E VERY year, the Monetary Authority of Singa-
pore (MAS) and the National University of Singa-
pore (NUS) in-
stitute more distin-
guished economists from a top university to serve as the NUS Term Professor, spend-
ning weeks giving lectures and seminars, and meeting policymakers. This year, one of the choices was particularly interesting: Benjamin Friedman of Harvard University.

He comes from a somewhat unfo-
table area called political economy, which focuses on matters that go beyond hard economics. Unlike many theoreticians who populate the economics profession at the academic level, Mr. Friedman likes to work on issues that are current and alive, such as the financial crisis and its consequences, the behaviour of banks, the growing inequality in societies around the world and even how moral issues such as tolerance and fairness are connected to the economy. And he writes not just in economic journals but also in publications that reach wider audiences, like the New York Review of Books and newspa-
pers.

One of Mr. Friedman’s pet topics is the non-economic consequences of econom-
ic growth, which he addressed in his pub-
lic lecture at NUS last month. One of his research findings is that there is a strong connection between living standards and political, social and moral progress. For in-
stance, with better living standards, peo-
ple have more opportunity to get ahead. Social cohesion has become coherent: eth-
nic and religious tensions go down and people are more willing to accommodate immigrants or those of other races. As well, people develop a greater sense of fa-
tism and generosity towards the disadvan-
taged and are more willing to support poli-
cies which go in that direction.

The opposite is also true: when living standards stagnate or fall, intolerance, re-
sentment and social tensions increase. “These are all recurring patterns,” he says in our conversation in a boardroom at the MAS, and they seem to be universal. “In my book, The Moral Consequences of Eco-
nomic Growth, I talk about religious perju-
dice, race relations and attitudes to immi-
grants. I looked at the US experience during the civil war, the British experience since the Napoleonic wars and the French and German experience since the 1870s. I also look in some detail at the Japanese and Italian experiences, and in a broad sense, kind of way at several other countries.”

By and large, the connection between economic growth and social and moral progress holds true just about everywhere.

Currently, one of the world’s biggest prob-
lem areas when it comes to growth is the economy, where several years of au-
thentic policies – especially severe cutbacks in public spending – have led to soaring unemployment and a host of social prob-
lems and tensions, such as political insta-
bility, anti-immigrant sentiment, worsen-
ing health and rising suicides, despair and frustration, especially among the young – who have borne the brunt of high unem-
ployment. “I was in Spain twice in the past year,” says Mr. Friedman. “It’s aston-
ishing to see what’s happening there.” Spain’s unemployment is 27 per cent and youth unemployment is 56 per cent. “I al-
so talk to some people in Greece regularly, and there is a real threat to the state. Even in the northern countries, the kind of pathologies you are seeing in France – they are the predictable pathologies you get when growth stops.”

“The Europeans are being very short-sighted about this, even the Ger-
mans. It hasn’t happened yet, but I don’t believe the Germans will be able to drive the southern tier countries ever further down and remain irredeemable them-
-selves. They’re already talking about very little growth in Germany. And while Ger-
man unemployment hasn’t started to go up in a major way, I would guess that it will. About 40 per cent of German exports go to the eurozone and a lot of that is to the southern-tier countries. France is al-
ready having quite a significant increase in unemployment, and the Netherlands too. Germany really stands alone at the moment, but I don’t think that will last. Once the Germans see the unemploy-
ment coming home to them, they’ll change their mind on austerity.”

Of particular interest to Mr. Friedman – and this is relevant to Singapore too – is how attitudes towards immigrants wax and wane depending on the state of the economy. In his research, he mapped US attitudes to immigrants against changes in living standards. He found that toler-
ance towards immigrants is closely related to improvements in economic well being, going back to the last century. To take some recent examples, he mentions that during the 1980s, under the Clinton ad-
ministration, anti-immigrant sentiment was low. “The Presidential candidate Pat Buchanan stood on an anti-immigrant platform in 2000, and got hardly any votes.”

During the Clinton years of 1993-2000, median incomes rose 2.3 per cent, more than in the earlier decade. But then, as the economy faltered after 2008, immigration has returned as a divi-
sive issue. In the 1980s too, there was pushback against immigrants. This came after a tough economic period in the 1970s and 1980s during which median incomes went down 0.2 per cent.

While Mr. Friedman is careful not to comment on Singapore (“I’ve only been here 12 hours,” he says), he suggests that the anti-immigrant sentiment here could have some link to the slowdown in eco-
nomic growth.

One of the reviewers of Mr Friedman’s work, Brad de Long, a Professor of Economics at the University of California at Berkeley, makes the perceptive point that popular opinion often gets the diagnosis wrong: “People who feel that they are living no better, or not much better, than their parents will search for enemies: Hollywood writers, foreigners, people of loose morals, and Harvard graduates ... Those for whom the American market economy is not delivering increasing prosperity do not reach for the right answers: implement policies to strengthen the safety net, provide security through social insurance, and improve opportunity through better education. Instead, they reach for the wrong answers: closing down society and denouncing enemies.”

Mr Friedman’s research suggests that the same may be true of economies other than America as well.

But while the emphasis on economic growth is central to his thesis, there is an important caveat: what matters is not just growth for its own sake, and not even just more jobs, but higher living standards for the average person. “The key factor is whether the broad bulk of the population is seeing an increase in its living standards or not,” he says. “My story is about those in the percentile 20 to percentile 80 group. There’s another story about the very rich. There’s also another story about the very poor.”

“In practical terms,” he adds, “this means looking at median incomes.” He also points out that for an economy at Singapore’s per-capita income level, most growth has to come from productivity improvements. “You cannot grow at Asian growth rates forever, because once you get to the frontier, you have advanced-country growth; you can’t be a first world country and grow at third world rates. So, welcome to the world in which productivity matters. Welcome to what advanced growth is about.”

It’s not easy, he points out. “Productivity-driven growth means you have to come up with improvements in production – you have to be inventive, and that is hard.”

What policies would help? He suggests three: A higher quality labour force, mainly through better education; a larger stock of capital – by reducing budget deficits and increasing private saving (though this is more valid for the US than Singapore at present); and improving the efficiency of the financial system and the way it allocates capital.

The latter is another topic on which Mr Friedman has written about at length, especially after the global financial crisis of 2008/09, in which the financial sector played a major role. He points out that one of the questions raised by the crisis was how efficiently the financial sector did its job of allocating resources – which should be measured. One way to do this, he suggests, is incrementally – by measuring the efficiency of different pieces of the financial system. For example, did securitised mortgages and derivatives instruments such as collateralised debt obligations (CDOs), which were packages of mortgage debt which the banks created and traded, lead to a more efficient allocation of capital for housing?

“If you hear people in financial markets talk, you might imagine that thirty years ago, Americans all lived in tents,” he says. “You would imagine that before we had a market for securitised mortgages, nobody built houses, because to build houses, you need to have securitised mortgages. Of course this happens not to be true: we lived in houses and we bought and sold houses long before collateralised debt obligations existed. So one question is, what difference does it make whether these instruments exist or not?”

When it comes to policies to regulate the financial market, Mr Friedman supports the idea of a Tobin tax – named after its proponent, the economist James Tobin. Essentially, it is a tax on financial transactions. Mr Tobin originally proposed that the tax be 0.5 per cent. Mr Friedman points out that the Tobin tax “would be so small that any real investor would not notice it, but an enormous amount of trading would disappear.”

In general, he feels that the actions taken to regulate the US financial sector after the global crisis have fallen well short of what is needed. The main regulatory initiative has been the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which he describes as “a terrible disappointment.”

“For a start, nothing much has been done about the ‘too big to fail’ problem,” he points out, referring to the need to insulate the economy from the consequences of financial institutions’ failure.

“There is this attempt to push out an Orderly Liquidation Authority to deal with this problem, but I’m not sure it’s going to be really effective. The excess trading that we were talking about has not been dealt with, either, nor the dependence of these institutions on trading. If you go back 20 or 30 years and look at the profits of any large bank, the profits from the trading function were relatively small. But now they are very large.”

He approves of the fact that some banks have slashed their investment banking operations – under which trading activities are typically housed. “That’s good, they should do more,” he says.

Terrible disappointment

“We also haven’t done anything about implementing the Volcker rule” (which seeks to ban financial institutions from doing proprietary trading that is not client-driven).

“I was an opponent of abolishing the Glass Steagall Act – the separation of securities trading from commercial banking. I would have strengthened it, not abolished it. In all these ways, Dodd-Frank is a terrible disappointment.”

Moreover, there are things in Dodd-Frank that are frankly counterproductive. For example, to rescue financial institutions, the central bank now needs the signature of the Secretary of the Treasury. But the Secretary of the Treasury is a political appointee – he is delivered up by the political process – and you are not allowed to object if he does something on political grounds. But the central bank governor is supposed to be independent.”

“Also counterproductive is that in one area after another, the Dodd-Frank bill didn’t actually make regulations. It called on the various agencies to make the rules. That was just an invitation for the banking lobby to intervene – at the Securities and Exchange Commission, at the office of the Controller of the Currency, at the Commodity and Futures Trading Commission and so on.”

“No, if you told me that Dodd Frank was one of a series of measures that the US would take, I would say oh fine, okay, and I would have voted for it. But if this is a once-in-a-generation attempt to reform the financial system, what a terrible disappointment. It’s very inadequate, it’s really sad.”

Does that mean the US economy – and the world economy – are still vulnerable to a repeat of the global financial crisis?

Mr Friedman leans forward and says: “To give you a very complicated answer, yes. You bet we’re vulnerable. Absolutely.”