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Up in Smoke

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What a difference a few days make ! As recently as early September we were being reassured, not only by politicians but by experts everywhere, from the halls of academe to newspaper financial pages, thatâ€”serious though things might beâ€”comparisons to the Great Depression were uncalled for. By the official end of summer, as I am writing this, that comparison is everywhere, if only as background for insistence that this time the downward spiral can be controlledâ€—provided that the government does the right thing, and does it fast. (Otherwise, as the current leader of the free world put it, "This sucker's going down.") Commentators argue about what that thing is, of course, though everyone agrees that it will involve huge wads of money.

The proposal on the table at the moment, the $700 billion U.S. government rescue operation, seems poised to turn into a gravy train, with financial operators of all sorts, not just the holders of failing mortgage securities, jostling to unload their deflating paper on the "taxpayer," that donor of last resort (generally left unidentified but, when you think about it, clearly an abstraction of the lower income people to whom the tax burden has been shifted further since the 1980s). If the House finally knuckles under and passes it, one thing is clear : the trillion dollars or so that you might have fantasized would some day pay for new schools, healthcare, or even just bridges that don't fall down, is going to flow instead into financial-institutional coffers, affecting nothing but the ability of those institutions to keep afloat (and pay their executives, employees, and investors). This will be money spent not for things or services but simply to replace some other money, now departed from this world of woe. Or, more accurately, money that people thought was real has turned out to be imaginary ; to deal with this, more imaginary moneyâ€”money that future economic activity is supposed to generateâ€—will take its place. Such a radical detachment of money from anything but itself may be hard to grasp, but it's the key to understanding what's going on.

Everyone agrees on the immediate origin of the current crisis. Alan S. Blinder, former Federal Reserve Bank governor and now economics professor at Princeton, put it this way : "It's easy to forget amid all the fancy stuffâ€—credit derivatives, swapsâ€—that the root cause of all this is declining house prices." People, from humble homeowners to Wall Street Masters of the Universe, imagined that house prices would climb forever. When they started to fall, the institutions that bought mortgages and borrowed against them, treating them as the equivalent of high-valued houses, suddenly found themselves unable to meet their obligations. They could now neither lend money nor borrow it ; attempts to raise cash by selling assets drove prices down faster. Investors panicked. And it turned out that the economy really is global : the American meltdown was quickly transmitted around the world, deepening the Japanese depression, shoving down the Russian stock market, threatening Chinese growth (if not yet driving the communist-capitalist miracle into near extinction along with the Irish Tiger), and damaging German banks. One result was the pressure from European and Asian central bankers that forced the American government to save insurance giant AIG, at a cost of $85 billion ; another is the arrival of foreign banks doing business in the US lining up at the promised governmental trough.

But why did housing prices go up and up ? For that matter, why did they stop ? Can it just be that what goes up must come down ? Economic writers like to treat the economy as if it were ruled by natural forces. But where once the call was for nature, in the form of the market principle, to be left free to work its wondrous best, now everyone has decided that it requires regulationâ€—levees, as it were, against the hurricane-force winds of individual greedâ€—to preserve the natural tendency towards growth. What is much less noticed (or admitted) is that it was precisely the lack of regulation that created the prosperity, such as it was, of the last decade, as well as the meltdown of the last two years.

The tight controls put on finance by New Deal legislation were undone, starting in the late 1970s, by presidents Carter, Reagan, and Clinton. In addition to this deregulation, along with banking innovations to get around remaining regulations, a shift in banking activity from managing deposits to earning fees by selling financial investments, and changes in the tax code, led to an astounding growth of financial activity. By 2007 financial services earned an historically high 28.3% of total corporate profits. It was, in fact, largely this growth in financial activity that appeared

both as "globalization" and as American prosperity. That prosperity, however, merited more skepticism than it received, punctuated as it was by market collapses and recessions.

The 1980s saw a wave of corporate mergers and takeovers, much of it highly leveraged (financed by borrowing). Those happy "greed is good" days were, however, darkened by the collapse of the savings and loan banks at the end of the decade. Enjoying their newly deregulated status to invest heavily in real estate, they ran up a loss of $160.1 billion, which the U.S. government (that is, those taxpayers, again) obligingly offset with a gift of $124.6 billion. Similarly, the dot-com bubble of the 1990s burst into a 30% drop in share prices in 2000 and a general collapse of investment.

In response to the weakened economy, the Fed cut interest rates between 2001 and 2003 from 6.5% to 1%. This led, as intended, to a massive increase of debt, personal and corporate. In particular mortgage lending took off, from $385 billion in 2000 to $963 billion in 2005. This, together with the refinancing of homes, was the basis for the post-2002 expansion of the Americanâ€"and so, to some extentâ€"of the world economy, along with the massive inflow of foreign funds in exchange for U.S. Treasury securities.
A technical innovation of this post-1980s debt-financed expansion was the "securitization" of mortgagesâ€"their grouping together into bundles sold as bonds. In this way the bank that makes the loans doesn't tie up its money in an actual piece of property, waiting for the loan to be repaid, but sells the right to collect the interest on those mortgages to investorsâ€"other banks, pension funds, etc.â€"in complexly structured packages called "collateralized debt obligations." The investors, of course, can sell these CDOs to others, or use them as collateral to take out giant loans to buy more securities or to gamble in the rapidly expanding field of derivatives (a type of investment well described recently in the Financial Times as "like putting a mirror in front of another mirror, allowing a physical object to be reflected into infinity ;" about $62 trillion in "credit default swap derivatives" is now floating around.). By January 2007, U.S. mortgage-based bonds at the base of this pyramid of financial instruments, rising far from the actual houses and the money to be paid for them, had a total value of $5.8 trillion. Of this, 14% represented sub-prime mortgages, entered into by people with poor financial resources. In 2006 these people began to have a hard time making their payments.

The foreclosure wave is not surprising, as the real wages of non-supervisory workers had reached their peak in the early 1970s and stagnated since then (the years after 2000 saw in particular a rapid decline in employer-financed health insurance), along with employment. When variable mortgage payments jumped, more and more people couldn't make them. Meanwhile, the Fed raised interest rates starting in 2004. This made mortgages more expensive and lowered house prices. These developments in turn made it difficult, or impossible, to refinance, as many home-buyers had been assured by lenders they would be able to do. By December 2007 nearly 1,000,000 households were facing foreclosure. Housing prices began to fall more rapidly ; the mortgage market collapsed, taking with it the whole structure of securitized investments, now a massive part of the financial structure in the U.S. and around the world.

Reregulation will not solve the problem of claims on investment income far exceeding the actual money flowing to meet them, any more than pouring more freshly-printed dollars into the bank vaults will. It's true that bailing out investment firms will help unfortunates like Treasury Secretary Paulsen, whose Goldman Sachs stock, valued at $809 million in January, had fallen to a paltry $523 million by September 19. But aside from helping out the occasional deserving millionaire, it is far from clear how freeing up the wheels of finance is going to save the world economy. What will the financiers invest in, if they become solvent again ? This is the big question that is neither asked nor answered. It's just assumed that the natural course of prosperous events will resume. If debt expansion could bring prosperity, however, we'd already be living in a golden age. The problem is that all the money that has sloshed around the world for the last thirty years has led less to growth in what economists, in times like these, like to call "the real economy"â€"the economy of production, distribution, and consumption of actual goods and servicesâ€"than to the expansion of the imaginary economy whose real nature is currently becoming visible.

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How did fictional investment come to have so dominant a place in economic reality ? And how far is the depressionary wolf from the door ? My next article, in the November Rail, will explore the roots of the current crisis in the development of the world economy since World War II ; a third, in December, will examine that development in relation to the cycle of prosperity and depression that has characterized the capitalist economy since the early nineteenth century.

New York, october 2008

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