

How to think about the crisis

Tuesday, 07 October 2008

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The Financial Crisis Goes Beyond Finance

The crisis today in mortgage lending does not come as a surprise to me. I discussed the build up to the crisis in a book published last year, *The Confiscation of American Prosperity* (1).

The book describes more than three decades of concerted efforts to restructure the economy to respond to the antiauthoritarian spirit of the 1960s. Most important of all, the counterrevolution to the 60s was concerned about a decline in the rate of profits. The objective was to remake the United States as a capitalist's utopia with strict market discipline for ordinary people, while showing special favors on business. Tax cuts, deregulation, and a more business-friendly legal structure became the order of the day.

In this environment, the legal framework for union organization soon became unfriendly. Success showed up relatively quickly in the labor market, where capital halted the increase of wages by 1972 - the year when real hourly wages peaked. Since then wages have oscillated but never again reached that level.

Profits began to recover, but on closer examination the recovery was unusual. In competitive industries, profits were not particularly high. Profits in producing goods concentrated in industries protected by intellectual property or government favoritism were better. But the big profits came in finance. Even major industrial firms, such as General Motors, Ford, or General Electric began relying on their financial divisions for much of their profits.

What was happening? According to the textbook model of economic growth, new productivity translates into higher wages, which, in turn, create more demand, which spurs industry to produce newer or better products, increasing productivity. In recent decades, debt rather than income spurred demand.

As profits recovered, more affluent people saw their portfolios increasing, creating what economists call the wealth effect: the increasing value of their stocks, and later of their houses, was treated as income, which generated demand. Frequently, people used their houses to borrow money to support this demand.

Production of physical goods was largely neglected. I am reminded of a conversation between Samuel Johnson and James Boswell, a quarter millennium ago. Boswell observed:

"Very little business appeared to be going forward in Lichfield. I found however two strange manufactures for so inland a place, sail-cloth and streamers for ships: and I observed them making some saddle-cloths, and dressing sheep skins: but upon the whole, the busy hand of industry seemed to be quite slackened. "Surely, Sir, (said I,) you are an idle set of people."

"Sir (said Johnson) "We are a City of Philosophers: we work with our Heads, and make the Boobies of Birmingham work for us with their hands."(2)

Johnson, of course, was being ironic. The philosophers of the new economy were not. They breathlessly referred to a weightless economy (3). Tom Peters, the management guru, derided old-line businesses as "Lumpy-object purveyors" (4). Even Alan Greenspan is fond of rhapsodizing about how modern production techniques are making the economy lighter and lighter:

"The world of 1948 was vastly different from the world of 1996. The American economy, more than now, was viewed as the ultimate in technology and productivity in virtually all fields of economic endeavor. The quintessential model of industrial might in those days was the array of vast, smoke-encased integrated steel mills in the Pittsburgh district and on the shores of Lake Michigan. Output was things, big physical things.

"Virtually unimaginable a half century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services. In 1948 radios were still being powered by vacuum tubes. Today, transistors deliver far higher quality with a mere fraction of the bulk. Fiber-optics has [sic] replaced huge tonnages of copper wire, and advances in architectural and engineering design have made possible the construction of buildings with much greater floor space but significantly less physical material than the buildings erected just after World War II. Accordingly, while the weight of current economic output is probably only modestly higher than it was a half century ago, value added, adjusted for price change, has risen well over threefold".(5)

Nobody seemed to sense that anything was awry. Leaders in the U.S. were content to let the modern equivalent of the boobies of Manchester produce their goods in Asian sweatshops, and then borrow the proceeds from their masters to support their consumption.

The game depended upon continued growth, whether illusory or real. Deregulation helped to promote illusions of prosperity. So did the dot.com hysteria of the late 1990s. When the bubble burst, the Federal Reserve came to the rescue with low interest rates. Temporarily lacking sufficient confidence in the stock market, real estate seemed a better bet.

Real estate prices soared. People could borrow more on their houses. And with rapidly rising real estate prices, people could comfortably lend money to people who could not afford the loans because, after all, real estate would always increase in value.

To make the illusion even more solid, people believed that they could avoid risk. Ratings agencies told investors that paper based on this real estate was just a shade more risky than U.S. government bonds. To seal the deal, investors sold "insurance," which promised to cover losses if the investment would go sour.

This insurance business was so brisk that the amount of insurance sold was many times more than the face value of the investments. After all, selling this insurance was an easy way to profit from real estate market, which had ahead to go nowhere but up.

When the music stopped playing, the regulators discovered that nobody was watching the store. Far more insurance was sold than the insurers could afford to cover. The ratings agencies are putting their seal of approval on the paper to get more fees.

The government just agreed to buy up bad debt to the tune of \$700 billion, bailing out both crooks and incompetents. The government debt will give the neoliberals excuse to cut more programs to help needy people, while bailing out the rich.

Something similar happened a few decades ago with another war, a different Bush, and the same John McCain. Many years ago, Lyndon Johnson, who would have just celebrated his hundredth birthday, found himself stuck in a war he couldn't win. He also knew that if he raised taxes to pay for the war, the public would demand an immediate halt with a fury that he could not resist. Johnson relied on borrowing, which raised interest rates.

Savings and loan institutions, like the investment banks today, borrowed short and lent long. In this case, people put their savings in the banks and the banks lent out money on 30-year mortgages. To prevent gouging and make mortgages affordable, the savings and loans were prevented from paying interest rates high enough to keep depositors from exiting, which could leave them bankrupt.

The Reagan administration, including daddy Bush, moved to deregulate the savings and loans. Given this newfound freedom, crooks and nincompoops (including the current President Bush's younger brother) rushed in to take advantage of profiting from other people's money. As the scope of this disaster was becoming obvious, five senators, including John McCain along with Alan Greenspan (perhaps the Godfather of the recent financial crisis), rushed in to defend one of the more egregious Savings and Loan operations run by Charles Keating. Oh, yes, a small savings-and-loan in Arkansas, which was connected with Bill Clinton (who later allowed Congress to deregulate the current financial system, led by Senator Phil Gramm, John McCain's chief economic adviser) also ran into difficulties.

The savings-and-loan scam crashed leaving the government to pick up the pieces at a cost that is still debated, but which was still well over \$100 billion - pocket change today.

The difference today is that our politicians now promise effective regulation this time around, just as they did with Sarbanes-Oxley in the wake of crash of Enron and the rest of the dot.com boom.

The Financial Side of the Financial Crisis

This crisis should be a teachable moment, but speculative excesses are a part of the DNA of capitalism. Leo Tolstoy began his epic novel, *Anna Karenina*, with the famous observation, "All happy families resemble one another, but each unhappy family is unhappy in its own way". Much the same can be said about depressions. Each depression seems unique and subject to as many interpretations as the most dysfunctional family. Hence what is unique to this crisis is the way that its build up departs from the general textbook model. Also, as I mentioned above, the other defining characteristic of this crisis is that debt rather than income spurred demand.

Financial assets demand a different treatment. Capital reacts with horror when wages increase, demanding the Federal Reserve to slam on the brakes. In contrast, soaring prices of financial assets are presumed to be incontrovertible evidence of a healthy economy.

The increasing value of these assets spurs people to increase consumption, often taking on debt, confident that their assets will appreciate even more. As Mark Twain observed about an earlier Gilded Age: "Beautiful credit! The foundation of modern society ... "I wasn't worth a cent two years ago, and now I owe two millions of dollars"."

In 2000, when the excesses and frauds of Enron, World Com, and the dot.com boom came to light, financial markets shuddered. The Federal Reserve came to the rescue lowering interest rates, which reduced monthly mortgage payments, allowing people to buy more expensive housing.

Once housing prices begin to rise, housing becomes an investment as well as the source of shelter. In addition, people, who suffered losses during the dot.com bust, saw housing is a safer investment than the stock market. Housing then transmuted into personal ATM machines, allowing people to borrow freely on the rising value of their property.

Underlying this financial froth, something more ominous was occurring. Business refused to spend much for investment in productive activities. Again, the textbooks tell a different story. They teach that high profits translate into investment, which create jobs, spurring demand, and making the economy grow. Such was not the case this time around.

Earlier this year, the British financial journalist, Martin Wolf, observed:

"The US itself looks almost like a giant hedge fund. The profits of financial companies jumped from below 5 per cent of total corporate profits, after tax, in 1982 to 41 per cent in 2007."(6)

This estimate is probably too conservative because many nonfinancial companies increasingly depend upon finance. General Electric, and in their more prosperous years, Ford and General Motors, largely depended upon finance. Retail companies offer credit cards in effect, selling insurance on their products in the form of extended warranties.

The U.S. Department of Commerce reported that in 1992 about a third of all workers employed in U.S. manufacturing industries were actually doing service-type jobs (e.g., in finance, purchasing, marketing, and administration). Updating this work, needless to say, has not been a high priority for government agencies.

Corporations also spend mind-boggling quantities of money just to purchase their own stock. After all, increasing stock prices boost executives' bonuses. For years, Exxon has been spending more money for stock buybacks than capital expenditures, all the while whining that the company needs more incentives to drill for oil.

What investment does occur is largely financed by depreciation allowances rather than previous profits. John Bellamy Foster offers an important measure of this reluctance to invest:

"Nine out of the ten years with the lowest net non-residential fixed investment as a percent of GDP over the last half century (up through 2006) were in the 1990s and 2000s. Between 1986 and 2006, in only one year - 2000, just before the stock market crash-did the percent of GDP represented by net private non-residential fixed investment reach the average for 1960-79 (4.2 percent). This failure to invest is clearly not due to a lack of investment-seeking surplus. One indicator of this is that corporations are now sitting on a mountain of cash - in excess of \$600 billion in corporate savings that have built up at the same time that investment has been declining due to a lack of profitable outlets."(7)

Finance is attractive for another reason: it employs relatively few people. The intriguingly-named FIRE sector, which includes finance, investment, and real estate, employs only about 8 percent of the private labor force. So, 8 percent of the workers generate 41 percent of the profits. Massive investments in information processing make such results possible.

Of the investment that does appear, finance may represent a disproportionate share. The government does not have recent data on types of investment by industry. The data do show that investment on information processing and software is about 37 percent greater than investment in industrial equipment and manufacturing equipment. Of course, information processing is also important in manufacturing, but the data is suggestive.

Where Did The Money Go and Will Jobs Also Disappear?

On Monday, September 29 the stock market lost more than \$1 trillion, about as much money as the Gross Domestic Product for an entire month. The next day, two thirds of the value suddenly reappeared. Yet, for the most part the tumult left most people unaffected, at least for the moment. More important, will the evaporation of all of this wealth affect ordinary people?

Karl Marx's concept of fictitious capital is very useful in understanding these wild swings. I have explored this subject in more detail in an earlier book, entitled Marx's Crises Theory: Scarcity, Labor, and Finance.(8)

For Marx, capitalism uses markets to distribute labor into productive activities, but it does so very imperfectly. Part of the problem is that lack of knowledge about the future causes imperfect investments. These imperfections magnify as the economy seems to prosper making people become giddy about their chances of success.

Crises are capitalism's way of purging unproductive investments. In this way, crises eventually make the economy stronger, unless they become so severe that they shatter the foundation of capitalism.

The crises will become more violent if the distribution of income becomes too lopsided, leaving investors flush with money, while consumers are relatively strapped. Massive amounts of money will flow into speculative ventures, creating bubbles. In effect, a market which is supposed to be a wonderful feedback system to inform capitalists about the needs of society, takes on a perverse logic of its own.

Eventually, the bubble pops and there is hell to pay. The question today is how extreme this shock will be. Capitalism has shown quite a bit of resilience in the past. What is happening now could turn out to be relatively mild or could be severe.

I use San Francisco as an analogy for my students. There will eventually be a serious earthquake that will do enormous damage. Nobody can predict what will happen. Even when the earth begins to tremble, the severity of the event may be in doubt.

Wall Street uses a somewhat related term, leverage, to describe the ability to magnify potential profits by investing borrowed money. When the economy begins leveraging, business borrows money to invest - not necessarily in productive assets. Leveraging can continue as long as people feel confident enough to finance these investments.

The government's modest limits on leverage have been systematically weakened, to the point where investment banks would be putting up as little as 3 cents, and even less, for each dollar invested. The riskiness of such practice should be obvious. A mere 3% drop in the investment would wipe out the bank's own share of the investment.

The Federal Reserve also promoted increased leverage by holding interest rates low. Other regulators also paved the way for more leverage. Companies that choose the path of lower profits and lower risks are written off as stodgy and old-fashioned. Their stocks will flounder, reducing executive' bonuses. So, Wall Street investors willingly increased their leverage and risk. After all, investors prefer companies with high profits. Few are willing to take the time or have the expertise to understand the risks that might make profits appear high.

In Wall Street-talk, increasing leverage works so long as investors maintain a balance between fear and greed. By fear, Wall Street means a reluctance to take on too much risk. Although Wall Street normally applauds greed, it associates excess greed with a foolhardy approach toward risk. During euphoric times when fear of risk subsides, people put money in ridiculous schemes.

In his delightful book, Charles Mackay, related tales of shady operators bilking early investors a few centuries ago.

"One projector set up a company to profit from a wheel for perpetual motion. Another projector proposed "A company for carrying on an undertaking of great advantage, but nobody to know what it is." "Next morning, at nine o'clock, this great man opened an office in Cornhill. Crowds of people beset his door, and when he shut up at three o'clock, he found that no less than one thousand shares had been subscribed for, and the deposits paid. He was thus, in five hours, the winner of 2000 pounds. He set off the same evening for the Continent. He was never heard of again."(9)

The newfound wealth during times of growing leverage can create more demand, which can increase jobs and wages. As noted previously, such has not been the case. Speculative wealth has not produced growth in wages for ordinary people or any significant growth in jobs. In fact, cutting jobs to increase profits has been a major factor in sustaining the boom. A few years ago, the business press praised this practice as financial engineering, as if it were providing a productive service.

One factor that contributed to the lopsided economic growth without jobs, which characterized the recent decades, is the practice of leveraged buyouts. Private equity companies, as they are known, buy up other companies using borrowed money, often based on the assets of the target companies. The takeover artists claim that they can create managerial efficiencies, making their takeover look attractive to potential investors. In reality, they charge their targets exorbitant fees, often paid for by debt that the companies must eventually pay back. Then, to cover this burden, the companies must cut both wages and jobs, as well as looting significant value from pension plans. Private equity businesses then turn around and sell these supposedly rejuvenated, but actually hobbled companies to an unsuspecting public, which fail to see the similarity between such investments and the perpetual motion machine that Mackay described.

In describing the necessity of a bailout for finance, the alarmists, who are not necessarily wrong, point to the job losses associated with the corporate restructurings that will follow bankruptcies. But these restructurings have been going on for decades. The bailout, however, is intended to facilitate a continuation of the destructive financial practices, which have also caused significant hardship to labor.

Obviously, a collapse will also harm workers and other ordinary people, but in the wake of a collapse the country will

stand a better chance to restore some sanity to the economy.

Conclusion: Capitalism 101 (A Foundational Course)

Capitalism is the most efficient system known to mankind. Central to this efficiency is the supposed ability of markets to channel capital where it is most effective. The current financial crisis might be expected to throw some doubts on this dogma, but I do not expect that to be the case.

For example, in 2001, in the wake of dot.com bubble, the New York Times reported on one of the many excesses of the period:

"In the last two years, 100 million miles of optical fiber - more than enough to reach the sun - were laid around the world as companies spent \$35 billion to build Internet-inspired communications networks. But after a string of corporate bankruptcies, fears are spreading that it will be many years before these grandiose systems are ever fully used."(10)

As mentioned earlier, the response was not to rethink the system, but to double down lowering interest rates to re-ignite the stock market. Investors, the government, and even ordinary people applauded the decision of Federal Reserve Chairman Greenspan, who appeared to be the wisest man in the universe at the time.

Greenspan's manipulation of the interest rate appeared to be so beneficial, because it occurred without any direct effect on the proverbial taxpayer. Parenthetically, why is it that this taxpayer ranks so much higher in our concern relative to the workers who make everything possible?

In retrospect, Greenspan's policy provided the fuel that helped to make the current crisis more threatening. Just as the solution to the dot.com crisis produced the current crisis, the present bailout, if it works at all, will create the preconditions for the next one.

The purpose of the bailout is to create confidence. Back in the 19th-century, the governor of Illinois gave an excellent analysis of the way confidence worked in financial markets. He said that confidence "could only exist when the bulk of the people were under a delusion. According to their views, if the banks owed five times as much as they were able to pay and yet if the whole people could be persuaded to believe this incredible falsehood that all were able to pay, this was 'confidence'."

His words may perhaps be the most succinct analysis of fictitious capital that I have read.

Now class, here is the question for all the students in Capitalism 101: explain to me how is that markets are so efficient in directing capital where it is most needed. Extra credit if you can do so without any giggles.

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