Creating Wealth by Asset-Price Inflation: A "total returns" approach to the U.S. Balance Sheet

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Summary

Since 1980 the U.S. Treasury has provided unprecedented tax favoritism for wealth. Reversing the philosophy of progressive taxation to lower taxes on the higher income brackets and property has contributed to soaring federal budget deficits. Yet in contrast to pre-1980 experience, interest rates have declined. The Federal Reserve has flooded the economy with enough credit to inflate prices for bonds, and also for stocks and real estate.

Lower interest rates mean that carrying charges on the rising debt overhead have grown more slowly than the volume of debt. Meanwhile, deregulation of lending standards has enabled debtors to pay interest mainly by borrowing against collateral whose price is being inflated, simply adding the interest onto the principal. This creates an exponential growth in debt – the liabilities side of the "magic of compound interest" balance sheet. But by 2006 the lowering of interest rates reached its practical limit, and the asset-price bubble burst, while leaving the debts in place. So debt/equity ratios have risen even further!

To trace how "wealth creation" during the Bubble Years 1981-2006 took the form more of capital gains than saving out of earnings, this paper adds the Federal Reserve's balance sheet estimates in its flow-of-funds reports to the national income and product accounts (NIPA). I focus on the real estate sector as the largest and best documented example of increasing balance-sheet wealth during the Bubble Economy's run-up. Investors aimed at total returns – current income plus capital gains – which they magnified by debt leveraging. This paper therefore provides a set of time series from 1945 through 2007 to juxtapose capital gains to national income, savings and new direct investment, and shows the extent to which asset-price inflation has been fueled by debt.

* Paper delivered in Berlin, Oct. 30, 2008, at the Böckler Foundation conference on "Macroeconomic Policies on Shaky Foundations –Whither Mainstream Economics?"

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When interest rates peaked in 1980, debt ratios had been rising steadily for 35 years. Rising wages and consumer price inflation were cited as reasons for the tightening of credit under Federal Reserve Chairman Paul Volcker. The bond market had been declining almost steadily, pushing the prime bank rate up to 20 percent. State by state, the nation's anti-usury laws were repealed to prevent a lending cutoff. The average maturity on Treasury debt shortened from over 7 years when World War II ended to just 2 years 10 months by 1980. This forced the government to keep coming back into the bond market to roll over its debt, "crowding out" private sector borrowing. A spate of books, articles and newspaper editorials warned that the economy had reached its debt limit.

Most observers expected to see the rising debt trend reversed either by net debt repayment or by widespread defaults wiping out over-indebtedness. In the international sphere, Mexico did indeed teeter on the brink of default in 1982, triggering so sharp a global crisis in Latin American and other Third World sovereign debt that new lending dried up for a decade. But just the opposite occurred in the U.S. and other leading industrial economies. Instead of receding to levels that could be carried, credit was loosened and interest rates fell sharply, making a U-turn that now has lasted 28 years. The next twelve Reagan-Bush years 1981-92 saw the federal debt quadruple, largely as a result of slashing taxes on property and finance. U.S. economic strategy aimed at paying debts out of capital gains, not by earning its way out of debt. The supply of credit – that is, the debt overhead – has soared, but has been used much more to bid up asset prices rather than to finance new capital formation.

The result has been a novel way for economies to inflate their way out of debt. Instead of the central bank inflating wages and consumer prices by deficit spending on goods and services, it has contained the inflation to the asset markets – first bonds, then stocks as a new debt market developed in the 1980s: high-interest "junk" bond financing for corporate takeovers. Raiders often paid over 15% for loans to make buyout offers, turning the stock market into a vehicle to load industry down with debt instead of raising new equity money for capital investment. *The net flow of funds was out of stocks into debt*.

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Even at high interest rates this created new billionaires, although Wall Street underwriters, banks and institutional investors got much more overall revenue – usually proportional to the adverse impact on employees by downsizing and outsourcing the labor force. The idea was to pay creditors by carving up companies, leaving a gain for the raider when he sold the company or floated it again on the stock market. These leveraged buyouts created a boomlet in targeted companies – and most companies became targets. Their best defense was to take a "poison pill," that is, so much debt onto their balance sheet that prospective raiders could not load them down with any more. The result was an unprecedented rise in debt/equity ratios.

Banks rebuilt their balance sheets by keeping retail interest rates over 20% for credit card debt and consumer loans, while rates for business borrowers were driven down steadily from 1980, reaching lows of around 6% for mortgages and just over 1% for short-term funds by 2006. The mushrooming supply of credit was accompanied by the loosest mortgage lending standards in history – standards which state attorneys general found to be outright fraudulent – inflating a new real estate bubble after 2001.

Homeowners, real estate and corporate investors were convinced that the process as making them richer, but control of wealth was passing out of the hands of nominal owners to creditors. Bankers and bondholders received most rental income and corporate cash flow. Debt leveraging was inflating their net worth on paper as asset prices rose by more than debt. Under Alan Greenspan's chairmanship (1987-2006) the Federal Reserve Board adopted asset-price inflation as official policy, applauded as "wealth creation." Bank lending was channeled to inflate stock market and real estate prices in what seemed to be a self-sustaining financial feedback process. *Asset-price inflation enabled debtors to pay the interest charges on their debt by new borrowing against the collateral whose price was being inflated instead of out of income being earned*. In fact, commercial real estate and many financialized companies, top-heavy with debt, had no income to declare. Bankers and bondholders got the cash flow as earnings were expensed as interest, leaving many owners only with hopes for a capital gain.

As the economy shifted away from earning income to riding the wave of asset-price inflation, the United States moved more deeply into what Hyman Minsky called the Ponzi phase of the financial cycle, in which earnings and cash flow fail to cover scheduled debt service.[1] In 1980 he had described this phase as a deterioration of credit quality into increasing fragility and instability. But unlike pre-1980 experience, the new surge in borrowing and more risky

[1] Hyman Minsky, "The Financial Instability Hypothesis," *Working Paper* No. 74, May 1992 (The Jerome Levy Economics Institute of Bard College), prepared for *Handbook of Radical Political Economy*, ed. Philip Arestis and Malcolm Sawyer (Edward Elgar: Aldershot, 1993). See also *Can 'It' Happen Again?* (M.E. Sharpe, Armonk, N.Y., 1982), esp. pp. 14-58.

debt/equity ratios did not push interest rates up. Just the opposite. Like John Law in the 1710s, Chairman Greenspan claimed to have found a new key to prosperity by the Federal Reserve flooding the economy with credit – that is, with debt.

Led by new and unregulated financial instruments, all categories of debt rose as a proportion of national income – federal, state and local government debt, real estate mortgages, consumer debt and corporate debt. All this debt seemed to be making the economy wealthier as long as the market price of real estate, stocks and bonds rose even more rapidly. The expansion of debt at the expense of equity was depicted as a process that would make people rich, not make it harder and harder to extricate themselves from debt. But since the stock market's dot.com bubble burst in 2001, followed by the real estate bubble in 2006, investors have learned that when asset prices plunge, the debts remain in place.

Creditors seek more risky projects as the array of productive candidates for funding shrinks. By the 1990s the largest mortgage lender was Countrywide Financial, and by 2006 it was servicing $1.5 trillion in loans – a sixth of the entire U.S. mortgage market. Its profits flowed mainly from subprime adjustable-rate mortgages (ARMS) with low "teaser" interest rates scheduled to rise in two or three years to as much as 9 to 11 percent. These "exploding ARMS" had low or even zero down payments. "Option ARMS" helped debtors carry their mortgages simply by adding the interest onto the principal for up to five years, increasing the original loan amount by up to 25 percent. Applying "the magic of compound interest" to the debtor's obligation, which grows exponentially, this add-on is called negative amortization.

By autumn 2008 some $96 billion in option ARMS were scheduled to reset at higher interest rates estimated to raise borrowers' average monthly payments by nearly two-thirds over the ensuing two years (an extra $1,053 due each month), taking late-payment penalties into account.[2] An August regulatory filing by Countrywide reveals that: "For the borrowers of $25.4bn in option-arms, their mortgage now typically accounts for 95 per cent of the value of their home, compared with 76 per cent when the loan was made."[3] Taking into account the additional debts owed to "non-profit" entities that lent down payments for many subprime deals, the result is negative equity for millions of homeowners.

Subprime loans became a major profit center for the finance, insurance and real estate (FIRE) sector. They consisted increasingly of no-documentation NINJA loans to borrowers with "no income, no job, no assets." Mortgage brokers fed these junk mortgages to packagers

[2] Saskia Scholtes, "Foreclosure fears grow as $96bn of risky loans come home to roost," *Financial Times*, September 2, 2008.
[3] John Authers, "Long View: This train crash's final impact is still awaited," *Financial Times*, August 16, 2008, based on the Fed's July 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices.

headed by the semi-public Federal National Mortgage Association ("Fannie Mae"), its sister Freddie Mac, and to Wall Street investment banks, which packaged them into collateralized debt obligations (CDOs) and sold them at a markup to pension funds and other financial institutions at home and abroad.

Trading in complex financial derivatives and auction paper proliferated. Investors took out insurance policies to minimize risk, but "monoline" bond insurers wrote policies flippantly without having anywhere near sufficient assets to cover the risk involved. The Federal Reserve Board was hamstrung by Mr. Greenspan's ideological intolerance for regulatory oversight, and stood by passively as credit rating agencies gave AAA ratings to packaged junk mortgages. The situation was much like Arthur Andersen giving Enron a good bill of health simply to get the company's accounting business. The degree of optimism entered a fantasy world.

All this was viewed as financial innovation achieving the proverbial free lunch – in this case asset-price inflation financed by debt creation. Yet there was something familiar about the bubble. Only the names had changed, not the dynamics at work. In 1930 a Federal Reserve economist, Charles Persons, explained that the looming economic depression was due essentially to the great wave of credit expansion in the past decade." Although like today, "There is a lamentable lack of comprehensive and accurate data concerning this process of debt creation," enough data were available to show that

> The great field of credit expansion in the last decade lies in the realm of urban real estate mortgages … The Federal and Joint Stock Land Banks refinanced a growing proportion …of rural land mortgages into long term paper. … Of similar tendency but more obvious in its recent developments is the newly originated and rapidly introduced device of urban real estate bonds. As a method of credit inflation this plan could hardly have been bettered … The volume successfully sold rolled up with the speed of the proverbial snowball traveling down a steep hill."[4]

Also like today, the economist noted: "a considerable volume of the sales recently made were based on credit ratings only justifiable on the theory that flush times were to continue indefinitely … It so happened that this new credit method coincided in the time of its introduction with the origination of new consumption goods of the widest popular appeal … This process of debt inflation went on apace … Temporarily we have spent, enjoyed and stimulated business activity. When the process of expanding credit ceases and we return to a normal basis of spending each year no more than we earn that year, there must ensue a painful adjustment period …"

In the 1920s the Federal Reserve Board held interest rates artificially low in order to encourage U.S. lending to Europe. The U.S. balance of payments was running a heavy surplus

[4] Charles E. Persons, "Credit Expansion, 1920 to 1929, and its Lessons," *Quarterly Journal of Economics*, November 1930:94-130. I am indebted to Eric Jantzen of itulip for bringing this paper to my attention.

stemming from Germany's World War I reparations debt to the Allies and the Inter-Ally arms debt to the United States. Higher interest rates to slow the financial bubble after 1927 would have deterred U.S. dollar lending to England and to German municipalities, interrupting the U.S. lending that kept the triangular flow of international payments intact.

But since the Korean War the U.S. has run a deepening trade and payments deficit. However, the United States has not had to raise interest rates since it decoupled the dollar from gold. Foreign central banks have found themselves obliged to recycle their dollar receipts into holdings of U.S. Treasury securities in order to prevent their currencies from rising against the dollar. Meanwhile, an enormous supply of Federal Reserve and commercial bank credit drove down interest rates, while loan maturities were stretched out (culminating in zero-amortization interest-only loans). The result is that carrying charges on this debt did not keep pace with its overall growth during Mr. Greenspan's tenure at the Fed. The Bubble Economy reflected his ideology of financial non-regulation. He seemed actually to believe that if his traditional Wall Street clients were making money, wealth was being created for the economy at large.

The United States resolved its debt problem not by "earning its way out of debt" but by creating yet *more* debt. The "miracle of compound interest" expressed itself mathematically much like "negative amortization" mortgages: borrowing the interest by adding its accruals on to the principal balance. This is the very definition of a Ponzi scheme. Compound interest keeps on doubling the debt volume as savings accrue interest that is lent out in the form of new loans – and doing so at a faster pace than the economy is able to produce a surplus out of which to pay the carrying charges. In the Ponzi stage of the financial cycle, earnings fail to cover debt service. But instead of worrying, investors expect to pay interest out of capital gains – and go on borrowing yet more against collateral, as long as it keeps rising in price. Real estate and financial investors measure their wealth creation by "total returns" headed by capital gains, not by how much they are able to save out of current earnings.

Where recent U.S. experience diverges from traditional textbook models is that the tsunami of new credit creation did not inflate consumer or wholesale prices. The inflation was confined to asset prices: bonds in the 1980s, stocks in the 1990s, and real estate after 2001 – and indeed, credit was bidding up asset prices faster than the interest that had to be paid. From 1992 to 2001 the largest gains in fact were in dot.com and high-tech stocks that had no earnings or dividends at all. Under conditions where $\Delta P_A > i$ (where P_A represents asset prices, and *i* the interest rate) sophisticated investors changed their investment strategy from seeking current income to maximizing "total returns," defined as capital gains *plus* income.

Under these conditions the term "capital" in "capital gains" is something of a misnomer. The majority of such gains are for real estate, because that is by far the largest category of wealth in the U.S. and other industrial economies, and land is the largest component on the real estate balance sheet. As the economic surplus grows in modern economies, the lion's share is spent on land – just as was the case from classical antiquity through pre-industrial Europe. The key to land-price variations is to be found in the rent of location, which in turn reflects investment in urban transport and other amenities and changes in zoning laws.[5] Most of all, the supply of credit grows exponentially while the supply of land remains fixed.

Next to real estate, the stock and bond markets produce the major price gains. These are accruing to finance capital, not industrial capital – including trading in derivatives by computer-driven models. The great credit takeoff since 1980 has not financed what the classical economists called productive lending and investment – loans that provide the borrower with the means to earn the income to repay the loan with its interest charge. Rather, it was extended for essentially speculative purposes – to buy assets that the debtors expected to rise in price at a pace fast enough to cover the interest charge as the debt-financed bubble was decoupled from the "real" economy. Capital gains became the name of the investment game as debts were to be paid out of the Fed's inflation of asset prices, not by earning more.

The upshot is that today's CEOs tend to view industrial companies primarily as vehicles to produce capital gains. Industry has been "financialized," that is, turned into financial vehicles to pay off bondholders and leave a capital gain for the buyer-on-credit. In the 1930s CEOs tended to be lawyers to deal with problems of bankruptcy and other basic survival requisites. In the 1940s, industrial engineers and "content providers" became the key; and from the 1950s through the '70s, sales personnel as marketing became the major growth area. But since the 1980s the stewardship of American companies has shifted to financial officers. Corporations are still financing new capital investment out of retained earnings, but they are running up debt even more rapidly – to take over other companies or merge, or simply for their "shareholder activists" to pay out as dividends to give a lift to corporate stock prices. Mr. Greenspan has called these capital gains "wealth creation" regardless of how they are achieved. But asset-price inflation becomes increasingly fragile as it becomes more debt-leveraged.

The U.S. tax code has played its own role in diverting savings, investment and credit creation away from tangible capital formation to the purchase of property already in place and of stocks and bonds long since issued. Capital gains taxes were lowered to half the rate levied on

[5] For a classic analysis see Thorstein Veblen, *Absentee Ownership and Business Enterprise in Recent Times* (1922). [See appendix.]

"earned" income (wages and profits), and most real estate was freed even from having to pay this, as long as the investor plowed the gain into yet more property acquisition. Absentee real estate owners were allowed to claim that their property was losing value on the pretense that buildings were depreciating – even in the face of the strongest real estate boom in U.S. history.

The tax code treats interest as a normal cost of doing business and hence tax-deductible, not as a voluntary choice as to how to finance the purchase of assets. In response to corporate raiders financing their takeovers with high-interest "junk" bonds that ended up driving many companies bankrupt, Congress changed the tax code so as not to permit interest on such takeover debts to be tax-deductible. However, this deduction is still permitted for real estate investors, who normally buy existing properties heavily on credit. Interest, depreciation and local property taxes tend to absorb all the cash flow reported by corporate and non-corporate real estate, leaving no income for the tax collector. As hotelier Leona Helmsley put it, "Only the little people pay taxes."

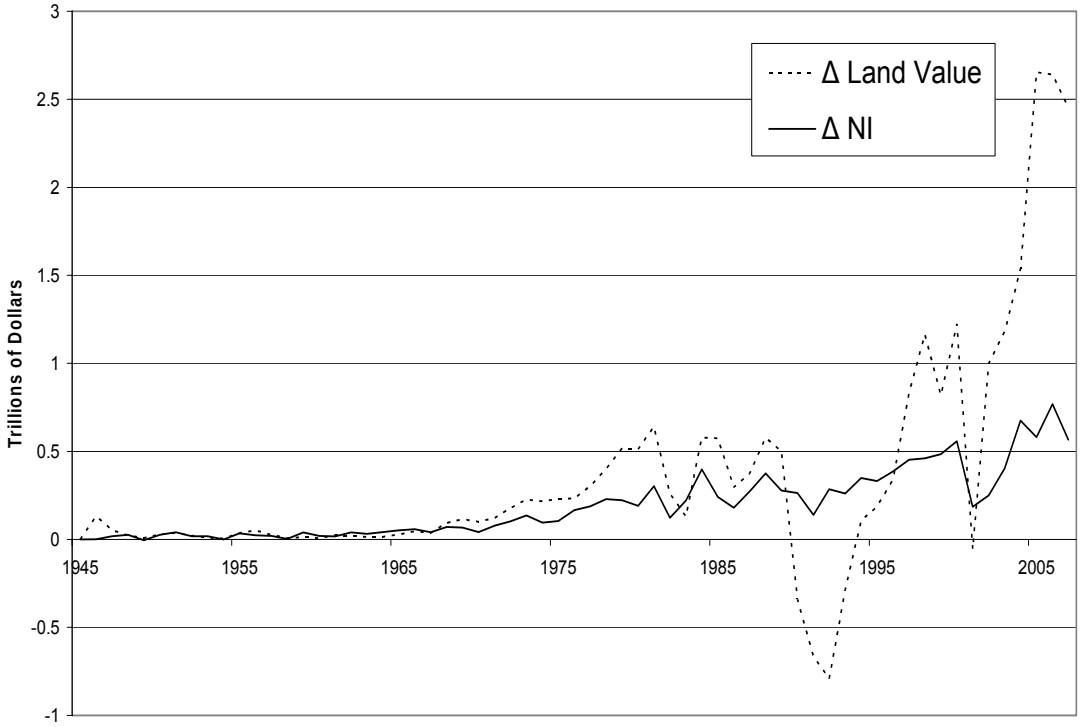
Real estate dominates the capital-gains economy

The motto for real estate investors is, "rent is for paying interest." Prospective buyers bid against each other to buy sites they expect to rise in price, with the winner normally being whoever is first to raise the maximum loan available by promising to pay the mortgage banker all the net rental income. What the investor wants is to resell at a price gain. After 2001 this speculative spirit came to characterize residential homeowners as well. They were advised to buy the most expensive property they could afford. The working assumption was that the higher the price, the more capital gain would be produced as asset-price inflation accelerated.

Statistical accounting formats did not keep up with this economic behavior. The National Income and Product Accounts (NIPA) were designed to trace current output and income, primarily to contain inflationary imbalance in the "real" economy of production and consumption. Left out of account is the balance sheet of assets and debts, and capital gains. There thus is little way to get a sense of proportion for the Bubble Economy. In fact, the real estate lobby has long pressured Congress to avoid making any such study. The motivation is apparently to prevent such gains from being taxed, on the assumption that what is not measured has less chance of being seen and taxed. Avoiding attention has helped lobbyists and think tanks lead America's popular media and politicians to depict the economy as aiming to earn income by producing goods and services, not to register asset-price gains. One hears no reference to John Stuart Mill's depiction of land-price gains as an "unearned increment" or free lunch, and yet new cuts in the capital gains tax are being defended in order to "encourage enterprise," as if real estate speculation was the kind of enterprise that the economy should encourage.

Chart 1

Each Year's Growth and Land Value
Far Exceeds the Growth in National Income



Official statistics detailing balance sheets for the U.S. economy are published by the Federal Reserve in the "Z" tables of its flow-of-funds tables. They are only partial, and real estate is the only sector for which the Federal Reserve publishes capital gains statistics as such (for land, and less visibly by estimating the rising replacement cost of "buildings and structures"). They show that recent annual capital gains for U.S. land alone are larger than the entire rise in national income. Land-price gains amounted to $2.5 trillion in 2006, including about $1 trillion for capital gains attributed to the rising replacement value of buildings as distinct from rising land prices. Even the Fed's low estimate (ignoring price gains for structures) was as large as all corporate profits (of which some 40 percent were reported by the financial sector, largely on its mortgage lending and repackaging), and four times as large as the rise in national income.

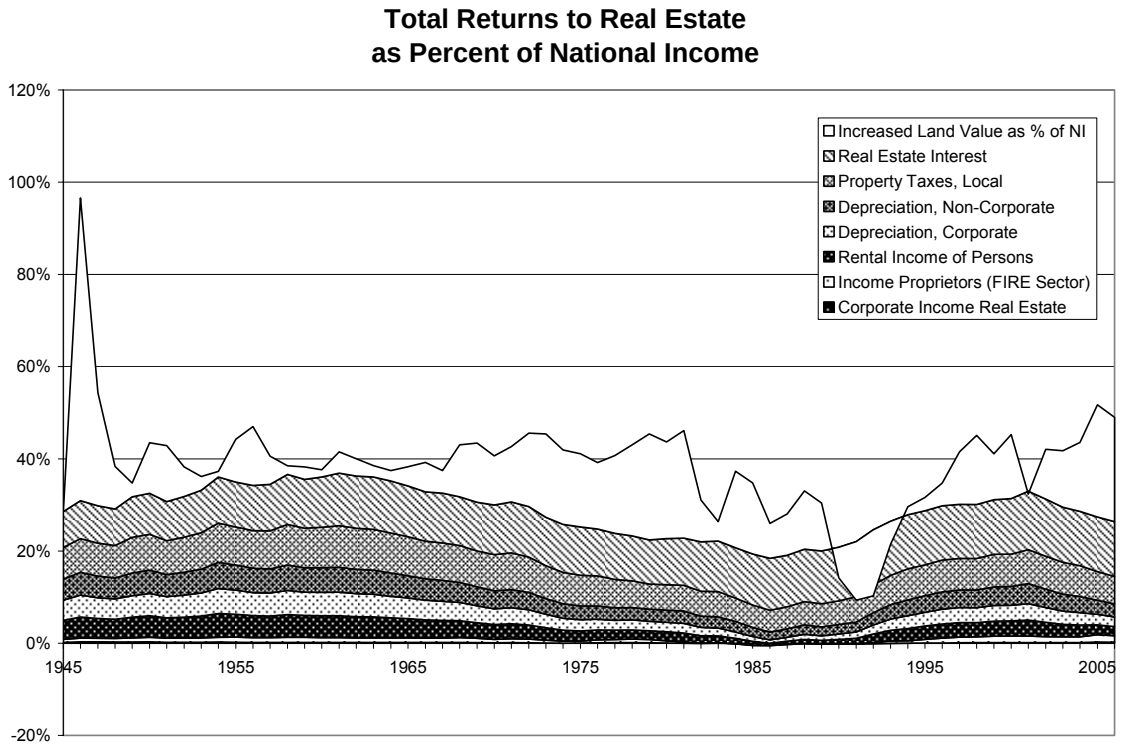
How asset-price inflation "creates wealth" by debt leveraging

Balance sheets in times past were built up mainly by earning and saving out of income (wages or profit) or by paying off debt. But in a Bubble Economy people "save" by seeking capital gains – and using as much debt leverage as possible to buy assets they expect to rise in

price. The aim is to maximize total returns (earnings plus capital gains) by buying real estate and companies on credit, hoping for asset prices to rise faster than the interest being paid. Financial balance sheets are built up, but this is not reflected in the National Income and Product Accounts.

Trying to build up balance sheets by running *into* debt has transformed the concept of saving to the point that the *net* saving rate has fallen to zero or even below it. To the extent that asset purchases are financed fully by debt – as in 100% mortgages – no net savings or investment are reported. *Gross savings remains high, but are being lent out rather than taking the form of tangible capital buildup or a liquid accumulation of savings*. [CHART 2, to come]

From the vantage point of how much financial balance-sheets are gaining (or losing), "saving" today – as defined by the rise in net worth – is taking the form primarily of capital gains, not saving out of "earned" income (wages and profits). Although the net savings rate cited in the popular press has fallen to zero (and even below zero if we net out foreign recycling of U.S. balance-of-payments deficits back to the United States by foreign central banks), the gross savings rate has been fairly stable. The decline in net saving represents the fact that nearly all "saving" is being lent out, not taking the form of new direct investment or savings free of debt. In fact, it is credit – bank lending – that is creating saving today, in what is a net wash – in a process which builds up the economy's interest and debt-servicing burden. **Chart 3**:



As wealth seeking comes to focus on capital gains, investors shift their focus from current earnings and profits to focus on "total returns" – current income plus asset-price gains. Mr. Greenspan called these gains "wealth creation," regardless of how it was achieved. But asset-price inflation becomes increasingly fragile as it becomes more debt-leveraged. Companies run up debt more rapidly as raiders acquire them in leveraged buyouts or borrow to take over other companies, while shareholder activists" may borrow simply to pay out as dividends to lift the stock price.

This represents a structural change in the focus of what wealth seeking is all about. It has become the rationale for the economy's managers to shift away from seeking profits to focus on promoting capital gains as the new "postindustrial" form of asset-price inflation.

Neither the Federal Reserve nor any other official agency publishes any calculation of capital gains as such. The only source where one can begin to derive statistics for "pure" asset-price inflation (balance-sheet price gains excluding actual new capital investment, which is still being financed mainly out of retained earnings, not debt) is in the Fed's statistics for land values. These are so conceptually flawed that since 1994 the Fed statisticians have been embarrassed to publish them as such. Statistics for land's market price must be backed into by subtracting the "value of structures" from overall real estate valuations. This calculation leaves so unrealistically low a valuation for land that in 1994 the residual value of all the corporate land owned in the United States was calculated to be *minus* $4 billion! In other words, when the "value of structures" was subtracted from overall corporate real estate valuation, the result was negative.

The problem lies in how the Fed imputes the value of structures. Corporate real estate (the third largest category, after household and non-corporate real estate) is calculated as being inflated each year by the construction-price index, so as to approximate the "replacement cost" of buildings.[6] But any price inflator for an asset is a form of capital gain. And the U.S. economy is not indexed. Wages do not rise when the cost of living rises, or are any other prices indexed. The logic behind pretending that property owners "deserve" to "keep up inflation" is a logic that they should benefit uniquely in a way that most people cannot share. It is, quite simply, an attempt to prepare the intellectual groundwork for saving the "free lunch" of asset-price inflation for absentee owners, speculators and other investors, while denying it to labor and enterprise.

Fiscal policy's role in promoting asset-price speculation

Real estate accounts for over a third of the economy's ebitda (earnings before interest, taxes, depreciation and amortization). Adding land-price gains to this net cash flow accounts for

[6] Fortunately the Fed does provide an alternative measure for original value of structures for corporate real estate as a memo item, but not for the non-corporate and residential property that accounts for most real estate.

fully half of U.S. national income, even without including construction and operating costs of residential and commercial real estate. As Chart 3 shows, adding capital gains to national income produces much sharper macroeconomic variations over time. From the vantage point of financial investors – and also that of the Federal Reserve in recent decades – this is a better measure to trace the economy's fortunes. When the excess of capital gains over new debt is added to net earnings for the real estate sector, the resulting "total returns" show a more rapid growth in bubble periods, but move into negative territory after the bubble bursts.

Mr. Greenspan's advice to homeowners to "cash out" on the rising market price of their homes by taking out home-equity loans to finance their consumption implied that the economy had entered a new era in which debts could be paid out of capital gains on a permanent basis. Normally property prices (*P*) represent rental cash flow (*r*) divided by the rate of interest (*i*). But Bubble Economy investors look not at current income – which they pledge to the bank – but at prospective capital gains ΔP. (So if $r = i$, then P = expected $(R + \Delta P) / i$. Even beyond this, asset-price ("capital") gains are not taxed nearly as high as wages and profit. Commercial real estate receives tax breaks that free it from having to pay income tax, most notoriously in the form of over-depreciation – the pretense that buildings are losing value even while the property's market price is soaring. Owning property also provides a tax subsidy (TS) in the form of interest deductibility, as well as low tax rates on capital gains and the ability of real estate investors to avoid paying such taxes altogether, as long as they plow their gains into the acquisition of yet more property. So the above formula for asset pricing becomes modified to P = expected $(R + \Delta P + TS) / i$.

Rising real estate prices thus reflect a financial dynamic that goes much further than merely capitalizing land rent at the going interest rate. It reflects an exponential rise in the volume of credit available to be lent out, while the land area remains constant. And as the exponential rise in lending (debt) divided by a given land area causes an exponential rise in land prices, the resulting rise in site values inspire expectations of equally exponential capital gains, bringing speculators and absentee buyers as well as direct users into the property market.

A rising pace of asset-price inflation may actually lead rents to fall in property bubbles, causing a further divergence between market prices for real estate and its capitalized rental value. Speculators buy up residential housing and commercial space, and then search for tenants to cover the interest charges. The supply of real estate tends to exceed the demand, and rents fall. The divergence of real estate prices from capitalized rental values thus works on the downside as well.

Today, widespread published expectations that real estate prices will fall by as much as 30% in 2008 is causing property prices to plunge, prompting speculators to withdraw from the market, leaving only current users as buyers. In this case, prices tend to fall below the discounted

rental income, which may actually rise as the estimated three million U.S. home foreclosures this year will not be available to be rented out, so rents actually may rise.

Why Can't Financial Bubbles create a Permanent Capital-Gains Economy?

The illusion that economies can pay their debts out of asset-price inflation has spurred an unprecedented growth of bank loans. Until about 2007 financial solvency was maintained much as it was for Third World debtors prior to 1982: Banks simply lent their debtors enough credit to pay the interest charges that accumulated. This kept the U.S. real estate bubble expanding until 2006. But the debt charges increased as interest rates tightened. Defaults occurred, inevitably, as the debt overhead slowed the economy's ability to pay rent and interest. Asset prices started to decline, prompting speculators to withdraw from the market. Foreclosures ensued, threatening the solvency of the most ambitious speculators and the most highly leveraged banks behind them.

Theories of financial bubbles treat crises as the culminating point. A sell-off clears markets and paves the way for recovery by restoring reasonable and indeed low asset prices. Minsky's "Ponzi" stage of the credit cycle – in which debtors borrow the interest to avoid defaulting – usually was assumed to be relatively short before bringing the debt expansion to an end. It was deemed a proper task of the central bank to raise interest rates to stop speculative "overheating," slowing new credit creation so as to prevent asset prices from going beyond the level that prospective earnings reasonably could justify. (The tendency of financial bubbles to spill over into trade deficits further supported the policy of raising interest rates, so as to attract enough foreign lending to stabilize the balance of payments and hence the exchange rate.)

Since the 1980s, however, the Federal Reserve Bank has pursued a policy of promoting one of the most prolonged periods of asset-price inflation in modern history. Rather than treating this as a financial distortion of the underlying "real" economy, Alan Greenspan and other financial promoters celebrated rising prices for real estate, stocks and bonds as wealth creation. This view fails to distinguish between what Adam Smith described in *The Wealth of Nations* – tangible means of production – and higher prices for assets already in place and for financial and property claims *on* "real" assets (stocks, bonds and bank loans). Rising net worth on the national balance sheets of households and business by inflating asset prices does not have the same effect as gaining wealth by increasing tangible capital investment. Failure to draw this distinction leads to fiscal and deregulatory distortions that increase economic overhead without raising real wealth.

The Fed's flow-of-funds reports and surveys of consumer finances showed U.S. balance sheets increasing in net worth, as long as asset prices rise more than indebtedness. But now that asset prices are plunging below debt levels to create "negative equity" for homeowners and even

for their bankers (as a result of loan defaults), today's financial crisis has spurred a debate over whether the United States may follow a prolonged Japan-style collapse of asset prices rather than asset prices quickly reverting to historical norms and resuming their growth.

Adding asset-price gains to the national income accounts helps explain why wealth is polarizing in the United States. As the financial sector gained economic power, it has translated this into lobbying power to back the political campaigns of lawmakers willing to promote tax advantages and subsidies for the finance and property sectors, and to deregulate their operations. The Bubble Economy could not have proceeded without this fiscal and political support.

This policy shift inverts the Progressive Era social and classical economic values that aimed to bring prices in line with cost-value. Instead of minimizing the "free lunch" extracted by financial and property claims, the *rentier* sectors seek as wide an element of price as possible over what is technologically necessary. These vested interests seek to maximize rent, interest and the asset-price gains that John Stuart Mill called the "unearned increment" in the case of land prices.

Most important of all in explaining the financial sector's rise to dominance over the production sector is the exponential growth of debt siphoning off wages, profits and rents, while shifting the tax burden onto labor. To promote this tax shift to encourage debt pyramiding on an economy-wide scale, the fiscal subsidy for finance and its major customers (real estate and monopolies) needs a rhetorical wrapping for the radical shift of economic categories – and hence of statistics. Attention must be shifted away from tangible capital formation to focus on the financial sector's balance-sheet concept of "wealth" and "capital" decoupled from capital investment in the "real" production-and-consumption economy, its wages and living standards, productive powers and even its ability to carry the soaring debt overhead.

Word count: 5,596

Appendix [See fn5]

Veblen's observations show that the capital gains economy focused on real estate has long been a staple of American wealth creation. His observations on the economic dynamics of small towns apply equally well to New York City and other large cities, where real estate dealing is just as important in politics and the creation of dominant fortunes.

Thorstein Veblen, *Absentee Ownership and Business Enterprise in Recent Times* (1922).

The country town of the great American farming region is the perfect flower of self-help and cupidity standardised on the American plan. Its name may be Spoon River or Gopher Prairie, or it may be Emporia or Centralia or Columbia. The pattern is substantially the same, and is repeated several thousand times with a faithful perfection which argues that there is no help for it, that it is worked out by uniform circumstances over which there is no control, and that it wholly falls in with the spirit of things and answers to the enduring aspirations of the community. The country town is one of the great American institutions; perhaps the greatest, in the sense that it has had and continues to have a greater part than any other in shaping public sentiment and giving character to American culture.

The location of any given town has commonly been determined by collusion between "interested parties" with a view to speculation in real estate, and it continues through its life-history (hitherto) to be managed as a real estate "proposition." Its municipal affairs, its civic pride, its community interest, converge upon its real-estate values, which are invariably of a speculative character, and which all its loyal citizens are intent on "booming" and "boosting" – that is to say, lifting still farther off the level of actual ground-values as measured by the uses to which the ground is turned. Seldom do the current (speculative) values of the town's real estate exceed the use-value of it by less than 100 per cent; and never do they exceed the actual values by less than 200 per cent, as shown by the estimates of the tax assessor; nor do the loyal citizens ever cease their endeavours to lift the speculative values to something still farther out of touch with the material facts. A country town which does not answer to these specifications is "a dead one," one that has failed to "make good," and need not be counted with, except as a warning to the unwary "boomer."

Real estate is the one community interest that binds the townsmen with a common bond; and it is highly significant – perhaps it is pathetic, perhaps admirable - that those inhabitants of the town who have no holdings of real estate and who never hope to have any will commonly also do their little best to inflate the speculative values by adding the clamour of their unpaid chorus to the paid clamour of the professional publicity-agents, at the cost of so adding a little something to their own cost of living in the enhanced rentals and prices out of which the expenses of publicity are to be met.

Real estate is an enterprise in "futures," designed to get something for nothing from the unwary, of whom it is believed by experienced persons that "there is one born every minute." So, farmers and townsmen together throughout the great farming region are pilgrims of hope looking forward to the time when the community's advancing needs will enable them to realise on the inflated values of their real estate, or looking more immediately to the chance that one or another of those who are "born every minute" may be so ill advised as to take them at their word and become their debtors in the amount which they say their real estate is worth. The purpose of country-town real estate, as of farm real estate in a less extreme degree, is to realise on it. This is the common bond of community interest which binds and animates the business community of the country town. In this enterprise there is concerted action and a spirit of solidarity, as well as a running business of mutual manoeuvring to get the better of one another. For eternal vigilance is the price of country-town real estate, being an enterprise in salesmanship.