Systemic Fear, Modern Finance and the Future of Capitalism

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CHART BOOK
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Figure 1
Mode of Power, Confidence, Ideology and Forward-Looking Capitalization

- Capitalist Mode of Power
- Confidence in Obedience
- Dominant Ideology
- Forward-Looking Capitalization
NOTE: Indices denote month-end closing prices. They are expressed in $U.S. and rebased with January 2002=100. The last data points are for April 30, 2010.

SOURCE: Datastream (series codes: TOTMKWD(PI) for the world stock market index; TOTMKUS(PI) for the U.S. stock market index; FINANUS(PI) for the U.S. FIRE index).
Figure 3
Capitalization Formulae
Or why stock prices are delinked from past and present profit

1. \[ \text{rate of return} = \frac{\text{expected future profit}}{\text{capitalization}} = \frac{\$100}{\$500} = 0.2 \]

2. \[ \text{capitalization} = \frac{\text{expected future profit}}{\text{rate of return}} = \frac{\$100}{0.2} = \$500 \]

3. \[ \text{capitalization} = \frac{\text{expected future profit}}{\text{normal rate of return} \times \text{risk}} = \frac{\$100}{0.1 \times 2} = \$500 \]

4. \[ \text{capitalization} = \frac{\text{future profit} \times \text{hype}}{\text{normal rate of return} \times \text{risk}} = \frac{\$50 \times 2}{0.1 \times 2} = \$500 \]
Figure 4

S&P 500: Price and Earnings per Share, 1871-2010

NOTE: Earnings per share denote net profits per share earned in the previous twelve months. Monthly earnings are interpolated from annual data before 1926 and from quarterly data after 1926. Stock price data are monthly averages of daily closing prices. Both series are expressed in $U.S. and rebased with September 1929=100. The last data points are March 2010 for earnings per share and May 2010 for price.

SOURCE: Robert Shiller
Table 1

S&P 500: Pearson Correlation Coefficient between the Annual Rates of Growth of Price and Earnings per Share
(Monthly data expressed as 3-year moving Averages)

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>CORRELATION COEFFICIENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 1873 – Oct 1917</td>
<td>+ 0.72</td>
</tr>
<tr>
<td>Oct 1917 – Mar 2010</td>
<td>+ 0.35</td>
</tr>
<tr>
<td>Oct 1917 – Dec 1929</td>
<td>+ 0.29</td>
</tr>
<tr>
<td>Dec 1929 – Feb 1939</td>
<td>+ 0.89</td>
</tr>
<tr>
<td>Feb 1939 – Sep 2000</td>
<td>– 0.15</td>
</tr>
<tr>
<td>Sep 2000 – Mar 2010</td>
<td>+ 0.64</td>
</tr>
</tbody>
</table>

SOURCE: Figure 4.

The Bondsman’s Fear of Death

“For this consciousness [of the capitalist bound to the steering wheel of a megamachine gone wild] was not in peril and fear for this element or that [such as falling profit or rising volatility], nor for this or that moment of time [like a sharp market correction or a declaration of war], it was afraid for its entire being; it felt the fear of death, the sovereign master [the ultimate wrath of the ruled]. It has been in that experience melted to its inmost soul, has trembled throughout its every fibre, and all that was fixed and steadfast has quaked within it [will capitalism survive?]”.

(with square brackets added)
Figure 5

S&P 500: Price and Earnings per Share, 1917-1952

NOTE: Earnings per share denote net profits per share earned in the previous twelve months. Monthly earnings are interpolated from annual data before 1926 and from quarterly data after 1926. Stock price data are monthly averages of daily closing prices. Both series are expressed in $U.S. and rebased with September 1929=100.

SOURCE: Robert Shiller (see Figure 4).
Figure 6
S&P 500: Price and Earnings per Share, 1970-2010

NOTE: Earnings per share denote net profits per share earned in the previous twelve months. Monthly earnings are interpolated from quarterly data. Stock price data are monthly averages of daily closing prices. Both series are expressed in $U.S. and rebased with December 2007=100. The last data points are March 2010 for earnings per share and May 2010 for price.

SOURCE: Robert Shiller (see Figure 4).
Figure 7
World Equities: Price and Earnings per Share, 1973-2010

NOTE: Indices denote month-end closing prices. They are expressed in $U.S. and rebased with January 1986=100. Earnings per share denote net profits per share earned in the previous twelve months. The last data points are for April 30, 2010.

SOURCE: Datastream (series codes: TOTMKWD(PI) for the stock market index; TOTMKWD(PE) for earnings per share).
Is the Dominant Ideology Broken?

Former Fed Chairman Alan Greenspan (2008)
The whole intellectual edifice . . . collapsed in the summer of last year. . . . [T]hose of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets’ state of balance. If it fails, as occurred this year, market stability is undermined.

Bernie Sucher of Merrill Lynch, quoted in Financial Times (March 2009)
Our world is broken – and I honestly don’t know what is going to replace it.

Gillian Tett, Financial Times (March 2009)
[T]he pillars of faith on which this new financial capitalism were built have all but collapsed, [and that collapse] has left everyone from finance minister or central banker to small investor or pension holder bereft of an intellectual compass, dazed and confused.

Editors, Financial Times (May 2009)
Uncertainty is the only certain thing in this crisis. . . . [A] dense fog of confusion has . . . descended, obscuring where we are – falling fast, slowly, bumping along the bottom, or finally turning the corner. . . . Are these downward blips in a gathering recovery or signs of a return to freefall? The answer is: no one knows. Mervyn King, Bank of England governor, is forthright: “Judging the balance of influences on the economy at the moment is extraordinarily difficult”. . . . Economies are behaving unpredictably and will continue to do so. The instability is both cause and consequence of the great uncertainty that has been spreading out from the financial markets. Fearful and confused, people react erratically to changing news, reinforcing confused market behaviour. It doesn’t help that our economic theories were constructed for a different world. Most models depict economies close to equilibrium. . . . And unlike what most models assume, prices are not properly clearing all markets. . . .

Gillian Tett, Financial Times (April 2010)
Three years ago, it seemed inconceivable that a country such as Greece would be allowed to default, or exit the eurozone. But back then it seemed equally hard to imagine that Lehman Brothers might fail. Now that Lehman has gone, who knows what the worst-case scenario might be? Could the eurozone break up? Could Greece default? What might happen to other debt-laden nations, such as the US, if the worst case scenario occurred? The one thing that is clear is that the answers to those questions now depend as much on culture and politics as on macro-economics. . . . In this new world of sovereign risk, what really matters is a set of issues that cannot be plugged into a spreadsheet. The old compass no longer works.