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Tower of debt will force roll back of free markets

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More than twenty years ago Margaret Thatcher asserted that 'You can't buck the market' and that 'there is no such thing as society.' The world changed. Today the Conservative party's leader David Cameron is keen to '…assert a fundamental truth: that markets are a means to an end, not an end in themselves. Markets are there to serve our society, not to suck the joy out of it or trample over its values.'

The world is changing again. The real fundamental truth is that the free market system has buckled under the pressure from a very different system which has stubbornly refused to change. In North Asia society prefers a system which targets full capacity and full employment and has little interest in maximising returns on capital. This system insists on bucking the market and the long held consensus view was that it would fail.

As we enter the second decade of the twenty first century it is now evident that, in preventing the deflation mandated by the North Asian system, we have passed the zenith of the free market system. If markets are 'to serve our society', for which read fund our governments, then they will have to be controlled.

Over the past few decades the 'free' adjustable system has, not surprisingly, taken the path of least resistance when faced with an opposing system rigidly designed to over-produce. It had shunned competition in those areas of over-production and adapted to consume the cheap products provided at uneconomic rates. When funds were not readily available for consumption it turned to readily available cheap debt in an era when over production and central bank purchases of western government debt kept inflation and thus interest rates low.

In this process of adaptation it was easy to believe that it was the parasite (consumer) which was growing strong at the expense of the host (producer). Cheap debt enabled strong consumption and rising asset prices produced the illusion of reasonable savings to provide for an ageing population. However the time came when the limits to leverage were reached. The decline in demand which ensued threatened to bring to pass the deflationary bust which the western authorities had fought for almost two decades. The consensus opinion was that it was the over-producing North Asian model which would fail. However year after year Japanese society weathered dire economic conditions rather than abandon their focus on over production and over employment.

In China a buoyant free market system did develop but the core of the system continued to over-produce fed by the milk cow of a command economy banking system. Just when it looked like the rest of Asia had been forced to capitulate to free market forces in 1997 governments prevented a free market in their exchange rates and joined the over-production party. Alan Greenspan spent most of his career fighting off the deflation which the North Asian model threatened. By 2008 monetary policy was no longer sufficient and a mighty fiscal response was thrown against the deflationary dynamic. The refusal to accept the deflation imposed by the North Asian model has produced massive government intervention and pushed fiscal debt to GDP sharply higher. Western governments are left with no option but to restrict and coral markets and force private sector capital into action in support of public debt markets. Only such actions, or rapidly declining demand for debt in the private sector, can support the scale of public debt burden now developing. At times there will be evidence that the G7 plan to rebalance global growth with higher consumption in the emerging world is working. In a free market system, replete with players desperate for a return to business as usual, such signs will be greeted with great fanfare. Expect the first trumpet of joy to sound as China returns to the steady but slow appreciation of its exchange rate relative to the US dollar.

However the simple truth is that it is too late for the free markets. The roll back of the free market has already begun, driven by the necessity to support a fragile teetering tower of public debt. Commercial banks' new capital adequacy ratios already require banks to hold higher levels of government debt. In due course a transaction tax on financial instruments, apart from government debt, will come to pass. A 'Buffett' tax which makes short termism expensive and forces owners to engage with managers will come to be seen as the natural solution to produce markets which 'serve our society.'

The ultimate weapon to force private savings to fund governments will be capital controls. To support public debt to GDP levels not seen since the second world war, we are likely to see a return to similar forms of market constraints which were necessary in that era. The 'new normal' is not sub par economic growth. The new normal is the roll back of the free markets.

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