

Stock Market Crash: Post Mortem for Milton Friedman

Interview with economist Robert Pollin

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We are in the midst of a major historic turning point, equivalent to the emergence of neoliberalism under Thatcher and Reagan” (Robert Pollin)

1—On Monday, the stock market recorded its biggest one day gain in history on news that the G-7 had settled on a plan to recapitalize the banking system. The Federal Reserve, the European Central Bank (ECB) and the Bank of England (BOE) all agreed to make direct capital injections into “systemically important” banks so they could resume lending and reduce stress in the credit markets. They also decided to insure deposits and to guarantee interbank lending. Do you think that these unprecedented steps will be enough to avert a meltdown of the financial system?

Robert Pollin: Of course, by Tuesday, the Dow fell again by over 733 points. Meanwhile, the Nikei in Japan fell by 10 percent on Wednesday. So, thus far, the answer to whether these steps are enough, on their own, to avert a meltdown is a resounding “no.” At the same time, to be fair, these measures have yet to have any real effect on banks’ balance sheets. Thus far, the stock markets are only responding to their own guesses as to what benefits, if any, these measures will have on stabilizing the balance sheets of financial institutions.

But there is another element that came into play especially over the past day. That is the reality within financial markets that the economic crisis has spread beyond Wall Street itself. It is now clearly becoming a crisis—a recession or depression, choose your own term—spreading into the realm of jobs, incomes, public sector budgets, and private non-financial profits as well. This means that averting a meltdown of the financial system will also require a massive stimulus of the non-financial side of the economy. We haven’t heard yet about any significant plans along these lines.

2— How much of the present crisis can be blamed on ideology? Do you think that the ideas of Milton Friedman or the 30 year-long bias towards market fundamentalism contributed to the present troubles in the financial markets? Is this the end of the laissez-faire, free market “trickle down” era?

Robert Pollin: This is certainly a massive crisis of Friedmanite economics and neoliberalism more generally—which all along was the ideology that touted free markets and deregulation to privatize profits, but to come begging for government bailouts when the inevitable crises

emerged. This is certainly not the first financial crisis under the neoliberal regime. There have been regular severe crises since the 1987 Wall Street crash. These crises were all quelled through Federal Reserve/Treasury bailout operations. Whether or not this crisis will mean the end of the neoliberal era will depend on political mobilization—specifically, how successful the left will be in building coalitions behind an agenda that combines egalitarianism with a stable financial system. I would say this: if the left is unable to defeat neoliberalism now, and build some version of social democracy or “leashed capitalism”, then we will never do it.

3-Secretary of the Treasury Henry Paulson’s \$700 billion bailout plan was opposed by over 200 economists. The vast majority of the economists supported the idea of capital injections into struggling banks rather than buying up their toxic mortgage-backed assets. (EU nations settled on the capital injections plan, too) On Monday, according to the New York Times, Paulson met with a group of CEOs from the country’s largest banks and announced his plans for distributing the first \$250 billion provided by Congress.

“Citigroup and JPMorgan Chase were told they would each get \$25 billion; Bank of America and Wells Fargo, \$20 billion each (plus an additional \$5 billion for their recent acquisitions); Goldman Sachs and Morgan Stanley, \$10 billion each, with Bank of New York Mellon and State Street each receiving \$2 to 3 billion. Wells Fargo will get \$5 billion for its acquisition of Wachovia, and Bank of America the same for amount for its purchase of Merrill Lynch.” (Calculated Risk)

Half of the money allocated by Congress is being given to many of the same Wall Street giants that are directly responsible for the current implosion of the financial system. Doesn’t this confirm our worst fears about Paulson, that he is merely a banking oligarch who serves the interests of the financial industry?

Robert Pollin: Paulson is a Wall Street man—and Goldman Sachs man, more specifically—through and through. There was never any doubt about that. He will always do his best to serve his Wall Street constituency. At the same time, this constituency has now been discredited to an extent unprecedented since the 1930s. So again, it will be a matter of how well the left mobilizes its forces to push for a different agenda with the Treasury and other major economic policy-making institutions. It will not be easy, and it won’t happen overnight. But now is most emphatically the time to make serious advances in building a serious alternative agenda.

4-Many pundits now point to the Lehman Brothers default as the main cause for last week’s turbulence in the stock market. Can you explain how one bank can have such a dramatic effect on global stocks and credit markets?

Robert Pollin: Henry Paulson made the decision for one day—and one day only—to try free market capitalism during a financial crisis. That is, he and Federal Reserve Chair Ben Bernanke decided that if Lehman Brothers can’t make it on its own, then, according to the logic of free market capitalism, they should be allowed to fail. But once they made that decision, such deep panic ensued, on Wall Street and financial markets throughout the globe, that they backed off literally the next day, when they bailed out AIG Insurance.

Under neoliberalism, financial market players have become accustomed to do as they wish when the market is going up, but to get bailed out when the market is going down—privatization of profits and socialization of losses. The collapse of Lehman sent the signal that the old rules of neoliberalism may no longer apply—that market losers may really go down hard, as the true-blue free market model—as opposed to the neoliberal model—says they must. That’s why Lehman’s failure caused such a massive panic.

5- Do you find it surprising that foreign investors and central banks have not sued the various US brokerage houses for selling them complex securities that were toxic? Why hasn’t the ECB or the BOE demanded that the US buy-back this fraudulent mortgage-backed garbage or threaten to boycott US financial products?

Robert Pollin: We have to be clear on what we mean by “foreign” investors. They may well be physically living in other countries, and their institutions may have business charters outside the U.S. But they are heavily integrated into the U.S. economy. Neither the European Central Bank (ECB) nor the Bank of England (BOE) want to see either Wall Street or the dollar collapse. They themselves would also go down in the event of a global depression. So they are not about to call for boycotts of the U.S. economy. The Europeans may have some harsh words for the US players behind closed doors. On the other hand, nobody forced the Europeans to buy mortgage-backed securities. They also would hardly want to claim to be untutored innocents playing above their heads in financial markets. They—like the Americans—had every opportunity to think about whether mortgage-backed securities were good ways to make big-time profits. They all decided to go for it.

6—The Obama campaign has reportedly received \$10 million from Wall Street contributors, whereas, the McCain campaign has taken in \$7 million. Does this explain why no one in Congress from either party is demanding that Glass Steagall be restored, or that all derivatives contracts be put under government regulation, or that all financial institutions (that pose a danger to the overall system) maintain capital cushion of 12 percent? Has the big money which flows into the political system made it impossible for congress to do the work of the people?

Robert Pollin: The big money flowing into Obama, and to Democrats more generally, certainly will make it more difficult for our elected officials to do the work of the people. But here again, Wall Street has now been discredited to a degree unprecedented since the 1930s. That should give the left serious political leverage, even while fully recognizing the influence that big money will continue to play with both the Democrats and Republicans. And we don’t need to go back to Glass Steagall specifically—the financial regulatory system that came out of the wreckage of the 1930s Depression. We need to recreate its basic principles and then some—that is, to create a regulatory system focused on financial stability and channeling credit to socially productive activities, like affordable housing, job expansion, and building a clean energy economy. Does that mean that the financial system should be state owned? Certainly there is a case for at least partial ownership. That is hardly an outlandish crazy-left idea now, since George Bush and Henry Paulson have made this a cornerstone of the Republican-led bailout plan. But the real issue—whether it be through public or private ownership or some mix—is to move financial institutions and markets in the direction of egalitarianism. That won’t occur automatically by any means even with publicly owned financial institutions.

7—So far, foreign flows into US Treasuries (to cover our \$700 billion current account deficit) have not been a big problem. But as the Federal Reserve and the Treasury expand their balance sheets to provide a backstop for the financial system—as well as emergency fiscal stimulus for maxed-out consumers—we could be facing a funding crisis as severe as anytime in history. In July, the purchases of US Treasuries hit a record low of roughly \$6 billion leaving a shortfall of \$50 billion. Now that we are headed into a global recession, do you think that foreign central banks will begin cutting back on their purchases of US debt? What effects will this have on the US economy (and the dollar)? Will interest rates rise sharply?

Robert Pollin: I think U.S. Treasuries are now, and will remain for some time, the single safest, and most desirable, financial instrument in the global financial system. I don't think foreigners will shift dramatically away from Treasuries, though they may do so modestly. At the same time, U.S. investors will continue to clamor for Treasuries as opposed to buying stocks, bonds issued by private companies, and derivatives. This will push down the interest rates on Treasuries. However, other interest rates will continue to be very high. The growing disparity between the low Treasury rates and the high rates on private bonds, including those of AAA corporations, reflects the very high level of risk—the “risk premium—that investors are now attaching to any security that doesn't have the full backing of the U.S. government.

8—In 1967 former Fed chair Alan Greenspan published an essay titled “Gold and Economic Freedom” which could have been written by a Libertarian like Ron Paul. The article proves that Greenspan has a good grasp of how low interest rates and credit expansion lead to disaster. In fact, he even blames the Great Depression on loose monetary policies. Here is a particularly revealing excerpt:

“When business in the United States underwent a mild contraction in 1927, the Federal Reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage. More disastrous, however, was the Federal Reserve's attempt to assist Great Britain who had been losing gold to us because the Bank of England refused to allow interest rates to rise when market forces dictated (it was politically unpalatable). The reasoning of the authorities involved was as follows: if the Federal Reserve pumped excessive paper reserves into American banks, interest rates in the United States would fall to a level comparable with those in Great Britain; this would act to stop Britain's gold loss and avoid the political embarrassment of having to raise interest rates.

The “Fed” succeeded; it stopped the gold loss, but it nearly destroyed the economies of the world in the process. The excess credit which the Fed pumped into the economy spilled over into the stock market — triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed.... The world economies plunged into the Great Depression of the 1930's....The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit...” (Gold and Economic Freedom, Alan Greenspan)

What role did Greenspan play in the current financial crisis and why did Greenspan leave interest rates below the rate of inflation for 31 months when he knew it would lead to catastrophe?

Robert Pollin: I don't agree that low interest rates and credit expansion lead to disaster. They only lead to disaster in an unregulated financial system, in which credit flows overwhelmingly support speculation as opposed to investments in productive activities that create useful things for people, like schools, housing and public infrastructure. Indeed, I strongly support an extensive system of government loan guarantees—i.e. credit risk insurance—to support private investments in retrofitting buildings and affordable housing. This will maintain low interest rates to finance these activities, and channel large amounts of cheap credit into these areas.

Greenspan himself is as responsible for this current financial disaster as anyone. His only competitors on this score are former Republican Senator and top McCain advisor Phil Gramm and former Clinton Treasury Secretary Robert Rubin. They all were relentless cheerleaders for financial deregulation—Democrats and Republicans alike. They were spouting nonsense about the virtues of unregulated financial markets for since the 1980s at least.

9—In “Imperialism is the Highest Stage of Capitalism”, Vladimir Lenin says: “The development of capitalism has arrived at a stage when, although commodity production still “reigns” and continues to be regarded as the basis of economic life, it has in reality been undermined and the bulk of the profits go to the “geniuses” of financial manipulation. At the basis of these manipulations and swindles lies socialized production; but the immense progress of mankind, which achieved this socialization, goes to benefit... the speculators.”

Despite the failures of the Soviet Union, is there anything in the analysis of Marx or Lenin that can help us to better understand this present phase of American-style capitalism?

Robert Pollin: This is very keen observation by Lenin—one among many, many others. As for Marx, he remains, in my view, the single most insightful thinker in history on the operations of a capitalist economy. This includes his voluminous writings on the nature of financial markets, which are full of tremendous insights. And remember, he was doing this writing 150 years ago, when he had very little to grab onto as he attempted to discern the nature of capitalism.

That doesn't mean that I agree with everything Marx says. I also don't see much point in assigning labels—Marxist or otherwise—to people. This is mostly a barrier to clear, straightforward thinking that might also someone be politically useful. And finally, in my opinion, there is a huge amount important thinking in Marx as to what is wrong with capitalism, but not very much about what to do about it. As such, in figuring out where we go from here, we are really on our own. There's not much point in trying to figure out what Marx would propose to do in our present situation. We will never know that; and even if we did know, it would still be up to us to figure out whether Marx was making any sense. Remember that Marx himself once said, in exasperation at his dogmatic followers, that “I am not a Marxist.”

10—Liberals and progressives in the US seem much more focused on social issues than

economic ones. Only recently, have they become more aware of the growing polarization between rich and poor and the inherent shortcomings of this crisis-prone, bubble-generating, wealth-shifting system. As the financial crisis spreads into the real economy triggering increasing unemployment, falling demand, tightening credit and soaring foreclosures; there will probably be many opportunities for change. Do you foresee a rise in “issue-oriented” populist movements or, maybe, a third political party? What are the immediate economic goals that progressives should pursue?

Robert Pollin: I do think we are in the midst of a major historic turning point, equivalent to the 1930s New Deal, or the emergence in 1979/80 of full-tilt neoliberalism under Thatcher in the UK and Reagan in the U.S. It seems clear that the economic agenda will rise to the top of the heap as a focus of concern for the left. This is not to denigrate other issues, such as the environment, anti-imperialism, racism, or sexism. But I think we will now be able to start seeing more clearly the connections between a critique of neoliberal capitalism and these other arenas of social and political struggle. For example, with the environment, it was only a year or so ago that the conventional wisdom held firmly that we could either have a clean environment, or a growing economy with an abundance of good jobs, but we couldn't possibly have both. Trade-offs such as this were inevitable. You were simply a confused, mushy thinker if you didn't understand this. It is now becoming clear that building a clean energy economy—and by this I mean a zero fossil fuel driven economy, with no “clean coal” and no nukes—can also be the engine to build a full employment economy as well as help construct a stable financial system.

Of course, to put such an agenda in place will mean treading through multiple political minefields. Should people work within their communities alone? In unions? Form a left caucus within the Democratic Party? For environmental justice groups? Keep trying to build third parties? I think all these approaches have merit, and that we on the left should try all of them. We should also have enough humility to acknowledge that none of us really knows what will work best under any given set of circumstances. Let's try a lot of things, keep learning, and stay open-minded. And I would emphasize one other thing. During the 1968 uprising in France, one of the most bracing slogans to have emerged out that struggle was “Be Realistic, Demand the Impossible.” I am more inclined to embrace its mirror image as a guide for moving forward. That is, “Be Utopian, Demand the Realistic.”

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