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Herman Daly: The Disconnection Between Financial Assets and Real Asssets

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This is a repost of Herman Daly's comments on the credit crisis from October 13 of this year. The original post and comments can be viewed here. Given Professor Daly's association with John Holdren, one can hope these heterodox first principles are being discussed at the highest levels.

Previously, Herman Daly wrote a guest post on the Steady State Economy, outlining core suggestions on how to overhaul our banking, financial (and value) systems. I encourage everyone to read it (if short on time, please read the conclusion). Professor Daly was Senior Economist at the World Bank before leaving to teach Ecological Economics at University of Maryland's School for Public Policy. He was also the catalyst for me to leave my own financial career and return to school to study the real economy (i.e. what we call the human economy is only a small part of a larger closed system). Below the fold are his thoughts on the current crisis (current being defined as last 30-40 years or so). (For comparison, here are links to what 'mainstream' economic icons George Soros, and Bill Gross are saying.)

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—pretty much the opposite of too little liquidity. Financial assets have grown by a large multiple of the real economy—paper exchanging for paper is now 20 times greater than exchanges of paper for real commodities. It should be no surprise that the relative value of the vastly more abundant financial assets has fallen in terms of real assets. Real wealth is concrete; financial assets are abstractions—existing real wealth carries a lien on it in the amount of future debt. The value of present real wealth is no longer sufficient to serve as a lien to guarantee the exploding debt. Consequently the debt is being devalued in terms of existing wealth. No one any longer is eager to trade real present wealth for debt even at high interest rates. This is because the debt is worth much less, not because there is not enough money or credit, or because "banks are not lending to each other" as commentators often say.

Can the economy grow fast enough in real terms to redeem the massive increase in debt? In a word, no. As Frederick Soddy (1926 Nobel Laureate chemist and underground economist) pointed out long ago, "you cannot permanently pit an absurd human convention, such as the spontaneous increment of debt [compound interest] against the natural law of the spontaneous decrement of wealth [entropy]". The population of "negative pigs" (debt) can grow without limit since it is merely a number; the population of "positive pigs" (real wealth) faces severe physical constraints. The dawning realization that Soddy's common sense was right, even though no one publicly admits it, is what underlies the crisis. The problem is not too little liquidity, but too many negative pigs growing too fast relative to the limited number of positive pigs whose growth is constrained by their digestive tracts, their gestation period, and places to put pigpens. Also there are too many two-legged Wall Street pigs, but that is another matter.

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 CO2). 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 now likely exceed marginal benefits, so that real physical growth makes us poorer, not richer* (the cost of feeding and caring for the extra pigs is greater than the extra benefit). 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, 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 allows pyramiding of bank money (demand deposits) on top of the fiat government-issued currency. Third, buying stocks and "derivatives" on margin allows a further pyramiding of financial assets on top 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, 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.

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. Of course they also buy real assets and their future earning capacity. 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.