

WALLSTREET FALLACIES

One can think of many areas where false or distorted beliefs play huge roles in justifying power, in perpetuating injustice, and in rendering ordinary people incapable of acting to bring about change. Racial theories and gender stereotypes come quickly to mind. Less noticed are beliefs about the dynamics of economic systems.

An obvious plausible explanation for our confusion in economics is that things are just too complex. In May 1996, \$1.25 trillion daily (yes, daily) crossed the wires which connect the world's major banks. How are we to understand this extraordinary phenomenon? Where is it going? For what purposes? How could it conceivably all work? And this is just the tip of a global economic iceberg which involves hundreds of millions of producers, retailers, accountants—indeed who is to be omitted from the list of participants? There is some small truth in the complexity explanation. But it is not that the fundamental processes are unknown. Lester Thurow suggested a useful analogy.

...Economics is much like geology. Geologists have a very good general understanding of the plate tectonics that underlie the San Andreas fault in California. They know with near certainty that there will be a big earthquake in California. But they don't whether it will be one second or a thousand years from now.

Economic models are very good at describing the fundamental forces and pressures, but they have proved of little use when it comes to timing.¹

As Thurow notes, the recent Asian “meltdown” (to switch metaphors) is not hard to explain, even if predicting when it would happen was quite impossible. When projects are built that everyone knows will lose money, when price/earnings ratios on stock equities go sky high, when commercial land values bear no semblance to earnings capacities, when foreign debt is accelerating geometrically faster than gross domestic product, we can be sure that an economic “meltdown” is coming, even if don't know exactly when.

But the disanalogy is also critical: Because the fundamental forces and pressures which explain earthquakes are not amenable to anything we can do, We can only respond to the consequences of an earthquake. But because we know a great deal more about the dynamics of economic systems than many suppose that we know, and because economic systems are human systems, we could, if there was the political will, do a good deal more than we do to alter “economic fault lines” before an economic earthquake. None of the things which led to the Asian crisis had to happen: The decision-makers—corporate leaders and government officials --could have made different decisions. And even now, there are things that are being done which will effect the situation, helping some and hurting others.

There are other and better reasons for confusions regarding economic matters. Typical discussions of these processes are arcane. How many of us, e.g., understand the role of the Federal

Reserve or the IMF, the mechanics of hyperinflation, “tight money” or “stagflation,” the difference between a credit market and the stock market, “derivatives,” or even presumably more familiar ideas, like “aggregate demand,” “transactions cost,” or “equilibrium.” You don’t have to understand quantum mechanics to know that you shouldn’t put a match to your gas tank to see how much fuel is left. Sadly, if you are not going to have the wool pulled over your eyes, you better have a handle on what the IMF is up to and where it gets its money. This ignorance, of course, is partly our own fault. But it is partly not our fault.

We trust “science” and perhaps we must. Still, when it comes to economic science we are easily bamboozled. Consider another example where voters are meant to count. Hawai`i’s economy is currently stagnant. An “Economic Recovery Task Force” was convened to offer solutions. They recommended corporate, franchise, and personal income tax reductions which would largely benefit high income earners. This would, it is claimed, “stimulate investment.” (To recover some of the State’s lost revenue, the Task Force wanted a large increase in the state excise tax on all transactions, the most regressive tax that one could have.) Voters have been bombarded with expensive advertisements aimed to convince them that these changes will benefit everyone. While the ads give no arguments—perhaps it is assumed that none are needed?-- the recommendations flow from what is regarded as solid economic reasoning. Growth requires investment; only people with extra cash and incentives can invest; hence, reduce the taxes on potential investors. QED. Unfortunately there is little empirical evidence that such policies work on a state or local level and precious little evidence that they work even on a national level. Moreover, we have quite good explanations of why they don’t. Indeed, a good deal of what counts as the conventional wisdom on such matters is simply wrong, either because we get only some simplification of a theory which bears no resemblance to “the real world,” or because some of the most important elements in the full picture are not part of the inquiry. (Here we put aside the fact that it was not in the interest of the Task Force members to look at the fuller picture!) For example, it is quite impossible to understand any economic process without paying close attention to the legal system and activities of government, and you can have full-fledged credentials in economics and have no acquaintance with so-called “financial economics,” which you may or may not find in the College of Business.

Our essay was motivated by Doug Henwood’s *Wallstreet*, a book which tries to overcome some of these liabilities and obfuscations. *Wall Street* is an effort to "get down and dirty with how modern American finance works and how it's connected to the real world."²

Henwood gives what may be the best connected account of stocks and bonds and their markets, the role of the central bank, the mechanics of financial innovations including futures, options, (and derivatives"), and the messy world of currencies. He sketches the Federal Reserve's flow of funds as the "connective tissue" of the highly fragmented US financial system, and offers arguments and facts which show decisively that most of the opinion so generously supplied by modern thinking on the relation of the financial system to the productive economy, to put the matter generously, is ideological claptrap. We begin with a sketch of a piece of the conventional wisdom on such matters, and then identify some of his most important claims.

Problems with the Conventional Wisdom

According to the conventional wisdom, equity markets are critical to the economy because they provide the instruments which make possible the assembly and allocation of capital essential to investment and economic development. They efficiently expedite the exchange of goods and services and in an uncertain environment, they facilitate risk management. Thus, through the financial investments of many, stock markets assemble capital. Because people are rational and markets mitigate the costs of acquiring information, capital is rationally allocated, that is, is put to its best use. Credit markets not only allow entrepreneurs to borrow, an essential condition of economic growth and innovation, but they ration such borrowing, encouraging profitable investment and discouraging risky speculative borrowing.

We can begin to see what is wrong with this by listing some of Henwoods most audacious (though correct!) claims. After this, we make the effort to see what is really going on.

1. "The US financial system performs dismally at its advertised task, that of efficiently directing society's savings toward their optimum investment pursuits. The system is stupefyingly expensive, gives terrible signals for the allocation of capital and has surprising little to do with real investment" (p. 3). Lawrence H. Summers, currently undersecretary of the Treasury, estimated that in 1987, financial markets consumed about one quarter of the profits of America's major non-financial corporations, about \$73 billion.³

Question: May it be that more money is to be made in financial markets than in "real investment?"

2. 90% of all US capital investment (Capex = Capital expenditures) between 1952 and 1994 was paid from the firm's own cash rather than raised in the stock market (p. 72). That is, "the stock market contributes virtually nothing to the financing of outside investment. Between 1901 and 1996, net flotations of new stock amounted to just 4% of nonfinancial corporation's capex" (p. 72) and new stock offerings were minus 11% of capex between 1980 and 1996. "Between 1981 and early 1996, U.S. nonfinancial institutions retired over \$700 billion more in stock than they issued" (p. 3).

Question: But why then are corporations such heavy borrowers? Perhaps there is more profit in buybacks and takeovers, moves which contribute zero to growth?

3. The rentier share of corporate surplus--dividends plus interest as a percentage of pre-tax profits-- has risen sharply, from 20-30% in the 1950s to 60-70% in the early 1990s. That is, "far from turning to Wall Street for outside finance, nonfinancial firms have been stuffing Wall Street's pockets with money" (p. 73).

Question: What does this mean for working people and control of the economy? Downsizing? Bailouts? Slow growth?

4. "The relationship between stock performance and economic growth is essentially patternless" (p. 125). That is, booms are not always good for stocks and stagnation is sometimes the most profitable period for stocks.

Question: What is the real role of the stock market? Perhaps it isn't mainly about economic growth, but about who controls what?

5. "The market in US government bonds in the biggest financial market in the world...Traders turnover an amount equal to a year's GDP in about three weeks" (p. 25). Remarkably, the average holding period of Treasuries is one month. At the end of 1992, total daily trading volume averaged \$400-550 billion or over \$100 trillion a year, or some 10 times that the NYSE.

Question: What does all this trading in government deficits accomplish?
Perhaps it is both a terrific way to keep the state safely in capital's hands and for the rich to get richer?

5. In 1991, finance, insurance, and real estate (FIRE) surpassed manufacturing's share of the GDP. "In 1993, manufacturing accounted for \$1.1 trillion of output and finance for \$1.2 trillion. Gross investment was \$882 billion--meaning finance 'produced' 34% more than the saving it theoretically channeled into investment" (p. 76). Indeed, FIRE's profits and salaries as share of gross investment went from a spectacular 20-25% between 1950 and 1980 to a truly stunning 43% average between 1990 and 1994. The transition of the US economy from manufacturing to "service" has been well documented; what has not is the composition of these "services."

Question: We tend to think of MacDonalds or of hospitals as typical "service" industries, but might it be that we should be focusing on the economic and social consequences of fact that FIRE is replacing manufacturing?

7. "At the end of 1995, U.S. households spend a total of 16.7% of their after-tax incomes on debt service--\$903 billion...a massive upward redistribution of income" (p. 65). In 1995, consumer credit financed 52% of the growth in consumption, eclipsing the mid-90s record of 36%.

Question: What are some of the consequences of this redistribution of control of the economy toward rentiers?

In what follows we try to identify some of the main mechanisms which help to answer the questions which we have raised, hoping to make a small contribution to the de-mystification of the capitalist political economy.

Real Investment and Speculation

We need first an elementary (if crude) distinction. Let us think of real investment as investment in anything which yields value added, either in products or services, what Keynes called "enterprise." Similarly, we can think of speculation as buying an asset, financial or other, in the hope of selling it at higher price in the future, near or distant. Such speculation simply transfers value from one person to another. It does not "add value." As is clear, real investment is job-creating and economic growth requires it. Speculation does neither.

Keynes discerned the problem:

Speculators may do no harm as bubbles on a steady stream of enterprise. But the

position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done (*General Theory of Employment, Interest and Money*, p. 159).

The casino that Keynes had in mind, of course, was the stock market. But of course, a good deal else has to be true if they are to be casinos. Money is the key—despite official doctrine.

According to the official doctrine, money—at least in the long run—is neutral, merely the “numeraire” representing real values (as determined by “free markets”) of things exchanged. Since buyers and sellers are “rational,” allocations of resources, including capital and wages, will be “efficient,” or the mix of inputs maximizes outputs. Financial markets “facilitate” this efficiency. Since markets are continually adjusting towards equilibrium, there should be no unemployment and no “crises” (assuming that government is merely establishing conditions for “free exchange” and not “distorting” the market).⁴

History unfortunately shows otherwise. Prices frequently do not represent “real” values, buyers and sellers are not “rational” in the economists sense, markets are not “free,” and, accordingly, money is not “neutral.” Henwood argues, rightly we think, that Keynes’s critique of classical theory was insufficiently radical. But before we see why, and the implications of this, we need one more idea which Keynes profitably exploited: the notion of uncertainty.

Uncertainty and Markets

Uncertainty is not “rational expectation” as that is understood in neo-classical theory. Writing in 1937, Keynes noted:

By ‘uncertain’ knowledge...I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty.... Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence...or the position of private wealth-owners in the social system of 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know (quoted by Henwood, p. 216).

It is just this, of course, which makes financial markets essential for capitalism and as Henwood puts it, makes credit “the mother of all financial markets” (p. 118). Henwood lists a number of reasons for this, but all involve guesses about the future.⁵ Hayekians see this most clearly. A market is not (contra equilibrium theory) an “end-state” tending, *ceteris paribus*, toward equilibrium, or a closed system, analysable ahistorically. As Lachman writes: “... The existence of human action consciously designed to produce certain effects, prompted by expectations which may, often do, fail, makes it impossible to look at the market process in this way.”⁶

Market outcomes are the unintended product of the conscious action of different actors each acting to bring about their goals. People at all levels of the economy do the best that they can—given their circumstances. But they can never have sufficient time and resources to acquire what, in any case, must necessarily be incomplete information. What propels the market as a continuous process is that there is a gap between actions based on plans embodying a mental picture of the future and the future itself.

This is especially critical as regards the decisions of capitalists. Once there is a fully-developed financial system, people with capital always have three distinctly different choices: They can invest productively, they can save, or they can speculate. As Marx had noticed (long before Keynes), capitalists gamble in buying the means of producing goods since these goods, once produced, must be sold at a profit. (This of course also explains the huge sums spent on advertising, market research, etc.) Businessmen may refuse this gamble, preferring to keep all their wealth in money or, even more critically, in speculation. This obvious fact is always ignored by policies which seek to promote investment with corporate giveaways. It is in this context that money has its most obviously non-neutral economic role. Indeed, as both Marx and Keynes saw, the fertility of money is the very flashpoint of the system, leveraging the vast profit possibilities for profit in financial markets. Keynes well summarized the consequence:

Thus the professional investor is forced to concern himself with the anticipation of impending changes, in the news or in the atmosphere, of the kind which experience shows that the mass psychology of the market is most influenced. This is the inevitable result of the investment markets organized with a view to so-called 'liquidity.' Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity...It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future. The actual private object of the most skilled investment today is to 'beat the gun,' as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating half-crown to the other fellow (p. 206, quoted from *The Collected Works*, Vol. VIII, p. 155).

Actors are “rational” if that means (as it should) that they have reasons for their decisions, but insofar as they are imprisoned by the vicissitudes of markets they cannot be rational in the economist’s sense. Henwood rightly insists: “Investing is a social activity: both amateur and professional investors spend lots of time gossiping, researching, and comparing performance. Financial markets are not the sum of the rational expectations of reasoning investors, but the collective judgment of a mob” (p. 176).⁷ The game is, as Keynes put in the *Treatise*, to “ape unreason proleptically,” that is to pretend that the future is already present. But if the game is to have any chance of success for the economy as a whole, there will need to be continuous financial innovation and the willing cooperation of the state.

The Role of Financial Innovation—and its consequences

Consider first continuous financial innovation. Because volatile currency and debt markets

make good financial projections impossible (p. 40), agents create innovative financial instruments. We can see this best in terms of Minsky's ordering of financial structures into three types, hedged, speculative and Ponzi. Hedged structures can service all their debts out of current income. Speculative units can meet interest payments, but new funds must be raised through the sale of assets or through new loans to pay off the principal (generating a potential Fisher "debt deflation" (p. 157). Ponzi operations cannot make even interest much less pay off principal without finding fresh cash (p. 222). The US was in the speculative realm in the 70s, moved decisively to a Ponzi stage in the 80s. Today, while the business sector is back in a speculative stage, households "continue to explore fresh Ponzi territory" (ibid.) But not only does household debt fill the pockets of creditors (and at least temporarily shore up aggregate demand), but lacking the benefits of government bailouts, households cannot win ponzi games. No one knows, of course, how far consumer borrowing can be pushed without courting disaster.

Derivatives are among the latest of financial innovations. (See p. 28 for a definition and examples, p. 35). They permit firms to hedge, but because their purpose is to be sold and transformed into money-- a commodity form raised to a higher level of abstraction, they also permit (and encourage) speculation and Ponzi schemes. It is thus that if each firm seeks to insulate itself against risk, as with almost all other micro-rational moves, such behavior increases systematic risk. **In conditions of uncertainty, acting to achieve individual goals (micro-rationality) worsens the conditions of further action (macro-irrationality).** (If everyone leaves home an hour earlier to avoid the traffic jam at 8:00AM, it occurs at 7:00AM!) Globalization, of course, exacerbates instabilities, rightly causing concern over events which are seemingly unrelated.

The State

The driving force of capitalism is profit. It is not merely that production is anarchic: all "investment" is anarchic, that is, individualistic, unplanned and uncoordinated. Accordingly, in capitalism there is no way for the social object of skilled investment to "defeat the dark forces of time and ignorance which envelop our future." Anarchic investment results in chaotic swings, from manipulating shortages to overcapacities, from capital-led investment booms to crashes of bankruptcies. Nor is there anyway, accordingly, to prevent these "crises" which are, as Thurow recently noted, "an intrinsic part of capitalism." But if the system is to reproduce itself, these "dark forces" need to be contained. This is the role of state.

This begins with trying to maintain a stable currency ("money is purely conventional...and some forceful monopolist--a central bank and a national treasury--has to be the ultimate guarantor of agreement, or convention would dissolve" (p. 232). It includes both being a big spender and a big debtor-including, at the state and local level, the floating of municipal bonds, which "assure that the budget will be full of subsidies and tax breaks to developers and contractors, that fresh land will be developed, and that in a crunch welfare or other public services will be cut but debt service will continue to flow" (p. 27). It runs to efforts to stabilize Ponzi operations (by clamping down in interest rates) and includes, where necessary, bailouts--e.g., \$200 billion for the S&Ls, Mexico, Indonesia, Malasia, Thailand, Korea.⁸

Because credit is the mother of all financial markets (p. 118) interest rates are critical as regards judgments by economic actors. For example, as Minsky noted, it may be that "at high enough short term interest rates speculative units become Ponzi units" (p. 223).

Nevertheless, one should not make too much of monetary and fiscal policy to stabilize economies. Again, while attention to the interest rate bears importantly on individual decision-making, macro-economic outcomes are complexly caused. "In a strong expansion, rising employment, incomes and profits will probably outweigh a modest increase in interest rates, and in a deep slump, low rates can be only a weak antidote..." (p. 121). T-bill rates of 0.28% in 1934 did not end the Depression; it took "a sustained bout of 15-20% short-term rates in 1980 and 1981 to shut down the U.S. economy under the Volcker repression" (p. 121). Moreover, tight money policies produce, in direct response, yet again new financial innovations, complicating the task of the Fed and often creating conditions worse than those for which they were the remedy.

It is hard to judge the actual capacity of the Fed to influence the economy, but, putting this aside, the goals of Fed policy are ambiguous, either willfully so or because decision-makers are trapped in ideology. Consider the Volcker experiment in monetarism. Was it motivated by the threat of financial collapse promoted by the shift to Ponzi schemes and a potential Mexican default? Or, was it prompted by predicted "wage push" inflation, which would threaten both corporate profits and the claims of creditors? Still as Wolman and Colamosca argue, inflation fears have been largely bogus. The inflation rate between 1972 and 1982 was a high 9.1%, but they explain this by Fed policy to pump up the economy to re-elect Nixon and the OPEC embargo. Inflation averaged 2.5% between 1950 and 1972 (even with the war in Vietnam) and 3.9% between 1983 and 1995 (p. 160f). Henwood concludes, "there can be no doubt...that monetarism in [the UK and US], and throughout the world from the Chilean coup onward, has been an important part of a conscious policy to crush labor and redistribute income and power toward capital..."(p. 201-202). Rentiers, of course, fear *any* inflation. Any increase in the general price levels reduces the value of interest payments on their loans, reducing their profit. And so is the President and the Congress in the thrall of the bond market.

Power and Exploitation

For Henwood, Keynes was insufficiently radical. There two related ways in which this is true, one more narrowly economic than the other. This first is perhaps clearest as regards item, **3. The rentier share of corporate surplus--dividends plus interest as a percentage of pre-tax profits-- has risen sharply, from 20-30% in the 1950s to 60-70% in the early 1990s.** For Marxists, exploitation in capitalism requires the pumping out of surplus value in production. We would insist that surplus value is the source of all profit, whether realized in the sale of products or in payments made to rentiers. But if rentiers are socially useless (as Adam Smith had already noticed) they will not concede to their euthanasia (as Keynes hoped). And they will not precisely because "they are the owners of productive stock and the creditors of its hired managers" (p. 211). Perhaps we can say that advanced capitalism in its latest "stage" is now largely a form of rentier capitalism. "The needs of money seem increasingly to take precedence over the needs of

production" (p. 237). This has, we think, enormous implications, including not only our understanding of capitalism but of class and of class struggle. As Marx noted:

All particular forms of capital, arising from its investment in particular spheres of production or circulation, are obliterated...It exists in the undifferentiated, self-identical form of independent value, money...Here capital really does emerge, in the pressure of supply and demand, as *the common capital of the class*.... [It appears] as a concentrated and organized mass, placed under the control of bankers as representatives of the social capital in a quite different manner to real production (quoted from Henwood, p. 238, from Marx, *Capital*, Vol. 3, pp. 490-491, emphasis in the original).

This hints at the more radical criticism. Henwood quotes Marx: "The individual carries his social power, as well as his bond with society, in his pocket" (p. 231). The metaphor says a good deal about us and our society. And we know what it says, even if we fail to see that the condition is neither unfathomable nor inevitable. Of course, all of us need what is made available by the efforts of others and all of us have something to sell. But where everything becomes a commodity--where all "values" are measured by "price"-- and where all real relations between people become money relations between things, while we celebrate our "freedom," we have, in fact, become prisoners of system which serves very well the powerful. So much for the power of economic fallacies.

Endnotes

¹ Lester Thurow, "Asia" The Collapse and the Cure," *New York Review of Books*, 5 February 1998, p. 22.

² Doug Henwood, *Wallstreet* (London and New York: Verso, 1997), p. 3.

³ Cited by William Wolman and Anne Colamosca, *The Judas Economy* (Reading, Ma.: Addison Wesley, 1997), who cite Kevin Phillips, *Arrogant Capital* (1995)).

⁴ This is the gist of the disagreement between so-called monetarists and Keynesians. Because for Keynes, wages are "sticky" and debt contracts are denominated in money terms, if prices fall, entrepreneurs have trouble paying wages and servicing debts. Money, hence, was not neutral. More generally, "equilibrium" could occur at any level of unemployment. This could be responded to by manipulating the interest rate which would then affect aggregate demand. As is clear, Keynes was still very much committed to some central assumptions of classical theory, including the idea of a general equilibrium. For monetarists, money is neutral. Hence, "central banks can only peg nominal quantities not real ones: 'the real rate of interest, the rate of unemployment, the level of real national income, the real quantity of money' are all beyond our powers." And accordingly, a "tight money" policy "should have no effect on real output, only on prices" (p. 201).

⁵ There are a number of reasons why interest rates are critical: There is the cost of playing with other people's money (p. 118), the effects of "sentiment," the relative attractiveness of alternative investments and finally the anticipated future value of money (p. 119). All of these function in decision-making; all of them, as above, depend upon trying to outguess the future.

⁶ See Ludwig M. Lachman, "Methodological Individualism and The Market Economy," in D.M. Hausman, *Philosophy of Economics* (Cambridge: Cambridge University Press), p. 305.

Frederick von Hayek and those who have followed his lead are surely conservative economists, most notably famous for criticisms of planning in socialist societies. Given their rejection of the idea of equilibrium, they are, perhaps incoherently, strong defenders of "free markets." For them, markets efficiently distribute requisite social knowledge.

⁷ For a wonderful account see Charles W. Smith, *The Mind of the Market* (Totowa, N.J.: Littlefield Adams, 1981).

⁸ "Would I like to figure out a way to save Mexico and still make investors take a haircut?" Treasury Secretary Robert Rubin asked rhetorically not long ago. "Yes, I would have. The problem is, we have not figured out an effective way to do that yet" (Quoted from the *New York Times* (12 October, 1997).

But as Thurow noted, "we know that insiders were the first to convert to dollars in both the 1982 and 1994-1995 Mexican crises. When the crisis in Asia has calmed down, it will be clear that insiders were once again the first to run" ("Asia: The Collapse and the Cure," p. 23). Nor can it be said as, by the IMF, that these meltdowns were produced by "badly run and poorly supervised banking systems and overvalued exchange rates" (Ravi Palat, "A Lost Decade for Asia," *The Hindu* (12 December, 7; Thurow, *ibid.* and Doug Henwood, "Asia Melts," *Left Business Observer*, #81 (21 January 1998).