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Wall Street and the Politics of Finance

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In the early days of the Obama administration there was an opportunity, at least in theory, to reconsider the role of finance in Western economies. The financial part of the economic crisis that the banks created left them vulnerable and dependent on visible public support. And while Mr. Obama came relatively late to this history, his decision to wholly revive finance capitalism will haunt the economies of the West until banks are returned to their useful social function as utilities.

Public anger over outsized paychecks, predatory practices and freedom from liability for several decades of straightforwardly criminal behavior aside, banks and the debt based economy they produce force the most destructive elements of capitalism onto a fragile world. Ironically, finance capitalism produces monumental wealth redistribution, the great boogieman of capitalist economists, and serves to justify acts of human and environmental devastation that, when viewed on their own, are quite obviously insane. And while this tendency can be attributed to capitalism in general, financial leverage adds a structural element to economic production that amplifies the worst tendencies of capitalism. The existing system of global finance must be gotten out of the way before less destructive modes of economic life are possible.

Andrew Haldane of the Bank of England has pulled together a critique of Western economics that is one step in the direction of understanding what banks have wrought. A central point in Mr. Haldane's thesis is that economists in the West have simply forgotten what was formerly known about the role of bank money creation in structuring the broader economy. Economist Mike Hudson knows this history and has gone a long way toward recovering it and adding new insights. Likewise Steve Keen (Primer on Endogenous Money) has taken the heat for formalizing what thoughtful economists understood in a general sense a century ago. But ultimately economics is only a framework for understanding the material facts that must be addressed.

A purposefully irrelevant discourse has surrounded wealth distribution in capitalist economies for eons. Most people don't consider banks to distribute, and redistribute, wealth, but they do. An intuitive understanding of this can be got to as follows—banks create money by making loans. (Mr. Keen provides the most straightforward explanation of the mechanics in his Primer, link above). When banks were heavily regulated, bankers earned regular bourgeois livings. When banks were deregulated, suddenly bankers had all of the money for themselves. They accomplished this (1) by creating a whole lot more money than they previously had (Haldane) and (2) by creating 'innovations' like securitization and off-balance sheet financial garbage dumps like SIVs (Structured Investment Vehicles) that allowed bankers to keep more of the money that they created.

The structural problems created by debt based money are (1) debt shifts real wealth from borrowers (labor) to lenders (financiers) and (2) this system is intrinsically unstable and ultimately, economically destabilizing. As Mr. Hudson argues, bank loans are predominately used to buy existing assets like houses and stocks and bonds rather than to invest in economic production. With mortgage loans in particular, rising debt inflates house prices, in turn requiring borrowers to commit ever-greater proportions of their future economic production to pay for them. But to fully understand how economically destructive this set of relationships is, it must first be understood how finance capitalism is economically destabilizing.

The late economist Hyman Minsky developed a range of theories around his insight that "stability is destabilizing" in an economic system with bank money creation. The theory states that during times of relative economic stability banks compete for profits by lending increasingly to marginal borrowers. In the later stages of a financial epic this leads them to make loans on the basis of rising asset values, e.g. home loans that can only be repaid while home prices continue to rise. ('Margin' loans made by Wall Street firms to their customers are behind every financial crash in modern history).

In the housing 'boom' of 1998-2006 bankers drove house prices higher by making loans to people who could only repay them if house prices continued to rise. When house prices began to decline in 2006, the gig was up and the banking system and the economy imploded. What wasn't reconciled, despite the implosion, is the banking sector's claims on future economic production. People who borrowed money to buy a house overwhelmingly still owe it against declining house prices. And 'Ponzi' finance, the term Mr. Minsky used to describe loans that can only be repaid when asset values are rising, is unambiguously 'predatory' in that bankers understand, or should understand, that incomes alone are insufficient to repay the loans.

Put another way, bankers don't care if someone borrowed $250,000 against a house that is now only worth $100,000—the loan amount to be repaid is $250,000. But because the house price has declined to $100,000, bankers can now buy two and one half of these houses for the original loan amount. And because the borrower must repay the full $250,000 plus interest and fees for a house now only worth $100,000, this represents a transfer of their future economic production to bankers of $150,000 plus interest and fees. When this is aggregated across all of the borrowers and all of the bank loans, it represents a massive transfer of wealth from the people who produce it to a group of people who have been given the right to create money at the push of a button—Wall Street.

Andrew Haldane argues that bank balance sheets across the West have expanded by the largest amount in human history in recent decades. This means banks have been making loans, and in so doing creating money, at the fastest rate in human history. In the early stages increased lending led to increased economic production fulfilling the capitalist rationale for finance capitalism. When banks were fully deregulated in the late 1990s bank lending led to financial boom-bust cycles, first in financial assets and later in housing. (S&L deregulation did the same in the 1980s). With financial profits now leading overall corporate profits higher, finance receives its largest proportion of economic 'production' in modern history (Corporate Profits as % of GDP, 2nd graph), this as the rate of overall economic growth is the weakest since the 1930s.

The residual issue not well understood by mainstream economists is the 'debt deflation' that existing debt causes because it must be repaid from declining incomes for houses that are worth less than the loan amounts against them. (Note to housing 'bulls': don't confuse policy particulars with 'natural' economic activity. Banks were forced to stop foreclosing on delinquent homeowners in 2011-2012 because they were doing so illegally. The recent 'mortgage settlement' allowed illegal foreclosures to resume with government protection). And while average incomes have been rising, median incomes continue to decline. Generally, median incomes represent the income of labor and average incomes (right tail of Pareto or 'power law' distributions) the incomes of finance.

Whatever the visceral anger toward Wall Street, the reasons why finance capitalism must be ended and banking returned to its social purpose as a utility are analytical. While financial crashes like that of 2008 are emblematic of systemic instability, it is the transfer of social wealth from labor to finance that is most socially, economically and politically destructive. The focus of official Washington on restoring the existing system as a means to restore economic vitality gets it exactly wrong. And calls to simply re-regulate the banks ignore that while the banks were regulated financial profits accrued that allowed them to buy deregulation from a compromised political system.

Finance capitalism can't be fixed because of its inherent contradictions. There is no 'natural' reason why banks, rather than public institutions, have the right to create money—that is a political outcome. And the political power of finance capitalism is more than just capture of the political system, it lies in the everyday power over the way that the world is set up—the relation between 'natural' needs like shelter, transportation, education and healthcare and the debt system used to 'buy' them that converts an increasing proportion of the product of our work to financial profits.

It is this last point that mainstream economists, liberals and most progressives don't get. By focusing attention on the nominal political system, the politics surrounding economic conditions are left hidden. The calls to 'get the money out of politics' also need to get the politics out of money. Finance capitalism, and capitalism more broadly considered, is a system of economic domination. And economic domination is political. As the saying goes, ‘economic democracy is a prerequisite for political democracy.’ And economic democracy requires institutions in the public interest.