

Failure of the Neoclassical Mindset: Beyond Mainstream Explanations of the Financial Crisis

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Following in the footsteps of the financial big wigs at the head of the Federal Reserve Bank (Alan Greenspan, followed by Ben Bernanke), most mainstream neoclassical economists optimistically projected that the 2002-07 financial expansion would continue indefinitely. Not surprisingly, the 2008 market collapse caught them by a huge surprise, or Chris Giles of the Financial Times put it, “left them with ample egg on their studious faces” (November 26, 2008).

A major reason for these economists’ bewilderment in the face of financial bubbles and bursts is that, according to their theoretical shibboleth, expansion of finance/fictitious capital on a macro or national level is not supposed to deviate much from that of industrial/real capital, as the magnitude of the former is essentially determined or limited by the requirements of the real sector of the economy. The theory maintains that there is an auspicious synergy between the financial and real sectors of an economy: finance capital tends to shadow industrial capital as if its main function is to grease the wheels of the real sector, that is, of manufacturing and commercial undertakings —just as it was more or less the case in the early stages of capitalism, when there was not yet a large, independent financial sector [1].

This theoretical mindset of neoclassical economists, both neoliberal and Keynesian traditions, follows from their faith in the (barter-like) Walrasian general equilibrium model in which there exists a continuous balance between supply and demand, or between income (as the monetary equivalent of supply) and expenditures (as the monetary equivalent of demand). Production is the starting point in this model: as manufacturers employ labor and means of production to produce goods and services, they also generate income in the form of cost of production, that is, in the form of wages/salaries, interest income, rental income, etc. As the recipients of incomes thus generated turn around and purchase what they have produced, they thereby also establish equilibrium between income and expenditures, or between supply and demand. The income-expenditure balance here is altogether tautological: what is cost of production to employers is (at the same time) income for factors of production. This (continuous or repetitive) relationship is illustrated in mainstream macroeconomics textbooks by a simple diagram called the “circular flow” diagram, or model.

The circular flow model does allow for temporary discrepancies between income and expenditures, as when, for example, a portion of people’s incomes, especially of high incomes, is saved, not spent. But this would not seriously disturb the balance between aggregate incomes and expenditures because the savings would be borrowed (through banks and other financial intermediaries) and invested by manufacturers, thereby closing the temporary gap between aggregate income and spending. This means that, in a simple

macroeconomic model, as long as aggregate national savings (S) are equal to aggregate national investment expenditures (I), that is, as long as “temporary leakages” from the circular flow are offset by injections of the same magnitude, equilibrium between supply and demand would prevail.

In the conservative/neoliberal version of the neoclassical economics the balance between S and I and, therefore, between aggregate income and spending, is restored/guaranteed by the forces of market mechanism: an excess of S over I would be only short-lived as this (temporary) oversupply of loanable funds would soon lead to lower rates of interest, or lower cost of borrowing, which would then encourage businesses/manufacturers to borrow and invest more. This process of borrowing and investing the cheapened or undervalued S would continue until the excess S is used up and equality between S and I is restored.

In the liberal/Keynesian version of neoclassical economics, however, such a spontaneous or automatic restoration of balance between S and I is not guaranteed, which means that a situation of $S > I$, or insufficient investment spending relative to aggregate savings, may persist for a long time. Under conditions of relative market uncertainty, even low interest rates would not induce manufacturers to borrow and invest, or expand. Nor would holders/owners of “idle” savings be willing to part with their savings when interest rates are too low; preferring, instead, to stay liquid in the hope of garnering higher returns when rates go up in the future—the often cited Keynesian term “liquidity trap” or “liquidity preference” was coined in this context. Under such conditions, the government could/should step in, borrow the “idle” savings and spend them (“in behalf of their wealthy owners,” as Keynes put it), thereby closing the savings–investment (or income–expenditures) gap.

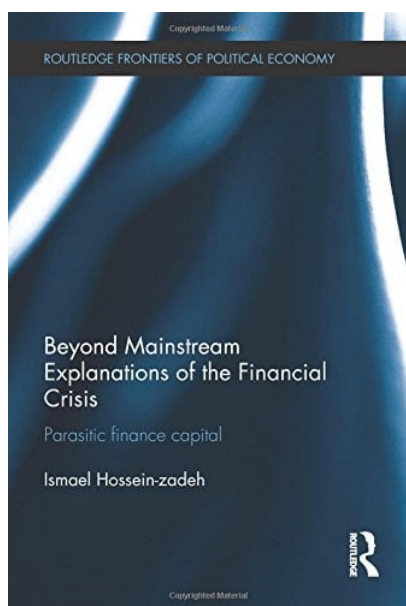
It is obvious from this brief picture that, according to neoclassical economics, the supply of credit and/or the volume of finance capital is determined or limited by the magnitude of aggregate supply/output, or national income; specifically, by the volume of national savings, which in turn is determined by the magnitude of national output. Although the central bank’s policy of “fractional reserve banking” can somewhat stretch the volume of credit beyond the volume of savings, loanable finance capital is ultimately constrained by the total amount of national savings.

While this view of savings as the main source of credit or financing of real investment projects may have been true in the early stages of capitalism (when banks as financial intermediaries between savers and investors recycled “idle” savings into money capital for productive investment), it is no longer the case in the era of advanced capitalist economies where well-established financial markets have become not only independent of but, in fact, dominant over the real or non-financial sector of the economy. The credit system in mature and highly financialized market economies of today is no longer confined by domestic savings or central bank regulation of money supply.

The institutional structure of the monetary/financial system which gives the commercial banks the power of creating money many times the amount of their reserves—by virtue of the so-called fractional reserve system—makes the supply of money much more flexible than the domestic savings or formal central bank regulations permit. Commercial banks and other financial institutions are quite resourceful in expanding their lending capacity beyond their legal limits. The apparent idea behind these limits is that, based on the amount of their loanable deposits (as determined by “reserve requirements”), the commercial banks first

determine their lending capacity and then go looking for customers. But the realities are quite the other way around. More than half of all new business loans are made to big corporations under credit lines the companies have negotiated with their bankers, legally entitling them to borrow agreed-upon amounts. As one officer of the New York Federal Reserve has put it, “In the real world, banks extend credit . . . and look for reserves later. In one way or another, the Federal Reserve will accommodate them” [2].

Furthermore (and contrary to the neoclassical “circular flow” model), in the era of highly “financialized” capitalism demand for credit is not limited to industrial or commercial credit. In the age of well-developed stock markets, futures markets, real estate markets, commodities markets, derivatives markets, and similar markets for speculation, a large part of credit is demanded for speculative debt financing, or speculative investment. Under these circumstances, parasitic finance capital, feeding on itself by sucking out economic surplus/profits from the real sector, has effectively undermined the neat neoclassical “circular flow” mechanism—where people’s savings and industrialists’ (retained) earnings are supposed to be recycled through financial intermediaries into productive investment. In the era of the dominance of finance capital, substantial amounts of the real sector’s profits-cum-savings that “leak out” of the income-expenditures circular flow into the financial sector never come back to be reinvested productively, as mainstream economic theory postulates. Instead, those savings are systematically syphoned off the real economy and invested in the unproductive, parasitic financial sector.



Economists have argued that the escalating financialization of the past several decades has been prompted by the “lackluster” growth and/or “low” rates of return in the real sector of the economy [3]. Evidence shows, however, that capital flight from the real to the financial sector has continued even when profitability has been robust in the real sector. For example, real-sector profit rates in the U.S. economy were quite healthy during all four periods of 1983-87, 1993-2000, 2003-2007 and 2009-2013. Nonetheless, financialization continued unabated even during these periods of healthy profits; indicating that the lure of speculative profits, greatly facilitated by the extensive deregulation of the financial sector, is strong enough to induce money capital to abandon manufacturing in pursuit of higher returns in the financial sector.

Capital flight from the real to the financial sector, and the divergence between corporate profitability and real investment were highlighted in an article by Robin Harding published in the Financial Times (of July 24, 2013). Headlined “Corporate Investment: A Mysterious

Divergence,” the article revealed that, in the past three decades or so, a “disconnect” has developed between corporate profitability and real investment; indicating that, contrary to previous times, a significant portion of corporate profits is not reinvested for capacity building. It is diverted, instead, to financial investment in pursuit of higher returns to shareholders’ capital. Prior to 1980s, the two moved in tandem—both about 9% of GDP. Since then, and especially in the very recent years, whereas real investment has declined to about 4% of GDP, corporate profits have increased to about 12% of GDP.

The systematic funneling of savings and profits away from the real to the financial sector has, indeed, been encouraged in recent years by the regulators: “In the past two decades most regulators have encouraged banks to shift assets off their balance sheets into SIVs [Special Investment Vehicles] and conduits,” reported the Financial Times (February 5, 2008). Special Investment Vehicles and conduits, like Private Equity Groups, are part of a vast network of shadow (trading) banks that specialize in buying and selling of companies, in managing/supervising with hedge, and in interacting and dealing with a whole host of other “financial engineering” services. Not surprisingly, the financial sector has been growing much faster in recent decades than the real sector of the economy, as it is increasingly absorbing larger and larger shares of national resources:

“In the real world most credit today is spent to buy assets already in place, not to create new productive capacity. Some 80 percent of bank loans in the English-speaking world are real estate mortgages, and much of the balance is lent against stocks and bonds already issued. Banks lend to buyers of real estate, corporate raiders, ambitious financial empire-builders, and to management for debt-leveraged buyouts” [Ibid.].

Professor Michael Hudson (of the University of Missouri, Kansas City) and a number of other financial experts have labeled the rapidly expanding financial sector as the FIRE sector—standing for finance, insurance and real estate. Designation of the term FIRE conveys (understandably) a negative connotation as the excessive expansion of this sector tends to re-allocate resources from productive to unproductive activities, to undermine the potential for real socio-economic growth and to further aggravate the already lopsided distribution of income and resources against the overwhelming majority of the people. The figure below clearly shows this ominous trend: it shows that while bank lending to the FIRE sector as a share of GDP has quadrupled since the 1950s, the similar ratio for bank lending to the real sector has remained nearly unchanged.

Total U.S. bank loans to real and financial sectors (% of GDP), 1952-2007.



Source: Based on the Z Table in the U.S. flow of fund accounts, series FL794194005.Q; as cited (and graphed) in Bezemer 2012: 20, Graph 1. 1.

The following are a few additional examples of the astronomical growth of the FIRE sector during the past three decades or so: Between 1980 and 2005, profits in the financial sector increased by 800%, more than three times the growth in non-financial sectors. In the early 1990s there existed only a couple of hedge funds; by 2007, their number had grown to 10,000. The number of mortgage brokers, replacing old-style Savings & Loans and regional banks, has likewise mushroomed in recent years/decades: 50,000 thousand of them,

employing nearly 400,000 brokers, more than the whole U.S. textile industry [4]. As the (unusually candid) manager of the hedge fund Raymond Dalio of Bridgewater Associates bluntly put it: “The money that’s made from manufacturing stuff is a pittance in comparison to the amount of money made from shuffling money around. Forty-four percent of all corporate profits in the U.S. come from the financial sector compared with only 10 percent from the manufacturing sector” [5].

As noted earlier, the neoclassical “circular flow” and/or “general equilibrium” model/theory is built on the basis of a near-barter economic paradigm, that is, an economy where money is implicitly treated as largely a means of exchange or circulation, not as an ideal or ultimate repository of the accumulated or concentrated wealth. In this model, financial cycles neatly follow real cycles: they expand when real cycles expand, and contract when they contract. As such, there is hardly any possibility for financial bubbles to emerge and expand independent of the real sector of the economy—the financial sector is treated essentially as a service or subsidiary sector to the real sector.

The circular flow model (like most other models) can, of course, serve as a useful tool or concept for analytical purposes. It is designed to show what happens when/if the circuit, or circular flow, breaks down, and what to do about it. The problem is that mainstream economists seem to have been stuck in the abstract model, in the earlier stages of capitalism, unable to see how in the era of giant banks and other colossal financial institutions finance capital can (and does) grow independent of industrial capital, thereby leading to financial inflations, followed by implosions.

It might be argued: who cares whether a financial bubble follows a real sector expansion or whether it is formed ab-ovo, i.e., in the absence of such an expansion. Such a distinction, however, is critically important to an understanding of how in the age of advanced financial markets finance capital has become largely independent of industrial capital, and how it has therefore undermined the neoclassical concepts of general equilibrium, of circular flow mechanism and of national savings as the main source of supply of money—in short, how it has rendered the neoclassical economists’ theory of credit creation, of investment financing and of money supply obsolete. Sucking financial resources from the rest of the economy, as well as generating fictitious capital out of thin air through speculation/gambling, parasitic finance capital feeds on itself—just like a real parasite. Neoclassical economists have not, so far, been able to reconcile the financial sector with their circular flow and/or general equilibrium model. Sadly, instead of trying to incorporate the financial sector into their real sector model, they have chosen to ignore it lest it should disturb their shipshape, convenient model.

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Notes

[1] This essays draws heavily on Chapter 3 of my book, *Beyond Mainstream Explanations of the Financial Crisis*.

[2] Robert Heilbroner and John Galbraith, Understanding Macroeconomics, Englewood Cliffs, NJ: Prentice Hall 1990, P. 383.

[3] See, for example, Robert Brenner, "What is Good for Goldman Sachs is Good for America: The Origins of the Current Crisis," <<http://www.sscnet.ucla.edu/issr/cstch/papers/BrennerCrisisTodayOctober2009.pdf>>; Andrew Kliman, The Failure of Capitalist Production: Underlying Causes of the Great Recession, Pluto Press 2011.

[4] Steve Fraser, "The Archeology of Decline: Debtocalypse and the Hollowing Out of America," TomDispatch.com, <<http://www.tomdispatch.com/blog/175623/>>.

[5] Kevin Phillips, Bad Money: Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism, New York: Penguin 2009, p. 211.

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