Financial Capitalism v. Industrial Capitalism

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Our economy is evolving into something different from what most people imagine it to be. The emerging system bears little relation to what academic textbooks describe, to say nothing of what politicians are promising.

Today's problems also are different from those which Marxists and other critics have long denounced. True, the class war has been put back in business since the collapse of Soviet Communism. But industrial capital as well as labor has come under attack in an internecine war of finance capital against industrial capital, and even against the power of governments to retain control over national economies.

Was Marx too optimistic?

In the face of this new form of economic warfare, capitalism's foundations are proving to be weaker than Marx had believed. One almost might wish nostalgically that the system still held the promise that it possessed for Marx and his Victorian contemporaries.

From the time socialists coined the term 'capitalism' in the mid-19th century, the word has been used mainly as an invective. Yet to Marx it signified the historical stage preceding socialism – a stage that promised to lead almost automatically to a better world. Capitalism's historical role was to prepare the world for socialism by integrating the world's national economies into a single market, whose business corporations would grow so large in scale as to constitute virtual planning. All that would be left for socialism to accomplish would be to take over a finely attuned industrial system and mobilize its economic surpluses to uplift humanity at large.

Stage-of-development theories are inherently optimistic in the sense that the next evolutionary step seems to be imprinted embryonically on society's (indeed, civilization's) DNA molecule. Marx even endorsed free trade on the ground that it would speed up this evolutionary process.[1] An enemy of bureaucracy, he saw the governments of his day dominated by landed aristocracies, militarized nobilities or colonial satrapies. Their tendency was to act as reactionary impediments to the economic organism trying to evolve forward, prone as they were to special interest pleading by the vested interests that retained political control over the fiscal and lawmaking processes.

As far as the financial sector was concerned, the fraud and corruption that characterized American railroad speculation and its stock waterings, and the failures of the great international investments in the Suez and the Panama Canals, brought ruin to the bondholders who originally subscribed to these projects. But this appeared to be simply part of the growing pains of industrial capitalism. In the end, rationality was expected to win out. In Vol. III of *Capital* (edited after his death by Engels), Marx expressed an optimistic faith that financial capital would become subordinate to industrial capital. He described the banking system as an 'integument' acting increasingly as the

[1] Marx, 'Protection or Free Trade: 1848 speech to the Chartists,' and *Critique of the Gotha Program.*

planning arm within industrial capitalism, bringing the world economy closer to international socialism.

In England, John Hobson found the taproot of imperialism to be the expansion of finance capital. A debt deflation led to underconsumption within the industrial economies, obliging financial expansion to take the form of a competition for colonies as spheres of influence, although most trade and investment would continue to be focused within the leading industrial nations themselves, for this was where most of the money was located.

In America, emperors of finance and the real estate kings they enthroned were gaining the upper hand over captains of industry. Thorstein Veblen analyzed how pecuniary relations – its financial and monetary structure – distorted the economic system away from how it would be run rationally by engineers. In Germany, whose banking and industrial structures had become more closely integrated than was the case either in England or the United States, the socialist Rudolf Hilferding coined the term 'finance capitalism' in 1910.

As England moved toward entry into the Great War, Herbert Somerton Foxwell wrote a series of papers for the *Economic Journal* expressing concern that continental Europe was winning an industrial edge over his own country precisely because of a more industrially oriented banking system. English banks had evolved at first out of the merchant banking of the goldsmiths – extending short-term credit to merchants to finance the shipping of goods, especially their importation and exportation – and then by the Bank of England monetizing loans to the government to finance its war debt (the purpose for which the Bank had been created in 1694). From the outset of the Industrial Revolution, however, English merchant banks stood aside from financing manufacturing technology. James Watt had financed the steam engine with funds borrowed from his family and friends, and subsequent industrialists were obliged to do the same. Most investment in industrial capital and other means of production was financed out of retained earnings. The commercial banking system limited its activities to advancing ready cash against export orders and extending other short-term business credit, duly collateralized. Matters are still the same way today.

After World War I the Treaty of Versailles saddled Germany with unrepayably large reparations debts. While the country stripped its economy in an attempt to pay these debts, the Allies found themselves strapped by America's unanticipated demand for payment for the arms it had supplied its military allies. Historically, such debts had been forgiven upon the ending of hostilities. The U.S. demand for payment of these debts virtually obliged England and France to take a hard creditor-oriented line towards Germany.

Financial theorists who insisted that economies could meet any given volume of debt payment or capital transfer represent an intermediate link between the Ricardian bullionists a century earlier and today's monetarists.[2] Their misguided policies were countered by John Maynard Keynes in England, and Harold Moulton in the United States, recognizing that there were limits to debt-servicing capacity. But governments did not respond to their reasoning, and failure of the 1931 London Economic Conference made the Great Depression inevitable.

Yet capitalism emerged from World War II in such good shape that even Stalin announced to the Comintern that there would be no postwar economic crisis. Unlike the case after World War I, the defeated powers were not burdened with reparations, but were rebuilt free of internal as well as foreign debt. This formed the basis of Germany's and Japan's economic miracles. In Germany's case the Allies cancelled the debts in their Clean Slate of June 1948. Japan found its post-feudal linkage between landed aristocrats, bankers and war industrialists broken by General MacArthur's land reform and associated bank reforms. The war industry evolved into a forward-looking Ministry

[2] I describe these financial debates in *Trade, Development and Foreign Debt* (London: 1992), Vol. II.

of Trade and Industry (MITI).

In the Allied economies, consumers emerged from the war free of debt (for there had been few consumer goods to buy during the war, and hence little reason to borrow), and indeed with abundant savings accumulated during the war. There was no postwar inflation, nor the kind of postwar deflation that had strangled England's economy after World War I.

Governments were relatively free of debt, as were the business and real estate sectors. Low wartime interest rates had enabled debt maturities to be stretched out, so that interest and principal obligations did not push up the cost of housing or factory output.

It seemed that capitalism's future would be limited only by technological horizons. Contrary to widespread fears of diminishing returns and resource exhaustion, fuel and mineral prices have declined thanks to better oil and gas extractive techniques, and mining innovations such as large earth-moving equipment and the pelletizing of iron ore. Plastics have replaced non-renewable resources in construction, automobiles and other products.

Indeed, a consumer revolution has occurred with the spread of labor-saving appliances, while a widespread automobile culture has extended home ownership over a broad landscape. Telephone costs have been slashed, while television has developed color transmission and cable TV. The spread of entertainment associated with computerization now enables people to entertain themselves to death, if they so choose.

Transportation costs have been vastly lowered by containerized cargo shipping and less expensive air travel, while space travel and the launching of communications satellites have helped integrate the world economy.

In the sphere of public health, wonder drugs (and DDT) were helping to eradicate major diseases such as malaria, while vaccines inoculated entire populations against polio, smallpox and other maladies. New diagnostic treatments from X-rays to CAT-scans have been accompanied by innovations in microsurgery, organ transplants and genetic engineering. People are now living longer. Social security and the funding of long-term pension plans has provided retirement security, while a social welfare net has been spread widely over the population, aided by equal opportunity laws.

What then has gone wrong? As labor productivity has risen and new technological horizons have opened up, why hasn't everyone become wealthy? Why haven't these innovations improved the quality of life proportionally?

One problem associated with the new consumer culture has been environmental degradation. Although recognized by mid-19th century economists (especially by American technology theorists such as Erasmus Peshine Smith and Marsh, who coined the term 'ecology'), this is just one dimension that has been dismissed from the academic economic mainstream as constituting an 'externality' (as Chapter 10 will discuss in greater detail).

The most serious problems lie in the financial sphere, where the economy's debt overhead has grown more rapidly than the 'real' economy's ability to carry this debt. One might call its demands for interest and amortization 'debt pollution', stifling the economic environment much as bad air and water plague the earth's biosphere.

Consumer spending has indeed risen remarkably, but in recent years it has been financed increasingly by debt, whose interest and amortization payments will absorb future earnings. These earnings no longer are rising, but have been drifting downward for most workers. Indeed, if women and ethnic minorities have gained equality in the work place in recent years, it is largely because they have been forced into the job market by a tightening wage squeeze on most families.

One of the most remarkable achievements of recent generations has been the disappearance of world war as an imminent threat. The collapse of Soviet Communism promised an end to the world arms race, yet governments still are running deficits. It is as if the ending of the Cold War has put the class war back in business. Military spending has not declined significantly, and governments throughout the world have now found a new source of budget deficits: tax cuts for the wealthy. In this new economic warfare, the most effective tactic is to offer modest income-tax reductions to the lower classes, while more than making up the difference by shifting taxation onto the shoulders of consumers via excise and value-added taxes, as well as increasing the social security tax levy.

If the world economy is becoming more closely integrated, the financial forces of corporate globalism are leaving less room for national governments to shape the economic environment within which their labor and capital operate. This globalism emanates from the United States, taking a centripetal form rather than spreading the wealth from the wealthy center to the poorer periphery.

Denominating a growing proportion of their public and corporate debt in dollars has vastly increased the debt burden for countries with depreciating currencies. It also has locked foreign economies into the orbit of U.S. economic diplomacy, largely by forcing them into dependency on the International Monetary Fund (IMF) its sister institution, the World Bank. These institutions are imposing the same creditor-oriented monetarism that wrecked the world economy in the 1920s, triggering the Great Depression. Instead of helping the world's poorer debtor economies develop, the IMF and World Bank programs 'underdevelop' them, polarizing their economies between a wealthy top layer and poverty for the vast majority. Turned into a U.S. Cold War arm under the stewardship of Robert McNamara, the World Bank has become a powerful arm of the new global class war, most notoriously Russia and East Asia.

The upshot has been to leave the world's poorer economies even deeper in debt, and so financially strapped that they are obliged to sell off to international financial institutions whatever assets remain in their public domain. While wealth and incomes have polarized as a result of the active intervention of the World Bank and IMF on behalf of the ruling kleptocracies throughout Africa, Latin America and Asia, the physical environments of these debtor economies have been devastated by the ecological consequences of the World Bank's raw-materials export programs. Pandemics have broken out as public health programs have been dismantled as domestic budgets have been stripped to service the mounting foreign debt. This has impaired the ability of governments to contain new diseases and undertake ameliorative social spending.

Instead of being used productively, privatization proceeds have been dissipated mainly to finance tax cuts for the wealthy and to un-tax foreign investment, while subsidizing capital flight. Privatization of the political process itself has turned control over to the largest campaign contributors and media owners.

The upshot is quite different from what seemed to be the technological promise of the early industrial postwar years. The world is now confronted with the deindustrialization without having raised living standards for most populations. Labor forces are being downsized without having achieved the prosperity that was promised. What has happened, in a nutshell, is that industrial capitalism has been replaced by full-blown finance capitalism.

Characteristics of today's rentier *capitalism*

The drive for capital gains in real estate and the stock market

Whereas the old industrial capitalism sought profits, the new finance capitalism seeks capital gains mainly in the form of higher land prices and prices for other rent-yielding assets. Partly this is an attempt to sidestep income taxation. Since the income tax was introduced, a growing portion of businesses revenue has been reclassified as non-taxable ‘cash flow’. In the real estate sector – the economy’s dominant sector in terms of asset size – re-depreciation and indeed, over-depreciation of buildings and the payment of mortgage interest leaves almost no taxable income at all! Much the same situation is found in the oil and gas business, in mining and forests, insurance and banking.

The tax collector (a euphemism for *taxpayers*) suffers as investors across the economic spectrum borrow funds so as to leverage a higher return on equity. Hoping simply to keep a capital gain for themselves, they have been willing to commit virtually all their cash-flow to banks and other lenders.

At least the old industrial capitalists made their profits by building factories and investing in capital equipment to employ wage-labor to produce products and services. Whereas these old capitalists found their epitome in manufacturing, the new *rentier* capitalism is centered in the FIRE sector. The new objective is to recycle the economy’s savings into real estate and the stock market to bid up land and equity prices, not to create new assets. In the stock market, capital gains are achieved by down-sizing the labor force and scaling back production so as to squeeze out more revenue rather than seeking to expand market share by undertaking new direct investment.

Land, the economy’s largest asset, hardly can be increased, but it can be bid up in price. Likewise, stock market prices rise not only because pension funding and other savings are being steered into the market, but because the volume of stocks actually is shrinking. Stocks are being retired by corporate raiders in exchange for high-interest (‘junk’) bonds, and by corporations using their earnings to buy their own stocks rather than to make new direct investments. (IBM is the most notorious example here, often spending $10 billion a year on its own stock rather than on R&D or other market-building investment.)

Asset-price inflation v. commodity-price and wage inflation

While U.S. wage rates are held down by de-unionization, out-sourcing (paying workers on a piecework basis rather than as full-time employees), and scaling back non-wage benefits, wages in other countries are eaten away by chronic currency depreciation stemming from debt-service outflows and remitted earnings.

Keynesian monetary analysis distinguished between profit inflation and wage inflation (and by extension, commodity price inflation). But there was no independent analysis of asset-price inflation as a distinct phenomenon. In an epoch when most funds were placed in bonds, inflation was seen simply as eroding the purchasing power of debt service, not as creating a demand for bonds. Today, as the Federal Reserve system pumps money into the economy by buying government bonds from the private sector, the monetary inflation has been contained largely within the securities market. The effect is to bid up financial asset prices, lowering their interest yields rather than requiring higher yields to compensate for price inflation.

Mobilizing pension-fund savings to bid up stock market prices

Marx held that profits under the old industrial capitalism stemmed from the employment of wage labor, which he defined *ipso facto* as exploitation. (The capitalist made his profit by selling the products of labor at a higher price than the labor cost him. Wage labor thus was the source of surplus value.) Modern finance capitalism has found a new way of exploiting labor, by mobilizing pension funds, Social Security and other retirement savings to bid up stock-market, bond and real estate prices. Meanwhile, a widening wedge of wage revenue is being siphoned off to pay interest on personal debts.

Under industrial capitalism and its predecessors, savings were accumulated mainly by wealthy *rentiers* who inherited their lands and real estate, trust funds and other assets. Under today's finance capitalism, savings by the labor force via pension funds and Social Security have grown to play a dominant role in the bond and stock markets. This poses the issue of whether labor's savings will be used for its benefit as a class, or for the benefit of *rentiers.*

Public budget deficits stem from the new financial warfare, not military warfare

National debts under the old capitalism stemmed almost exclusively from wars. Today's deficits stem mainly from cutting back taxes on the wealthy, especially on the real estate, financial and insurance sectors.

Whereas the old capitalism was militarized, the new financial capitalism has led to such heavy national debts that economies no longer can afford conventional warfare (at least not the old fashioned kind; Vietnam ended that forever). A rising proportion of public budgets is now devoted to paying interest on the public debt. To make matters worse, tax rates are being cut for the *rentiers* who receive this interest, while their array of special exemptions and tax breaks are widened as they gain control of the political process through campaign contributions and ownership of the media. Monopoly power often is buried in balance sheets under the category of 'good will', whose leverage increases with compliant government agencies. And by gaining control of the leading business schools through endowments, *rentiers* mould the educational process so as to make all this appear quite natural.

The value-free economics of *rentier* capitalism

Whereas classical economic theory was taught largely by religious officials, often as moral philosophy at Christian colleges, the study of economics has now shifted to the business schools whose objective is simply to teach students how to get rich, not how to be happy or how to promote overall public welfare and prosperity.

The classical economists focused on rent theory as the paradigmatic 'unearned income' as compared to industry. But today's economics ignores land as a factor of production. The idea of rent has been all but dropped from study.

The old capitalism used public-spirited rhetoric while relying on government for support (including police). The new finance capitalism uses an individualistic rhetoric while buying control of governments and depending on them to lend defaulting debtors the funds to pay their creditors, and to guarantee security of financial assets for their holders.

As envisioned by Marx, industrial capitalism was characterized by a class war between the workers and their employers. But industrial capital, as well as labor, is victimized by today's finance capitalism. Industrial corporations are targeted by raiders to be carved up, while the labor force is downsized and out-sourced. And whereas the old capitalism used a nationalist rhetoric to expand throughout the world, the new finance capitalism uses an internationalist one-world rhetoric while in practice creating economic polarization and asymmetries between the financial centers and the rest of the world.

Denial of the contrast between productive and unproductive labor and investment

The U.S. labor force employed in industry and agriculture, transport and power production – what the 19th-century classical economists classified as ‘productive labor’ – barely has increased since 1929. Nearly all growth in employment has occurred at the federal, state and local government level, and in the FIRE sector and related services (such as law).

Distinguishing between productive and unproductive labor and credit, the classical economists classified such employment as ‘unproductive’, and hence in the character of economic overhead. But today it is being welcomed as ushering in the post-industrial society. Today’s finance capitalism deems all labor, investment and debt to be productive, regardless of how it is employed. There thus seems to be no basis for calling the proliferation of claims *on* wealth an economically unproductive or parasitic activity.

Shifting the tax to industry and consumers so as to un-tax *rentier* returns

Under industrial capitalism and its predecessors, taxes were levied mainly on land and real property. (Capital gains initially were taxed as normal income in the United States in the 1920s.) But finance capitalism shifts taxes from *rentier* FIRE-sector gains onto the shoulders of labor and industry. Taxes are levied increasingly on consumers via sales and other excise taxes and a VAT, rather than on income and wealth.

Equilibrium economics v. exponential growth in the economy’s debt overhead

Early economic theory dealt with exponential rates of growth. At the time of Britain’s colonial war in America, Richard Price contrasted the growth rates of savings at compound and simple interest. In 1798, Thomas Malthus applied this comparison to contrast ‘geometric’ rates of population growth to an (allegedly) only ‘arithmetic’ growth in its food supply.

The basic model for financial crises was that of debt trends rising exponentially until they reached a limit beyond which debt-service obligations could not be met. At this point credit was destroyed and the economic system was brought down with a crash.

By contrast, modern theory assumes that automatic stabilizers will return economies to a state of equilibrium if and when they are disturbed. Such theories assume negative feedback (diminishing returns or diminishing marginal utility), not positive feedback such as exponential debt growth or increasing returns.

Ancient economic thought focused on the debt problem, that is, the tendency of debts to grow exponentially, exceeding the economy’s ability to pay (and to produce). Modern economics assumes that money is only ‘a veil’, not intervening in economic processes as such. Concentrating on the ‘real’ tangible economy (depicted as operating without debt distortions or related debt overhead), modern economics banishes the debt problem to the realm of ‘externalities’.

Culture is another economic ‘externality’ that is ignored. A century ago, optimists imagined that by increasing productivity, industrial capitalism would provide more leisure time, and hence would usher in higher cultural horizons. But by opposing a role for government and using the public debt as a lever to privatize hitherto public services – including public TV and radio broadcasting, national film boards, arts and other cultural programs – finance capitalism has tended to commercialize culture by downgrading it to the most common (lowest) but also most profitable common denominator.

Ancient economic thought also viewed wealth and income as addictive. It coped with the threat that wealth tended to lead to abusive hubristic behavior on the part of the rich. A designated role of religious and social values was to counter this human tendency toward addictive selfishness. But modern economic theory is based on a view of human nature that unrealistically assumes diminishing marginal utility for each successive unit of wealth. The problem of wealth addiction – and hence, drives for personal power – is not recognized, nor are problems of consumer addiction.

The new business mentality is different from that of traditional societies. Most tribal communities seek to socialize their members not to be hubristic. But today's wealth is egoistic in ways that injure others, lacking a contextual self-steering mechanism. The personal characteristics required for success under finance capitalism are associated with a stripping away of anything not directly associated with a 'bottom line' mentality.

Expensive or 'high' culture (such as opera, symphony orchestras) is likely to suffer financial strangulation. To the extent that the new decadence emphasizes surface effects, the character of motion pictures is likely to shift away from plot-intensive movies about character (and how it deals with the hubristic temptations of wealth and success) to sensational effects. In a sense, one could say that culture becomes 'proletarianized'.

In the 1830s the British economist William Nassau Senior began his class in political economy at Cambridge by announcing, 'I am not here to talk about how to make you happy, but about how to make you rich'. The way to get rich is very simple. All you need is greed, and that is something that can't be taught. It requires a deprivation of culture and what many societies believe is the social sensitivity that makes us human.

New well-paid graduates are obliged to work between 80 and 120 hours a week. This is how corporations weed out new prospective employees. It was much the same for bankers, accountants and lawyers in the 1960s. The objective was to weed out any new recruits that had a personal life, family, hobbies, intellectual or cultural interests, or anything that might take precedence over the corporate life. Their entire personal horizon was supposed to consist of working in a dedicated way for their employer.

Not everyone wanted to go through this weeding-out process. Bankers used to joke that the best foreign currency traders, for instance, had to come either from the Brooklyn or Hong Kong slums – someone from a poor household, without gentlemanly culture, often from an immigrant family, whose sole personal horizon was to make as much money as possible.

In this sense today's *rentier* culture is dehumanizing. As the leadership of corporations has passed from what Thorstein Veblen called the 'engineers' to the financial managers, the objective is not to produce more or expand market share, but to increase the price of stocks, other securities and real estate. If executives find their self interest in 'working for the stockholders', it is largely because they take more of their remuneration in the form of stock options than in salaries. They use corporate revenue not to fund new direct investment but to buy up their own stock to support its price. They also cut back on low-profit activities so as to increase earnings, and hence to increase the per-share price.

The resulting 'culture of greed' has become anti-technological in seeking short-term payoffs. Corporate managers are rotated from one department to another, running them as autonomous profit-centers, regardless of the company's overall long-term position. One sees in these new managers – Russia's '7 bank barons' as well as US corporate managers – an adolescent immaturity, a childish, self-centered, narcissistic lifestyle. They tend to view life as a game, which one 'wins' by accumulating more toys/money than one's rivals.

The perverse role of today's debt, credit and savings

While taxes are used increasingly to service the public debt rather than to undertake public works and employ labor, a debt deflation in the non-financial sector depresses goods and service prices, as well as wage rates. Savings consist largely of interest and dividends on financial investments, and are recycled into debt service and more financial speculation rather than into new direct investment and employment.

<u>The dysfunctional evolution of today's commercial banking</u>

Under the industrial capitalism that developed in France and Germany, banks played a major role in providing long-term funding to industry, both as direct lender and stockholder. But today's banks play little direct industrial role, even as intermediaries, and the stock market is not a major source of new direct investment funds. Banks limit themselves to extending credit collateralized by receipts for goods already shipped to customers – bankers' acceptances and collections outstanding. Even in this area, large firms are now bypassing the banks by issuing their own commercial paper.

The role of real estate has changed largely because the modes of financing long-term mortgage credit changed in the 1930s. The S&Ls and mutual savings banks mutated away from something aimed at small home-buyers to large real estate developers. They were gobbled up by the large FIRE-sector complex and made part of the globalization process.

Marx forecast that capitalism would industrialize the less developed world, but did not foresee that industrial capitalism would become subordinated to financial capitalism. The old captains of industry have been replaced by FIRE-sector emperors of finance and real estate kings.

Bohm-Bawerk and others imagined that more 'roundabout' technological modes of production would gain prominence, imagining that interest was a payment for waiting or 'time preference'. But today's financial system is slashing R&D and time-taking technologies in order to get quick payoffs, rather than going hand in hand with technology.

Whereas industrial capitalism was nationalist and state-sponsored, today's global finance-capitalism is dismantling governments. It claims to be peaceful, as only governments and nation-states can wage wars.

<u>Changing character of the balance of payments and foreign exchange rates</u>

International payments and currency values in 19th-century practice and theory was dominated by import and export trade. Although investment and 'invisibles' were recognized already by James Steuart and 'mercantilist' political arithmeticians, they played a secondary role and were not quantified on a systematic statistical basis until after World War I. Today's international payments and currency values are swamped by capital movements, especially short-term stock and bond funds. To earlier economic writers this would be a case of 'the tail wagging the dog'.

Definition of a Bubble Economy

A bubble is first perceived by the public as a situation in which price/earnings ratios rise without correspondingly higher prospective growth in earnings. Stock market and real estate prices rise not because of a reasoned calculation that these assets will generate new revenues to make them worth more, but simply because of an excess of savings over and above direct investment opportunities to absorb them. The asset-price inflation seems to possess a momentum in and of itself, creating an expectation that the assets can always be sold to somebody else for a higher price.

The transition to a full-fledged bubble economy occurs at the point where the carrying charges of real estate that is rented out – or interest charges and related carrying costs of other asset ownership – exceed the earnings and cash flow being generated. Indebted landlords often choose to walk away from their property at this point, and businessmen walk away from their debts.

How long can a bubble last? If there a limit to the process, what is it?

The degree to which debt may rise as a proportion of personal, corporate and government income depends on the rate of interest charged, the maturity of the debt (*i.e.*, how much has to be repaid or rolled over each year), and the degree to which taxes and other break-even costs absorb revenue. Once the point of inflection has passed – once interest and other essential expenses exceed revenue – the economy begins to shrink. A break in the chain of payments soon occurs.

Just when and where this happens rarely can be forecast. Typically there is financial fraud involved, as when a currency trader in Singapore brought down Baring Brothers. Such behavior tends to proliferate in bubble situations. The stock market comes to resemble a Ponzi scheme, requiring a larger flow of revenue each month to reward earlier investors.

An alternative definition of a Bubble Economy therefore focuses on asset-price inflation – rising stock market, bond market and real estate prices in the face of an economy-wide debt deflation. Rising debt-carrying charges exceed the growth in wages, real estate rental cash flow, corporate profits and government fiscal revenues. A debt deflation occurs when interest charges absorb all the overall earnings gain. After subtracting taxes and defraying rental costs, debt service and other basic expenses, median wage and consumption levels fall – and the debt service is plowed back into new lending and speculation.

Economic polarization between creditors and debtors is aggravated by tax cuts for the wealthy and a reclassification of financial and real estate returns as capital gains or various forms of untaxed 'reserve' funds.

How the Bubble's health requires a dying economy

The bubble's health (if one can refer to a financial cancer as having health) derives from the economy at large losing momentum by employing its savings in an unhealthy way. Any threat of restored health in the 'real' Main Street economy threatens to doom the Wall Street bubble, for not only must savings increase, they must be diverted away from tangible capital investment to continue to bid up the prices of stocks, bonds and real estate. What is healthy for Wall Street is thus anathema to Main Street. This is why Wall Street investors instinctively recoil when employment and investment rise.

The essence of the global financial bubble is that savings are diverted to inflate the stock market, bond market and real estate prices rather than to build new factories and employ more labor. The system threatens to collapse in such a way that will leave a legacy of financial cleanup costs for the bad debts that form the counterpart to the economy's 'bad savings', that is, savings lent to speculators who use the money simply to buy existing properties rather than to create new assets.

This recognition by Wall Street's financial strategists underlies the push to privatize Social Security. The system is not sick, but that is not the point. The real objective is not to bail it out, but rather to bail out the stock market. If the vast sums invested in government securities could begin to be switched into the stock market, the effect would be to bid up equity prices. Of course, when it comes time for the system to begin paying out -- when the number of retirees exceeds the number of new employees contributing to the system – the result will be a stock-market outflow.

But that, as Rudyard Kipling would say, is another story. Most of today's fund managers will be happily retired, living off their accumulated bonuses. The population at large will be advised to hold onto its stocks for the long run. They will be reminded of how equities have outperformed bonds over the past two centuries.

Financial players themselves operate in the short run. At the first sight of a downturn they bail out, seeking to ride the waves both up and down. Never has their advice to their customers been so much at variance with the financiers' own practice.

Beyond the business cycle to a phase change

Whereas industrial capitalism was characterized by business cycles, the new financial capitalism is not primarily cyclical in character. It represents a structural change, for as Hegel pointed out, an increase in quantity becomes, at a point, a change in *quality.*

Industrial capitalism was technology-driven. Mechanized production undercut the costs of labor, while tending to make skilled labor and highly educated labor more important (*viz.* Veblen's emphasis on society's economic planners and 'engineers'). But today's financial capitalism seems at odds with technological advance, R&D and more 'roundabout' production. It devalues education, prizing something that cannot be taught in schools: greed, which earlier societies associated with crude narrow-mindedness.

The global (*i.e.,* U.S.-centered, outward-reaching) financial system is something new, yet also a retrogression to the 'pre-capitalist' usury problem, of debt claims coming to exceed the economy's ability to produce and to earn. Interest-bearing debt growing at compound interest has been around since 3rd-millennium Sumer. After polarizing societies and being a major catalyst in the concentration of landownership (*viz.* Isaiah and the Roman historians), it ended up strangling antiquity.

The problem of pre-capitalist *rentier* formations has survived, however, in the capitalist DNA molecule. This DNA may have imparted a fatal flaw to modern capitalism, a disease that has broken out as a cancerous form. The debt overhead rising to crush economic takeoffs signals the dominance of finance over industry, of 'virtual wealth' (that is, debt-claims *on* wealth) over what economists still call 'real' wealth, as if finance were less real than tangible physical structures.

What is new today is therefore that in previous history, only at the end of antiquity – in Rome – were the dynamics of debt (which Einstein called the miracle of nature) unchecked. In the Mesopotamian homeland of interest-bearing debt, non-commercial debts were annulled by royal fiat when they became overgrown. In modern times, bankruptcy wiped out debts on the individual and enterprise scale, and even that of governments. But the debt phenomenon has now broken free of constraints to become autonomous, not subordinate to the 'real' economic processes, *e.g.,* the tangible accumulation of wealth and the ability to pay.

To call today's finance capitalism 'modern' would be to imply that it is progressive. But it is retrogressive to the extent that it represents a relapse back into pre-capitalist problems of usury (but not direct slavery). What is modern is that whereas the debt burden was decried in classical antiquity, today's debt fluorescence is welcomed in its mirror image – 'savings' on the asset side of the economy's balance sheet – as heralding a prosperous postindustrial society.

Savings (which find their counter part in other peoples' debts) are supposed to be inherently associated with the ability to reach new technological horizons, medical and health horizons, and cultural horizons. But to the extent that debt/savings to hand in hand with economic polarization, these horizons are being limited rather than expanded.

The question is, what is to be done? How should the genetics of our system be re-engineered so as to make it immune to the debt cancer?

Industrial capitalism was notorious for creating damaging 'external' environmental effects such as environmental pollution, industrial accidents and social suffering. Finance capitalism threatens to exacerbate rather than cure these externalities. Privatizing the political process is likely to deter the implementation of behavioral checks such as holding industries liable for their cleanup costs, from environmental pollution to the medical costs associated with smoking-related diseases.

Today's finance capitalism also has disappointed hopes for further progress in medical technology. Privatizing the health-care system shifts the decision-making objective from curing diseases to making a profit. Like banking and finance, the highest-cost medical technology may move offshore to tax-avoidance 'banking' centers where expensive new medical technology need not be extended to cover large numbers of patients.

Having become autonomous, the debt-cancer has gained control of national and global policy. Indeed, we are seeing today the dollarization of debt in countries whose debt-service forces a chronic currency depreciation. At the end of the 1970s, Canadian municipalities managed to save a few tenths of a percentage point of interest by borrowing in d-marks and Swiss francs. As the Canadian dollar fell, debt service in these currencies rose. Likewise in Asia today, when capital flight undercut the currencies of Thailand, Indonesia, Korea and neighboring countries, their currencies fell, bankrupting many indebted companies.

The process of privatization exacerbates this phenomenon all over the world. The revenues of electric utilities and other hitherto public monopolies are in local currency, but their debts are denominated in dollars. This transfer problem creates currency pressure – and the more the currency falls, the higher the dollarized debt-burden becomes.

Imagine the problems that would result in creating a Russian mortgage market to privatize real estate. Revenues would be in roubles, but interest payments to foreigners would be in dollars. As the rouble falls, the cost of servicing its mortgage debt will rise.

This threatens to impose a permanent debt deflation, inverting the persistent worldwide inflationary trend that existed until quite recently. A hint of what is to come may be seen in the postwar deflations of the 1870s in America after the Civil War, and the 1920s deflation in England following World War I. Whereas industrial capitalism in many respects benefited from the monetization of Europe's and North America's war debts, we may think of the coming financial dystopia as a post-Class War debt deflation.

The recycling of savings into real estate and stock market bubble financing is something that has never happened this way before. In past times, people borrowed for real estate only out of need („mortgaging the homestead"). S&Ls and Japan's *jusen* are relatively recent, post-Depression phenomena. Savings banks were designed in the 19th century ago to lend to neighborhood workingmen, not to large Florida, California and Texas real estate developers. The 'mutuality' of savings banks is now being destroyed.

These structural changes in the economic system are not periodic, except to the extent that economies also were strangled by an overgrowth of debt in antiquity. Society lapses into a chronic depression. New structures may emerge as economic momentum is lost, enabling new forms to develop (albeit out of the particular way in which their predecessors fell apart).