Popular Economics
Promoting the Popular Understanding of Economics

THE NEW ECONOMIC REALITIES
Coping with Difficult Financial Times

Introduction

"Economists are people who see something work in practice and wonder if it would work in Theory."

--President Ronald Reagan

"Economists, learning to observe their facts more closely, have begun to discover that, even in the most ordinary currents of daily life, their consumers do not quite live up to the idea that the economics textbook used to convey. On the one hand their wants are nothing like as definite and their actions upon those wants nothing like as rational and prompt. On the other hand they are so amenable to the influence of advertising and other methods of persuasion that producers often seem to dictate to them instead of being directed by them."

--Joseph Schumpeter, author of Capitalism, Socialism, and Democracy

How do we understand the financial world we live in today? It is a world where nothing is certain or fixed, except the certainty of change. Everything from jobs to interest rates is unpredictable. There is no longer any certainty of a steady income, or a pension, or even a good education. Health care is guaranteed to no one except the retired.

By 'we', I don't mean the top 1 percent of the wealthy whose incomes have increased 176 percent in the past 30 years, but you and I, those working households whose average incomes have actually fallen since the 1970s, after inflation is factored in. Just since 2000, real incomes for working households under 65 have fallen 5.4 percent, according to the U.S. Census Bureau.

In fact, men aged 30-39 earned $5,000 less in 2004 than their father's generation in 1974, according to the Census Bureau. Fathers fared better then their sons for the first time in American history. And so wives and mothers had to join the work place for their families to maintain a decent standard of living.

The result has been a declining quality of life for most Americans. We are no longer the tallest people (an important measure of overall health), work longer hours than either our European or Japanese counterparts, have the highest per capita prison population, and are the only developed country without a universal healthcare system, yet health care costs twice as much per person as that of our peers.

What happened in the 1970s that started the downward trend in our overall well-being? And what can ordinary Americans do to cope with and even overcome its consequences? Why should this be happening when we are still the richest country on earth?

The 1970s was an era of increasing worldwide uncertainty—for workers, the government, and businesses. OPEC and the 1973 Arab oil embargo came at a time of the Vietnam War and the consequent large budget deficits, which created a wage-price spiral that sent the inflation rate to a high point of 14 percent and unemployment rate to 8 percent in 1980.

This caused both public and private institutions to find ways to reduce their exposure to the increasing risks to their finances. Federal Reserve Chairman Paul Volcker began varying short-term interest rates in 1980 to better manage the money supply, for example, raising the fed funds rate to more than 16 percent in order to drive down the inflation rate.

Banks were then caught in a bind. They had lent out money at single-digit fixed rates in the 1970s, but now had to borrow money at the current higher Federal Reserve funds rate. This caused many of them to run out of money to lend, and so they began to offer adjustable rate mortgages that mirrored the higher variable rates. This passed on the interest rate risks to borrowers (i.e., consumers).

And what scared banks, scared the corporations. They began to lobby the government via such organizations as the Business Roundtable, made up of the CEOs of the top-100 corporations, for less regulation.

And that meant lobbying for smaller government and lower taxes. They blamed government for the economic mess, when in fact it was OPEC and the oil embargo combined with overspending on Vietnam, the longest war in U.S. history that caused the stagflation of the 1970s.

This led to the election of Ronald Reagan in 1980, with his government-is-the-problem mantra. The Reagan administration aimed at deregulating whole industries; first the airlines, then banks, then telecommunications, then energy. Greater competition could mean cheaper services, but also meant a greater danger of business failure.

This also led to an economic term coined by Harvard economist Joseph Schumpeter,'creative destruction'. Creative destruction meant speeding up the competition that encouraged stronger, more innovative companies to conquer their markets and the weak to disappear. The result? Greater job uncertainty as companies—and industries—disappeared in the blink of an eye.

Creative destruction also meant keeping costs low as the risks of failure grew, especially labor costs, and the long drought of low or no wage increases began for the majority of wage-earners that has lasted until today. It also meant transferring retirement risks to the employees in the form of 401(k)s that turned defined benefits with a lifetime guaranteed income into defined contributions by employer and employee that put the investment risk on the employee.

The economic justification for shrinking government was called supply-side economics. It was a modern variation of the classical economics of Adam Smith, who first propounded his theories of less government in 1776. He believed that shrinking government regulation and taxes would unleash the initiative and energy of private individuals.

But the supply-siders led by such conservative, neo-classical, economists as Milton Friedman took it to its extreme—ignoring a society of "we the people", for "me, the people be damned!" By opposing unions (and facilitating globalization of the workforce), taxes, and any form of government regulation, Milton, et. al., wanted a workforce that would become more 'flexible' in their job demands, enabling companies to more easily hire and fire their employees.

Deregulation also helped to spawn the digital age, which unleashed a great surge in labor productivity. But that productivity has benefited just the few. Between 1974 and 2000 labor productivity increased 56 percent in the value of output per worker hour, while incomes rose 29 percent. But between 2000 to 2005, productivity rose 16 percent, yet the median worker's income fell 2 percent, challenging the "the notion that a rising tide will lift all boats," said a recent report by the Pew Charitable Trusts entitled Economic Mobility: Is the American dream Alive and Well?

In fact, history shows that the tides are no longer rising as fast. From 1820 to 1973, U.S. per capita gross domestic product (the sum total of all goods and services produced domestically) grew an average 52 percent for each generation. But since 1973, per capita wealth has grown just 17 percent per generation—one-third the rate for prior generations.

What does that say for economic opportunity and the chance for upward social mobility that is part of the American dream? What institutions support the status quo, vs. those that want to share the wealth with a greater portion of income-earners? One staggering statistic that jumps out is the growth in income inequality since the 1970s. The real, after tax income of the wealthiest 20 percent rose 69 percent from 1979 to 2004, whereas it rose just 9 percent for the poorest 20 percent.

One key is that the economic myth of classical, free market, economics is no longer working for most Americans. The faith in so-called Laissez-Faire capitalism spawned more than 200 years ago by Adam Smith is waning. That faith was stated recently by Ben Bernanke, our new Federal Reserve Chairman.

“Although we Americans strive to provide equality of economic opportunity, we do not guarantee equality of economic outcomes, nor should we. Indeed, without the possibility of unequal outcomes tied to difference in effort and skill, the economic incentive for productive would be eliminated, and our market-based economy—which encourages productive activity primarily through the promise of financial reward—would function far less effectively.”

The evidence from modern economic research is showing that our market-based economy is overwhelmed by the complexities of the modern world. It has encouraged predatory behavior leading to corporate malfeasance by the likes of an Enron that has siphoned off $ billions in wealth from ordinary Americans.

What can ordinary Americans do to understand and cope with the incredible complexities of our modern economy? By examining the latest research we may hope to discover the biases and myths that underlie our capitalist system, and the prescriptions for its cure.

Does the American version of capitalism provide equality of opportunity for all, or for the most able, only, for instance? If so, who do the less talented turn to for advice? Those most talented will always rise to the top, but modern research is showing that whole classes and income groups can be held back by institutional (and political) factors such as taxation policies that favor the richest, or economic theories that would abolish all forms of regulation and governmental oversight.

Without effective government, we revert to a form of Social Darwinism where only the fittest survive. Taken to its extreme, a truly market-based economy would abolish our social safety net as well as an adequate health care system and retirement income for all but those favored few.

There are answers to this dilemma. In fact, other industrialized countries have been trying newer forms of capitalism that provide more equality of opportunity and protection for the poorest and oldest citizens. The U.S. of A. has that same opportunity, if it can escape the free market myth of equal opportunity for all without any government intervention or regulation.

The love of independence and free markets can be excessive, blinding Americans to their faults. Examining our lives through economic activity helps us to clarify the picture of who we are as well. It is true that we are obsessive about self-improvement, being only too aware of our frailties and prone to self-criticize. So we have always been susceptible to snake oil salesmen. In this case, it is those who promise instant financial health or an early retirement.

Economic reality as seen through the Economic Sciences (a Nobel Prize category) doesn’t embody one political system. Both planned and free market economies use—and abuse—its principles. All of our political parties claim its insights - whether Republican, Democrat, Independent, Libertarian or Green. Such an avowed free marketer as former Federal Reserve Chairman Alan Greenspan (see the Ayn Rand essay), has served the White House of both parties, for instance.

Modern economics is becoming more attuned to the real world. Its practitioners cover a fast changing field that examines how human beings attempt to survive and prosper as they go about their daily tasks. Both governments and the private sector use its tools to protect assets as well as redistribute them.

It is an admittedly inexact science, since it deals with human nature in the pursuit of human welfare. Yet as economists learn more about human nature and the world around them, society can benefit in many ways, from lower unemployment and inflation to more sustainable growth rates, less volatile markets (hence less risk), and less secrecy in an ever-expanding global economy.

That is perhaps why former Federal Reserve Chairman Alan Greenspan, an economist, was perceived to be one of the most powerful men in the world. Not just because he was at the helm of the world’s dominant economy, but because he seemed to have a clear vision of human nature. Its fundamentals are unchanging in his view, therefore we must be wary of its excesses – such as irrational exuberance or infectious (corporate) greed – that our penchant for irrational behavior leads us to.

“It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously,” he said once when speaking of the damage that Enron had wrought to its employees.

Economic research has therefore branched into other scientific fields. Using psychological insights, for example, it is called Behavioral Economics and examines such propensities as herd behavior in the financial markets.

Comparative and Political Economics study how different economic systems function within their political systems and why such systems arose. On a more applied level, economics has studied who escapes the ghetto and why, the economic roots of terrorism and gun-violence, the problems of housing affordability, as well as the reason for disparities of incomes both within and between countries.

Then there are the mathematical and statistical analyses of technical market factors in microeconomics that seem to obey other laws. They have led us to derivatives trading and other hedging mechanisms that attempt to shield our assets from excessive risk while coaxing higher returns. And Information Economics helps us to understand why markets don’t function as perfect competitive models—because market information isn’t equally accessible to all.

We should remember that even mathematics and statistics are human sciences and so subject to failure. The collapse of Long Term Capital Management, a hedge fund that included a Nobel laureate economist as its founder, is but a most recent example of mathematical models that didn’t take into account our irrational propensities.

Then we have the examples of junk bond kings and corporate raiders like Michael Milken and Ivan Boesky in the 80’s, the corporate malfeasance of Enron and Worldcom in the 1990s, and now accounting and insider trading scandals that graphically illustrate market imperfections as well as the frailties of human nature.

It therefore behooves us to better understand our economic behavior and not be blinded by utopian visions or abstract ideologies. Too many investors have lost their life savings by trusting in the vision of an unfettered free market being the surest way to a higher standard of living.

What vision should we carry of ourselves? Berkeley Economics Professor and 2001 Nobel laureate George Akerlof, for one, put it very succinctly in a New York Times editorial.

“If you let your toddler out of her playpen, you need to watch her more carefully. This wisdom is known by every American parent but has been systematically ignored in economic deregulation…Now is the time to remember the lessons of the playpen: increased scope for action must be accompanied by increased regulatory oversight.”

Could it be that even though 231 years have passed since Adam Smith wrote “The Wealth of Nations”, we still have much to learn about all too human nature, and what is best for us?