ECONOMICS

Capitalism takes its lumps

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THE NEW PARADIGM FOR FINANCIAL MARKETS

The Credit Crisis of 2008 and What It Means

By George Soros

Public Affairs, 162 pages, $24.95

ECONOMICS FOR EVERYONE

A Short Guide to the Economics of Capitalism

By Jim Stanford

Fernwood, 250 pages, $24.95

Two books, one by a critic of capitalism, the other by a hugely successful maestro of hedge funds, offer insights into the current crisis of the financial system. Jim Stanford, an economist for the Canadian Auto Workers union, sees many of the problems as the result of capitalist economics. Soros, a Wall Street profiteer, focuses on the present credit crisis in which banks and other financial institutions are suffering huge losses on loans that cannot be repaid, backed by assets that cannot be collected.

Their reasons and their prescriptions are very different. Stanford offers the conventional protests of the left in a fresh package. Neo-liberalism, his name for global capitalism driven by liberals turned raptors, is the problem, as he sees it. This is exploitation theory with a soft edge and a bit of humour. "Never trust an economist with your job," he quips.

Stanford follows a line of historical materialism made famous by Karl Marx. "Capitalism first emerged in Western Europe ... in the mid- 1700s ... evolved from advanced feudal monarchies." Actually, such capitalist institutions as floating rate loans and bonds discounted from their matured value were being used in Venice in the 13th century. Labelling capitalism as an 18th-century innovation focuses mostly on land enclosures and the rise of an urban proletariat, as the post-Marxist writers still like to say.

Stanford says that profits have risen in much of the world. The statement is true, although the more meaningful question is whether the profits are anything more than payments for risk and inflation. In any case, a well-fed managerial class has emerged in Russia, Brazil, Singapore, South Korea, India and China. The reasons are diverse. Central planning died and liberated talent and money in Russia. Brazil, like Canada, is enjoying a boom in natural resources. India abandoned high tariffs that subsidized an inefficient economy. Singapore has low tariffs, terrific economic management and a superb infrastructure. South Korea is about incredibly hard work in an unfettered economy. And China is about the unleashing of a capitalist economy within a communist shell. "It is glorious to be rich," said a high Chinese Communist government official at a party congress last year. Marx would have been appalled.

George Soros is also a critic of capitalism, at least the capitalist excesses that have created the credit crisis. He is an insider, connected to heads of state and managers of central banks - and a part-time philosopher.

The New Paradigm for Financial Markets is two books in one. The beginning and end deal directly with the credit crisis. In between, there is an essay on Soros's concept of what he calls "reflexivity," the observation that since perceptions about markets influence how they work, economic analysis is wrong to assume the existence of immutable laws that are valid regardless of human action. It's nice to know his thoughts on epistemology, but Soros is at his best discussing finance.

Soros offers up a brilliant chronicle and analysis of the credit market meltdown that began in August, 2007. His subject is the worldwide buildup of debt that exceeds the world's gross domestic product. In other words, there is much more credit and debt than underlying economic activity to support it. All this creative finance went on, he explains, because "cheap money engendered a housing bubble, an explosion of leveraged buyouts, and other excesses."

He identifies the ogre behind the bubble as none other than the U.S. Federal Reserve Board, headed by chairman Alan Greenspan. At each crisis, the Fed lowered interest rates - that is, the cost of money - encouraging the belief that it would fix every problem of bad investment decisions allowed by cheap money with still cheaper money. The Fed organized the rescue of Long-Term Capital Management in 1998 when its $1.2-trillion (U.S.) bag of interest-rate bets made it too big to be allowed to fail. In 2000, after the dot-com bubble burst, the Fed began dropping interest rates to a level below the inflation rate, creating what amounts to free loans.

The consequences of cheap loans were stunning. Soros notes that U.S. homeowners financed a $9-trillion spending spree as their house prices rose by 50 per cent from 2000 to mid-2005. By early 2006, money extracted from home equity by mortgage extensions made up 10 per cent of U.S. disposable personal income. Cheap money drove up the prices of houses and told owners that the debt they incurred in borrowing against their houses would be covered by price appreciation. When the music stopped, house prices fell. Banks seizing houses that backed loans in default found they had assets worth less than their loans. They had to write off their losses, and the balloon of cheap money driving a huge structure of debt and financial instruments burst.

Soros is a partisan. "Only a Democratic president can be expected to turn things around and lead the nation in a new direction," he writes. Monetarism, the policy of managing the economy by controlling the money supply, is what Soros calls "a false doctrine," a point with which Stanford agrees. Soros urges the Fed to regulate lending ratios in order to control mortgage securities that have so far been unregulated, and to create an exchange for many currently unregulated financial instruments. The Soros prescription is to corral the bad loans, liquidate inflated credit instruments such as packages of other packages of yet still other packages of dubious loans, and then set limits on the creation of these toxic and, it turns out, explosive assets.

Stanford and Soros are on common ground in their focus on the contradictions of capitalism. Soros provides an agenda of what needs to be done. Stanford plays some riffs on old socialist thought. Soros figures that appropriate regulation will save financial markets. Stanford says the cure is social justice, recognition of such things as the unpaid labour of homemakers and a shift of women's domestic chores to men and government. In the near term, I'll put my money on the Soros cure.

Andrew Allentuck writes often for Report on Business. His book When Can I Retire? will be published this year.