Michael Hudson and Dirk Bezemer:

**Finance Is Not the Economy:**

**Finance should be subtracted from GDP accounts**

The banking and financial system may fund productive investment, create real wealth, and increase living standards; or it may simply add to overhead, extracting income to pay financial, property, and other rentier claimants. That is the dual potential of the web of financial credit, property rights, and debts (and their returns in the form of interest, economic rent, and capital gains) vis-à-vis the “real” economy of production and consumption.

The key question is whether finance will be industrialized — the hope of nineteenth-century bank reformers — or whether industry will be financialized, as is occurring today. Corporate stock buybacks or even a leveraged buyout may be the first step toward stripping capital and the road to bankruptcy rather than funding tangible capital formation.

In Keynesian terms, savings may equal new capital investment to produce more goods and services; or they may be used to buy real estate, companies, and other property already in place or financial securities already issued, bidding up their price and making wealth more expensive relative to what wage-earners and new businessmen can make. Classical political economy framed this problem by distinguishing earned from unearned income and productive from unproductive labor, investment, and credit. By the early twentieth century, Thorstein Veblen and others were distinguishing the dynamics of the emerging finance capitalism from those of industrial capitalism.

The old nemesis — a land aristocracy receiving rent simply by virtue of having inherited their land, ultimately from its Norman conquerors — was selling its property to buyers on credit. In effect, landlords replaced rental claims with financial claims, evolving into a financial elite of bankers and bondholders.

Conventional theory today assumes that income equals expenditure, as if banks merely lend out the savings of depositors to borrowers who are more “impatient” to spend the money. In this view, credit creation is not an independent and additional source of finance for investment or consumption (contrary to Marx, Veblen, Schumpeter, Minsky, and other sophisticated analysts of finance capitalism). “Capital” gains do not even appear in the NIPA, nor is any meaningful measure provided by the Federal Reserve’s flow-of-funds statistics. Economists thus are operating “blindly.” This is no accident, given the interest of FIRE sector lobbyists in making such gains and unearned income invisible, and hence not discussed as a major political issue.

We therefore need to start afresh. The credit system has been warped into an increasingly perverse interface with rent-extracting activities. Bank credit is directed into the property sector, with preference to rent-extraction privileges, not the goods- and-service sector. In boom times, the financial sector injects more credit into the real estate, stock, and bond markets (and, to a lesser extent, to consumers via “home equity” loans and credit card debt) than it extracts in debt service (interest and amortization). The effect is to increase asset prices faster than debt levels. Applauded as “wealth creation,” this asset-price inflation improves the economy’s net worth in the short run.

But as the crash approaches, banks deem fewer borrowers creditworthy and may simply resort to fraud (“liars’ loans,” in which the liars are real estate brokers, property appraisers and their bankers, and Wall Street junk-mortgage packagers). Exponential loan growth can be prolonged only by a financial “race to the bottom” via reckless and increasingly fraudulent lending. Some banks seek to increase their market share by hook or by crook, prompting their rivals to try to hold onto their share by “loosening” their own lending standards. This is what happened when Countrywide, Wachovia, WaMu, and other banks innovated in the junk-mortgage market after 2001, followed by a host of community banks. Rising fragility was catalyzed by Wall Street and Federal Reserve enablers and bond-rating agencies, while a compliant U.S. Justice Department effectively decriminalized financial fraud.

The 2008 financial crash pushed the bubble economy to a new stage, characterized by foreclosures and bailouts. Faced with a choice between saving the “real” economy by writing down its debt burden or reimbursing the banks (and ultimately their bondholders and counterparties) for losses and defaults on loans gone bad, the policy response of the US and European governments and their central banks was to save the banks and bondholders (who incidentally are the largest class of political campaign contributors). This policy choice preserved the remarkable gains that the “One Percent” had made, while keeping the debts in place for the “99 Percent.” This accelerated the polarization that already was gaining momentum between creditors and debtors. The political consequence was to subsidize the emerging financial oligarchy.

In light of the fact that “debts that can’t be paid, won’t be paid,” the policy question concerns how they “won’t be paid.” Will resolving the debt overhang favor creditors or debtors? Will it take the form of wage garnishments and foreclosure, and privatization selloffs by distressed governments? Or will it take the form of debt write- downs to bring mortgage debts and student loan debts in line with the ability to pay? This policy choice will determine whether “real” economic growth will recover or succumb to post-bubble depression, negative equity, emigration of young skilled labor, and a “lost decade.” According to our analysis, the present choice of financial and fiscal austerity in much of Europe threatens to subject debt-ridden economies to needless tragedy.