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The Wealth Wipe-out

OVER THE PAST 200 years, the forces that drive the capitalist economy engineered the wipe-out of wealth on a scale that cannot now be calculated. But we can begin to calculate the wipe-out of wealth since 2008. The numbers are frightening.

I estimate the probable losses as a result of the Depression of 2010 at US$45 trillion (£23 trillion). A trillion has 12 zeros – 000,000,000,000.

The depressing effect on economic activity will be felt for a generation. For in the magical world of money, all is not what it

seems. Pinning down the numbers can be mind-numbing. Take the case of the dispute between the IMF and the Bank of England over how much the banks would lose, because of their carelessness with other people's money. This illustrates the uncertainties in trying to compute how much wealth will be wiped out by the Depression of 2010.

The IMF estimated that the financial sector alone would lose $945bn (nearly a trillion dollars). Its calculations were based on prices in the marketplace which, you would think, was the ultimate authority on the value of assets. But banks, while guardians of the *doctrine* of the market, tend to work with numbers that happen to suit their balance sheets. And the Bank of England, using *those* numbers, decided that losses from the American mortgage crisis would be $150bn. It castigated the IMF's estimates as "misleading" because "they confuse true credit losses and losses implied by market prices".

When the bankers are confused, it is time to step back and apply common sense. Here, I offer my estimates of the eventual losses based on assumptions

which, I acknowledge, seriously understate the likely outcome. Estimating the world-wide erosion of residential property values, for example, entails heroic assumptions about values in the developing world. However, I have approached this calculation with caution.

Analysts will argue about my estimates, but I have chosen to use conservative assumptions. In downturns, prices do not slide to a halt when they reach the point on the graph that represents the long-run average rate of growth. They overshoot. Thus, the IMF calculates that the UK house price bubble was of the order of 27% above what could be explained by the so-called "fundamentals" (the growth of incomes, for example, and of productivity in the economy).[1] My 20% yardstick avoids the accusation that I am sensationalising, by exaggerating.

In the UK, residential property was valued at £4 trillion in 2006, according to Halifax, the nation's largest mortgage bank. If house prices drop by 10%, a loss of £400bn would be incurred. I forecast

1 IMF (2008: 113, Box 3.1).

that the erosion of value would be nearer to 30% – a wipe-out of £1.2 trillion. A 30% drop, however, would mean applying the brakes just at the point where prices hit their long-run trend. In reality, they will overshoot that point, dropping by something like 40% before beginning the bounce back. For the present calculation, however, I assume a decline in capital value of 20%.

In Australia, residential property was worth about AU$3 trillion in 2006. In 2008, owners in some areas of Sydney sold their homes at prices that were nearly half the peak prices. Across the country, a 10% drop would incur a loss of AU$300bn (£150bn). Again, I assume a 20% drop in value.

In the US, the value of wealth tied up in residential property alone declined by $3.4 trillion in the two years following the peak in prices in July 2006. The total wealth in the homes of American families exceeded $30 trillion. Assuming prices drop by no more than 20%, the wealth wipe-out in the US residential sector alone is more than $6 trillion.

Worldwide, I estimate residential property to drop by about $20 trillion. This

wipe-out of wealth embodied in people's homes alone will be enough to lock the global economy into depression, whatever the GDP numbers may say about the "recovery" in some countries in 2009.

The Wealth Wipe-out of 2010

Asset	*Amount: US$ trillion*
Capital (stocks & shares)	$15
Residential Property	$20
Commercial Property	$10
All assets	*$45 trillions (£23 trillion)*

Source: author's estimates

That my calculations seriously understate the likely outcome is illustrated by Ireland. The IMF estimates that its house prices rose by 32% above the level that could be explained by trends like the growth of productivity. Again, ignoring the overshoot, I base my wealth wipe-out estimate on a price drop of 20%. *That decline has already been achieved, for new-build properties in Dublin.*

A few countries, like Canada and Austria, avoided the worst excesses of a bubble. Their residential property sectors did not escape unscathed, but I have

chosen to make no allowance for losses in this group of countries.

For commercial property, land values started to decline in countries in the eye of the credit crunch hurricane. In the UK, a 12% decline in the value of land in the first three months of 2008 was triggered by the reduction in purchases by building companies.[2] Banks compounded the crisis by continuing to lend to investors in commercial property, even though prices had dropped by 15%. This led the Bank of England to warn the banks that they stood to lose a fifth of their profits linked to the prospect of a £5bn wave of real estate defaults.[3]

But it was not just private investors who "didn't get it". Market evidence of the downturn was not reflected in the official propaganda. The British government's Valuation Office website, for example, maintained that land values would continue to rise all the way to 2012. Such illusions were also on display in the USA. Data published by the central bank suggested that land values had risen by

2 Barnard (2008).
3 Bank of England (2008).

$1.5 trillion in 2006/07. These gains were supposed to have been achieved in a period when America's housing market was stricken by the sub-prime crisis.[4]

The erosion of value locked up in the capital of productive enterprises has barely begun. As the spill-over effects are felt in the consumer markets, and the sectors that produce heavy goods (steel, and so on), the wipe-out of wealth will escalate to at least $15 trillion. In China alone, $2.5 trillion (£1.25 trillion) was wiped off the value of businesses when stocks lost half their value between October 2007 and April 2008.

Omitted from my estimates is the wipe-out of value in the public sector. Few countries (Britain is an exception) have adequate inventories of publicly owned assets. The decline in the value of these properties is relevant when attempting to anticipate the scale of the downturn. Governments will not be able to raise as

4 I owe this estimate to Michael Hudson, an authority on the Fed's statistics. He calculates (Personal Communication, April 11, 2008) that, if the data is remotely accurate, then realistic ratios of land value to total value of property would register a rise in land values of $2.5 trillion.

much money from the sale of assets as before, as they try to offset the loss of tax revenue by selling land and shares in public enterprises.

The wipe-out of wealth matters for two reasons. In the value-adding economy, employment depends on the willingness of people to spend and invest. But when the value of people's wealth declines, they reduce spending in the shops. The curb on consumption ripples through the worldwide trading system. Secondly, investment. As the economy contracts, enterprises reduce the capital they lock up in their production facilities. So the capital-producing industries (like steel making) are forced to reduce output and the people on their payrolls. And as the capital of banks shrinks, the credit that can be extended to their borrowers contracts.[5] Most small businesses rely heavily on credit facilities to keep trading. When the lines of credit dry up, they close down.

In the spring of 2008, this process of contraction was launched with a vengeance.

5 IMF (2008: 11).

IKEA, for example, the Swedish manufacturer of household furnishings, revealed that sales of its flat-pack products had gone flat. And Daimler, the German up-market car manufacturer, warned that sales in the US would drop substantially. No country in the world will escape the horrors as a result of the failure to respond to the warnings I published in 1997 and 2005. In January 2010, the IMF announced that the world's biggest banks would have to raise billions of dollars to head off a funding crisis. Despite the scale of the problem, the IMF soothed fears by claiming that government action had "forestalled another Great Depression".[6]

Demystifying Economics

BEFORE DIGGING further, we need to decode the concepts used by economists. For reasons that will become plain, our society operates on the basis of language that camouflages a large slice of reality.

For example, the crisis in the financial markets cannot be blamed on the subprime racket in the American housing

market, as governments, central bankers and the media claim. The seizure of the banking sector in 2007 did stem from the advance of mortgages to people with poor credit ratings. When people began to default on their payments, the money conduits that channelled cash into the economy dried up. But the catastrophe that struck banks on both sides of the Atlantic was not *caused* by the sub-prime scam.

I will expose the truth about what drives the capitalist economy into the steel buffers at the end of every business cycle. I will explain why the financial crisis would have happened anyway, *even if America's financiers had refused to lend a single cent to a low-income family*.

The sub-prime episode is a bit player in the history of how one group of people within capitalist societies get rich at the expense of the majority. In the 19th century, working people understood that it was the landed aristocracy that pocketed the windfall gains, living lives of opulence without having to work. Today, exactly the same predatory process is at work.

Most of the star players have changed

their names and appearances, but they are still capturing the bulk of the surplus income. The money is now distributed in disguised forms, but it comes out of all our pockets. And it is still unearned.

The facts are horrifying, with disastrous consequences for the free enterprise economy. The scale of the rip-off is not documented in the national statistics. But I will provide you with a sense of the enormity of the injustice that is the fault line in the foundations of the market economy.

The process by which the burden is heaped on the producers of wealth can be exposed. Michael Hudson, using statistics buried in the reports of bulletins published by the Federal Reserve, the US central bank, explain how bankers have replaced the land magnates of old as the new aristocracy. Once upon a time, tenants paid rent for the use of land to landlords. Today, the bulk of those rents are disguised as interest and paid to the financial sector to fund mortgages.

In the following chapters, I will explain the way our lives are distorted because of the way in which real estate income is distributed in favour of the banking sector.

Dr. Hudson, a professor of economics and former Wall Street analyst, observes, for example, that

> property taxes no longer recover the land value being created by public investment and prosperity. This leaves property owners with a rising 'free ride' from asset-price inflation. Property taxes used to be the mainstay of state and local finances, accounting for nearly two-thirds in 1930. But the tax burden has been shifted steadily on to consumers and business. This tax avoidance for real estate at the local level also occurs at the federal level. [7]

Coming to grips with the economics of property is central to making sense of turbulence in the markets. Excavating the logic that underpins the distribution of income in America, for example, explains why so many wage-earners were lured by the buy-to-let property mania in Britain. This is how Dr. Hudson put it

> Land-price gains ... far overshadow earned income. These gains explain why property owners are able to pay most of the rental value to bankers as interest: the aim is not so much to earn current income but to ride the crest of asset-price inflation and make a capital gain on the site's rising locational value.

7 Hudson (2008).

For home owners, riding the crest of the price rise is exhilarating. Then, the crash comes, and the depression sets in as house prices drop.

Where's the Knowledge?

OURS IS NOW a knowledge-based economy. Why, then, is knowledge so imperfect that huge losses are incurred which could be avoided? Our case study is the way in which banks fail to fulfil their obligations to clients, by showing due diligence in their money-making activities.

Banks are commercial enterprises. They make money out of money. If they can gain an advantage at your expense, they will do so – if it's not breaking the law. But moneymen constantly push out the boundaries of what can be done with the aid of new technologies and the latest schemes of fortune seekers. That is why regulators cannot catch up with current practices. They cannot anticipate the particular form taken by the next land-related financial scam. By the time the penny's dropped – it's too late.

There is little point in complaining about

banks doing what the law permits them to do, even if the result is anti-social. In fairness, we need to judge them on the basis of their own standards – the efficiency with which they make profits from dealing in cash and credit.

Losses at 10 banks (January 2007 to April 2008): $bn

Bank	$bn
Citigroup	40.9
UBS	38.0
Merrill Lynch	31.7
Royal Bank of Scotland	17.3
Bank of America	14.9
Morgan Stanley	12.6
HSBC	12.4
JP Morgan Chase	9.7
IKB	9.1
Washington Mutual	8.3

The justification for liberalising the financial sector in the 1980s was that private enterprise – when released from the leash of government control – becomes more efficient. How do banks measure up against this standard? The table provides a sense of that sector's performance in the business cycle that followed the great

liberalisation of their activities. In the 15 months between January 2007 and April 2008, 10 banks had to write down $195bn. The knock-on effects, for shareholders, were drastic. One British bank, HBOS, saw its stock market capitalisation crash from £40bn to under £18bn.

How can we explain this appalling entrepreneurial record? Let's assume, for argument's sake, that bankers are economically illiterate. Would that excuse their abysmal failure to perform according to their own propaganda? It is to this question that we must now turn. Because if the bankers – who are closest to what is happening in the money markets – cannot know that an explosion is in the making in their market, we cannot expect politicians to know any better. And if that *is* the case, my accusation against the political class – that it failed in its duty of care to citizens – must be rejected.

DURING THE Cold War, capitalists claimed they were superior to communists in producing wealth. Free markets were more *efficient* at producing

wealth than centrally planned economies. True. But such arguments are no longer valid. The USSR has now disappeared, but China – a hybrid of communism and capitalism – is outgunning the Anglo-American model.

Capitalism is a destroyer of wealth. The gap between actual and potential output widened, going into 2010. Goldman Sachs economists estimate that the gap exceeds 10% of the trend measured in 2005. The human cost: 31m people under- and unemployed in the US (January 2010), and nearly 3m people unemployed in the UK. Someone needs to tell them why they are barred from work. Eulogies on capitalism won't work: China's growth rate is back to double digits. And that's under the centralised rule of communists in Beijing.