Dix Sandbeck
dix@dixsandbeck.ca
The Journal of COMER, Dec 2003

The Newspeak of Economics

Irrational exuberance

It is a widely held notion that conservatives are frugal and abhor deficits, while liberals are spendthrifts who gladly will spend what they have not. But in today's America, such simplicity belongs to a bygone past. In times, when more and more of the political discourse sounds dangerously Orwellian, concepts like deficits and fiscal responsibility have acquired new meanings. Behind the veil of neoconservative newspeak, the message has become: What is good for our wealth maximization, we'll make you believe is good for America.

Let us take a look at how the economy developed since Reagan launched the neoconservative revolt of the wealthy. His slogan of trickle down economics that justified his tax cuts worked well enough at the top, where the wealthy saw their incomes rise dramatically. However, trickle down actually turned out to be trickle up for the poor, who saw their income trickle up to the top as their share of the pie fell in real, inflation-adjusted terms during the eighties and early nineties. On top of this, the supply-side argument justifying the tax-cuts—that they would spur the economy enough to make revenue rebound—turned out to be just as bogus. Instead, budget deficits soared.

The Clinton presidency turned the situation around by implementing modest tax raises for the highest income brackets and increase deductible items for lower and middle-income groups. Giving income groups with high propensities to consume more disposable income propelled the economy into a period of sustained growth. This meant that while the trend of rising inequalities hadn't stopped, the American workers were at least able to see their real wages grow again. Nevertheless, at the top, phenomenal gains continued to be reaped by groups such as whiz-kids in the booming high-tech industries and top corporate executives. These gains were to a large extent fueled by issuing key employees with stock options that could be turned into gold in a stock market that apparently only knew one direction – up.

By the end of the nineties, question marks started to hang over the stock market. Already in 1996, Alan Greenspan made his famous remark about "irrational exuberance," easily decoded to mean that in his opinion the stock market had gone too high. However, the market only twittered for a few days, then resumed its flight. When the discord between valuations and the real economy continued to widen, the question increasingly became: what kind of market correction was the economy headed for? Would it be orderly, or another black day?

A mismatch of growth

The success of Clinton's economic policies, including turning the deficit around, eventually produced budget surpluses during his last years in office. This was good news for ordinary Americans as well as for America's future. Lower debt payments meant that there would be more money for federal discretionary spending on items such as education, the environment, and infrastructures. But, indirectly, it also played a role in amplifying the mismatch between the stock market and the real economy. This, eventually, would be bad news for a lot of wealth holders invested in the market.

To understand what caused the mismatch, one has to see the difference between rising markets as a cause for growth in wealth, and a cause for growth in incomes. When wealth grows as result of rising markets, it might just mean that the market has put a higher valuation upon a given holding of financial assets. This wealth effect can occur without any transactions have taken place; it might purely be a paper phenomenon. Of course, there always lurks the possibility that the market will go down and erase the putative wealth gain again before it is realized through transactions.

When income grows as result of capital gains, it is a different story. Before that can happen, transactions have to take place; in a stock market, between stocks on one side and money on the other (ignoring the possible cases where stocks are exchanged for other stocks, which cannot realize capital gains income, but only exchange wealth effects). When money and liquid financial assets (money substitutes) change hands they can create incomes through the exchanges. In isolation the exchanges are—as all exchanges are seen in isolation—zero-sum phenomena, but the income in the form of capital gains will materialize if the traded financial instrument has a higher money valuation than its last trade. The changes in economic aggregates that they might engender are not a result of the exchanges themselves, but a result of changes in the economic valuations, and in the direction of the dependent flows leading up to the exchanges.

Stock market valuations, seen narrowly as claims on real assets in the economy, are at best based on fuzzy estimates. If they have gone too high, that by itself might not matter for individual investors' chances of generating capital gains. What matters for investors are the market's sentiments about valuations, which will decide whether or not it is possible to sell stocks back into the market at higher prices. But at the same time, a net flow of money has to enter the market from somewhere, otherwise the flow of transactions cannot create a net outflow of capital gains. Contrariwise, if a net flow of money keeps pouring into the market, aggregate stock valuations must continue to rise, whatever their connection to the underlying assets are. This basic rule of exchange has not changed in modern markets; what have changed is the complexities of the transfer mechanisms, which shift money, wealth and income components in and out of the markets, and connect them to other parts of the economy.

The investment trap of liquid financial assets

Standard economic theory tells us that savings equals investment, but it doesn't differentiate between investments going into the real economy and investments going into liquid financial holdings. It simply assumes that this distinction doesn't matter because investments in financial holdings sooner or later will end up in the real economy. But in a modern economy this is no longer a certainty. In modern economies, there exist huge stocks of financial holdings having the ability to trap investments (i.e. money or money substitutes) within loops in the financial sector. And not only that—in their quest for returns investors will try (through economic or political means) to appropriate money flows from other sectors in the economy for this purpose. This was a key rationale for the return to economic policies of top-heavy tax cuts of the Bush administration.

However, when wealth holders are successful in this process of appropriating cash flows from other sectors of the economy, they also need new financial outlets to reinvest their gains, which is a function of modern wealth-holders' low propensity to send marginal income back into the economy as consumption or investments in real economic activities. This means that investment effects on growth and distribution can be radically different than assumed by standard theory. Investments that go directly into the real economy have a relatively broad potential for creating jobs and incomes. Conversely, investments ending up in the traps of liquid financial holdings have little direct job creating potential (except for adding to the growing ranks of stockbrokers, portfolio managers, financial analysts, lawyers, etc., engaged in the burgeoning financial sector). They represent incomes that have not only low propensities to consume, but increasingly also, low propensities to invest in the real economy.

The aggregate growth of liquid financial assets have since the early 1980s outstripped growth in the real economy between two and three times. This rise is the result of a number of trends: securitization of illiquid assets such as home mortgages and small business loans, corporate direct issue of debt, etc. However, a big source for the growth in the stock of liquid financial assets has been the growth in government debt. This meant that an increasing part of government expenditures were paid for by borrowing the money from the wealthy (which, through the foreign trade deficit, include foreign wealth holders and governments), instead of being paid for by taxes.

The significance of government deficits

When a government resorts to deficit financing, it often creates benefits. The question is—just as when a business borrows money from the bank—will the borrowed money create net gains over time that can be used to amortize the debt at some time in the future? Raising public debt to finance short-term Keynesian demand stimuli, or for creating physical or social infrastructure, can raise society's future productive potential. In such cases, the burden on the economy is light since part of the productivity growth can be used to repay the debt. In some cases, raising debt levels and thus accepting the concomitant deficits can be vital for sustaining the economy through a rough patch if the debt is used to sustain incomes with high propensities to consume.

However, if increasing debt levels persist over time and, in particular, when they are caused by policies that increase income disparities and the growing financial overhang on society—as top-heavy tax cuts do—it will create structural problems. This was the case during the Reagan administration, which stubbornly adhered to defunct supply-side policies based on the claim that tax cuts would incur enough new economic activity to recoup the revenue lost to the tax cuts. This didn't materialize and instead the policies created a structural mismatch between government revenues and expenditures. When real interest rates also shot up, this fueled the growing income inequities that became a hallmark of the period.

After Clinton put a brake on the federal deficits, the issuance of federal debt shifted into a lower gear. This meant that there no longer was an ever-rising pool of federal debt instruments to absorb wealth holders' need to reinvest the gains from the previous cycle of profits, interest income, and capital gains. Instead, by the mid-nineties, the money increasingly flowed into an already bullish stock market, where nobody cared about traditional dividend income, but only about the promise of capital gains. But this had a severe drawback: stocks are ultimately tied to assets in the real economy. At some point, this reality moves to the forefront. When that happens, being invested in the stock market turns into the art of avoiding holding the can when the dam bursts.

The true agenda of Bush policies

The problematic nature of the stock market's unlimited capacity for reinvesting returns explains some of the economic policies of the Bush White House. The tax cuts, which Bush made the focal point of his economic policies, served a double function. The first was the old-fashioned goal of putting more disposable income into the hands of the wealthy, his main base of support. The second goal was subtler. When the tax cuts, predictably, again plunged the economy back into the cycle of budget deficits and rising federal debt, the growth in interest yielding federal debt reemerged as a reinvestment outlet for the wealthy's growing incomes. It might not be as fancy as investing in the stock markets, but it is infinitively more secure.

With the poor falling out of the system at the bottom and the wealthy's economic responsibilities for society's up-keep through taxes reduced by their friends in the White House, the burden of carrying the debt increasingly falls on the shoulders of a shrinking middle class. Furthermore, as the government's interest payments accelerate and expenses for the military-security complex upkeep being off-limits as targets for savings, all other discretionary spending will be crowded out. This means that middle-class America also can look forward to deteriorating benefits from public services as consequence of the neoliberal policies.

In the end, however, these policies have their limits, especially since the deficit increasingly is financed by foreigners. In order for that to continue, the US must run a constant real sector deficit in its balance of payments against the rest of the world (although the US can pay for a part of this deficit by creating money used as international reserves[1]). However, this put strict limits on the interest policies that the Federal Reserve can follow, since the wealth holders financing the deficits in order to be willing to continue financing the debt want robust real interest rates, in particular the foreign wealth holders,

[1] See "Bretton Woods and the Forgotten Concept of International Seigniorage" Journal of COMER. Sep, 2003

who also have to factor currency risks into their expectations for returns[2].

This process will not be much different from the debt-for-asset swaps that the policies of the Washington Consensus in the 1990s forced upon several Latin America countries, where the arm-twisting in most cases formally was done by the IMF. Nor will the coming debt-for-asset swaps in the US exclude assets in the health and education sectors. In fact, according to the neoliberal narrative these sectors, which contain some of the largest pools of public assets, should anyway be turned over to private interests as these are proclaimed to be the best to run them[3].

In the newspeak of the Bush White House, its unraveling foreign policy and self-created quagmire in Iraq is called "progress." Support for corrupt and authoritarian regimes is called "spreading democracy" as long as they pass the test of being friendly to the US. On the economic front, the exploding deficit is termed "incredibly good news,"[4] and the plunder of the public portrayed as "returning the money to the people." Unfortunately, in a world of disjointed news cycles and constant mindless entertainment barrages, many average citizens find it difficult to decode the reality behind the newspeak of the neoliberal narrative: that the current government's destructive policies, both foreign and domestic, serve the interests of a small, myopic elite without regards for the human and economic costs they entail.

---

[2] Written in late 2003. The balance of payments deficit reached $788 billions for 2007 or more than 5% of GDP. Of course, the cost has been a falling dollar (confirming Friedman's old dictum that the Fed can control interest rates or the currency's exchange rate, but not both). Nevertheless, the US has with comparable ease been able to sustain the enormous deficits, once again proving the incredible advantage it gained when Bretton Woods elevated the use of the US dollar as the world's primary reserve currency. What is important today is that the reserve currency advantage is not just connected to traditional balances created by international trade, but also—of increasing importance—for wealth holding purposes. Despite the obvious currency risk connected to storing wealth in dollars, the liquidity and transactional convenience attached to financial assets denominated in American greenbacks appears still to be able to keep the ship floating.

[3] Private interests might indeed often be better to provide services at low costs, since privatizations typically involve exchanging good jobs with benefits for minimum-wage contractual work without benefits. However, such gained cost "efficiencies" will typically involve a loss of quality and, it goes without saying, add fuel to the trend of widening incomes discrepancies and general social imbalances. It therefore generates social costs that seen from the view of social accounting must be included.

[4] A sound-bite from the start of his presidency, widely quoted in the news media. See for example The Austin Chronicle, Sep. 6, 2002. http://www.austinchronicle.com/gyrobase/Issue/column?oid=101752