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Stop panic in the City – abolish capitalism!

October 4, 2007

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Credit crunch? Crunch capital! Why the stock market is a crazy way to organise an economy.

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What a bloody insane way to organise an economy. What other conclusion can be drawn from the panic that is sweeping the financial markets? Starting with problems in the US housing market, the credit crunch has spread across the world. A mere six months ago the chairman of the US Federal Reserve asserted that “*the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained.*” The investors in the stock markets have confirmed that he was wrong. Fears of panic are in the air.

The bubble so many denied has burst. In America, for example, the **Washington Post**'s main source on the housing market in its bubble years was David Lereah, the chief economist with the National Association of Realtors and the author of the 2005 bestseller, ***Why the Housing Boom Will Not Bust and How You Can Profit From It***. Realtors make their money selling, you guessed it, houses and land. But, then again, during the 1990s stock market bubble, the press reported uncritically similar economists who claimed that

there was no bubble and stocks would rise forever. Critics were ignored – even after events proved them right.

The reason why economists (repeatedly!) deny the possibility of bubbles lies in the neo-classical model of the economy, which assumes perfect knowledge and perfect foresight. For stock markets, this ideology goes by the name “**Efficient Market Hypothesis**” (EMH) There can be no bubbles because, by definition, they cannot exist! Of course, the awkward fact that bubbles have always existed is glossed over, supplemented by claims that *this* boom (unlike the previous ones) is **not** a bubble because of some wonderful new invention (the more “experts” go on about a never-ending boom, the more worried you should get – a crash is on its way!).

According to EMH, information is disseminated equally among all market participants, who hold similar interpretations of that information and can get access to all the credit they need at any time at the same rate. That is, everyone is considered to be identical in terms of what they know, what they can get and what they do with that knowledge and cash. This results in a theory which argues that stock markets accurately price stocks on the basis of their unknown future earnings, i.e. that these identical expectations by identical investors are correct, and so investors are able to correctly predict the future. Yet if everyone held identical opinions then there would be no trading of shares as trading obviously implies **different** opinions on how a stock will perform. Similarly, in reality investors are credit rationed, the rate of borrowing tends to rise as the amount borrowed increases and the borrowing rate normally exceeds the leading rate. The developer of the theory was honest enough to state that the “*consequence of accommodating such aspects of reality are likely to be disastrous in terms of the usefulness of the resulting theory ... The theory is in a shambles.*”

Thus the world was turned into a single person simply to provide a theory which showed that stock markets were “efficient” (i.e. accurately reflect unknown future earnings). In spite of these slight problems, the theory was accepted in the mainstream as an accu-

the “experts” will repeat their usual mantras on how wonderful the economy is doing (this being the standard – but unspoken – definition of what constitutes a good economy) and the folly of “socialism” (for anyone but the ruling class).

Two things are sure. First, the current spate of panic shows how irrational capitalism is. State aid and regulation will not solve the problems it habitually causes, only its abolition will. It could be argued that the stock market is necessary for “individual liberty” (always identified with capitalism) and so it would be wrong to abolish it. This kind of argument could, perhaps, make sense if it were not for the fact that the rest of us have to pay the costs for its speculation based on ignorance. The financial system has implications for the real economy and real people. Time to get rid of it!

Secondly, anarchism will not come about via an economic crisis but only by the direct action of those exploited and oppressed by it. Only by taking investment decisions away from “experts” and placing it in the hands of ordinary people will current generations be able to invest according to their, and future generations’, self-interest. It is hardly in our interest to have an institution whose aim is to make the wealthy even wealthier and on whose whims are dependent the lives of millions of people.

the financial leadership in the United States and the political leadership all joined in one word, one phrase. 'The fundamentals are sound.' That was, I say, repeated and repeated. Ad nauseam. But the fundamentals are sound. One hears that again on occasion today ... And my last word is – whenever anybody hears it said that the fundamentals are sound, you should have a slight sense of unease." But, then, he tried to analyse capitalism as it is rather than what it should be according to the textbooks (and was pilloried for it by the true believers).

Will there be a depression? That is always likely, particularly if the governments of the world take the rhetoric of the free-market capitalists seriously. Yet the role of the state is much larger than in the 1920s, stabilising aggregate demand. It is more than willing to solve financial woes by throwing (our!) money at them. But the market is unpredictable and the future is unknown. The current panic may spread and burst the UK housing bubble, impacting badly on consumer spending. Since the end of social Keynesianism in the 1980s, capitalism has been dependent on bubbles, military spending and personal debt to give the appearance of dynamism (in this sense, Keynesian demand management has been privatised). Profits have been high and the working class does not seem to be threatening profit margins by obvious resistance at the point of production (personal debts, after all, have to be paid – another benefit of privatising demand management along with the high interest rates!).

While trying to predict the future is a sure way to make a fool of yourself, particularly as it would amount to the banality of saying there will be a recession or not. The welfare state for the rich could fail as lots of easy credit has resulted in a level of debts which may become unserviceable while productivity growth has become sluggish. Another possibility is that capitalism will stagger on, with the panic receding (for the time being) on the back of our money the state hands out to those who like to belittle the welfare state for the many. Either way, as long as the rich are getting richer

rate reflection of finance markets. Why? Well, the implications of this theory are deeply political as it suggests that finance markets will never experience bubbles and deep slumps. That this contradicts the well-known history of the stock market was considered unimportant. Unsurprisingly, *"as time went on, more and more data turned up which was not consistent with"* the theory as the model's world *"is clearly not our world."* It *"cannot apply in a world in which investors differ in their expectations, in which the future is uncertain, and in which borrowing is rationed."* It *"should never have been given any credibility – yet instead it became an article of faith for academics in finance, and a common belief in the commercial world of finance."* (Steve Keen, **Debunking Economics**, p. 246, p. 234)

This theory is at the root of the argument that finance markets should be deregulated and as many funds as possible invested in them. While the theory may benefit the minority of share holders who own the bulk of shares and help them pressurise government policy, it is hard to see how it benefits the rest of society. Alternative, more realistic theories, argue that finance markets show endogenous instability, result in bad investment as well as reducing the overall level of investment as investors will not fund investments which are not predicted to have a sufficiently high rate of return. All of which has a large and negative impact on the real economy.

Instead, the economic profession embraced a highly unreal economic theory which has encouraged the world to indulge in stock market speculation as it argues that they do not have bubbles, booms or bursts. Perhaps this has to do the implications for economic theory for this farcical analysis of the stock market? As two economists put it: *"To reject the [EMH] for the whole stock market ... implies broadly that production decisions based on stock prices will lead to inefficient capital allocations. More generally, if the application of rational expectations theory to the virtually 'idea' conditions provided by the stock market fails, then what confidence*

can economists have in its application to other areas of economics ... ?" (quoted by Doug Henwood, **Wall Street**, p. 161) Quite!

Unsurprising, when the going gets tough the capitalists get going – to the state, asking for help. There is a bitter irony hearing calls for welfare for hedge funds from the very same people who usually urge the state get out of the way and let market forces determine everything. Just as ironic, we have the millionaires of the City, who habitually threaten to move offshore unless they can be left alone to maximise profits, now seeking the British taxpayer to help them out. But such is the nature of capitalism – market discipline for the working class, welfare for the rich.

And the central banks will intervene, under the rhetoric of saving millions of “ordinary” investors and savings. Apparently the institutions of finance capital are too important to fall – unlike, say, coal mining, ship building, and the host of other industries Thatcherism destroyed in its attempt to break working class resistance. But, of course, workers in those industries were unlikely to vote Tory, nor contribute millions to its coffers.

Ultimately, stock markets are a way for the very rich as a class to own an economy’s productive capital stock as a whole, they are a source of political power and a way to have influence over government policy. They have little positive impact on the real economy (beyond transferring and concentrating wealth from the working class to the ruling class, which is very positive for the latter!). While supporters of capitalism claim that stock exchanges mobilise funds for business, in fact between 1952 and 1997 about 92% of investment was paid for by firms’ own internal funds and so *“the stock market contributes virtually nothing to the financing of outside investment.”* Even new stock offerings only accounted for 4% of non-financial corporations capital expenditures. Worse, *“the signals emitted by the stock market are either irrelevant or harmful to real economic activity, and that the stock market itself counts little or nothing as a source of finance. Shareholders ... have no useful role.”* (Henwood, p. 72, p. 292) Ultimately, investors are not in a position

to assess the quality of the assets on a financial institution’s balance sheet. In fact, most people don’t even know what those assets are and this produces serious negative effects on the real economy.

As Henwood notes, there *“are serious communication problems between managers and shareholders.”* This is because *“[e]ven if participants are aware of an upward bias to earnings estimates [of companies], and even if they correct for it, managers would still have an incentive to try to fool the market. If you tell the truth, your accurate estimate will be marked down by a sceptical market. So, it’s entirely rational for managers to boost profits in the short term, either through accounting gimmickry or by making only investments with quick paybacks.”* So, managers *“facing a market [the stock market] that is famous for its preference for quick profits today rather than patient long-term growth have little choice but to do its bidding. Otherwise, their stock will be marked down, and the firm ripe for takeover.”* While *“[f]irms and economies can’t get richer by starving themselves”* stock market investors *“can get richer when the companies they own go hungry—at least in the short term. As for the long term, well, that’s someone else’s problem the week after next.”* (p. 171)

Ironically, this situation has a parallel with Stalinist central planning. Under that system manager of State workplaces had an incentive to lie about their capacity to the planning bureaucracy. The planner would, in turn, assume higher capacity, so harming honest managers and encouraging them to lie. This, of course, had a seriously bad impact on the economy. Unsurprisingly, the similar effects caused by capital markets on economies subject to them as just as bad, downplaying long term issues and investment in favour of short term profits for the few. And it hardly needs to be stated that capitalism results in production being skewed away from working class needs and that the “efficiency” of market allocation is highly suspect.

What now? Will the panic result in a crash? As one of the better economists of the last century, John Kenneth Galbraith, once wrote with regards the Great Depression: *“throughout the 1930s*