The Newspeak of Economics

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The Revolt of the Wealthy

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.

Irrational exuberance

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?

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.

A mismatch of growth

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.

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) in loops in the financial sector. 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. However, when they are successful in this, they also need new 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.

This means that investment effects on growth and distribution can be radically different from what is 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. They create 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, the biggest source for the rising 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, instead of being paid for by taxes.[1]

Government deficits

When a government resorts to deficit financing, it often can create benefits. The question is—just as when a business borrows from the bank—will it create net gains over time? Public debt raised to finance short-term Keynesian demand stimuli, or for creating physical or social infrastructures, 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, even accepting a deficit can be vital for sustaining the economy through a rough patch.

However, if increasing debt levels persist over time it often indicates unsolved structural problems. This was the case during the Reagan - first Bush era, when stubborn, but defunct, supply-side policies created a structural mismatch between government revenues and expenditures. When real interest rates also shot up, the problem became the main cause for a regressive change in income distributions.

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 incomes 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 music stops.

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. The second goal was more subtle. 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.

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. As interest payments again begin to crowd out discretionary spending, the average American can also look forward to see his benefits from public services deteriorate. Furthermore, if the trend is not stopped, it must be followed by large-scale privatization drives of public assets. Nor will this exclude those in the health and education sectors. These will be needed to periodically refinance the broken tax system and open up new fields for capitalization that can absorb the continuing expansion of wealth at the top.

The True Agenda of Bush Policies

In the newspeak of the Bush White House, its unraveling foreign policy and self-created quagmire in Iraq is called "progress." On the economic front, the exploding deficit is termed "incredibly good news,"[2] 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: that the current government's destructive policies, both foreign and domestic, serve only the interests of a small, myopic elite, without regards for the human and economic costs.

Notes

1. Through the foreign trade deficit, this include both private foreign wealth holders and as well as sovereign wealth funds (i.e. the part of foreign governments excess dollar reserves that are put into investment funds).

2. 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