Index

Note: *Italic* page numbers indicate charts and tables

academic economists 130, 238, 242, 253, 255
accounting practices 22, 50, 151, 152, 158
fixed-cost financing 86
Japan 111, 113
adverse selection, banking 103
affordability of housing 191
ageing population, Japan 122–3
"agent/principal problem" 230–1, 235
aprioristic bias 130, 238, 255
asset prices
avoidance of policies that increase 177, 257–8
impact on savings and investment 193
and inadequacy of neoclassical consensus 238, 244, 252
and low interest rates 212
overvaluation of 166, 173, 185–90
sharp fall in, triggering financial crises 170, 171–2, 176, 177, 182, 257
volatility of 151
Woolley Centre research 252–3
asset pricing, scientific approach 252–3
Augmented Dickey–Fuller (ADF) test 259

Badger, Tony 104
balance sheets
banks cutting back 101–2
of banks, rapid expansion 89, 179
companies 202–3
household 75–7, 200–2
misinformation 150, 157, 162–4
off-balance-sheet finance 85–6
Balassa–Samuelson effect 124, 205
Bank of England (BoE) 61, 68
Financial Stability Report 187–8
purchase of bonds 190

bankers
adverse selection 103
advice from 102–3, 104
eurozone, state control 104–5
banking
barriers to entry 93–4, 97, 98
reform, UK objection to 105
rise in riskiness of, UK 93
bankruptcies 76, 95, 97, 99, 140, 166
Lehman Brothers 87–8
banks
bankruptcy 87–8
capital requirement 100–1
concentration of 93, 94, 97–8
equity ratios 101–2
market-making activities 94–5
regulation issues 82–3, 90, 95, 99–100, 103–4
return on equity 90–3
source of political contributions 103
subsidised by taxpayers 87, 95, 99
Barnier, Michel 104
barriers to entry, banking 93–4, 97, 98
Basel III agreement 101
Bernanke, Ben 136
"best practice" agreement on bonuses 234
Bini Smaghi, Lorenzo 139
bond yields 4, 5, 182
and eurozone confidence 138
fall in, effect on pension savings 211
and future rate of inflation 189
and mortgages, US 180
and quantitative easing 182, 214–15, 216
and US monetary base 182
bonds
and Equity Risk Premium (ERP) 248–9
impact of inflation 249–50
nominal vs. inflation-protected 189–90, 214–16
overvaluation of 190, 192
return to investors 152–3, 188–90
bonus culture 229–35
convex contracts 73
damage to economy caused by 226–7
and investment decisions 17–18, 32
“short termism” induced by 19–20, 65
borrowing and risk 192–3
BRICs (Brazil, Russian, India and China),
foreign exchange reserves 131
Brittan, Sir Samuel 3
budget deficits see fiscal deficits
business debt 163, 170, 171, 183
business (de)leveraging 11, 77–9
business investment
and demand for goods 43
and inflation 203–4
Japan 109, 117
and depreciation 118–19, 161
and low cost of borrowing 181
low levels of 24, 52
alternative explanations 47–60
and trend growth rate 225
and output 82
and output gap 25, 26, 27, 224
and profit margins 15–16
“buy-backs” of shares 13, 18, 72, 75, 77, 78, 203, 213, 237
capital investment 17
and change in management incentives 74, 225
fall in 24, 25, 69
and growth/output 32, 164, 221–4
Japan 109–10, 113
perceived cost of 71–2
vs. share purchases 32, 74, 181–2, 213
capital/output ratio (COR) 223, 224, 225–6
calculation 110
manufacturing vs service sectors 43, 114, 261–2
capital productivity, decline in 221–4
cash flow 8–9
business sector
fall needed in 11, 14–15, 42, 45
and fiscal deficits 10, 35–7
rise in and low investment 74–5, 81–2
and unemployment 36, 37
use of 213
household sector 37, 38, 41–2
Japan 107, 108, 113, 114
cash, impact of inflation 249–50
central banks/bankers
EMH, impact on policy of 244, 248, 252
and financial crisis 90, 136–7, 166
inflationary expectations, measuring 135
mispri sing of assets 257–8
policies and behaviour of bankers 88–9
and quantitative easing 179–80, 182, 190, 208, 258
see also Federal Reserve
Chancellor, Edward 56
China 55–6, 124, 131, 143–4
Chote, Robert 61
commodity prices, impact of quantitative easing 212–13
competition, decline
in banking/finance 93–4, 98, 103
and high profit margins 59, 60, 86–7
and monopoly power 97, 229–30
consumption
Japan 116–17, 118, 124
“convex contracts” 73
corporate debt 163–4, 165, 171
corporate investment see business investment
corporate output 66, 83, 164
“corporate veil”, Japan 123
corporation tax 15, 19–20
and depreciation allowances 112–13, 118, 120, 255–6
reduction for small companies 235
US effective rate, decline in 224, 225
CPI see inflation
credit agencies, assessment of risk 166
current account balances 44, 45, 145, 207, 256
cyclical vs. structural problems 7–8
and output gap 25–7
policy issues 69–79
dealing activities of banks 90, 94–5, 101
debt build-up and rapid fall in asset price 257
debt, household 40, 141, 170, 171, 183, 201
debt, private sector see private sector debt
debt reduction, aim of long-term policy 199
debt-to-equity ratio see leverage
debt-to-GDP ratio 13
G5 countries 185
garlic belt countries 140–1
Germany 130
Ireland 184
Japan 124, 171
US 85–6, 131, 163, 175, 199–201, 211
defaults, rise in 76, 131–2
Index

deflation 50, 124, 139, 166–7, 217
defleveraging 75, 77–9, 203, 237
demographics, Japan 121–2
depreciation allowances, Japan 107–8, 110, 111
  assessing adequate rate for 112–13
  and corporate investment 118–19
  effect on published profits 113
  impact of reducing 116, 119–20
  need for reduction in 113–14
  overstatement of 115, 116
  as percentage of investment 108, 109
Deutsch, David 219, 243
direct investment abroad, US 50–1
discretionary savings of households 209, 211
dividend payout ratio 115–16, 156
Draghi, Mario 140
dernagings per share 19–20, 114, 115, 153, 187, 232
dernings’ yield on US stocks 155–6
economic theory
  dissenting voices and creation of next consensus 239–41
  EMH, damaging impact on banking policy 243–4
  existing consensus, inadequacy of 237–8
  innovation needed in 243
  paradigm shift, need for 238–9, 241–2
  revolution in 238–9
  efficiency of capital, decline in, US 164, 221, 223, 224
Efficient Market Hypothesis (EMH) 192, 243–4, 252, 257
deficiencies of 245–8
emerging economies
  exchange rates 205–6
  size relative to Keynesian trio 127
employment 31–2
  in non-union industries 53
  outlook for 226
  rise relative to output 61, 62, 63, 64
  see also unemployment
epistemology and bad economics 243, 253
equity 11–12
  capital ratio of banks 82, 94, 98, 101–2
Equity Risk Premium (ERP) 248–9, 252
  equity valuation 185–8
  errors in forecasting 61–8
  eurozone bankers and politicians 104
  eurozone crisis 137–43
exchange rate(s)
  China 129, 131
  and inflation 205, 206, 217–18
  international cooperation 143
  intervention 147, 207–8
  Japan 124
  and quantitative easing 213–14
  and relative productivity 205–6
  weak, and growth 228
  explanation vs. prediction 219–20
exports 44, 128
  Japan 108, 118, 119
  need for expansion of 43
  UK, oil balance 146
 Federal Reserve 64–5, 67, 68, 227
  bond purchases 190, 192
  foolish policies of 89, 228, 243
  management remuneration paper 73–4
  quantitative easing, “QE3” 135, 208, 216
  stock market valuation 187
Fifield, Anna 130
financial companies, “too big to fail” 87–8, 95, 99
financial crises 169–70
causes 87–90
  difficulty of forecasting 176
  and fall in asset prices 170, 171–2, 174, 176, 177
  and high debt levels 170–1, 175–6
  policy guides to avoid future 177
fiscal balance 7
fiscal deficits 4, 6, 69–70, 129, 144, 175, 211
  and business sector cash flows 8–11, 35–7, 75
  government deficits 4, 129, 211, 230
  historical rises in 126, 130, 195–6
  Japan 6, 7, 117–18, 124, 196
  and longer-term problem 70
  reduction needed by Keynesian trio 137
fiscal stimulus 71
  and excessive rise in debt 131–2
  four changes limiting 127–30
  Germany and China 129, 147, 208, 256
  Keynesian trio 125–6
  more needed to avoid recession 72
fixed-cost financing 86
forecasting
  errors, UK and US 61–8
  future crises 176
  future returns on equities 248–9
  of inflation 61, 62, 63, 189, 249–50
  vs. risk assessment 219
for eign exchange reserves, China 131, 143
foreign investment, US 50–2
France
debt-to-GDP ratio 185
eurozone membership 35
fiscal deficit 6
household savings 39
obstacle to reform 104
profit margins 29, 30, 31, 33, 34, 35
see also G5 countries
G5 countries
current account and fiscal deficits (surpluses) 144
government deficits and national debt 129
household savings 39
weak recovery 3, 4
see also France; Germany; Japan
“garlic belt” countries
debt ratios 140, 141
unemployment 140, 141
wage costs 139
General Theory of Employment, Interest and Money, The (Keynes) 239
Germany
avoidance of fiscal stimuli 130–1, 208, 256
beneficiary of weak euro 143
bonds relative to Italian 138
current account surplus 144
fiscal deficit 6
Landesbanken 104
national debt ratio 129, 130
need for tax cut 141
and weakness of euro 143
see also G5 countries
globalisation and profit margins 54–6
gold standard, support for 130
Goodhart, Charles 179, 180
goods’ output
capital requirements 261–2
as % of total international trade, UK and US 43, 44
as % of total, UK and US 43, 43
see also manufacturing
government bonds, lower yields on 180
government deficits see fiscal deficits
Great Depression (1930s) 150, 171–2, 198–9, 238–9
“great moderation” 136
“great recession” 2, 67, 130, 199, 239
Greece
hardship professions 142
managed exit from eurozone 142
wage costs 138–9
see also garlic belt countries
growth 47, 50–1, 117
of emerging economies 205–6
and fall in efficiency of investment 221–4
key barrier to 226–7
risk of faster rate 227–8
sustained, achievement of 220–1
trend growth, US 225–6
growth rates 48
guarantees, made to banks 87, 98–9
Haldane, Andy, BoE 188
Harding, Robin 64, 130
horizons, long vs. short-term 24–5
house building 39–41
fall in, US 209, 210
and inflation 202, 203
Japan 121
house buying, fall in 76, 200–1
house prices 177
link to discretionary savings 180, 181, 209–10
and quantitative easing 180
and share prices 171–3, 174
UK 177, 185, 190–2
household leverage 75–6, 76, 201
household liabilities 39, 40
household residential investment 39, 41, 202–3, 209
household savings 201
and cash flow 37, 41–2
and debt reduction 76–7
G5 countries 39
and inflation 202, 204
Japan 119–21, 121, 124
link to house prices 180, 181, 209–10
low levels, UK and US 39, 42, 76
pensions, US 210–11
UK and US 38, 40, 41
household spending 76–7
and house prices, US 180–1
and inflation 200, 202, 204
housing construction see house building
hyperinflation 126, 179, 217, 257
IMF, data on private sector debt 184–5
imports 43, 44, 128
UK, oil balance 146
US dependence on oil 144, 145
Index

275

incentives for management 232, 234
changes in 8, 17, 18, 20, 32–3, 63
damaging to economy 74–5
perverseness of 83, 227
reform of 231–2, 234
and underinvestment, US 117
Incremental Capital/Output Ratio (ICOR) 223, 224, 225–6
inefficiency of markets 248, 253
inflation
and business investment 203, 204
choices for policymakers 67
CPI 5–6, 64–66, 133, 196–204, 250, 265
and debt growth 199–201
and fiscal deficits 195–7
fiscal stimulus 208
forecasts 61, 62, 63
and growth 220, 227
and household savings 201, 202, 204
methods of raising
exchange rate intervention 207
fiscal stimulus 208
monetary stimulus 209–17
protectionism 207–8
and national debts 195–7, 198
and output gaps 65–6, 66, 132–5
quantitative easing 208–9
real exchange rates 205–6
and real returns on cash and bonds 249, 250
and residential investment 202, 203
targets, raising to boost demand 197–8
UK and US (1970s) 132, 133
volatility of, US 64–5
inflation-protected bonds 188, 190, 214–15, 216, 250–1
inflationary expectations 64–5, 67, 71–2, 134–5, 215–17, 227–8, 256
innovation in finance 103–4
instrumentalism 220
intercompany asset transactions 152
interest rates 4, 5, 6
low, effect on corporate behaviour 72
low, effect on savings 212
near-zero, failure to encourage investment 213
rise in early 1980s 135, 136
sharp rise in 1995
international cooperation 143, 145–7
international trade 127–8
investment 221–7
see also business investment; capital investment
Ireland, private sector debt 184
Italian bonds, fluctuation in 138
Italy see "garlic belt" countries
Japan
avoidance of recession 118
business investment 109, 117
consumption 116–17, 118, 120
debt levels, households and business 171
demographics 121–2
depreciation and profits 113–15
exchange rates 124
exports 108, 118, 128
falling inflation and rising deficits 196
depreciation 6, 7, 117–18, 124, 129
household savings 121
investment spending and depreciation 109, 119
national savings 122, 123
payout ratios, shares 115–16
profit margins, decline in 31, 33, 35
real wages and labour productivity 112
sector cash flows 108
jobbers/jobbing 100
Kay, John 242
Keynes Fund 252–3
Keynes, John Maynard 70, 72, 193, 239
Keynesian Trio (Japan, UK and US) 72, 125–30, 208
King, Lord Mervyn 104
Krugman, Paul 57–8
Kuhn, T. S. 241
labour costs 35, 53, 112, 134, 138–9
labour productivity see productivity of labour
labour share of output 28, 56–7, 112, 118
Lachman, Desmond 147, 256
land prices
and cost of housing, UK 191
and share prices, Japan 173
Law of Large Numbers (LLN) 96, 97
leasing debts 86, 184
Lehman Brothers bankruptcy 87–8
lenders/lending 11, 101–2, 131–2, 192–3
leverage 11–12, 14, 15, 201–3
corporate 77, 163–6, 257
debt-to-equity ratio 11
household 76, 201
US foreign subsidiaries 50, 51
LIBOR scandal 95
Lilley, Peter  89, 90
luck element, market making  96, 97
management horizons  24–5
management remuneration  73, 131
benefit culture  57–60
discouraging investment  204–5
economic effects  67–8
reform of  231–4
rewarding risk-taking  99
and volatile profits  151
manufacturing
capital requirements, US  261–2
Japan  114, 115
returns on capital, UK  145, 146
“marked to market” accounting  22, 151, 152, 158
market-making, banks  94–5
Martin, William McChesney Jr  89
mean reversion, profit margins  27, 28–32, 83, 83–5, 251, 259
Minsky, Hyman  192–3
misinformation  149–50
models
simplification of  73–4
see also neoclassical consensus
monetary base
and bond yield, US  82, 182
and level of stock market, US  183
and quantitative easing  208–9, 214
monetary policy  7, 125, 137
central bankers  89, 90, 136
doubtful benefits of continued use  169–70, 242
leading to debt and asset bubbles  131–2
savings surplus assumptions  70–1
monetary stimulus see quantitative easing
monopoly power  58–9, 97, 227, 229
“moral hazard”, increase in  132
mortgages
impact of government bond yields  180
stricter terms for  76, 201
myth surrounding Lehman Brothers
bankruptcy  87–8, 90

national debt  71, 124, 129, 130, 184, 195, 197, 198
national income and product accounts (NIPA) data
relation to published accounts  157
validity check on profits published  156
and volatility of profits after tax  20–2, 150

neoclassical consensus  238, 239
dissenting voices  238–41
limitations of  241–2
Minsky’s questioning of  192–3
need for new paradigm  242–3
net oil imports, US  144, 145
net worth (returns on equity)  47–50, 152, 153, 155, 158–60, 162
nominal bonds  189–90, 214–16

Ockham’s razor  59
OECD
blame of technology for rise in profit margins  56–7
fiscal deficit estimates  9
Japanese growth  108–9
output gap estimates  25–7, 33–5, 66, 132, 135, 224
US growth  225–6
off-balance-sheet financing  85–6, 184
Office for Budget Responsibility (OBR)  61–2
oil balance, UK  146
oil imports, US  144, 145
oil shocks  132
Olson, Mancur  142, 230
output order flow, market makers  96–7, 98
output and employment, UK  61, 63, 64
financial companies  82, 83
of goods  43, 44, 145, 146, 261
output figures
need for publication of  234
vs. sales, Japan  232–3
output gap  25
and inflation  65–6, 132–5
OECD estimates  25–7, 33–5, 132, 135, 224
overstatement of depreciation, Japan  115, 116
of profits, US  149–51, 155–6, 158, 161–2, 164–6
paradigms, challenging existing  238–9, 241–2
parsimony principle  59, 62
partnerships, market makers  100
patent protection  229
Paul Woolley Centre  252–3
payout ratio, profits  115, 116, 154, 156
PE multiples  153, 187
pension savings, US 210–11
philosophical errors 219–20
planning restrictions, UK 191
political contributions, bankers as source of 103
population, Japan 121–2, 122
Portugal see “garlic belt” countries
prediction vs. explanation 219–20
pricing policies 18–19, 32
private sector debt 183, 184, 201
deleveraging 75–7
calculation of 131–2
and inflation 199–201
Ireland 184
prior to financial crises 170–1, 198
rate of change 175
productivity of capital, decline in 221–4
productivity and exchange rates 205–6
productivity of labour 29, 66
Japan 111, 112, 113
UK 61, 62, 221, 221, 226
US 63, 64, 67, 221, 222, 224, 226
profit margins 30
and business investment, US 15–16, 42
financial vs. non-financial 83, 84, 85
impact of bonus culture 59–60
mean reverting 27, 28–32, 83, 83–5, 251, 259
and output gap 34–5
and union membership 55
profit maximisation 227, 229, 230–1
profit volatility 20–1, 23, 60, 115, 149, 150
profits paid to shareholders 13–14
profits published by US companies
and management remuneration 150–1, 231
overstatement of 149–51, 155–6, 158, 161–2, 164–6
validity of 156
volatility of 20–1, 23, 60, 115, 149, 150
vs. Japanese profits 114–15
vs. national accounts 157
prospects vs. forecasts 219–28
protectionist measures 207–8
q ratio 185–6
quantitative easing 179–80, 182, 258
and commodity prices 212
Fed’s programme ("QE3") 135, 208–9
impact on bond market 214–15
impact on demand 212, 216
impact on exchange rates 213–14
impact on household savings 210
uncertain outcome of 217
random fluctuations, market making 96, 97
Random Walk Hypothesis (RWH) 246
raw materials, price rises 212–13
real equity returns
impact of inflation 189, 249, 250
long-term stability, US 29, 153–4, 167, 190
UK and US banks 90, 91, 92, 98
variance compression 246, 247, 250–1
real exchange rates
and inflation 205–6
Japan 124
real short-term interest rates 6
real wages 29, 134
and labour productivity, Japan 111–12
reform 255–8
in banking, obstacles to 104–5
corporation tax, Japan 120
dealing activities of banks 101
depreciation allowance, Japan 118
remuneration practices 231–2, 234
regulation, finance and banking 82–3, 90, 95, 99–100, 103–4
relative prices of equities 244–5
remuneration contracts, management 231
reform needed 231–2
rent extraction/gouging 103–4, 105, 142, 229–30
residential investment and inflation 202, 203
retained profits 14, 152, 154, 155, 162
return on corporate equity (ROE) 19
bonuses linked to 151, 232
and convex contracts 73
non-financial companies 155
unrealistic press reports 166–7
see also real equity returns
return to equity investors 153, 154, 155
returns on capital 29, 31–2, 49, 50, 85, 86, 146
capital/output ratio 110
Japanese accounting 111, 113
risk assessment
by management 17, 19, 20, 58
vs. forecasting 219
risk(s)
in activities of market-making 95
bankers’ behaviour 98, 99, 167
of large asset price falls 185
in the pattern of borrowing 192–3
of quantitative easing 179–80
rise in inflationary expectations 71, 208, 215, 216, 227–8
INDEX

-riskiness of banking
  methods of reducing 100–1
  rise in 92–3
  and rise in profits 86
-Roosevelt, Franklin D 104

-sales
  and prices 18–19
  vs. output 232–4

-savings
  Japan 121, 123, 208
  surplus, structural 69, 70–1, 208, 227, 230, 231, 256
two-way effect of low interest rates 212
see also household savings
-science and economics 219–20, 248
-services
  capital requirements, US 261–2
  increasing demand for 43
  profitability of financial 105
  returns on capital, UK 145, 146
-share prices
  and efficient market hypothesis 244–6
  fall in, trigger for financial crises 177
  and house prices, US 172, 174
  and land prices, Japan 173
-share purchases by companies 78, 181–2
  “buy-backs” 14, 18, 72, 75, 77, 203, 213, 237

-sharholders
  of bank shares 98–9
  Japan 115, 123
  and management, conflict of interests 230–1
  profits paid to 12–14, 24–5, 77
-skil element, market making 96, 98
-Spain see “garlic belt” countries
-spare capacity/resources 8, 19, 58, 135
  and inflation 68, 132, 134, 195, 207, 227
-stagflation 72, 195, 220
during the 1970s 132, 133, 134
standard deviation, volatility measure 92, 93
-state pension schemes, massive deficits in 210–11
-stock market
  crashes 170, 172
  fluctuations and profits 23, 116, 158, 159
  jobbers 100
  overvaluation of, US 176, 185–6
  transparency 96–7

  and US monetary base 183
  and US pensions savings 210
  valuation 185–8
-Stolper-Samuelson theorem 55
-structural savings’ surplus 69, 70–1, 208, 227, 230, 231
-structural vs. cyclical problems 69–79, 256
-subsidies provided to banks 87, 95, 98–9, 102, 103
-Summers, Lawrence 124
-tax cuts, US 173–4
-technology
  investment in new 17–18, 29, 111
  and profit margins 56, 57
-TIPS (Treasury Inflation Protected Securities) 214, 215, 216, 250–1, 251
  “tracker funds” 234, 245
-trade balance improvements 43, 145, 206, 228
-trade union membership 53–5
-transparency in markets 96–7
trend growth rate 48, 117, 225–6
-understatement of profits, Japan 113, 114, 115, 116, 149
-unemployment 67
  and business cash flow, US 36, 37
  effect of trade unions 53
  fiscal deficit preventing rise in 70
  garlic belt countries 140–1
  and inflation (stagflation) 133, 134
  and rise in inflationary expectation 134–6
  rising trend in 1970s 132, 133
-unidentified miscellaneous assets 158–60
-unincorporated enterprises, Japan 120
-union membership, US
  and profit margins 54, 55
  and strike action 54
-valueation of equities 187–8
-variance compression, real equity returns 246, 247, 250–1
-volatility of bank ROE 92–3
-volatility of profits
  and lower dividend payout 115–16
  and management remuneration 150–1, 231
  published by companies 20–1, 23, 60, 115, 149, 150
-Volcker, Paul 136, 137
wages
  France 35
  “garlic belt”, fall in 139–40
  and inflationary expectations 134
  and labour productivity 29, 111–12
  and unemployment 53, 140

weakness of recovery, reasons for 3–45
White, Bill 74–5, 179–80, 217
Wright, Stephen 176, 185–6, 187, 188, 243, 257
  “write-offs” of assets 22, 151–2
Yellen, Janet 67, 187