Jim O'Neill: Can economics shake its shibboleths?

Since the 2008 financial crisis, economic orthodoxies have been collapsing left and right. Under conditions of low unemployment, elusive inflation, weak productivity growth, and high profitability, economists in advanced economies may need to go back to the drawing board, **writes Jim O'Neill**

Jim O'Neill is Chairman of Chatham House

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Challenging convention

Though economics aspires to the rigor of the natural sciences, at the end of the day it is still a social science. At no point in the past 40 years has this been more evident than it is now.

For decades, conventional macroeconomic analysis has rested on the edifice of the Phillips curve, which asserts a clear tradeoff between unemployment and inflation: when the unemployment rate falls below a certain point, inflation must rise. But this assumption has not been borne out in the decade since the 2008 financial crisis. In both the United Kingdom and the United States, for example, the unemployment rate is historically low, yet inflation remains weak.

The declining power of labour may explain why the Phillips curve no longer seems to hold true

Or consider monetary policy. Even after years of quantitative easing (QE) and ultra-low interest rates, central bankers in the advanced economies – particularly the eurozone – have continued to undershoot their inflation targets. Economists have also had to question long-held assumptions about downward nominal wage rigidity, an artifact of the 1960-70s, when organized labour was much stronger. Clearly, the idea that employees will always resist cutting wages (or workers' hours) no longer applies.

In fact, the declining power of labour may explain why the Phillips curve no longer seems to hold true. But, even more important, it could be the reason why measured productivity remains persistently weak. After all, companies that can easily hire and fire employees or force them to adjust their price point have little reason to risk vast sums on new buildings and equipment that might not even be used until the next business cycle.

If this is the case, one solution to the productivity problem is simply to make labour markets less flexible and labour less cheap. If business leaders and economists object to that, perhaps they should stop prattling on about productivity all the time.

What explains the conundrum?

Another big theoretical assumption, particularly at the micro level, is that strong profit growth will attract new entrants to the market, thereby spreading profits more broadly at the expense of the previous incumbent. And this, in turn, should encourage more investment, thereby boosting productivity and wages for workers. But again, there is little evidence of this assumption being borne out in recent years.

To the contrary, corporate profits and market concentration are both on the rise. What explains this conundrum? It is not that Karl Marx was right all along that capitalism is doomed to fail. Rather, it is the result of particular developments in financial markets, regulatory policies, and incentive systems in the era since the 2008 financial crisis. Clearly, it has become far too easy for dominant market players to resist competition. But there are many ideas floating around that might address that problem. One issue that I have touched on before is stock buybacks, which may be allowing corporate executives to boost their own earnings without having to invest in productivity gains.

Companies that are not contributing to productivity growth…shouldn't be enjoying a free lunch

Fortunately, politicians of all stripes have begun to question why current tax and regulatory policies seem to be encouraging such behavior. As a general principle, companies that are not contributing to productivity growth or helping to solve broader social challenges shouldn't be enjoying a free lunch. The British construction company Persimmon, for example, has been posting higher earnings not because of investments it made, but because the UK government introduced a special loan scheme for first-time homebuyers. And most of the major pharmaceutical firms now seem to show an interest in research and development only when they are buying a new drug and need to conduct clinical trials to secure exclusive rights to it.

The biggest challenge to economic orthodoxy is China's growth

Finally, at the global level, the biggest challenge to economic orthodoxy is the continuing growth of China since it launched its policy of economic "opening up" in the Deng Xiaoping era. There is growing evidence to suggest that the US will do almost anything to stop China's rise, even if it means denying prosperity to the Chinese people. Those who have closely followed China's development over the past 40 years know that a significant dose of capitalist ideology has seeped into the country's nominally communist political economy. But this fact seems to have eluded more ideologically predisposed Western economists.

Indeed, as Singaporean economist Kishore Mahbubani noted recently in The Straits Times, America's hardline approach to the Chinese tech company Huawei appears to be driven wholly by ideology. Rather than adopting a more measured strategy to ensure that the company (and others like it) abides by mutually agreed global rules, US President Donald Trump has made it a bargaining chip in his trade war. If that is what the alternative to old orthodoxies look like, we should all be worried.

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