Real Wealth or a House of Cards

by Herman Daly

The current financial debacle is really not a "liquidity" crisis as it is often euphemistically called. It is a crisis of overgrowth of financial assets relative to growth of real wealth. Growth in US real wealth is restrained by increasing scarcity of natural resources, both at the source end (oil depletion), and the sink end (absorptive capacity of the atmosphere for CO_2). Further, spatial displacement of old stuff to make room for new stuff is increasingly costly as the world becomes more full, and increasing inequality of distribution of income prevents most people from buying much of the new stuff—except on credit (more debt).

Marginal costs of growth (the change in total cost of producing one additional unit) now likely exceed marginal benefits, so that real physical growth makes us poorer, not richer. To keep up the illusion that growth is making us richer, we deferred costs by issuing financial assets almost without limit, conveniently forgetting that these so-called assets are, for society as a whole, debts to be paid back out of future real growth. That future real growth is very doubtful and consequently claims on it are devalued, regardless of liquidity.

What allowed symbolic financial assets to become so disconnected from underlying real assets?

First, there is the fact that we have fiat money (based solely on the government designating it as legal tender) not commodity money. For all its disadvantages, commodity money (gold) was at least tethered to reality by a real cost of production.

Second, our fractional reserve banking system (wherein the banking system can create multiple amounts of new money for each dollar of new deposits) allows pyramiding of bank money (via checking accounts) on top of the fiat government-issued currency.

Third, buying stocks and "derivatives" on margin (borrowing funds to pay for some portion of the investment) allows a further pyramiding of financial assets on top of the already multiplied money supply.

In addition, credit card debt expands the supply of quasi-money as do other financial "innovations" that were designed to circumvent the public-interest regulation of commercial banks and the money supply. I would not advocate a return to commodity money, but would certainly advocate 100% reserve requirements for banks (approached gradually), as well as an end to the practice of buying stocks on the margin.

All banks should be financial intermediaries that lend depositors' money for investment in the real economy, not engines for creating money out of nothing and lending it at interest. If every dollar invested represented a dollar previously saved we would restore the classical economists' balance between investment and abstinence. Fewer stupid or crooked investments would be tolerated if abstinence had to precede investment. Of course the growth economists will howl that this would slow the growth of GDP. So be it—growth has become uneconomic at the present margin as we currently measure it.

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The agglomerating of mortgages of differing quality into opaque and shuffled bundles should be outlawed. One of the basic assumptions of an efficient market with a meaningful price is a homogeneous product. For example, we have the market and corresponding price for number 2 corn—not a market and price for miscellaneous randomly aggregated grains. Only people who have no understanding of markets, or who are consciously perpetrating fraud, could have either sold or bought these negative pigs-in-a-poke. Yet the aggregating mathematical wizards of Wall Street did it, and now seem surprised at their inability to correctly price these idiotic "assets."

And very important in all this is our balance of trade deficit that has allowed us to consume as if we were really growing instead of accumulating debt. So far our surplus trading partners have been willing to lend the dollars they earned back to us by buying treasury bills—more debt "guaranteed" by liens on yet-to-exist wealth.

Our brilliant economic gurus meanwhile continue to preach deregulation of both the financial sector and of international commerce (i.e. "free trade"). Some of us have for a long time been saying that this behavior was unwise, unsustainable, unpatriotic, and probably criminal. Maybe we were right. The next shoe to drop will be repudiation of unredeemable debt either directly by bankruptcy and confiscation, or indirectly by inflation.

This piece is condensed from Credit Crisis, Financial Assets, and Real Wealth *posted at theoildrum.com.*

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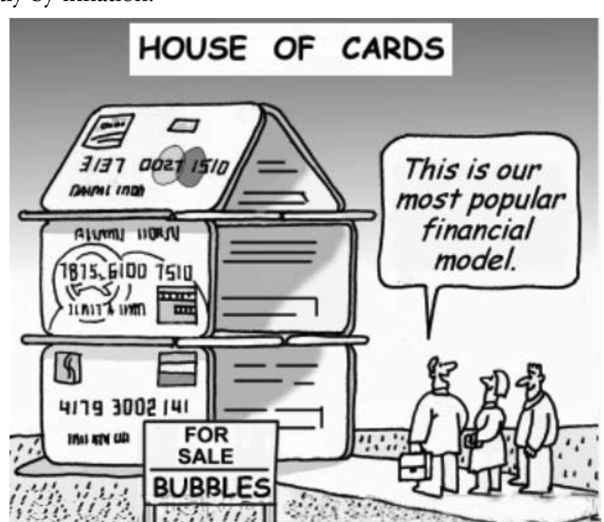

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