Wolpe Lecture – 10 September 2009

SPEAKER

Gabriel Palma is a Chilean national. He is Senior Lecturer at the Faculty of Economics, Cambridge University, where he has taught Econometrics, Macroeconomics, Development and Economic History since 1981. He is also co-editor of the Cambridge Journal of Economics, and a member of three Task Forces in Joseph Stiglitz Initiative for Policy Dialogue, Columbia University (Capital Market Liberalisation, Macroeconomics for Developing Countries, and Industrial Policy in Developing Countries). His research interests predominantly focus on two areas: the economic history of Latin America, and the political economy of recent economic reforms in Latin America and Asia (including papers on income distribution, de-industrialisation, financial crises in Latin America and East Asia, capital controls in Chile and Malaysia, trade and industrial policies, and the political economy of economic reforms in Mexico, Brazil and Viet Nam). He has also published on the history of ideas in *Development Economics and Politics*, especially on radical critiques of the current orthodoxy. He is co-editor of books on Nicholas Kaldor's and Richard Kahn's contributions to political economy; he is also co-editor of a book on the 1997 East Asian financial crisis and of a two-volume feschrift for Geoff Harcourt. He is currently writing an economic history of Latin America since independence, and a book on the political economy of neo-liberal reforms in Latin America and East Asia.

Global Financial Crisis – Toxic Assets, Toxic Ideology

Introduction[1]

Economic theory has missed the crisis and cannot explain and understand what is going on. In one of the sections of the paper that accompany this talk, it deals with this problem in economic theory, but that part need only be read by economists, since it is only they who have to be convinced that the discipline of economics is useless.

What components of economics can assist us in understanding the current crisis? The Keynesian tradition is the only one that is helpful at this moment in time. Paul Krugman had a long article in the *New York Times*, which is a detailed self-criticism of his own macro-economic theory and provides the economic community with an opportunity to reflect on past theoretical mistakes (*New York Times* on 6 September 2009).

To understand this crisis, we have to look at the political settlement and the distribution in which it operates – this is a crisis of the political economy not an economic crisis focusing on interest rates, the role of central banks or inflation targeting. Even further, it is a neoliberal crisis, the ideology that gained power since 1979 and which was rigorously pursued by US President Regan and UK Prime Minister Thatcher.   It concerns how the global capitalist elite tried to form capitalism into a rentier's paradise and how the capitalist elite tried to use the state to further this process. How could

[1] Note – all graphs were taken from the paper which accompanied Palma's lecture entitled 'Revenge of the Market on the Rentiers'.

capitalism have its cake and eat it – the rentier's wanted all the benefits of capitalism without having to have all of the competitive struggles (all the carrots without the sticks)?

This was an attempt to transform capitalism into Gore Vidal's idea of 'socialism for the rich and capitalism for the rest.'

One way to understand the crisis is that the market took its revenge with the capitalist elite by calling their bluff.

Here are a few of the basic numbers of the crisis:

- $50 trillion is the total cost so far including the loss of asset prices which is approximately 1 year of the world's GDP
- UN Commission chaired, by Joseph Stiglitz, said that 200 million people will fall below the poverty line and 50 million will lose their jobs as a result of this crisis

This is something really overwhelming in size.

How did the crisis actually happen?

The key point here to start is that like every financial crisis (a point by Charles Kindleberger , in his book *Mania's, Panics and Crises* now in its 4^{th} edition and which chronicles financial crises since the Napoleonic wars), this is a crisis of liquidity. Kindleberger says that the one thing that is important is where liquidity gets out of hand then borrowers and lenders accumulate unnecessary risks. Financial systems are unable to handle their own affairs and a crisis becomes inevitable.

But, let me first put this in terms of a context of economic theory.

What is mainstream economics in 2 minutes?

(He drew a graph on the board)

Imagine a set of agents (it could be households, firms, governments) with 2 assumptions: rationality (that they selfish they want to look after their own affairs) and if you allow them to interact in markets, the outcome will be economic equilibrium. This is what economics is about – things about investment and savings, inflation, unemployment – all have as their ideological basis that they naturally tend towards equilibrium. But this equilibrium is very specific because, these two assumptions, combined with good property rights result in equilibrium through a natural process (an ideological belief). In the 1980s people tried to enrich this understanding through introducing things like market failures (principal-agent, imperfect information, grounded rationality). These market failures helped to explain why so much of the real life economy was in a consistent state of sub-optional equilibrium. But, these market failures cannot explain the current crisis.

A better analytical framework was provided by John Maynard Keynes. One of his key assumptions Keynes was that sometimes, for purely endogenous reasons, an economy can end up in crisis.

This specific crisis is the result of excess liquidity.

The normal explanation, based on classical economics is not able to explain an endogenous crisis because markets are meant to be self correcting towards equilibrium. But the internal dynamics relating to excess liquidity has had a long genesis. Keynes and Kindleberger agree because when they say when liquidity gets out of hand, then a crisis can result.

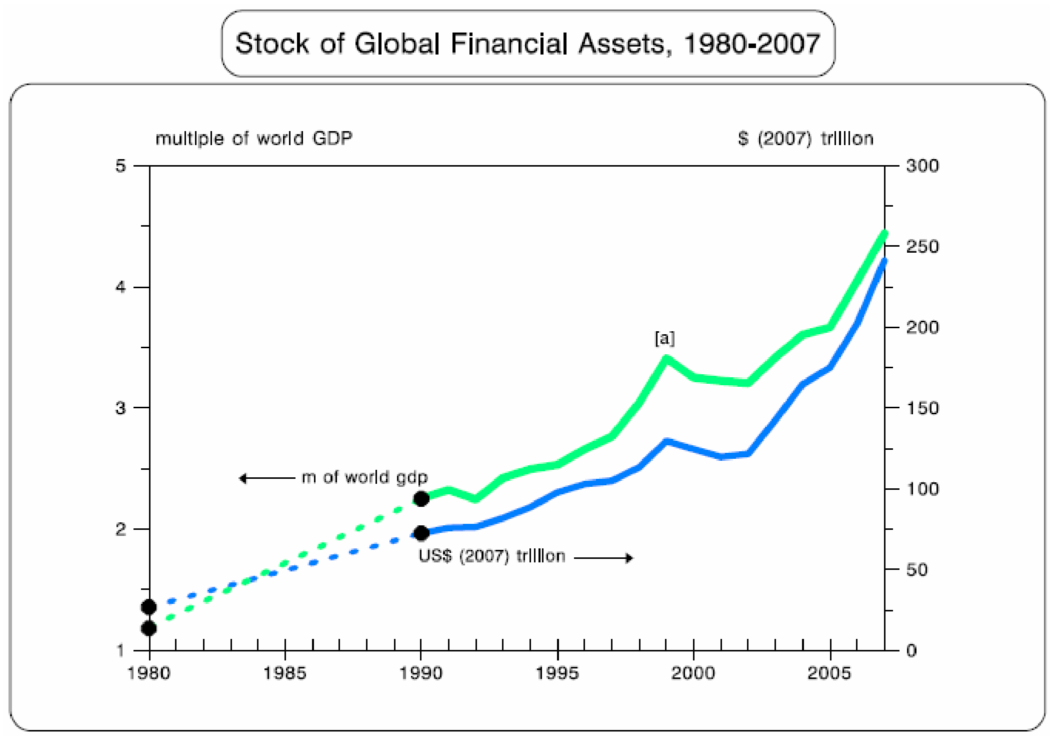
Where does excess liquidity come from?

The most obvious crises in recent memory are those as a result of the 1973 oil boycott. In comparison though, the current crisis is much more significant.

Some of the numbers and figures of the stock market and the extent of the crash in 2008:

- Value of all core financial assets – In 1990, it was roughly $25 billion but by the time of the crisis it was $250 billion. The financialisation literature now effectively showed that there was a complete decoupling of the financial market from the real world economy (whose assets were worth significantly less).
- In relative terms, this explosion of finance was much larger in the European periphery and developing world than the USA and UK. Look at what happened in South Africa. The massive increasing liquidity was positively damaging for South Africa, and was not just a waste of resources. When finance becomes overblown, it has a direct negative effect in the rest of the economy.

FIGURE 1



From the paper presented alongside the lecture

Take the example of Iceland, where the percentage of finance to the rest of the economy grew so much that some people in the IMF now say that Iceland is no longer a country, but a hedge fund.

<u>United States of America</u>

This is clearly the most important case, since this is a USA crisis both in terms of ideology and in effect.

The key idea of Keynes Bretton-Woods institutions was to transform finance through stationary processes – hence the financial stability from 1950 – 1981. These included capital controls and financial regulations and were implemented to make sure that financial markets would be predictable and stable. However, once this changed from the early 1980s onwards towards the Washington Consensus, the key idea was to liberalize the economy through deregulation, which allowed finance to explode.

Deregulation and liberalization were key components of the Washington Consensus. The Washington Consensus said that the regulation in place during the high water mark of Bretton-Woods was 'financial oppression' which was damaging for the real economy and what needed to be done was to liberalise these markets.

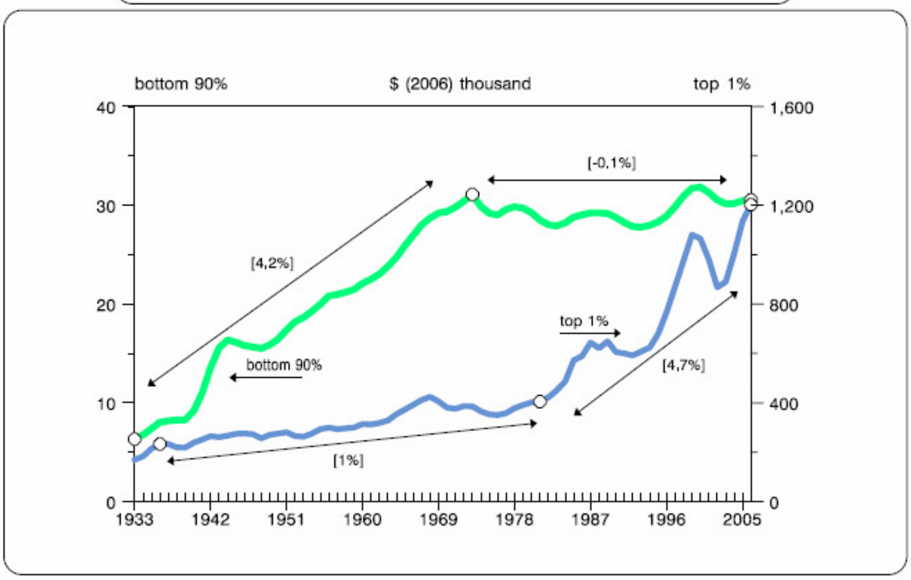
And this idea succeeded – see in South Africa where the financial sector jumped from 4% to 13% of GDP within a decade from the early 1990s.

How did we get into such a mess today?

Inequality is one of the components of what neoliberalism is actually about. Look at income distribution in the USA, as seen by their tax returns. At the beginning of the Reagan and Thatcher period, the top 1% of the economy owned 9% of economy but 2006, the top 1% owned 23% of economy.

FIGURE 7

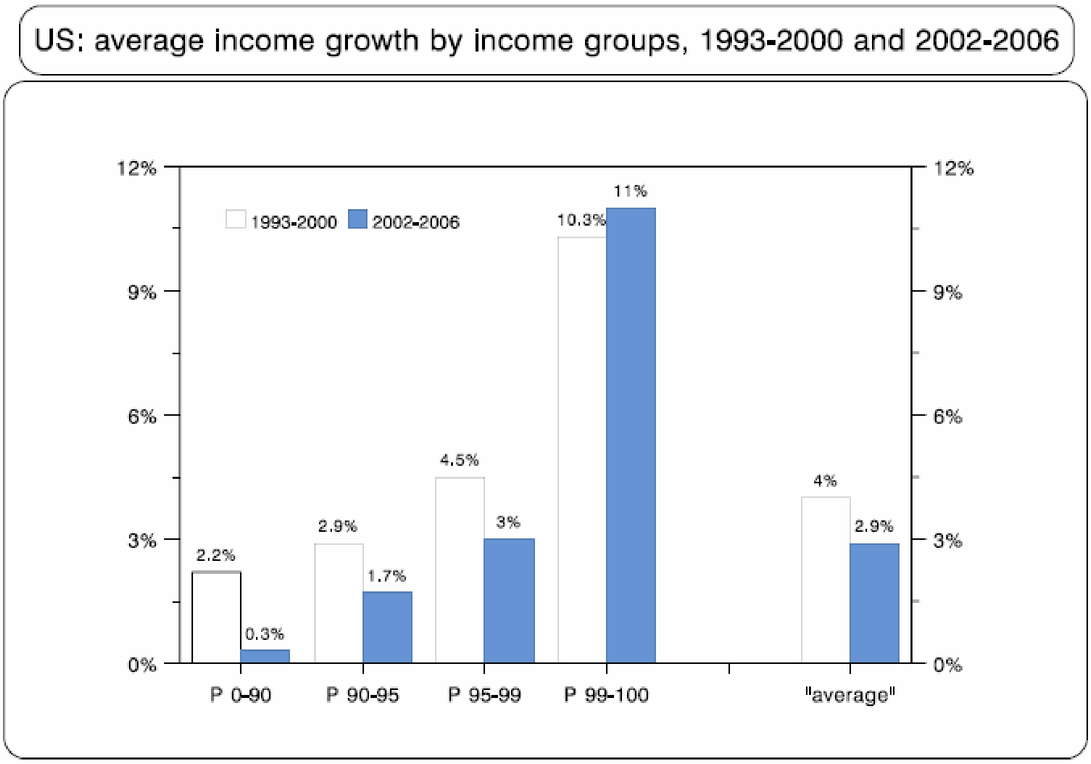
US: average income top 1% and bottom 90%, 1933-2006



This process of inequality was worse than what happened in Chile under Pinochet. There has never been a force as powerful as neoliberalism as an ideological project, especially in the context of democracy. Neoliberalism is not a set of policies, it is a new technology of power and dispossession. Neoliberalism is really a political pact. During the Clinton period, of all the income growth in the USA, 45% of the income growth was appropriated by the top 1% and during Bush Jnr period, 74% of all income growth was appropriated by the top 1%. And this happened within a democracy, not within some authoritarian system. Where is this financial crisis then? Where did all of this excess liquidity come from? $3 trillion was appropriated by top 1% in the USA. This is the excess liquidity that was at the heart of the current economic chaos.

Polani pointed to this kind of crisis. Look at the financial income of the US of the bottom 90% in comparison to the top 1%. You can see the extent to which the wealthiest are growing in comparison to the poorest. Average income in the USA of the bottom 90% of the US has been stagnant for 30 years (see graph below). In comparison, the richest grew at over 100 times that. How can you have this kind of inequality in a democracy without any political instability? Again, we see how powerful the neoliberal ideology is.

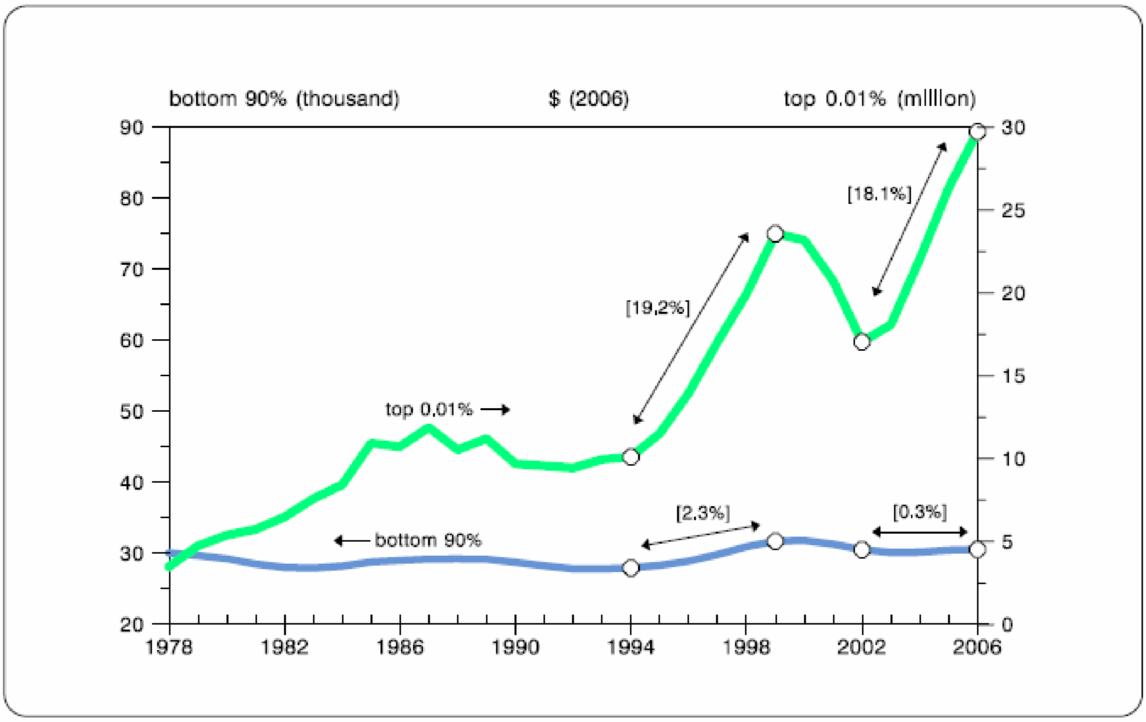
FIGURE 9



• P = percentiles. ***Source***: Piketty and Sáez (2003).

FIGURE 10

US: average income of the top 0.01% and of the bottom 90%, 1978-2006



The key issue is the connection between liquidity and inequality and this factor is the best one to help explain the financial crisis.

See the connection between inequality and the size of the financial sector. The share of the top 10% of national income grew so rapidly and the increasing inequality was feeding through financial liquidity.

The most important idea from today's lecture is that the increase in inequality helped to fuel the crisis. Look how connected (and this is an old fashioned Keynesian point) the link between inequality and financial assets are. See how they track one another. The increase in inequality is being fuelled by the increase in financial assets.

FIGURE 11

US: income share of the top 10% and value of financial assets as % of GDP, 1947-2007

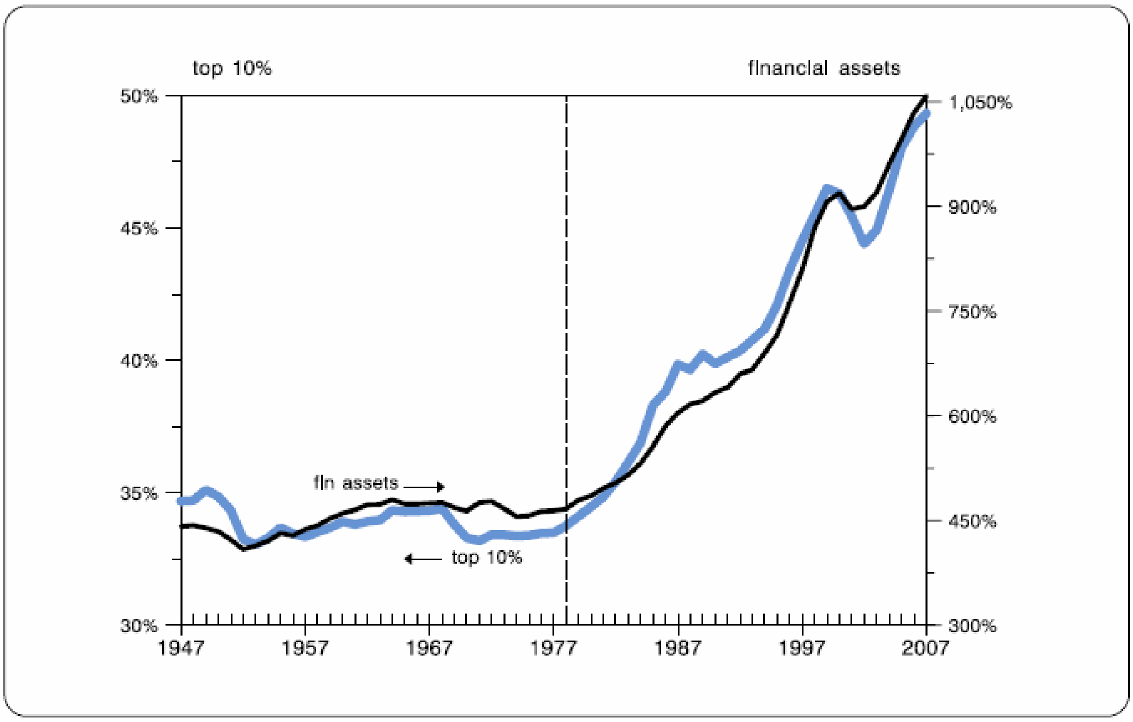
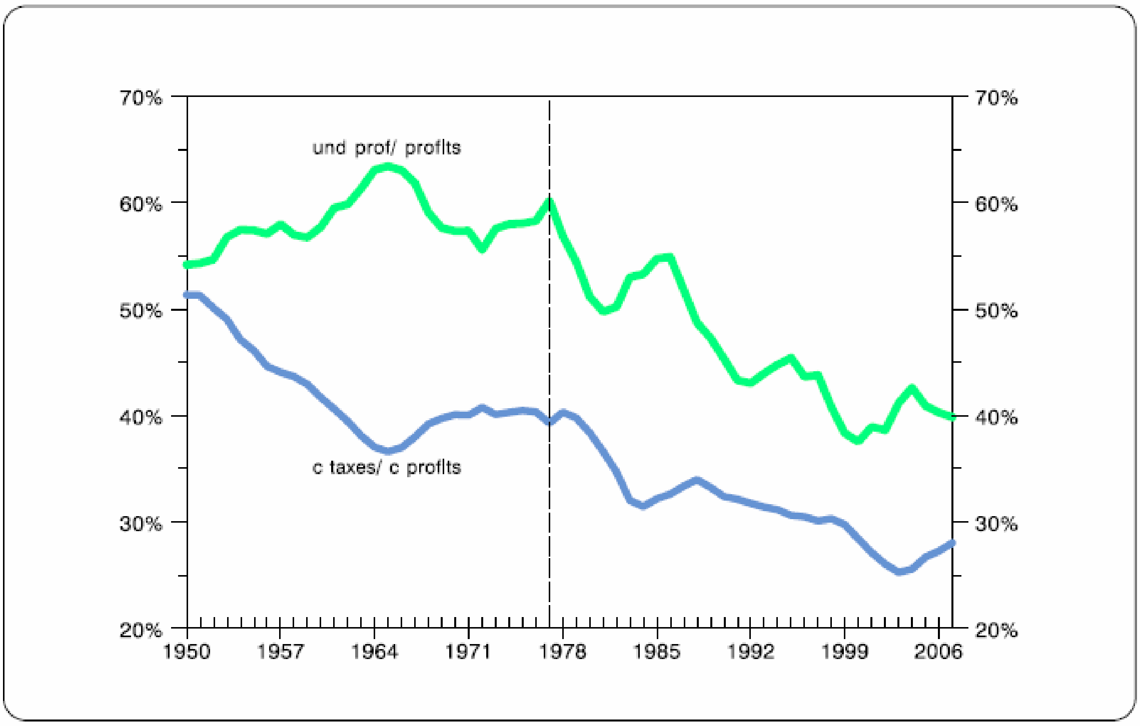


FIGURE 14

US: undistributed corporate profits and corporate taxes as % of corporate profits, 1950-2007



Damage in the real economy

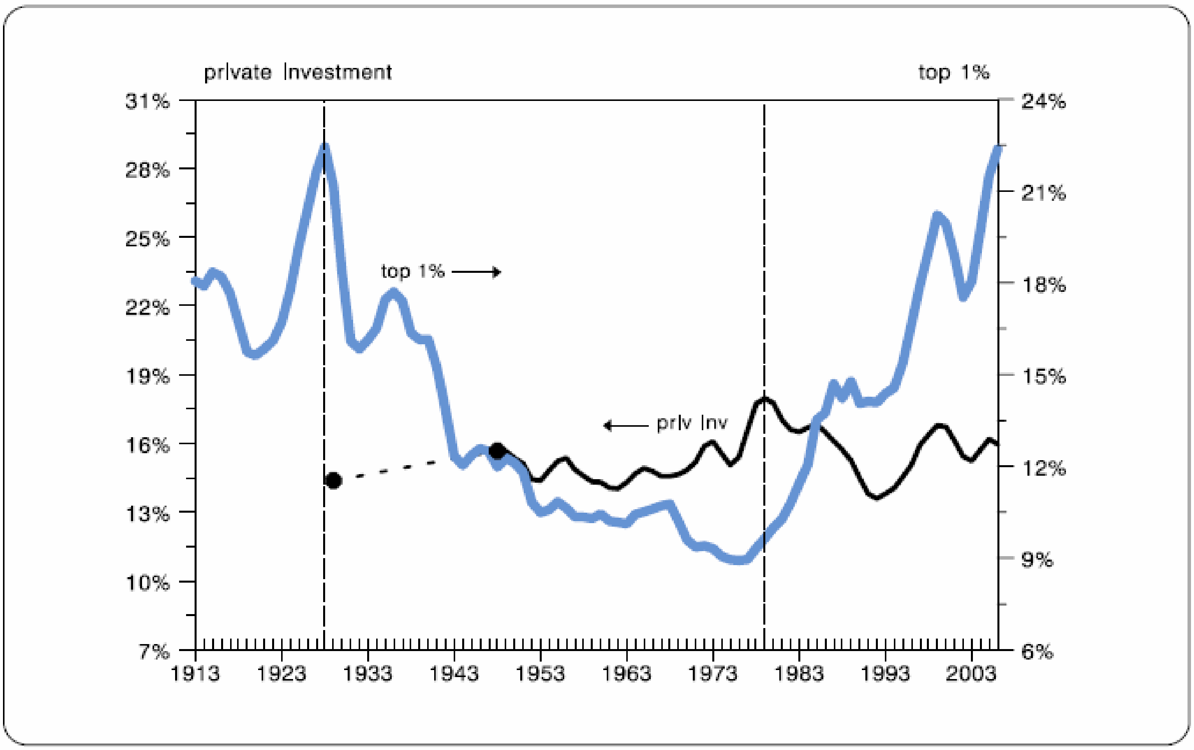
Let me give you one figure to illustrate my point.

Tax cuts during Bush Jnr period totaled $1.7 trillion from 2000 till 10 August 2007, when the financial crisis began. What was the total increase in Federal Debt in the same period? $1.7 trillion. This is one of the reasons why the debt was growing. This was one of the results of as corporate savings collapsed.

US investment

FIGURE 15

US: Income share of the top 1% and share of private Investment In GDP, 1913-2006

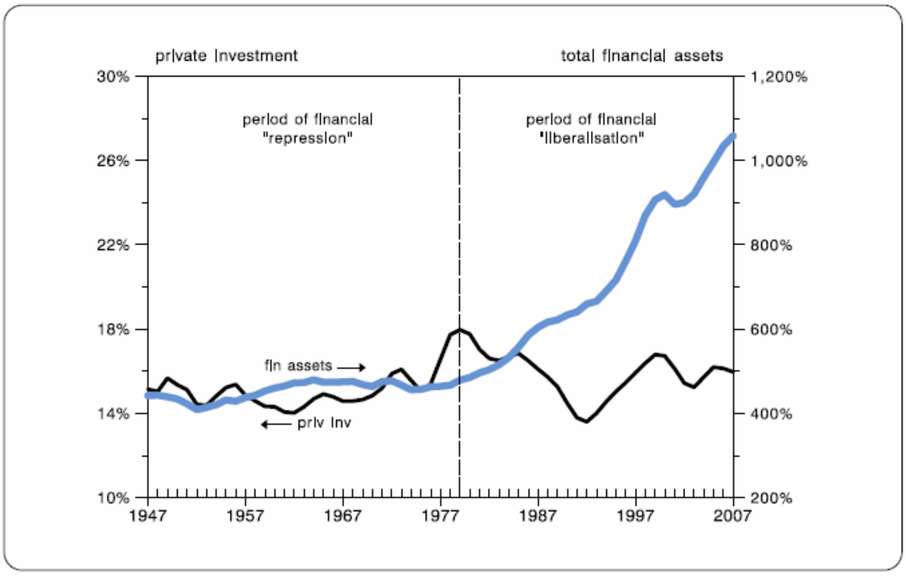


See on this graph the extent to which inequality was exploding while investment was declining.

Investment and financial sector

FIGURE 16

US: total financial assets (all sectors) and private investment as % of GDP, 1947-2007

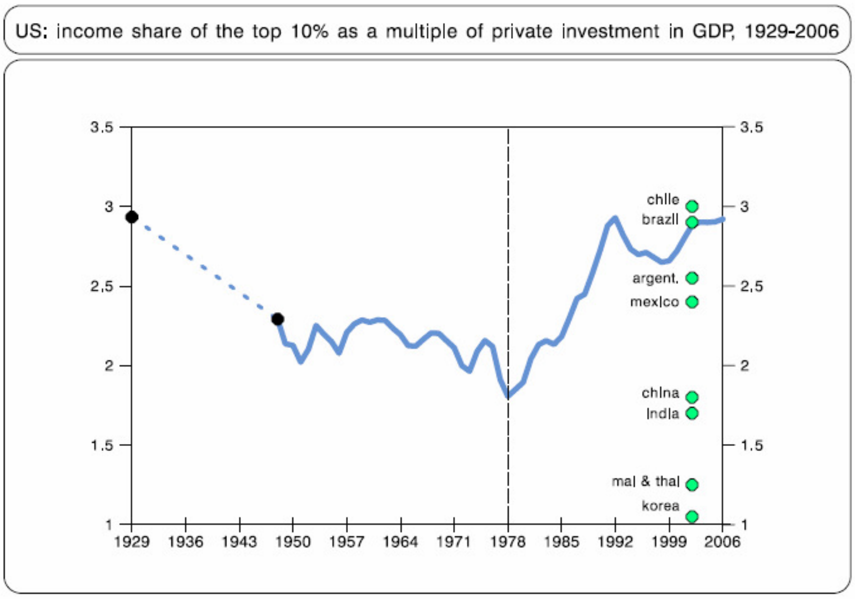


This is the damage done to the actual economy.

Imagine one window to look at these policies is the extent to which the elite appropriates wealth and what amount of that wealth is reinvested into the economy (see graph 19).

If you look at the US since the change in 1980 – the wealthiest section of the population only replaced about half of the profit that they made from the economy and the ratio below went from 2 to 3. This was the Latin Americanisation of the USA.

FIGURE 19

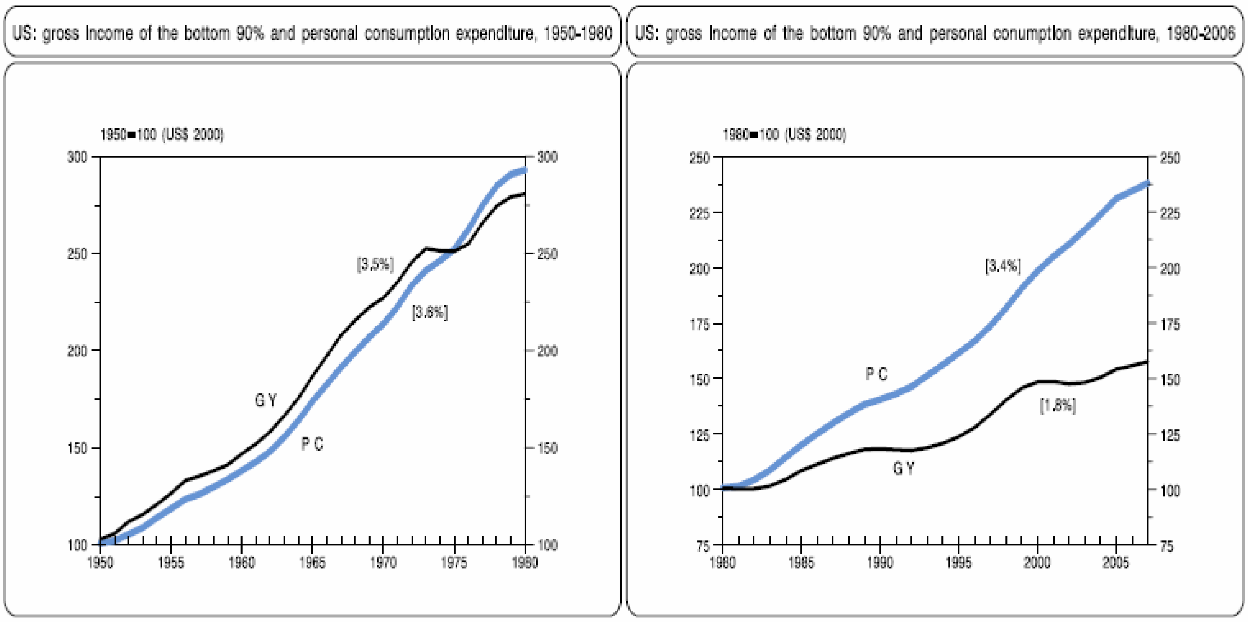


Neoliberalism is a trick to bring standards and distributional outcome of the most unequal parts of the world into industrialized countries.

A brief look at South Africa points out that local capitalists put very little back into our economy.

Labour market & wages (USA)

FIGURE 22



• **GY** = gross income of the bottom 90 per cent; and **PC** = Personal Consumption Expenditure.[111] 3-year moving averages. Percentages are average annual real rates of growth in respective periods. ***Source***: US Census Bureau (2008).

See how stagnant the average wage was before 1980. Neoliberalism was squaring the circle. The massive accumulation in the USA was simple enough to keep the rate of increase in consumer spending stable but this was only politically sustainable only through the accumulation of debt.

The explosion of the net worth of the bottom 90% of the population was a result of a partial payment-partial lending which was a neoliberal strategy.

What was the material foundation of this?

The virtual reality of exploding net worth and easy access to credit was encouraged, even though many people could not really afford it.

The neoliberal thinking was that this consumption should be fueled by part paying and part lending. Rather than paying the level of wages that were necessary to achieve the growth of aggregate demand required to sustain the process of capital accumulation, it was much better for the capitalist elite to 'part-pay/part-lend'. This trick can be seen by the figure quoted above, where the increase in the US Federal Debt was matched by the extent of the tax cuts during the same period. Foucault discussed the rationality of neoliberalism because what it became in practice was an attempt to transform capitalism into a 'rentier's paradise' – to have all of the benefits of capitalism without the competition and technological change that is normally the only real intellectual justification of capitalism in the first place.

The key characteristic of capitalism is that it is the first economic system in which in order to stay afloat, you needed to keep moving.

Hence, this crisis is really the revenge of the market against the rentiers.

One of the key characteristics of securitization was how to make a financial sector that allowed the transformation of financial markets where you could not lose. Las Vegas was in trouble when the USA was booming - who needed gambling when you have Wall Street?

The neoliberal elite tried to make the system as un-transparent as possible and transfer of risk from one agent to another all the way down the chain so that no one would actually have to have the risk on their books?

If you look at what has happened with the US or UK stimulus plan – the way that it has been done- it shows that very little has actually happened in the way people are thinking about the nature and cause of the financial crisis. For example, every time that the Chancellor in the UK has taken over a company, the UK government has paid 2 or 3 times the market value.

As to what kinds of stimulus packages the US is offering to its own economy: it has given less than $1 billion on green projects or infrastructure development. This is a relatively very small amount of money in the context of the extent of the current financial crisis.

So far, it is almost as if nothing has happened – the ideological framework is the same as are the standard ideas about how to solve the current crisis with multiple acts of crony capitalism still being advocated and implemented. The one liner about current financial crisis is currently how to keep financial dinosaurs on life support?

No one at the moment is thinking of any serious ideological change.

As another example – the US total debt obligation is $60 trillion, which translates into $520 000 per household and another $120 000 per person. If the debt were to be paid in 30 years it would need an interest rate of 0%, with no one being able to take any more loans during this period. The current debt load seems to be completely unpayable.

QUESTIONS

1. **Why has Obama taken the same economic advisors as Clinton and why was someone like Joseph Stiglitz not brought in?**

It was a surprise. When he was running for president, he had a different group of advisors and then he got rid of his economic team and brought in the Clinton team once he made it into office. Many people think that this is a Goldman Sachs team – there was also a bit mania on the part of Obama. He brought them in to restore the confidence of the market.

Please can everyone take a look at the full version of the paper, it is the Wolpe website.

2. **Is this conspiracy or human folly?**

They (neoliberals who designed the system) really believed that this was sustainable, which is interesting from a psychological point of view. CEOs really betted their whole companies on wishful thinking. One example is how corrupt the rating system of various companies is – its rating of specific US companies made Zimbabwe seem transparent.

The crisis took them all by surprised because they were under the illusion that it was sustainable. No power in the world can sustain itself in the long run without ripping itself apart. Elites ultimately become uncontested and self-destructive.

3. **The disconnection between the financial markets and real markets caused by speculation in derivatives, will this not ultimately lead to the breakdown of the capitalist system?**

We have seen how the real and financial markets separated from one another, which we could call a form of decoupling. People really thought that increasing inequality was sustainable.

However, capitalism to be resilient animal, which comes back in a variety of forms after specific setbacks.

4. **Did you see this coming? There were youtube videos talking about the coming crisis for a long period beforehand**

No, no one did.

Take the example of teaching economics at university. Nothing has happened with the way that economics is taught at the moment. The capacity to deny and to live in lies continues. This is all the more important when we look at the issue of the way that mathematics is used within economics to ‘prove’ things. The problem with mathematical theology is not that it is mathemattical, but that it is theology.

5. **Was this not undisputed greed? How does one bring people back from a place where they were so greedy?**

It is quite fashionable these days to blame greed. But, I don't blame greed. When you have these agents interacting in markets (according to traditional economic theory), the system is meant to facilitate and promote that greed. What we need is to createrules that regulate the greed in society from bending the rules. Think of it as a process.

The real problem was not that people were greedy, but that those who are greedy have the power to deregulate the markets. Proper regulation can cope with greed.

6. **Is this not a part of the crisis is that the shift of productive capitalism towards the East. Is this crisis not just a way to try and delay the inevitable?**

This neoliberal paradigm was an attempt to secure rentier capitalism with all of the carrots and no sticks.

There is no doubt about it though, the political and economic consequences of the rise of the east is coming in the world economy and it will have a major impact on how the world operates.

7. **Is there a role for accounting and fractional reserve banking – by lending money into existence?**

My parents are accountants and so I have a lot of respect for it. If you think of the whole process of financial deregulation was an attempt to transfer risk down the line, then the misuse of accounting was a part of the problem. You were paid to say what the person who is paying you wants to hear. Part of the new regulation system is what needs to result from this.

What needs to be done is a major change in the way that corporations represent themselves.

For instance, the top 4 banks in the US have assets of 7.5 trillion dollars and 6 billion off the balance sheets.

Conspiracy is how to get public goods without paying for them.

The 'end of history' kind of thinking is that is going to be the 1000 year Reich, that this rentier's paradise would last forever.