Contours of Crisis
Fiction and Reality

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CHART BOOK
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Preface

There are many explanations for the current crisis, but they all seem to share one thing in common. The view of most observers is that this is a financial crisis, a crisis that originated in and was amplified by the financial sector.

Of course, when theorists speak about a financial crisis, they don’t speak of finance in isolation. They speak of finance in relation to the so-called real capital stock. The current crisis, they argue, happened not because of finance as such, but due to a “mismatch” between financial and real capital. According to this view, the world of finance deviated from and distorted the real world of accumulation; and since there is no such thing as a free lunch, the ensuing crash is the price we all have to pay for failing to prevent the distortion.

This mismatch thesis – the notion of a reality distorted by finance – is broadly accepted. It is the basic premise of liberals, it is endorsed by Marxists, and it guides policy makers.

There is only one problem. The mismatch itself does not – and cannot – exist, and for the simplest of reasons: the very distinction between “real” and “financial” capital is entirely fictitious. . . .
Presentation Signposts

The Mismatch Thesis
• Duality: “financial capital” versus “real capital”
• Crisis: when finance distorts reality
• Fiction: when economists invent impossible equalities

The Duality
• Hume’s classical dichotomy
• The real world: material production and consumption
• The financial mirror: symbolic images and echoes
• Capital goods versus capitalization

Marx’s View
• Why is finance a fiction: no “principal”; putative profit; the varying rate of interest
• The dilemma: finance “distorts” values
• The Ghost in the Machine: crisis brings finance down to earth
• Why is there no Marxist theory of finance?

Irving Fisher’s House of Mirrors
• From capital wealth to income services
• From income services to income value
• From income value to capital value
• From capital value to capital wealth
• The two sides of the balance sheet

The Quantity of Wealth
• The real benchmark: what is finance “equal” to?
• Can material qualities be quantified: the Cambridge Controversy
• Fundamental quantities of physics: mass, distance, time, electrical charge and heat
• Fundamental quantities of economics: utils and socially necessary abstract labour
• Revealed preferences: let prices tell all
• The curse of equilibrium: Can we know it when we see it? Does it ever happen?
• The big cheat: reality is in the mirror, but the mirror is shattered
• With nothing to match, what is there to mismatch?

Microsoft vs. General Motors
• Who is the giant, who is the dwarf?
• Productive capacity and employment
• Equity and total capitalization
• A “technological fix”? 

Tobin’s Q: Adding Intangibles
• Market value of equities and bonds versus current cost of fixed assets
• Why is Tobin’s Q greater than 1?
• Dark matter and the intangible revolution
• Going in reverse: let the market tell all

Boom and Bust: Adding Irrationality
• Why does Tobin’s Q fluctuate?
• When people misbehave: distortions
• The curse of excess: too optimistic, too pessimistic
• Bubbles and fake wealth, crashes and underpriced assets
• Order in the chaos: pro-cyclical irrationality?
The Gods Must Be Crazy
• A world turned on its head: capitalists accumulate when capital “decumulates”?
• Force is nothing but its effect: toward a power theory of capital
The world confused financial assets with real ones

AT THE heart of the current crisis is a fundamental confusion about the nature of wealth. Think about it from the perspective of a Martian. Were an extraterrestrial to be shown a room full of gold ingots, a stack of twenty-dollar bills or a row of numbers on a computer screen, he might be puzzled as to their function. Our reverence for these objects might seem as bizarre to him as the behaviour of the male bowerbird (which decorates its nest with shiny objects to attract a mate) seems to us.

Wealth consists of the goods and products we wish to consume or of things (factories, machinery, an educated workforce) that give us the ability to produce more such goods and services. Financial assets arise from the desire to postpone consumption so that money can be saved, either for precautionary reasons or to invest so that more goods and services can be consumed in the future.

Looked at in that way, financial assets are not "wealth" but a claim on real wealth. If those claims multiply or rise in price, that does not mean aggregate wealth has increased. If a pizza is cut into eight instead of four slices, there is no more food to eat. If everyone sitting at the table is given shares in the pizza and the share price rises from $1 to $2, the meal will still be no bigger.
Divergence: Fictitious Capital Unleashed

“All connection with the actual process of self expansion of capital is thus lost to the last vestige, and the conception of capital as something which expands itself automatically is thereby strengthened. . . . The accumulation of the wealth of this class [the large moneyed capitalists] may proceed in a direction very different from actual accumulation. . . . Moreover, everything appears turned upside down here, since no real prices and their real basis appear in this paper world, but only bullion, metal coin, notes, bills of exchange, securities. Particularly in the centers, in which the whole money business of the country is crowded together, like London, this reversion becomes apparent; the entire process becomes unintelligible.”


Convergence: Fictitious Capital Tamed

“In order for the price system to work, financial forces should cause fictitious capitals to move in directions that parallel changes in reproduction values. . . . By losing any relationship to the underlying system of values, strains eventually build up in the sphere of production until a crisis is required to bring the system back into a balance, whereby prices reflect the real cost of production. The fiction of fictitious value cannot be maintained indefinitely. At some unknown time in the future, prices will have to return to a rough conformity with values. . . .”

Table 1
Irving Fisher’s House of Mirrors

<table>
<thead>
<tr>
<th>QUANTITIES (REAL)</th>
<th>PRESENT CAPITAL</th>
<th>FUTURE INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>capital wealth</td>
<td>① → income services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>↓ ②</td>
<td></td>
</tr>
</tbody>
</table>

| VALUES (FINANCIAL) | capital value | ← ③ | income value |

“The statement that ‘capital produces income’ is true only in the physical sense; it is not true in the value sense. That is to say, capital-value does not produce income-value. On the contrary, income-value produces capital-value. . . . [W]hen capital and income are measured in value, their causal connection is the reverse of that which holds true when they are measured in quantity. The orchard produces the apples; but the value of the apples produces the value of the orchard. . . . We see, then, that present capital-wealth produces future income-services, but future income-value produces present capital-value”.

Table 2

The Many “Quantities” of Energy User-Producer Inc.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>Price ($ mn)</th>
<th>“Quantity” of Capital (utils) by year of equilibrium</th>
<th>Normalized “Quantity” of Capital (utils) by year of equilibrium</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1) Auto Factories</td>
<td>(2) Oil Rigs</td>
<td>(3) Eq. in 1970</td>
<td>(4) Eq. in 1974</td>
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<tr>
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<td>52</td>
<td>590</td>
<td>700</td>
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</table>

NOTE: The numbers of auto factories (Column 1) and oil rigs (Column 2) are hypothetical.
Column 5 = value of Column 3 in 1970 * Column 1 + value of Column 4 in 1970 * Column 2
Column 6 = value of Column 3 in 1974 * Column 1 + value of Column 4 in 1974 * Column 2
Column 7 = value of Column 3 in 1979 * Column 1 + value of Column 4 in 1979 * Column 2
Column 8 = Column 5 / value of Column 5 in 1970 * 100
Column 9 = Column 6 / value of Column 6 in 1970 * 100
Column 10 = Column 7 / value of Column 7 in 1970 * 100
Figure 2
The Many “Quantities” of Energy User-Producer Inc.

NOTE: The number of auto factories and oil rigs is hypothetical. The annual “quantity” of capital (in utils) is computed first by multiplying the number of auto factories and oil rigs by their respective equilibrium price; and second by adding the two products. The “quantity” of capital with a 1970 equilibrium assumes that the “util-generating capacities” of an auto factory and an oil rig have a ratio of 2:1 (based on respective prices of $200 mn and $100 mn); the “quantity” of capital with a 1974 equilibrium assumes that the ratio is 1:1 (based on respective prices of $300 mn and $300 mn); and the “quantity” of capital with a 1979 equilibrium assumes that the ratio is 1:2 (based on respective prices of $400 mn and $800 mn).

SOURCE: Table 2.
NOTE: The per cent figures indicate, for any given measure, the size of Microsoft relative to GM.

SOURCE: Compustat through WRDS (series codes: data29 for employees; data8 for net plant and equipment; data24 for price; data54 for common shares outstanding; data 181 for total liabilities).
NOTE: The market value of equities and bonds is net of foreign holdings by U.S. residents. The last data point for the current cost of corporate fixed assets is for 2007. The extrapolation assumes that in 2008 this cost rose by 6% – an increase equivalent to the average annual growth rate during the previous ten years.

NOTE: The market value of equities and bonds is net of foreign holdings by U.S. residents. The 2009 estimate is based on extrapolating the underlying series. The last data point for the market value of corporate equities and bonds is for 2009:Q2. The extrapolation assumes that during 2009:Q3 the market value of equities rose by 20% and that the value of bonds remained unchanged. The last data point for the current cost of corporate fixed assets is for 2007. The extrapolation assumes that over the next 21 months (by 2009:Q3) this cost rose by 10.5% – an increase equivalent to the average 21-month growth rate during the previous ten years.

SOURCE: See Figure 4.
* Computed annually by adding to the historical average of the growth rate of current corporate fixed assets 2.5 times the deviation of the annual growth rate from its historical average.

NOTE: Series are smoothed as 10-year moving averages. The last data points are for 2008.

NOTE: The market value of equities and bonds is net of foreign holdings by U.S. residents. Series are shown as 10-year moving averages. The last data points are 2009:Q2 for the market value of corporate equities and bonds, and 2008 for the current cost of corporate fixed assets.

SOURCE: See Figure 4.