IN THE MARKETS WE TRUSST.

The financial markets are revered, treated as God-like, not to be taken for granted nor disobeyed, less their wrath destroy the unwary or the plain stupid. The humbling of the bumbling Truss by the markets shows once again that it is economics which dominates politics and not the other way around.

Actually the financial markets are nothing more than the abattoir where the past unpaid labour of the working class is cut up into pieces then divided amongst investors. It is the arena where traders seek to outwit and outmaneuver each other while traversing the economic landscape lit up by the headlight of profit, interest and rent. When the headlamps are brighter - when profits and rents are rising without money costing too much (interest rates) - they speed up, and when the headlamps dim because profits and rents are falling while the cost of money (interest rates) are rising, they are forced to slow down. The reason for these contrary movement is determined by risk, when the flow of surplus value is in full spate it is risk-off, and when the flow diminishes, it is risk-on.

Since 2008 the financial markets have been abnormal. The financial crash created an epic liquidity crisis in the markets. Quantitative Easing was the solution. Central Banks bought bonds in order to inject liquidity into the market. In effect they reversed their role. Instead of being the lender of last resort which they were at the height of the credit crisis, in its aftermath, they became the buyer of the last resort. This had the effect of opening up markets and consequently enriching bond holders while driving down the rate of interest.

As a result, there was more money and it was cheaper. As money is the elixir of capitalism, central bankers believed it would accelerate economic activity. Instead this elixir turned out to be more anti-histamine than stimulant, preventing the economy from sneezing but not boosting it. Instead of making society richer it made the speculators richer. This plays to the nature of capitalism which is based on accumulating wealth, even if the wealth is nothing more than a paper claim on the production of wealth.

To pay for all these casino chips, government spending had to be kept down otherwise inflation would have been triggered. While the prices of luxury goods soared as speculators cashed in some of their chips, all other prices stagnated or fell as the spending power of workers was cut. The problem with luxury goods is that they are not a magnet for investment being handcrafted, whereas the goods consumed by workers, being mass produced, are a magnet for investment. This is the story behind the explosive growth of the Chinese economy which ended up dominating the global consumer goods industry, and by cheapening its production at scale, prevented workers in the West storming the casinos.

It is the case than many left reformists have claimed there was an alternative. The state could have boosted the economy by becoming an investor, by say setting up an investment bank as Corbyn and Macdonald proposed, compensating for what was essentially an investment strike by capital. But this would have been tantamount to scabbing against capital, it would have meant breaking the investment strike, it would have revealed to society that investment need not be driven solely by profit. This could not be tolerated as we saw in the run up to the 2019 UK election.

The reformist critique of Quantitative Easing (QE) was unscientific. A scientific approach poses the question as to why a phenomenon comes into existence, not the alternative question, why it need not have come into existence. QE was not a choice but a necessity for capitalism. It was the only way to free up the markets and to reduce the cost of capital at a time when labour needed to be squeezed in order to restore the rate of profit.

Did they succeed? Partially, but only because of China and its incredible wave of industrial investment which restored demand in the world economy. Without China it is likely the state of the world economy post-2008 would resemble what is to come. The ultimate irony is that no sooner had China extended a hand lifting up the world economy, then it was being throttled by the US and the EU trying to cut China down to size. That's gratitude for you. But then, all is fair in love and competition.

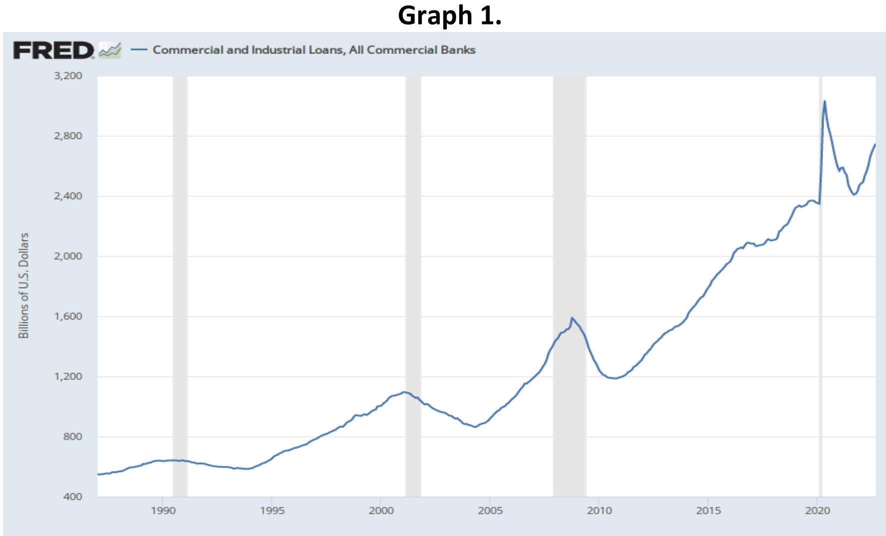
Low interest rates

Of all the sources of revenue arising from the carving up of unpaid labour, the regulating source is enterprise profit. Enterprise profit is what is left over after the owners of a corporation have paid out their fellow crooks - the bankers their interest, the landowners their rent, and the state their tax. It is the enterprise rate of profit which determines the level and tempo of investment.

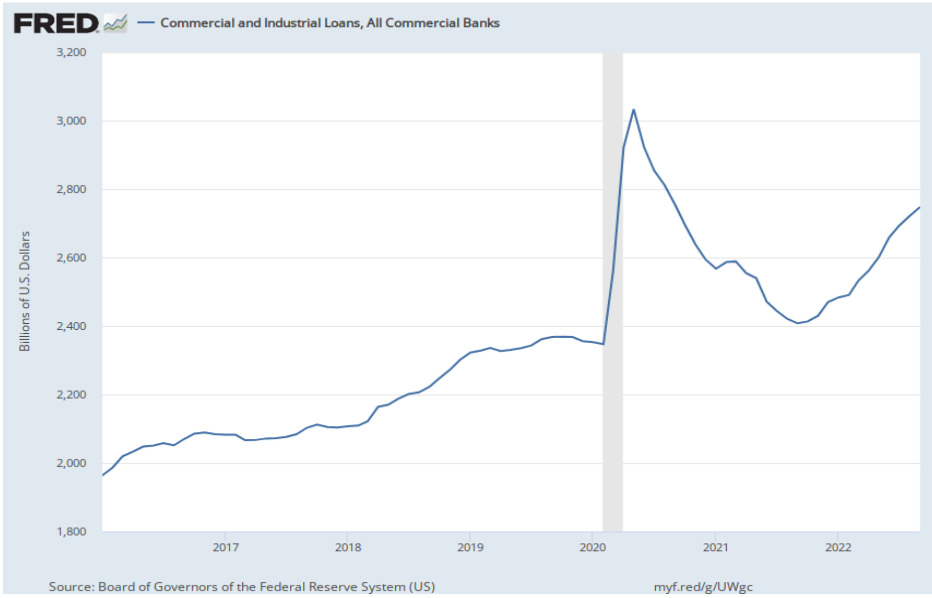
And it is the level of investment, both for fixed and circulating capital, which determines the rate of interest because it sets the level of demand for loan capital. In normal times it is the phasing of the industrial cycle or business cycle (as non-Marxists call it), which creates the market for loan capital. At the beginning of the up cycle, in the period of *rising animation,* interest rates begin to rise as the economy and production revives. In the longest cycle, that of *prosperity*, the demand for loan capital is tempered by the rise in internal funds (growing profits) ensuring there is no over-rapid rise in interest rates. But it is in the last and shortest phase of the up cycle, that of *overproduction*, a time when profit margins begin to be compressed despite the rise in output, that interest rates erupt, as employers and traders go cap in hand to the banks begging for extra credit.

Here the issue of circulating capital becomes crucial. The turnover of capital starts to decelerate meaning it takes longer to realize profits. Let us say, what took 60 days to produce a thing and to sell it, now takes 90 days. Accordingly, capitalists have to find an extra 30 days of working capital, and worse, it takes longer to collect their profits to pay off that capital. In this period of heightened risk, a bankers' market, interest rates easily double and even treble. We can see the effect of the demand for loan capital in the following two graphs. (These kind of short term loans generally have a term of under 2 years.)

Graph 1.



Graph 2.



In Graph 1 we see the undulating path of the industrial cycle. The demand for these short-term loans rises in the up-phases and falls in the down-phases particularly the phases of recession and stagnation. Graph 2 shows the desperate rush for funds as the pandemic broke and before Covid support funds filled the gap. The subsequent rise from the end of 2021 is an inflationary story where rising costs required more working capital.

Between them the rate of profit and the rate of interest form a scissors effect or should we say the bolt cutter snapping the chain of credit. Falling profitability forcing up interest rates puts an end to the up cycle and ushers in the down phase of the cycle. The dividing line being the fracturing of the chain of credit leading to the scramble for cash, commonly known as the financial emergency. Of course the chain of credit can be held together by central banks. They can suppress the rise in interest rates and make available new sources of credit. They did this in early 2016 and in 2019 preventing the stalling world economy from entering into recession.

But recessions are not optional. They are the period in which excess capital, primarily debt formed capital is purged. It is also the period when the demand for loan capital collapses crushing interest rates. Together this purge and the fall in interest rates, not forgetting a rise in the exploitation of labour and more austere government spending, creates the ground for an improvement in the rate of profit fueling a new cycle of accumulation.

Should this purging of capital not take place, should interest rates fail to assume their policing role by weeding out unprofitable capital and distressed debt, it means these pressures keep building up. Here it is important to distinguish between insolvent capitals and illiquid capitals. An insolvent capital is one which makes insufficient profit to service or repay its debts and survives only by taking on more debt. Thus the more debt it acquires over time the bigger the subsequent loss to lenders. An insolvent capital is critically vulnerable to the movement of interest rates. On the other hand, an illiquid capital is a profitable capital which has sufficient profits to increase its debts or its equity to improve its cash-flow. The former wastes capital while the latter can add to its capital without becoming unprofitable.

In a normally functioning economy, it is interest rates which separates the one from the other. An insolvent company attracts a much higher interest rate than does a company suffering a temporary cash flow shortage. It is what the Austrians would call *interest rate discovery*, or the correct pricing of risk. But this cannot happen when interest rates are repressed as they have been.

Repressing interest rates creates its own problems. It leads to increased fragility. As companies and individuals become more laden with debt, they can only stagger on provided the surface is even. The preservation of a clear path becomes absolute. Even the emergence of small potholes presents insurmountable obstacles for companies and individuals so laden they can barely keep their balance.

The hunt for yield created by the repression of interest rates.

There are three categories of derivatives as defined by the bearer of risk. The first is the simplest. Outright speculators or their agents betting in a personal or business capacity on the movement of prices or rates both interest or of exchange. If they get it right they make money and if they get it wrong they lose money. How much they gain or lose depends on the amount of leverage which can range from 20 to 2.5 depending on the existing level of volatility. The second category is the insured risk, proper hedging. Here corporations but also individuals seek to minimize their risk or exposure by hedging against contrary movements. Here the risk is born by the insurer or the counter-party bearing the risk.

It is the third category which is our focus. Leverage used for the maximization of income. This is driven by the hunt for income. With interest rates so low and share prices so high, the cost of a claim on future surplus value either in the form of profits, interest or rents has become exorbitant. For example when the rate of interest is 3% it takes only a £100 investment to claim £3 annually up to due date. But if the rate of interest falls to 1% it now takes an investment of £300 to claim £3 annually. But if an income of 3% is needed to meet obligations, then it is necessary to treble the investment, which in most cases means additional borrowing or leverage. As long as financial markets are stable and interest rates are flat, this kind of behaviour is both rewarding and low risk. However, in the event of interest rate turbulence, this kind of behaviour becomes challenging.

This is why fiscal and monetary policy has to be aligned. There is no room for error on either side. When the Bank of England put a deadline last Friday on its support for the markets it was quite clear that the Bank was strong-arming the government into changing direction. That change occurred over the weekend when most of the unfunded tax cuts were reversed with Hunt additionally offering the markets the prospect of spending cuts including curtailing the blanket cap on energy bills by April. The change in energy support from a cap to an escalator is likely to save as much as the £32 billion in tax reversals that were agreed over the weekend, thereby filling the projected £60 billion hole in government finances.

Of course the BOE cast itself as the reluctant hero of the hour by rescuing Truss from herself. But in fact it is the BOE who is the actual villain for it was the BOE's policies which drove down interest rates causing the excesses which almost felled the pension industry and which could still fell the mortgage industry. The Bank claims to be independent, but in reality it serves the interest and needs of capital, as it has done in the past and as it will continue to do in the future. The issue of its independence is purely semantic.

Truss & Kwarteng.

The markets' anger at the Prime Minister and her Chancellor does not hinge on their programme of tax cuts, low government spending and deregulation. Their anger is over mis-timing and over miscalculation.

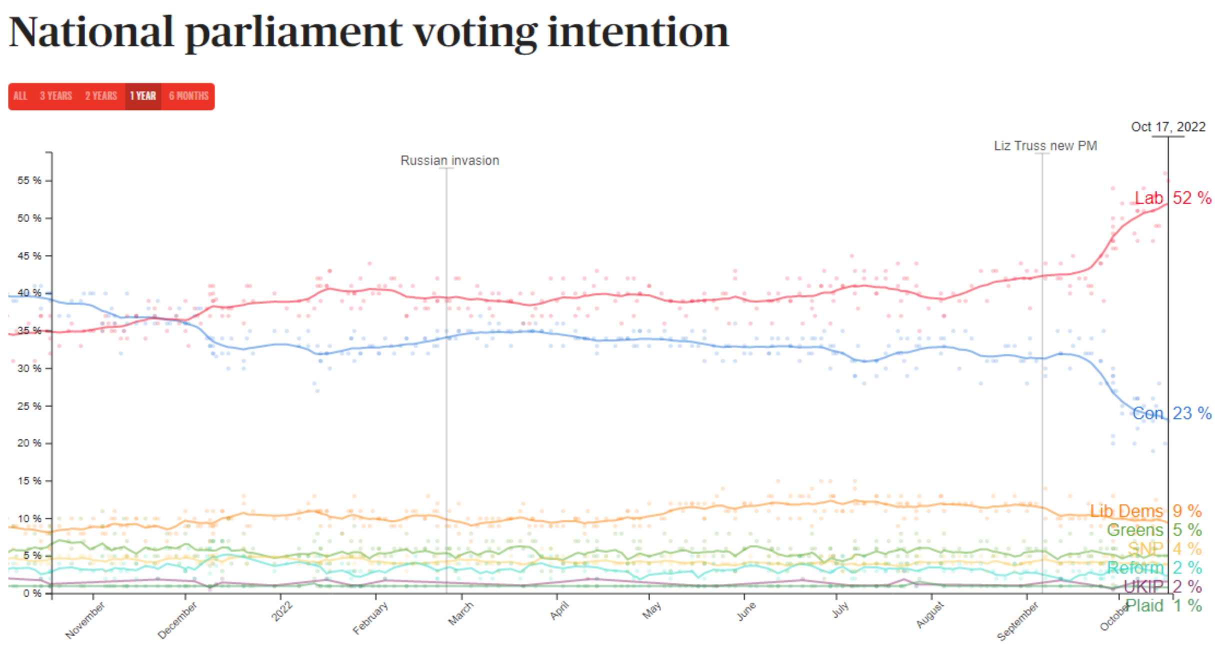
Markets are fragile. They are fragile because of the disruption to production and the labour market caused by the pandemic and then the war in Ukraine which Truss was a leading provocateur of.

Under these market conditions the imperative is caution not wild ideological abandon. As I pointed out earlier in an introductory note to an article published on the 23rd September, Truss would be forced to alter course and sack her Chancellor to save her own skin and to appease the markets which demanded a sacrifice. I still believe Sunak would have been a better fit than Hunt given the state of the Tory Party.

The question keeps being posed, will Truss survive as Prime Minister? This is not the right question. The correct question is whether the populist faction in the Tory Party, dominant until now, has been crushed. The answer is yes. This means that Truss who headed this faction, who was its last gasp, who gambled all and lost, will be ousted from office when the time is right. She may have declared on the BBC that she will be leading the Tories into the next election, but that is just one of her many delusions.

She should look at the following graph while noting that 70% of the population disapprove of her.

Graph 3.



Conclusion.

The damage has been done. Despite the reversal it is likely that interest rates will peak higher than they would have had Truss not been elected Prime Minister. The British economy is in dire straits, and it will be impacted more severely than most by the intensifying global recession. Can it survive as a standalone economy? Probably not. Will the issue of Brexit, shockingly curtailed and twisted in the run up to the 2019 election, be revived. Probably yes. It will be one of the challenges the next Labour government may not be able to avoid. In the meantime, the previous Prime Minister, you know the one who destroyed a leading economy, who was responsible for the unnecessary deaths of tens of thousands of his citizens and who partied while other kept their distance, gets paid £150,000 per appearance to entertain the rich. Shows you how stupid and vulgar the rich are. Clearly it's not only Prime Ministers that need to be got rid of.

Brian Green 18th October 2022.