

Post-crisis perspective: sorting out money and credit and why they matter!

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Introduction

The Queen of England, on a visit to the London School of Economics in November 2008, asked a poignant question: “Why did no one see it coming?” Fortunately, some economists did (Bezemer 2009), though their views were mostly ignored, given that they operate outside the mainstream (neoclassical) framework. As for neoclassical economists, they missed the crisis by design, given that they view finance (banking, money and credit) as a “veil” that does not impact real economic activity.² In other words, the most important crisis since the Great Depression fell outside the purview of their models; it was a “black swan.”

The failure of mainstream neoclassical economics to integrate crisis speaks to the framework’s ideological fixation with stability and general equilibrium models.³ In response to the failure of the (Dynamic Stochastic General Equilibrium) models to predict the crisis, Robert Lucas (2009), the doyen of mainstream economists, founder of micro-foundations for macroeconomics, winner of the 1995 Nobel Prize for economics and a former president of the American Economic Association, wrote the following in the *Economist*:⁴

“The charge is that the forecasting model failed to predict the events of September 2008. Yet, the simulations were not presented as an assurance that no crisis would occur, but as a forecast of what could be expected conditioned on a crisis not occurring.”

Andrew Haldane (2016), Chief Economist at the Bank of England, responded as follows to the comment from Lucas:

“This is no defense. Economics is important because of the cost of extreme events. Economic policy matters precisely because of these events. If our models are silent about these events, this jeopardizes the very thing that makes economics interesting and economic policy important.”

As Haldane suggests, economics can ill-afford to remain silent about extreme events, especially given their real-world consequences (rising unemployment, bankruptcies, etc.). An

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² Solow (2010).

³ Jamie Galbraith (2009) suggests that neoclassical economics has “formed a kind of Politburo” in which “no one loses face in the club, for having been wrong, and still less is anyone from the outside invited in.” Paul Romer states that “For more than three decades, macroeconomics has gone backwards.”

⁴ Robert Lucas, in his role as president of the American Economic Association, in 2003 stated that macroeconomics “central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades.” As Steve Keen (2011) writes neoclassical economists “had no idea of what was about to happen....and fundamentally.....no one but themselves to blame for their ignorance.”

alternative, more appropriate real-world approach is to integrate finance and economics and to abandon the a priori equilibrium assumption. Taking such a step will help us understand (1) why financial crises occur, and (2) what, if anything, can be done to mitigate the frequency and magnitude of these events.

The proper response to the key question raised by the Queen of England, which had much in common with the children's book, *The Emperor's New Clothes*, was that mainstream neoclassical economics failed to see it coming by design – they ignored the role of credit and asset prices. To achieve proper balance in the real world, economics and finance must be reunited.

History of capitalism: both dynamic and also unstable

Capitalism is an inherently cyclical system that periodically experiences crises. The endogenous source of this cyclicality can be attributed to risk-taking in an uncertain environment. To its credit, capitalism has generated prolific wealth creation for more than two hundred years that have resulted in improved living standards. Even the most trenchant 19th century critic of capitalism, Karl Marx, celebrated the productive achievements of capitalism. Curiously, his insights into the evolution of capitalism were far more profound (and lyrical) than the more mechanical views of well-known advocates of free markets, such as Milton Friedman and F.A. Hayek. As Marshall Berman (1982) writes in *All That Is Solid Melts into Air*, Marx praises owners of capital (“bourgeoisie”) “more powerfully and profoundly than its members have ever known how to praise themselves.”⁵

Marx (1844) writes in the *Communist Manifesto* that capital:

“...has created more massive and colossal productive forces than have all preceding generations together. Subjection of Nature's forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalization of rivers, whole populations conjured out of the ground – what earlier century had even a presentiment that such productive forces slumbered in the lap of social labor?”

The highly dynamic nature of capitalism differentiates it from previous social systems (e.g., Feudalism). Marx poetically acknowledges that capital:

“cannot exist without constantly revolutionizing the instruments of production, and thereby the relations of production, and with them the whole relations of society. All fixed, fast-frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, all new-formed ones become antiquated before they can ossify. All that is solid melts into air, all that is holy is profaned, and man is at least compelled to face with sober senses his real conditions of life, and his relations with his kind.”

⁵ Although Marx continued to be ignored by mainstream economists, his insights into the workings of the capitalist system have become more relevant in recent years, primarily given the failure of the mainstream neoclassical framework.

Marx's analysis did not end there. Marx (1844) also wanted to understand capitalism's "pathology," namely its endogenous tendency toward crises. In his words, modern capitalist society:

"...is like the sorcerer who is no longer able to control the powers of the nether world whom he has called up by his spells. There is too much civilization, too much means of subsistence, too much industry, too much commerce. The productive forces at the disposal of society no longer tend to further the development of the conditions of property."

Marx's comment that "all is solid melts into air, all that is holy is profaned" speaks to the dynamism of an **evolving** (organic) economic system where nothing is fixed. As the Irish poet, William Butler Yeats writes: "Things fall apart, the center cannot hold." Schumpeter's comment about creative-destruction looms large over the process of capitalist development. Wealth creation and instability are closely linked in capitalism, according to Marx, whose approach is entirely at odds with stability and equilibrium.

Capitalism has experienced two **major** crises over the past one hundred years, the Great Depression of 1929 and the recent global financial crisis (GFC) of 2008.⁶ The Great Depression spurred innovative government action that generated extraordinary performance during the next quarter century (1945-1970). Policies were introduced that constrained finance, supported organized labor and collective bargaining, and the creation of a strong social safety net (that included Social Security). Remarkably, this framework successfully generated stable robust real economic growth, declining inequality and financial stability, during the "Golden Age" of capitalism.

Eventually, this too faded. As real economic growth slowed, and inflation accelerated during the 1970s, businesses coalesced around changes that gradually pushed the US economic system toward a neoliberal (or free market) approach. The initial steps were taken during the Carter Administration, which cut capital gains taxes and deregulated various industries, including airlines, trucking and finance. However, neoliberal ideas became fully endowed during the Reagan Administration. Reagan adopted free market policies that included deregulation of finance, a frontal assault on organized labor, cutbacks in the social safety net, tax cuts for the wealthy and the creation of a business-friendly, deregulated environment, in short a return to the laissez-faire policies that pre-dated the Great Depression.

A key component to the economic shift was the deregulation and liberalization of financial markets. In part, this transition was driven by globalization and technological changes, but it also was based on the emerging ideological belief in efficient markets. Basically, mainstream economists ignored financial markets, choosing to treat them as another sector in the economy, based on a belief that they could regulate themselves. The unbridling of financial markets led to the buildup of credit and asset prices in a series of financial (boom-bust) cycles that ultimately culminated in the disastrous collapse of 2007-2009. The failure to understand the real-world implications of decision-making have imposed disastrous consequences on most Americans that have become quite clear since the global financial crisis struck in 2007-2009.

⁶ Smaller crises have occurred as well, including the stock market crash in October 1987, banking/thrift crisis in 1990-1991, numerous crises in emerging markets, Long-Term Capital Management, the tech bubble in 2001, etc. The focus in this article is on the two major crises.

Finance: need to understand banking, money and credit

To explore the origins of the global financial crisis, the first step is to specify the relationship between banking, money and credit. According to the mainstream view, a bank serves as an intermediary between a borrower and a lender. As a pure intermediary, a bank has no impact on real economic activity. This view – taught in most Economics 101 textbooks – implicitly assumes that **money is available in finite quantities that are regulated by the central bank**.

Several years ago, Paul Krugman and Steve Keen engaged in an enlightening back-and-forth about banking, money and credit. The discussion examined whether banks lend existing money (implying money is neutral) or newly create the money they lend (money is not neutral).

Economist	Category	Result
Krugman (2012)	Money is neutral	Banks lend already existing money
Keen (2011, 2017)	Money is not neutral	Banks newly create the money they lend

In support of neutral money (mainstream view), Krugman (2012) casually asserts:

“Think of it this way: when debt is rising, it’s not the economy, as a whole borrowing more money. It is rather, a case of less patient people – people who, for whatever reason want to spend sooner rather than later – borrowing from more patient people.”

Krugman notes that banks lend existing money as intermediaries between borrowers and savers. In other words, a bank must have \$100 in deposits before it can make a loan for \$100. Deposits create credit (or a bank liability is needed for a bank to create an asset). This view asserts that money is neutral and can be ignored, as it has no relevance for real economic activity. This view seems to be intuitive, in fact almost obvious; after all, if I do not have \$10, I cannot lend it to you.

Conversely, Keen (2011) argued that banks newly create the money they lend. If true, this suggests that money creation impacts real economic activity and is not neutral. But how does a bank “create” money? **When a bank makes a loan, it simultaneously creates a deposit (which is money) for the borrower in an identical amount.**⁷ For example, if I borrow \$10,000 from my bank, the bank creates a deposit account in my name with \$10,000 in it. In creating credit, a bank necessarily creates a deposit and thus, money. This is how double-entry bookkeeping works. Loans create deposits.

According to Richard Werner (2012), more than 95% of all money created in the US and UK is a direct result of credit creation by banks. When a bank creates credit, it also creates money. Post-Keynesians have been making this argument for more than three decades, though few have listened (e.g., Basil Moore was an early proponent) and this view was recently affirmed by the Bank of England (McLeay 2014a and 2014b): “Whenever a bank

⁷ Keen (2011 and 2017) and Werner (1995, 1997 and 2012).

makes a loan it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money." Yet, despite the factual basis of this claim, it has been ignored by neoclassical economists, given their attachment to equilibrium analysis.

Banks are authorized to create credit, ex nihilo ("out of nothing") so credit (money) cannot be neutral. **In creating credit, a bank creates money that a borrower uses to purchase goods and services that add to aggregate demand and economic growth.** Banks are not limited to acting only as intermediaries that move money from savers to borrowers.⁸ Importantly, banks also determine **how credit and money are allocated. In the real-world, money creation distinguishes banks from other financial intermediaries (e.g., shadow banks) that can extend credit but do not possess the authority to create money.** Within the financial sector, only banks are granted this authority. Money is a form of credit, an obligation to pay. In Werner's (2012) words, "banks are the creators of the money supply" and "this is the missing link that causes credit rationing to have macroeconomic consequences." In short, finance (banking, money and credit) matter!

Transition from flattened to unbridled finance

The government response to fixing the financial system during the Great Depression was comprehensive. Policymakers adopted a framework that successfully constrained excessive credit growth and protected financial stability. These policies worked remarkably well for more than three decades. For example, the passage of the Glass-Steagall Act (Banking Act of 1933) regulated interest rates that banks and thrifts could pay on deposits (Regulation Q); fragmented permissible activities for various financial institutions; separated investment banking from commercial banking; and created deposit insurance for small bank depositors.

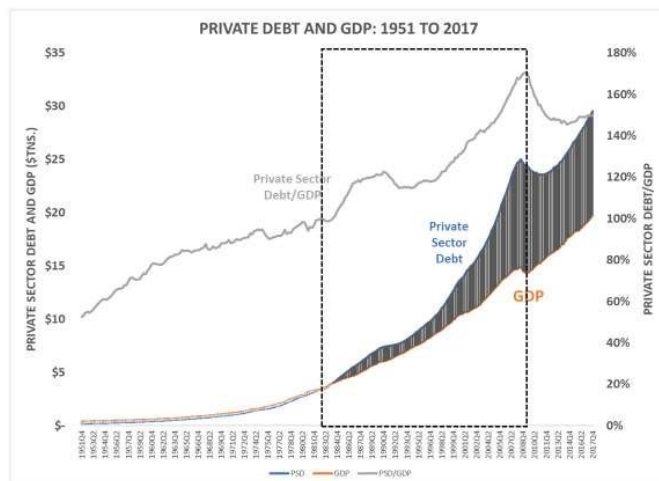
These policies constrained finance and successfully protected the US economy from excessive credit creation, asset price bubbles and boom-bust cycles as banks and other financial market participants focused on supporting the real economy. However, as growth slowed during the 1970s, debate commenced about whether to remove these constraints, given rising volatility. There was little consensus and no action was taken. Then, in 1980 Congress passed legislation that eliminated restrictions on interest rates paid by depository institutions, allowing banks to compete for business. The expectation among policymakers and financial regulators was that the price mechanism would ration credit in place of the quantitative restrictions (Regulation Q) that were then being eliminated.⁹

The chart below illustrates the shift that occurred as financial markets were deregulated and liberalized. During the postwar period (1945-1980), growth in credit was tightly correlated with GDP growth. The two increased in parallel, given that newly created credit generally targeted the production of goods and services (real economic activity). In this early phase, real economic growth drove credit creation and a repressed banking system was held subservient to the needs of productive capital.

⁸ Mainstream economics continues to assert that credit and money are neutral and do not impact real economic activity. Neoclassical economists have good reason to be defensive. Given the structure of their models, dropping the neutral money assumption will result in an indeterminate outcome.

⁹ The lessons from the Great Depression had been long forgotten by 1980 as the "turn toward markets" unfolded, driven mostly by corporate interests and right wing ideologues. In the words of Mark Twain, "history does not repeat itself, but it often rhymes."

As constraints on credit growth were lifted during the 1980s and 1990s, private sector credit surged relative to GDP. From 1980 to 2007, household debt more than doubled relative to GDP, increasing from 47% to 99%; in nominal terms, it increased from \$1.6 trillion to \$14.4 trillion.



Productive versus financial uses of credit

In addition to the explosive growth in credit, the manner in which credit was deployed also shifted toward financing transaction in housing and other assets (e.g., equities, bonds, et al). As noted above, up until the early 1980s, credit was used mostly to finance production of goods and services. Growth in credit from 1945 to 1980 was closely linked with growth in incomes. The incomes that were generated were then used to amortize and eventually extinguish the debt. This represented a healthy use of debt; it increased incomes and introduced negligible financial fragility.

However, as constraints were lifted, credit creation shifted toward asset-based transactions (e.g., real estate, equities bonds, etc.). This transition was also fueled by the record-high (double-digit) interest rates in the early 1980s and the relatively low risk-adjusted returns on productive capital. The expansion of credit lifted asset prices, fueling creation of more credit. Over time, financial innovations, including securitization and derivative instruments, also contributed to the explosive growth in trading activities that accompanied asset price appreciation.

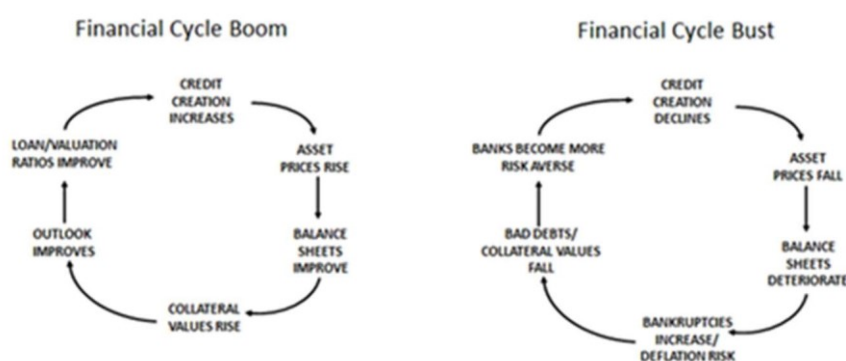
IMPACT OF DEREGULATION AND LIBERALIZATION		
	PRE-1980	POST-1980
CREDIT GROWTH/GDP	STABLE	RISING
USE OF CREDIT	PRODUCTIVE	SPECULATIVE
IMPACT ON STABILITY	FINANCIAL STABILITY	FINANCIAL INSTABILITY

Unlike credit allocated to the production of goods and services, a decision to allocate credit to finance transactions in already existing assets (e.g., home mortgages) does **not** increase

value-added or GDP (wealth-effects aside). As the *International Currency Review* stated in December 1987:

“Financial markets are quite special. They are subject to particular sources of instability that are not well understood and that have much more to do with the psychology of crowd behavior than with the behavior of goods markets. This kind of latent instability does not affect product markets at all.”

Positive feedbacks between credit growth and asset prices during the neoliberal era is illustrated in the stylized boom-bust cycle description below. The full scope of these relationships reflects the role of “crowd psychology” in unconstrained (self-regulating) financial markets. Ultimately, this process is not sustainable, as “trees do not grow to the sky.” When this process unwinds, it can trigger a severe financial crisis.

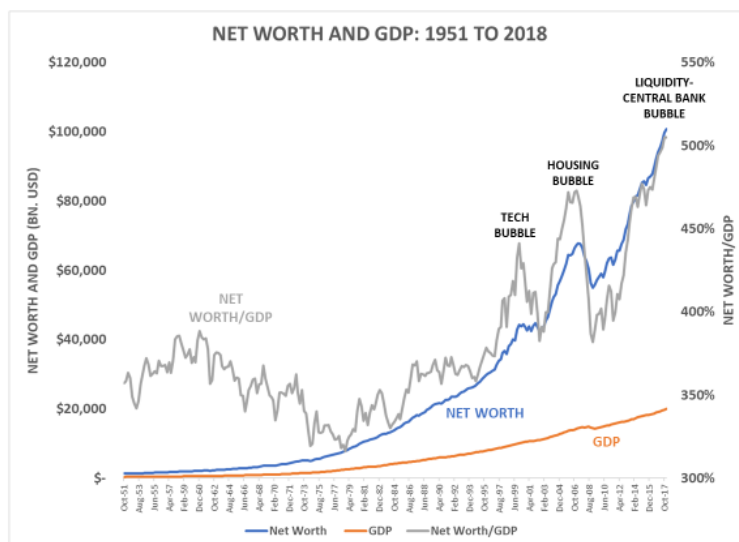


Financial deregulation and the shift to neoliberal policies spurred financial cycles that previously were dormant throughout the postwar era (1945-1980). Importantly, asset price appreciation does not result in creation of value. If the price of an asset increases, the gains to the seller are offset by the increased cost to the buyer. For example, if Susan makes a \$40,000 profit on the sale of her house, the purchaser must pay the higher price. A financial transaction necessarily has both a buyer and a seller. If the price of the house rises, the seller benefits, but the buyer pays the higher price. From a wealth creation perspective, this transaction is necessarily **zero-sum** (negative-sum, once fees are included). **In brief, wealth has been redistributed, not created.** This distinction between wealth creation and wealth distribution is at the heart of financial crises, given that credit-induced asset price booms ultimately are not sustainable (though admittedly, the precise timing of the reversal is highly uncertain, given what Keynes properly described as “animal spirits.”).

From 1980 to 2007, rapid credit growth primarily fueled transactions in already existing assets (mostly real estate), not real productive growth.¹⁰ In addition to extensive lending to households during this period, lending by financial firms to other financial firms increased from \$0.5 trillion in 1980 to more than \$18 trillion in 2008, or from 20% to 123% of GDP. This activity reflected the securitization process and the growth of extensive inter-connections between financial institutions that heightened systemic risk.

¹⁰ The Quantity Theory of Money implicitly assumed that credit is deployed only to support production of goods and services. However, from the early 1980 to 2007, and even more so from 2000 to 2007, most credit targeted the financial circuit, or the Finance, Real Estate and Insurance (FIRE) sector. This distinction explains the reasons for the decline in velocity that began during the 1980s. For more see Werner (2012).

The easing of quantitative restrictions on credit creation powered positive feedbacks between credit growth and asset price appreciation that fueled serial boom-bust cycles between the late-1980s and 2007. Household net worth increased from \$9 trillion (1980) to close to \$68 trillion in 2007, before falling to \$55 trillion during the GFC. In response to the liquidity-induced QE-bubble engineered by the Fed and other central bank since the crisis ended, US household net worth today stands at a record \$101 trillion (505% of GDP).



Category error: money and credit are different

The decision to deregulate and liberalize finance effectively treated finance as another sector in the economy. However, this view ignored what differentiates banks from other sectors in the economy. **Banks create money** with distinct social consequences that differentiate them from other sectors in the economy. A decision by the banking system not to extend credit in uncertain times can have untoward consequences for asset prices and/or economic activity; conversely, a decision to expand credit can fuel inflation in goods and services or in asset prices.

The application of “free market” rules to banks introduced positive feedbacks between credit growth and asset price appreciation that over the past century have twice culminated in major crises. Once unbridled, credit creation feeds asset price appreciation which in turn results in creation of still more credit. Banks and other financial institutions benefit, as profits accelerate with rising asset prices, until the process can no longer be sustained, perhaps because interest rates rise, asset prices peak, expectations shift, et al. As the process reverses, only intervention by the government is capable of restoring stability to the financial system. A failure of the public sector to act can trigger a debt-deflation depression. This underscores events leading up to the depressions in 1929 and again in 2008.

Importantly, the decision by government to enact policies that “flattened” finance during the Great Depression acknowledged this reality. The extraordinary economic performance that followed during subsequent decades included rapid real economic growth, declining income inequality and financial stability. As Adair Turner (2015) notes, even the free market economist, Henry Simons, a co-founder of the conservative Chicago School, stated

that application of “free markets” to money and credit was a “category error.” Given the social nature of money, **finance must be treated differently. In other words, flattening finance and targeting it toward production of goods and services is a prudent policy.**

The powerful ideological aversion to government intervention that has been dominant in the US over the past thirty-five years has resulted in the unfortunate creation of an enormous infrastructure of ideological support for free, deregulated financial markets. (e.g., Efficient Markets, Rational Expectations, Modern Portfolio Theory, CAPM, Black-Scholes, etc.). Much of this has emanated from the free market Chicago School. This highly ideological view asserts that government intervention is unnecessary and often disrupts optimal market outcomes. It hides its ideological roots behind the supposed virtues of “economic science” that appears natural (invisible hand). However, ultimately what has been created is a political framework that largely benefits those that have previously benefited from the economic system (Balder 2018). Some critics of government intervention have improperly (absurdly) blamed the 2008 crisis on government intervention (e.g., the Community Reinvestment Act and/or Government Sponsored Enterprises).

However, when financial markets collapsed in 2008, the government stepped in to stabilize conditions. This intervention was nowhere near as comprehensive and far-reaching as the policies put in place during the Great Depression, which put workers first. The initial decision to stabilize the financial system in 2008 was prudent, though arguably many of the largest US banks should have been nationalized. No one went to jail, other than Bernie Madoff. The failure to place constraints on the activities of these institutions or to address the underwater mortgages held by many middle-class families has left the US financial system susceptible (once again) to the excesses of financialization.

The global financial crisis

During the early 2000s, the real estate “wealth-effect” sustained aggregate demand and corporate profits, as the bottom 90% of households borrowed (against their home equity) to supplement declining incomes. These activities fueled the upward movement in asset prices and generated rising profits for financial institutions. The securitization of these loans in turn created additional trading opportunities that generated still more profitability for the financial sector. Profits for the financial sector peaked at 40% of overall corporate profits in 2001-2002, having more than doubled from levels during the 1950s and 1960s. From 2000 to 2006, real estate lending accounted for more than 84% of overall net lending to households, as housing prices nearly doubled.

The Fed adopted an increasingly asymmetric monetary policy during the late-1990s and early 2000s, leaving markets alone as asset prices appreciated (faith in the “free market”). However, when conditions deteriorated, the Fed intervened, lowering rates and injecting liquidity (if needed). As the Fed adapted to unbridled financial markets, investors increased risk-taking. Fed policy was labeled the “Greenspan Put,” which provided investors with an adjustable floor on asset prices. As stock prices rose, so did the floor value of the “put,” which spurred investors to increase risk-taking and leverage.¹¹

¹¹ Curiously, the Fed lowered short-term interest rates to a 45-year low of 1% in June 2003, which fueled the housing bubble despite evidence that the economy was recovering from the tech bubble.

The Fed could have utilized a symmetric policy, either tightening and easing when conditions warranted, or leaving markets to determine the proper valuations. Instead, its framework boosted risk-taking and helped fuel excessive credit growth and over valued asset prices. It was the Fed's primary responsibility to maintain financial stability; that was the principle reason for the creation of the Fed in 1913. The decision to deregulate and liberalize financial markets made the Fed's job more difficult. Arguably, the shift toward an asymmetric approach, though regrettable, might have been inevitable, given emergent pressures from policymakers and investors.

In any case the Fed's approach certainly was not what former Fed Chair William McChesney Martin had in mind when he stated that the Fed's job is to "remove the punch bowl just as the party gets going." The Fed learned in March 1997 that raising short-term rates to stem a bubble could have serious political consequences (that might have jeopardized its so-called independence). Although the Fed might have thought itself independent from government, it clearly was not independent of the financial community. In addition, the "Washington Consensus" (efficient markets, etc.) dominated policymakers and regulators, who failed to understand (as Hyman Minsky and others operating outside the mainstream framework did) the impact of deregulation on market structure and behavior.

The Fed also had access to other tools, including margin requirements on stock transactions and loan-to-value (LTV) ratios for real estate. Utilizing these tools would likely have triggered pressures from market participants and policymakers. Selective credit controls, while sensible, were a non-starter as asset prices appreciated. The potential downside to the Fed taking these actions (raising interest rates or deploying credit controls) dwarfed any potential upside, especially given that asset price inflation (unlike inflation in goods and services) were viewed by investors as capital gains (and thus, income).

It seems unlikely that the Fed will take decisive actions to constrain boom-bust cycles, especially given pressures from market participants and its own concerns about protecting its so-called "independence." The failure to fragment and compartmentalize financial organizations during the debate about Dodd-Frank, as occurred following the Pecora Hearings with the passage of the Banking Act of 1933, et al, was unfortunate, and all but ensures that another crisis will follow. Despite the starring role played by banks and other financial institutions in the GFC, the pressures placed by the financial lobby and the out-of-power party (Republicans) make it remarkable that any legislation was adopted. In any case, the next round of major reforms will need to focus on fixing the structure of financial markets (and not regulation).

Post-crisis recovery: 2010 to today

The global financial crisis had much in common with the Great Depression during the 1930s. As market liquidity dried up in 2008, highly leveraged financial institutions were paralyzed, and asset values and GDP collapsed.¹² Given declining credit quality, opacity (no one knew where the exposures were nor how exposed a counterparty might be) and the erosion of trust, access to the inter-bank market dried up. Massive leverage and inter-connectedness between

¹² The bankruptcy of Lehman Brothers alone did not cause the crisis though it had severe knock-on effects on AIG, money markets, commercial paper, etc. As Kay (2015) notes Lehman was not a consequential institution, though it was "too inter-connected to fail." It was not important, but it was systemically important.

large financial institutions (banks and shadow banks) created enormous potential counterparty risk that deepened the crisis. Only the colossal intervention by the Fed and US Government were capable of stabilizing the financial system (e.g., AIG, Citicorp, money markets, commercial paper markets, etc.).¹³

The policy response to the GFC by the US Government and Federal Reserve successfully staved off another Great Depression, though losses to middle-class households were significant (including declines of 44% of net worth from 2007-2010). The consequences of the Great Depression (including declines of one-third of GDP and 25% unemployment) were largely attributable to the reticence of President Hoover to utilize fiscal spending to stabilize the economic system. In 1932, the government created the Reconstruction Finance Corporation (RFC), to help stabilize the faltering financial system, though it was “too little, too late.”

Remarkably, Marriner Eccles, a banker from the State of Utah, who would subsequently become the Chair of the Fed, was the only witness in a list of more than 200 who opposed budget balance in a hearing before the Senate Finance Committee in February 1933. Eccles recommended massive public sector spending to address the imbalances between production and spending.¹⁴ The Roosevelt Administration, which assumed office one month after Eccles testimony, though initially reticent not to balance the budget, subsequently created the New Deal that laid the groundwork for robust economic growth after the Second World War.

In contrast with the success of US economic activity during the Golden Age, the actions taken by the US Government and the Federal Reserve in response to the more recent global financial crisis have resulted in weak growth for several reasons.

- First, the decision not to provide debt relief to middle-class homeowners with underwater mortgage debt has slowed growth in aggregate demand and GDP.¹⁵
- Second, the shift in corporate governance toward shareholder value maximization has pressured and incentivized CEOs to utilize earnings to make payoffs to shareholders (via share buybacks and dividend payments. These have reduced productive growth, wages, R&D, etc.¹⁶
- Third, implementation of Quantitative Easing (QE) policies have created liquidity that has boosted stock prices, benefiting the wealthiest households (the top 10% who own 90% of all financial assets), while doing very little for real economic growth, wages, investments, etc. Very little of this money has been invested in productive activity that benefits US workers.

The failure to make greater use of fiscal policies to provide debt relief to middle-class households and invest in infrastructure has resulted in slow growth over the past decade at a cost to the bottom 90% of US households. The policy framework that has been in place for much of the past 35-years has mostly benefited the wealthiest US households. This is readily

¹³ See Haldane (2010) and Bookstaber (2017) for a more detailed treatment of systemic risks and the financial network.

¹⁴ Senate Committee on Finance (1933). Eccles analysis of the causes of the Great Depression preceded Keynes' publication of *The General Theory* by three years. Eccles awareness of the impact of the distorted distribution of income on aggregate demand and real economic growth was prescient.

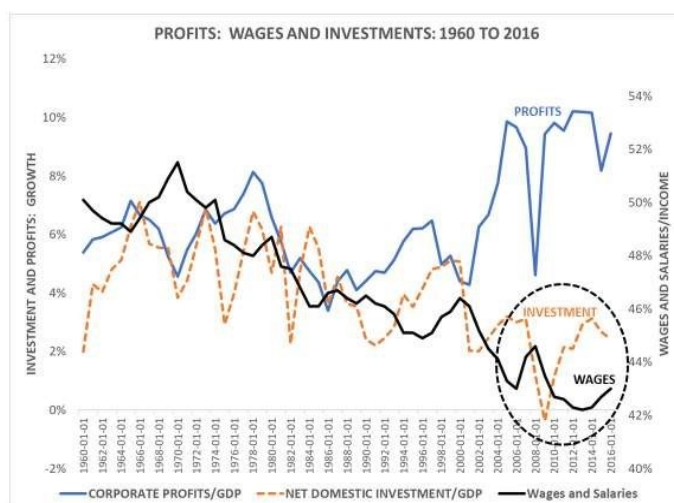
¹⁵ Main and Sufi (2014).

¹⁶ John Kay (2015) states: “The belief that the profitability of an activity is a measure of its social legitimacy has not only taken root in the financial sector but has spread its poison throughout the business world.” Lazonick (2015) has provided extensive detail about this important topic.

apparent in the redistribution of income and wealth that has been presented by Piketty, et al (2018).

The tax cuts engineered by Reagan, Bush II and Trump also have benefited the wealthiest households. In lieu of tax payments to the government, these households often own the government debt that has been issued to cover the shortfalls. In lieu of a liability to the IRS, these households now possess an income-earning asset, the interest of which is paid by the USG. And the evidence is quite clear that very little of these tax cuts are invested by households in new productive activities – most simply find their way into the financial markets, further boosting asset prices.

Another perspective is to examine the divergence between rising corporate profits and falling investment, wages and salaries throughout the current recovery. **Ironically, profits are at record levels and have been throughout the current recovery, despite weak growth in investment and real economic activity.** This points to the persistence of financialization – the stock market has continued to soar while wages and investment (and real economic growth) are in the doldrums – but for how long can this pattern be sustained?



Conclusion

The adoption of neoliberal policies, including the deregulation and liberalization of finance, has benefited the wealthiest segments of society at the expense of the bottom 90% of households.¹⁷ There is a need to balance market outcomes so that they better impact the bottom 90% of households, who have paid a significant price over the past 35 years as income and wealth have been redistributed to the top 10% of households.¹⁸

Financial policies should be adopted that simplify, flatten and reconnect finance with real economic needs, including job creation, increased wages, investments, infrastructure, R&D, etc. Buybacks of shares by non-financial corporations (under SEC Rule 10b-18) should be eliminated. Permissible activities for financial institutions should be fragmented, much as they were during the Great Depression. A Tobin Tax on financial

¹⁷ Balder (2018).

¹⁸ Piketty, et al (2018).

transactions should be administered with the revenues utilized to support a Marshall Plan to rebuild decaying infrastructure.

Tax policies should be revamped to reverse the excessively generous treatment of the wealthiest segments of US society, including income and estate taxes. Taxes on capital gains (and “carried interest” should be equalized with income taxes. **The belief that the wealthy invest the funds from their reduced taxes in productive activity is mythical – mostly, they spur speculation (and rising asset prices), not investment!** The fact that the top 0.1% of US households now own as much wealth as the bottom 90% is not a healthy condition for a democracy. The notion that the wealthy engage in philanthropy to offset their advantaged situation may be well-intentioned but undermines the role of government and establishes an unhealthy relationship between donors and recipients.¹⁹

These agenda items comprise a wish-list that is clearly not acceptable in the current political environment. Is another major financial crisis required before proper measures to balance the needs of the bottom 90% can be considered? Is the current emergence of populism a “canary in the coal mine”? The current-day reality, the role of lobbyists, Citizen’s United versus FED, Janus versus AFSCME, et al, makes this shift appear inconceivable. So why write now?

A parallel exists with the early 20th century that provides some grounds for optimism. The formation of the Progressive Party during the early 1900s formulated policies that similarly were not initially acceptable, given opposition from a laissez-faire government and eventually the Supreme Court (sound familiar?). However, the framework continued to evolve and eventually, during the Great Depression, much of it was implemented providing remarkable benefits to workers who had been ignored during the early decades of the 20th century.

In any case, continuing down the current neoliberal (laissez-faire) path cannot end well. Another major financial crisis (potentially more devastating than in 2008, albeit with different causes) could well energize even more virulent populist forces. The next generation and the generations after that should demand changes that include a more “just” government as a countervailing force to neoliberalism and free markets.

Neoliberal policies have contributed to the polarization of income and wealth. Sadly, the financial industry that has been a chief beneficiary has successfully bamboozled people into thinking that their current activities are essential for economic growth (“God’s work” in the words of Goldman Sachs CEO Lloyd Blankfein). Despite the devastating crisis in 2008, nothing has been done to constrain finance from continuing to operate in its own self-referential world, “trading with itself, talking to itself and judging itself by performance criteria it has generated.”²⁰

Hopefully the next generation, which has already faced a very difficult road, will recognize that people make their own history – FDR’s New Deal provided a turning point in capitalism toward a blend of markets and community that benefited the middle-class, while constraining finance. Lessons from the recent teacher protests against massive cutbacks in educational funding in the states of Oklahoma, West Virginia, Arizona, et al attest to the strength of movements that emanate from the bottom-up with broader societal interests in mind.

¹⁹ Anand Giridiharadas (2018) makes a powerful, compelling, contrarian argument about the role of philanthropy.

²⁰ Kay (2015).

Alternatively, if the system does not adapt, capitalism may well confirm Marx's vision and bring about its own demise. Fortunately, alternative approaches are readily available, if only the political will exists.

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