some companies but sacrifice thousands of manufacturing jobs in the process. If jobs were a higher priority, he said, the Obama Administration might reconsider such a strategy.

If the public welfare were your primary criteria, Mitchell said, perhaps one would go further: "95 percent of the financial sector is completely unproductive. Does it help produce anything real? No. No it help anybody get jobs? Not really, or certainly not as many as would be produced by investing those resources in productive ways."

Different roads to take

After S&P released its report, John Chambers, chairman of the sovereign ratings committee at S&P, said that if the U.S. were to implement significant austerity programs along the lines of those introduced in the United Kingdom, it would restore the debt outlook to stable.

"The refusal to introduce austerity is the only option the US government has if it wants to serve its workers and businesses responsibly." — Bill Mitchell, University of Newcastle, Australia.

L. Randall Wray, an economist at the University of Missouri, Kansas-City, called the report a "purely political statement," and questioned whether making political statements or threats should be part of a ratings agencies job.

But — leaving aside the appropriateness of a ratings agency's unsubtle warning about the harm to creditworthiness that it would impose were it's particular policy preferences not adopted — do governments actually have a choice of what to do?

Wray said that, in fact, different countries have responded differently, demonstrating that governments have multiple policy options that can produce very different outcomes.

S&P revised the economic outlook of Britain's debt to negative from stable in May 2009. In 2010, a recently elected Conservative-led coalition in Parliament introduced drastic austerity measures. S&P immediately restored the U.K.'s economic outlook to stable.

But Eric Tymoigne, an economist at Lewis and Clark College, used the United Kingdom not as an example of a happy ending (S&P's advice is followed, and the country, with an improving economy gets S&P's seal of approval), but of the deeply negative impact that excessive austerity can have on a fragile economy. "They sacrificed their recovery," he said. "If you try to introduce austerity in a recession you can end up with a lost decade."

Baker pointed out that, notwithstanding S&P's restoration of the "stable" label to the U.K.'s economic outlook, British citizens are still suffering from high unemployment, stagnant growth, and cuts in social services.

John Weeks said that by focusing on the perceived wishes of investors instead of the interests of citizens, British officials had made an essentially undemocratic decision. And the popular resistance to austerity cuts in the U.K. underscores that point, he said.

Wray used Japan as a counter example. S&P has downgraded Japanese debt several times in the last decade, citing its rising deficit. Japan has been struggling with low demand for decades, and officials did not implement austerity programs or significantly cut spending, Wray said. The result has been extremely low unemployment, as well as low interest rates.

Though Chang pointed out that most of the Japanese debt is owned internally, he agreed that Japan should serve as the model for the U.S. when responding to the S&P report and, more generally, when forming policies to respond to the recession.

Mitchell said that, in responding to the S&P report, the correct, and most democratic course, response would be simply to ignore it. Indeed, Mitchell added, "the refusal to introduce austerity is the *only* option the US government has if it wants to serve its workers and businesses responsibly."

A vicious cycle?

In order to achieve greater democratic control of public policy, Chang said, it was necessary to "demarcate [the market] and prevent it from spilling into other areas. We need to start rolling the market back, like the government has been rolled back since the 1970s."

In the short term, Chang said, the policy makers in the U.S. should refocus their attention on the needs of the public. In the long term, several economists interviewed stressed the importance of putting constraints on capital markets. Some argued that constraints were need in order to limit the actual influence that bondholders have in the policy making process. Others, who were skeptical of the financial — as opposed to political impact — that the bond market can exert, still thought controls were needed to make clear to the public that elected officials had no justification for catering to the market's desires.

John Weeks of the University of London said that the U.S. and the U.K. should institute currency controls and capital controls and should consider taxing financial transactions.

"Those are good things," MacEwan agreed. "They limit the prerogatives of capital in a useful manner."

MacEwan stressed that significant tension will remain between the democratic state and international capital as long as global institutions lack the will and the power to effectively regulate financial markets.

But John Agnew, a geographer at the University of California Los Angeles, stressed that the U.S. still has a huge amount of leverage in the global economy, and there was much that could be done domestically to influence the international regulation of markets.

“When the U.S. does something, every country in the world pays attention,” he said. “If we got a couple of the biggest, most powerful governments together, they can easily begin to regulate this.”

The starting point, MacEwan repeated, was to change an ideology that conflates and the presence of profits with the economic health of ordinary citizens. He described a “vicious cycle” at work in American policy making, in which a greater concentration of power in capital markets “results in decision making that reinforces that power, and leads to worse economic policies for the rest of us, and less democratic control over the economy.”

“The problem that we face is how to turn that vicious cycle into a virtuous circle,” he said.

In that sense, he said, regulating capital markets and the ratings agencies were just one part of the solution, and “the rest has to do with ideology.” To begin to change an ideology of conflating private and public interests, “We need to take advantage of all the different ways you can do things that involve public involvement.”

For MacEwan, that means locating areas where the economy can be brought under greater social control, whether it is empowering labor unions to represent the interests of the broader public, or providing universal social programs that, in his terms, create a “social wage” which is shared by all members of society and is not tied to income.

Ha-Joon Chang of Cambridge said that the U.S. government is aggressively pursuing several new free trade agreements, which have been shown to increase the profits of some companies but sacrifice thousands of manufacturing jobs in the process. If jobs were a higher priority, he said, the Obama Administration might reconsider such a strategy.

While on the surface, unions and social programs might seem disconnected from the influence of capital markets, MacEwan argued that the connection exists because they bring more of the economy under democratic control, thus helping to change the ideology that encourages officials to analyze policies on the basis of their effects on financial markets, and not on their effects on the public.

If we had begun to change this ideology years ago, MacEwan said, “Maybe we wouldn’t be in this mess in the first place.”

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