Global 21st Century Economics: Beyond Market Fundamentalism and State Intervention

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Abstract:

This presentation is investigating the root causes and origins of the Great Recession that started in 2007-2008 with the housing market collapse and the unprecedented meltdown of the global financial sector. It analyzes the socio-economic factors that led to the crisis: among them misguided fiscal and monetary policies which started in the 1970s, the biased standards set by such institutions as the World Bank and the I.M.F., and the global economic anarchy that ensued after the effective termination of the Bretton Woods system in 1973. It traces world governance from G 7, G 8 to G 20 and anti-globalization movements. It outlines an inquiry into the efficacy of the historically unprecedented government bailouts of private companies and to what extent these measures were state socialist. If certain gargantuan concerns are deemed "too big to fail", the average citizen – still threatened by record unemployment and home foreclosures - before such policies certainly appears too small to count! It explodes the fallacy of a "jobless recovery" that has been held up to the U.S. public as the only feasible paradigm for more than a generation now and it explains why such false promises won't do for the future. It looks at artificial shortages of key resources – such as the so-called 'rare earths' - and the consequences of the environmental crisis, the increasing unaffordability of oil, the *de facto* world reserve currency. It will discuss the parameters of a new global financial and economic system beyond the gold standard and fiat money, optional "world money" like Special Drawing Rights [S.D.Rs.], minimum wage theories, basic income guarantees and the 'right to work' from the station point of classical economic Georgist principles and it will make recommendations as to what needs to be done "beyond market fundamentalism" and "state interventionism" on that basis to get out of the global crisis, put people back to work, get them back into their homes, close the wealth-poverty gap locally and globally, and provide wealth for all on the basis of a sustainable future for our blue planet.

21st Century Economics:

Beyond Market Fundamentalism and State Intervention

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What caused the Great Recession?

The most popular answers can be broadly classified in two categories. A list of the first would have to include:

- overregulation
- government intervention
- excessive bailouts
- Fed 'printing' money
- Abandoning the gold standard
- taxes on business
- illegal immigrants
- outsourcing
- labor unions
- Hugo Chavez
- communist subversion
- foreign agents
- workers' literacy
- a president without birth certificate

These answers by and large blame the left.

Reasons blaming the right most commonly include:

- greed & fear
- human nature
- irrational exuberance
- a financial tsunami
- a perfect storm in the global stock market
- glitches in the transmission of financial information
- too much slack in general accounting standards
- international Ponzi schemes
- some hedge fund managers having a bad hair day
- Kenneth Lay on crack
- Herbert Hoover
- Andrew Mellon
- Alan Greenspan reading Ayn Rand

One thing both schools of thought generally hold in common is that business cycles cannot be foretold and that financial information and economic data can only be interpreted with hindsight. Finance writer Roger Lowenstein puts this as follows:

"It would be an oversimplification … to blame Greenspan for everything that happened to interest rates over that period [of 1987 – 2006], but it was his unmistakable legacy to stretch the boundaries of tolerance, to permit a greater easing of credit than any central banker had before. … It was a central tenet of the Greenspan worldview that market excesses - [or] 'bubbles' – could not be detected while they were occurring. … If central bankers could not be trusted to say that markets were wrong, neither could they be trusted to interfere in them – to prick the bubble before it burst on its own. … Greenspan was emboldened in this view by … Ben Bernanke. Considering the question in 1999, when the prices for dot-com stocks were close to their manic peak and when, …, the existence of a bubble could have been detected by a child of four, Bernanke [and Greenspan on the

contrary] insisted that until it popped, it was … impossible to say … that prices weren't fully justified."[1]

In other words the smartest guys on the block were continually getting caught in their own delusional schemes. A financial bubble has been described as an unhinging of market behavior from supply and demand that is a complete disconnect from economic reality. Of the two models explaining the Great Recession the first can be called the state-interventionist and the second the market-fundamentalist model. The second has been popularized again in the Thatcher-Blair, Reagan-Bush era: Government is the problem not the solution. If you apply this extreme libertarian view of the deregulation gurus of this period[2] to traffic conduct then police would be obsolete and every driver could choose his own personal speed preference or what side of the street to drive on. Never mind that most of us would then become road kill and traffic before long would break down altogether! If markets are ever so self-regulatory why not traffic and why not every other sphere of human activity? That romantic view of markets leaves out that even Wall Street boys will be boys and that market behavior is largely testosterone driven. In other words governments even at their most minimalist as 'traffic cops' have to step in *before* excesses occur as (in the words of J. K. Galbraith) "countervailing power".[3]

For several generations economic teachers would use the Great Depression as the prime example of an economy completely derailed. Kindleberger, Galbraith, Niall Ferguson and other economic historians correctly identified the Florida real estate bubble in the twenties as one contributing factor among many others. This became part of the popular lore of the era as the first Marx Brothers picture *The Cocoanuts* not by coincidence has Groucho Marx pitch underwater Florida real estate to gullible out-of-state investors.

Today we are able to look at the origins of the Great Recession, and we are unmistakable clear on what caused it: the subprime or mortgage crisis which in turn led to the global credit crisis. While the vast majority of financial analysts and mainstream economists were paid handsome sums to close their eyes to the obvious, some broke ranks and

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[1]. R. Lowenstein, *The End of Wall Street*, New York, 2011, p. 4
[2]. Like Arthur Laffer
[3]. See: J.K. Galbraith, *American Capitalism*, New York, 1963

predicted the crisis as inevitable, so Robert Shiller, Nouriel Roubini, Kenneth Rogoff and to an extent Paul Krugman and Joseph Stiglitz.

Among Georgist economists who did the same were Philip Anderson, Fred Foldvary, Mason Gaffney, Fred Harrison, Andrew Mazzone and myself. J.J. Smith has pointed out that theorist based on the Georgist paradigm are able to predict coming crisis more accurately. But even Schumpeter who can by no stretch of the imagination be called a Georgist adhered to cyclical boom-bust models. Schumpeter may be the most sophisticated of the neo-classical theorists who combined the long-term cycles of Kondratiev with shorter ones of Homer Hoyt and others. In order to forestall future calamities it is worth to take a closer look at the events that led up to the Great Recession and at those factor that might prolong it.

In the late 1999 the Glass-Steagall Act, a.k.a. the Banking Act of 1933, was repealed and replaced by the Gramm Act. Glass-Steagall established the Federal Deposit Insurance Corporation [FDIC] and it was designed to reign in speculation after the unprecedented market crash of 1929. One of its functions to regulate interest rates in savings accounts was abolished in 1980 the year Reagan was elected into office. The Gramm Act effectively removed the separation that had been instituted between investment banks which issue securities and commercial banks which accepts deposits. "The deregulation also removed conflict of interest prohibitions between investment bankers serving as officers of commercial banks. Experts believe that this repeal directly contributed to the severity of the Financial Crisis of 2007 – 2011 by allowing Wall Street investment banking firms to gamble with their depositors' money that was held in commercial banks owned or created by the investment firms"[4]. In other words the Gramm Act directly prepared the way for what Susan Strange has called "Casino Capitalism".[5] Thus financier could begin to bet against their clients' interests with impunity and (surprise) they did.

In the late 1990s the enthusiasm for internet companies spawned an overvaluation of IT companies which crashed in March 2000. "The period was marked by the founding (and, in many cases, spectacular failure) of a group of new Internet-based companies

[4]. Wikipedia, Glass-Steagall Act
[5]. Susan Strange, *Casino Capitalism*, New York 1997

commonly referred to as dot-coms. Companies were seeing their stock prices shoot up if they simply added an 'e'-prefix to their name and/or a '.com' to the end, which one author called 'prefix investing'. A combination of rapidly increasing stock prices, market confidence that the companies would turn future profits, individual speculation in stocks, and widely available venture capital created an environment in which many investors were willing to overlook traditional metrics such as the price/earnings ratio in favor of confidence in technological advancements."[6]

The widely held belief that cyberspace activities, outsourcing of tasks to the other side of the planet and virtual offices could replace real-life, real-time working processes and relations experienced an acute reality check.

Another case in which "the smartest guys in the room"[7] felt they could outsmart their most savvy investors if not again reality itself was the Enron scandal, which "revealed in October 2001, eventually led to the bankruptcy of the Enron Corp., Houston, Texas and the dissolution of Arthur Anderson, ... one of the five largest audit partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was attributed as the biggest audit failure. ... Enron's $63.4 billion in assets made it the largest corporate bankruptcy in U.S. ...As a consequence of the scandal, new regulations and legislation were enacted to expand the accuracy of financial reporting for public companies. One piece of legislation, the Sarbanes-Oxley Act, expanded repercussions for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders. The act also increased the accountability of auditing firms to remain unbiased and independent of their clients. "[8]

The Sarbanes–Oxley Act, a.k.a. the Accounting Reform and Investor Protection Act, or SOX, is a U.S. federal law enacted on July 30, 2002. The bill was enacted as a reaction to the major corporate scandals of the period, including Enron, Adelphia, and World Com. "These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the nation's security markets. The act contains 11 sections, ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission [SEC] to implement

[6]. Wikipedia, Dot-com bubble
[7]. Also the title of a popular U.S. documentary on Enron by Alex Gibney
[8]. Wikipedia, Enron scandal

rulings on requirements to comply with the new law. It created a new, quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. The act was approved [by Congress with overwhelming majorities and] President George W. Bush signed it into law, stating it included "the most far-reaching reforms of American business practices since the time of FDR."[9] Throughout economic history in practically all societies with codified law there has been a difference between the spirit and the letter of the Law, meaning even exquisitely just laws have little used if they are not enforced, and the best laws are toothless and useless if the designated enforcement agencies habitually look the other way and sit on their hands. Not quite a year after Enron, on July 21, 2002 to be exact, came the bankruptcy of World Com which was mostly caused by reporting expenses as earnings on a large scale or reporting revenues that were entirely imaginary. "By the end of 2003, it was estimated that the company's total assets had been inflated by around $11 billion."[10] In retrospect a near decade later all these bankruptcies and numbers appear almost quaint, although at the time they occurred everyone appeared dismayed and scandalized about it, even those who directly or indirectly benefited from these mega-frauds. Bernard Madoff with his pyramid scheme hauled in nearly six times that sum and Madoff larcenous quantities in turn were dwarfed by the Great Recession that followed. It is possible that a pick pocket may work alone, but it defies all probability that a theft in the magnitude of $ 63 billion can be instigated by one man all by himself without abetting or colluding parties. When we asked the question at an economics conference a few years ago whether Enron and Madoff were not the rule instead of the exception to the rule of the system there was general consternation. Today this very issue poses itself with increasing insistence, indeed, the survival of the global economy and the world financial system may depend on a significant overhaul of the same. When Galbraith in his *Brief History of Financial Euphoria* describes the type of business leader who habitually cause this kind of mass deception as persons "with a foolish disregard for legal constraints" he was not thinking of a state of affairs in which any kind of legal constraints were entirely absent.

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[9]. Wikipedia, Sarbanes-Oxley Act
[10]. Wikipedia, World Com bankruptcy

After the crash of the IT market low interest rates from the Fed would fuel the mortgage and subprime bubble. For half a decade mortgage brokers seemed not to be a able to do anything wrong and they were regarded as demi-gods. By the summer of 2006, however, the bull market of the real estate industry collapsed and real estate prices dropped disastrously. And with a year's hindsight the National Bureau of Economic Research [NBER] declared December of 2007 as the beginning of the Great Recession. In that same period not by coincidence Bank of America acquired Countrywide Financial, the market leader in subprime mortgage arrangement. Mid-March of 2008 the venerable investment bank Bear Stearns is bailed out by the Fed. In early September '08 Fannie Mae and Freddie Mac, the public private housing and mortgage companies, have to be put into receivership by the U.S. government. Mid September Lehman Bros. goes bankrupt, the largest such failure in the financial history of the U.S. if not the world. Towards the end of September in short succession first A.I.G., the "largest insurance company in the world" has to be bailed out with tax-payers dollars with an amount upward of 1 trillion dollars, followed by Washington Mutual's bankruptcy and successive acquisition by Morgan Chase, the "largest banking failure in U.S. history". We are here witnessing a race to the bottom of negative records that find no parallel in other countries or historic periods. Wachovia needs to be bailed out and is auctioned of to Citigroup "in a forced marriage". Later Citigroup in turn is largely taken over by the government. Warren Buffet appears on Charlie Rose and declares an "economic Pearl Harbor requiring action by Congress". Lowenstein speaks of that supremely devastating period as follows: "The U.S. was compelled to socialize lending and mortgage risk, and the ownership of banks on a scale that would have made Lenin smile."[11]

"The devourer devouring is getting devoured," is the way such processes are described in the Rig Veda, one of the oldest scriptures extant that in its oral tradition goes back some twenty millenniums. If there is nothing new under the sun, this mechanism is a vicious circle we certainly want to stop repeating.

In October '08 the Senate approves of the Troubled Asset Relief Program, a.k.a. TARP that would ultimate encompass over a trillion dollar. In November the U.S. Treasury and

[11] . R. Lowenstein, *The End of Wall Street*, New York, 2011, Introduction, p. XXII, the chronology of events is largely taken from Lowenstein and Wikipedia

the Fed force Bank of America to acquire an insolvent Merrill Lynch. Before the end of the year GM and Chrysler file for bankruptcy protection, now only the "fourth largest in the U.S. behind Lehman, WaMu and World Com", the usual suspects already discussed. As the U.S. without General Motors appear like Paris without the Eiffel Tower or Egypt without the Pyramids both companies are then bailed out with more tax payers dollars "one of the last acts of the G.W. Bush presidency." In March of 2009 the Dow Jones at 6,547 drops to a twelve year low with banking stock dropping 88 % and general stock 57 %, "the worst slide since the Hoover market in 1929 – 32". One fourth of subprime holders become "seriously delinquent". By the fall of 2009 government spending accounts for 26 % of the entire U.S. economy its biggest share in 60 years, it continues to provide financing for nine out of ten homes and it is actively overseeing GM, the biggest car company, AIG, the biggest insurer, Citigroup, the second biggest bank, and Fannie Mae and Freddie Mac, the "bulwarks of the mortgage industry". Throughout 2009 15 million families owe more than their homes are worth. From 2007 till today – summer 2011 – the financial sector has shed close to 700,000 jobs.

These are, in effect dizzying precipitations of event which have slowed down, but they have not come to a full stop. Although the analysts have declared the Great Recession officially over in the summer of 2009, the jobless rate is still at a record historic high and the homeowner delinquency continues nearly unabated. The Soviet system based on a command economy planned five years in advance has proven fallacious and practically untenable in 1989. The Russian successor state promptly went into state bankruptcy not a decade later, and all heavily state-interventionist models have been toned down if not entirely phased out for decades. Keynesianism and neo-Keynesianism was dead and monetarism and market fundamentalism reigned supreme. With the Great Recession that began in 2007 that is also alternatively called the Big Credit Crunch or the Global Financial Crisis the pendulum may not swing back to command economics or systemic state interventionism as these models have proven untenable: "The collapse of the U.S. housing bubble caused the values of securities tied to U.S. real estate pricing to plummet, damaging financial institutions globally."[12]

[12] . Wikipedia, Great Recession

Other than the Dodd-Frank Act, a consumer protection act meant to end the idea that institutions may be "too big to fail", three incisive reactions to the worst global crisis in several generations need to be mentioned:

- The Stiglitz Report
- The Angelides Report
- The Levin-Coburn Report

The most academic of the three is the Stiglitz Report. Set up by the French President Sarkozy, it analyses indicators like the Gross Domestic Product [GDP], and makes recommendations as to such indicators needing to be replaced by other more comprehensive measures that include quality of life, life style and other areas of the human socio-economic experience. The Stiglitz Report proses the Adjusted Net Savings [ANS] indicator to replace the outmoded GDP concept. It operates with the notion of 'human capital' which from a resources-based station point and from the perspective of Georgist theory highly problematic in itself. Another issue is its attempt at universal monetization of every aspect of life. On the positive side it would provide tools to measure progress in more integral and comprehensive way than has been provided by customary mainstream indicators. Jared Diamond, the antrhopologist, has developed a consumption factor model that would do away with many of the reductionist, quantitative biases encoded in the GDP analysis. As this report is being discussed in depth by two panels at this conference I will not dwell on it. Suffice it to say that Stiglitz, with Krugman, after the demise of J. K. Galbraith, has become one of the most lucid, erudite, and eloquent torch bearers of the neo-Keynesian paradigm. Therein lies both his strength and his weakness.

The Angelides Report has been popularized in a preliminary version by the financial bestseller by Bethany McLean and Joe Nocera, *All the Devils are Out*, and it is praiseworthy in looking for culprits of the financial crisis. It is also modelled on the Pecora Commision which in the early thirties investigates the causes of the Great Crash of 1929. It is too early to say to what extent it may or may not be successful.

The Levin-Coburn Report, on the other hand, appears as the most weighty and politically substantial of the three. It may also become the most far reaching. It states clearly: "that the crisis [of 2007 – 2011] was not a natural disaster, but the result of high risk, complex

financial products; undisclosed conflicts of interest, and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street. Concluding a two-year bipartisan investigation, Senator Carl Levin, D-Michigan, and Senator Tom Coburn M.D., R-Oklahoma., Chairman and Ranking Republican on the Senate Permanent Subcommittee on Investigations, released a 635 page report on their inquiry into key causes of the financial crisis. "Using emails, memos and other internal documents, this report tells the inside story of an economic assault that cost millions of Americans their jobs and homes, while wiping out investors, good businesses, and markets," said Levin. "High risk lending, regulatory failures, inflated credit ratings, and Wall Street firms engaging in massive conflicts of interest, contaminated the U.S. financial system with toxic mortgages and undermined public trust in U.S. markets. Using their own words in documents subpoenaed by the Subcommittee, the report discloses how financial firms deliberately took advantage of their clients and investors, how credit rating agencies assigned AAA ratings to high risk securities, and how regulators sat on their hands instead of reining in the unsafe and unsound practices all around them. Rampant conflicts of interest are the threads that run through every chapter of this sordid story." The Levin-Coburn report expands on evidence gathered at four Subcommittee hearings in April 2010, examining four aspects of the crisis through detailed case studies: high-risk mortgage lending, using the case of Washington Mutual Bank, a $300 billion thrift that became the largest bank failure in U.S. history; regulatory inaction, focusing on the Office of Thrift Supervision's failed oversight of Washington Mutual; inflated credit ratings that misled investors, examining the actions of the nation's two largest credit rating agencies, Moody's and Standard & Poor's; and the role played by investment banks, focusing primarily on Goldman Sachs, creating and selling structured finance products that foisted billions of dollars of losses on investors, while the bank itself profited from betting against the mortgage market.

It remains to be seen whether these reports shall have the last words on the crisis. More crucial, however, is that action needs to be taken that such global financial pyramid schemes will remain outlawed in the future. The survival of humanity, indeed, depends on such action.