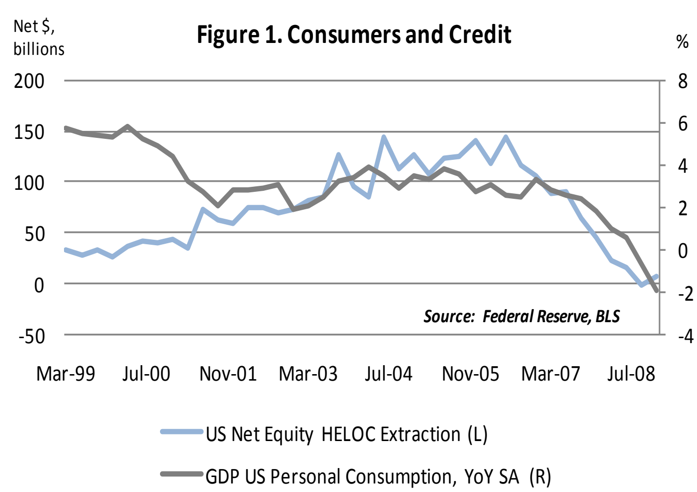
Capital Offense:

A disproportionate amount of mind share has been devoted to the financial aspects of the crisis. Investors and policy makers alike may be distracted by this over-emphasis and thus leaving them vulnerable to other aspects of the crisis. More specifically, the underlying challenge is sustaining aggregate demand in the face of a shift in income share towards profits and away from wages and salaries.

Aggregate Demand

The Great Depression and indeed the current crisis are linked by macro-economic similarities that extend beyond the dramatic deterioration of credit conditions. Consider the preceding expansions. Both the one that the preceded the Great Depression, and the more recent one, shared the common characteristic of having been driven by consumption. This was especially true of consumer durable goods. And in both cases the increase in aggregate demand was fueled not by higher wages and salaries, but yet increased in part from credit cards and homes equity credit (HELOC). In fact, as you can see from the chart below the run-up in consumption in the wake of the Great Moderation coincided with the increase in consumer-leveraging, as homeowners increasingly borrowed against the steadily rising value of their homes to fund their purchases.



When the credit cycle crested the economy busted. The financial aspect of the crisis continues to command attention. The financial markets, as a channel of capital distribution, have re-opened and yet the banks remain dysfunctional. They are not acting as financial disintermediaries between savers and borrowers, while in the same way they continue to contract in aggregate.

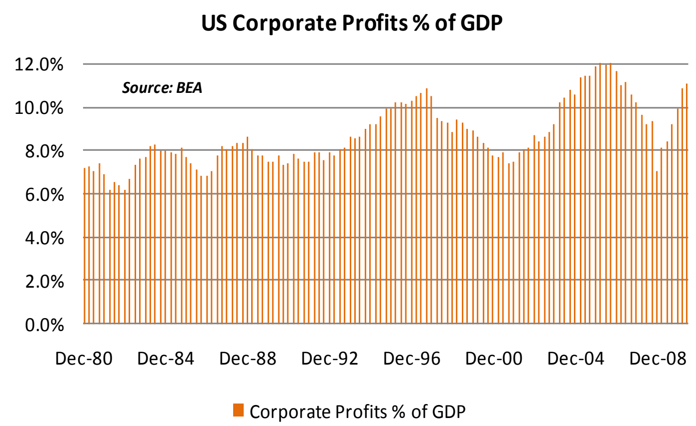
Indeed, the engine of the economy does not lie in the circulation of capital but with aggregate demand. In fact, prior to the ideological rise of monetarism and the 1963 publication of Milton Friedman and Anna Schwartz 's *Monetary History of the United States,* the traditional view was that the Great Depression was about insufficient aggregate demand rather than the tightening of credit conditions *per se*.

The New Deal, of course, was aimed at restoring aggregate demand. Naturally, banks were largely sidelined as the government stepped in to fulfill the financial disintermediary functions. Those programs, what are often called in a derogatory sense entitlements, and may be better thought of as the basket of goods (and services) citizens receive, and once considered socialistic, like unemployment compensation and social security were meant, from an economic point of view to help underpin demand even if one wasn't working, or the bread winner of a household was not longer able to work, or if one was lucky to get too old to work.

National Income Shares

A nation's aggregate income can be divided into two parts: wages and salaries on one hand and profits on the other. The Great Depression was preceded by a shift of national income shares toward profits and away from wages and salaries.

Work cited by the American historian James Livingston (Rutgers University) found that 90% of American taxpayers had less disposable income in 1929 than they did in 1922, which corporate profits rose by nearly two-thirds and dividends doubled. The top 1% of tax payers experienced more than a 60% increase in disposable income.



In the US, since the recovery began, total US wages and salaries have risen by $168 bln, while profits have risen by $528 bln. BCA Research indicates this is the first time profits have outperformed wages and salaries in absolute terms in 50 years.

The Economist notes that this is not strictly a US phenomenon. It recently reported that since the recovery began, German profits have risen 113 bln euros (~$160 bln), while wages and salaries have risen by 36 bln euros. The UK situation is more uneven: profits have risen by GBP14 bln (~$23 bln) while wages have fallen by GBP2 bln.

The Real De-Coupling

When thinking about post-WWII institutions, the UN, the IMF, the World Bank, GATT/WTO and Bretton Woods quickly come to mind. There is another one that is often forgotten. There was a social pact of sorts that linked wages and salaries to productivity gains. Various forces led to a break of this pact and the de-coupling was between wages and salaries and productivity.

From 1973 through 2007, US productivity rose 83%. Real median wages rose 5%. Mean wages rose faster reflecting the rising income inequality. In an international ranking of income equality the US is in 90th place with a .45 GINI score (on a scale of 0-1, with the higher number being associated with greater income inequality), more than twice as high as Sweden, which enjoys the least income inequality and has a GINI score of 0.23.

Wealth is also highly concentrated. The quality of the data varies around the world, but academic work suggests that 10% of the world adult population control about 85% of the global household wealth, based on data from 2000. In the US, the top 10% own almost 70% of the household wealth.

Switzerland is the only major industrial country that wealth is more concentrated and its top 10% account for a little more than 73% of the nation's household wealth. In comparison, France was at 61%, Sweden was near 58.5% and the UK was at 56%. Ten percent of Canadian adults control 53% of the country's household wealth, while in Germany the figure is near 44.5% and Finland is near 42.5%.

Atrophy of Net Investment

If the consumption was the main engine of growth, then maybe this shift in national income shares and wealth is part of the larger re-balancing of the economy toward investment. Yet investment remains weak in gross terms but also when adjusted for depreciation.

This is an important though often overlooked characteristic of investment. Investment is not only labor saving, but it is capital saving. Depreciation allowances for capital equipment can fund the replacement of the existing stock of capital and it is this replacement that carries with it the bulk of technological advances. There has been a secular trend toward the atrophy of new net investment.

Net new investment did not lead the recovery in the 1930s and it is not leading the economic recovery today. The capital stock per worker was actually lower in 1939 than in 1929, though national output and income had regained their pre-depression peaks by 1937. The recovery of 1933-1937 was fueled not by recapitalized banks and businesses investing, but by rising demand for consumer goods, which was itself a result of shifting income shares from profits and toward wages and salaries. This was paid for at the time by government spending and enforced by a re-invigorated labor movement.

Ever since the Great Depression, economic recoveries have been led by a demand for consumer goods, not investment goods. The Reagan tax cuts in 1981 were aimed at encouraging investment. It did not. The top 50 corporate beneficiaries actually reduced capital expenditures in 1982 and 1983. Net new investment trended lower through the 1980s. The Bush tax cuts also did not stimulate investment as had been intended by the advocates.

Now What?

Unlike after the Great Depression, this recovery has been marked by a shift in the national income toward profits and away from wages and salaries. Yet investment is not particularly strong and accounts for too small of a share of GDP advanced industrial countries to truly fuel a recovery. Private investment is not needed in aggregate as many industries suffer from excess capacity and replacement of depreciated capital carries with it technological advances.

Profits without suitable investment opportunities become the hot impatient capital that is sloshing around the world. This is the fuel of speculative bubbles and investment tsunamis. It is part of the reason why modern capitalism, not just in the Anglo-American countries but also in continental Europe, has such large financial superstructures. The role of the government as a lender of last resort demonstrated in recent crises. Its ability to underpin aggregate demand is less appreciated. If the political winds favor cuts in spending now and less transfer payments, where is aggregate demand going to come from?

The best and brightest are focused on re-building the financial system. They are concerned about global imbalances. The major imbalance in national income shares is rarely discussed, but can be found at the root of the crisis. This is the ultimate challenge of market economies: sustaining aggregate demand. The 1980-2007 solution of deregulation and capital market liberalization has reached some sort of end. The shift in national income shares during the recovery suggests not only that a new solution is not at hand, but we are likely moving away from it.

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