

## **The Flaw: Examining the Roots of Economic Malaise**

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[http://www.huffingtonpost.com/stephen-lambert/post\\_1119\\_b\\_772911.html](http://www.huffingtonpost.com/stephen-lambert/post_1119_b_772911.html)

The dramatic increase in income inequality over the last ten years is not news to readers of this site, but the extent to which it actually caused the financial crisis is still not widely appreciated. As Ray Brescia pointed out this month in all the debates over the Dodd-Frank financial reforms, few in Congress raised questions about the impact of growing inequality on the very crisis that brought about the need for reform.

As a producer of documentaries and television programs there are different ways in which one can tell the story of what's happening to the economy. At Studio Lambert we produce two mainstream shows that probably only exist because they reflect the economic zeitgeist -- *Undercover Boss* on CBS and *The Fairy Jobmother* which launches this week on Lifetime. Arianna Huffington was kind enough to say that *Undercover Boss* sheds light each week on the chasm between America's haves and have-nots. She thought it put flesh and blood on statistics like the fact that thirty years ago top executives at S&P 500 companies made an average of 30 times what their workers did and now they make 300 times as much.

But to understand the real significance of this inequality one needs a more analytical approach than a reality show can offer. We've just finished producing a feature documentary called *The Flaw* that attempts to explain the underlying causes of the crisis in more depth than any documentary to date. The film premieres in the UK next month, but after a preview screening a couple of weeks ago at London's Royal Society of Arts, Matthew Taylor, Tony Blair's former head of the policy and now head of the RSA, wrote, "it is a terrific film, intelligent and persuasive, but also entertaining, witty and at times moving. Most fascinating to me was its core thesis; that the biggest driver of the crisis was wage and asset inequality."

So what is the film's argument? The title refers to Alan Greenspan's admission in his testimony before Congress that he had discovered "a flaw in the model that I perceived is the critical functioning structure that defines how the world works so to speak." A humbled Greenspan admitted that it had been a mistake to put so much faith in the self-correcting power of free markets and that he had failed to anticipate the self-destructive nature of wanton mortgage lending and the housing and credit bubble it generated. Greenspan had taken the view that the central bank shouldn't question increasing asset prices, it should only take action when they started to fall. He cut interest rates and tried to boost activity whenever there was the slightest drop. And, of course, boosting economic activity is just a euphemism for trying to encourage consumers and businesses to borrow even more.

The film highlights the fact that the only other time in the last century when top earners had such a high share of total income was just before the Great Crash. The share of total American income going to the top 1% peaked in 1929 at about 22%. After the Crash and the start of World War II it fell steadily so that by the 1970s the top 1% were receiving only 9% of national income. But then it started to rise again; in the last ten years it has shot up like a 4th of July rocket to about the same level as in 1929. This increase can largely be explained by the credit bubble that Greenspan presided over.

Economic activity, profit growth and credit creation are all intimately linked. As George Cooper, author of *The Origin of Financial Crises: Central banks, Credit Bubbles and the Efficient Market Fallacy*, explains in the film, "if the banks are more willing to lend it becomes easier for companies and households to spend, because they can borrow money. As credit rises, corporate profits rise which means pay and dividends rise. Well who tends to own the shares in the corporations and the shares in the banks? Generally it's the wealthier people that own the capital stock of an economy. So if profitability is being boosted then there's a natural tendency to polarize wealth distribution within the economy as well. It's a symptom of a credit cycle."

This new inequality can also be seen in the way that the bottom 90% lost out. In the three decades after the WW2 they were getting roughly 65% of national income, but since the 1980s it's fallen to 50% as the double whammies of the rise of globalization and de-industrialization hit the American workforce. What is often not appreciated is how this upward income redistribution in itself tends to ignite asset bubbles. As you go up the income distribution scale, what people spend their money on changes: there is a relative decrease in expenditure on consumer goods and an increase on housing and financial assets.

"The income redistribution created a bidding for houses," explains Cornell University's Professor Robert Frank. "People at the top buy mansions. People in the middle don't seem offended by that in America. They want to see pictures of the mansions. But when the people at the top build bigger, their bigger houses shift the frame of reference for people who are near them in the income distribution; people who have a lot of money, but not quite at the top. So you get a cascade one stage at a time that drifts down through the income distribution." Robert Schiller of the Case-Schiller Housing Index fame shows how house prices, when adjusted for inflation, remained flat for a century between 1890 and 1990 and then there was a huge bubble in the US starting in 2000.

"On the one hand you have home buyers who are struggling to make ends meet," argues Harvard economic historian Louis Hyman, "looking for the only way they know how to make money in our economy. They can't make money through their labor, so but maybe they can make it through buying a house and seeing the value of that house increase. So people look to mortgages, these easy-to-get mortgages as a way to finally get their share of the American Dream. And, on the other hand, the income inequality produced a ready supply of capital at the top to be invested in these kinds of mortgages. So while the top was not willing to pay the bottom higher wages, they were willing to lend them money."

The compelling, but flawed, logic of mortgage securitization finance is explained by some of its first-hand practitioners. And Josh Zinner and Sarah Ludwig of NEDAP, one of the many

campaigning groups promoting financial justice for the low income communities, point out that the majority of the loans that were generated and then sold to Wall Street to be securitized were refinance loans.

They weren't adding to home ownership. 77% of the sub-prime loans made were refinancing loans made to people who had built up equity in their homes. "If you look at the deed records for low income neighborhoods," says Zinner, "you'll see so many homes where people were refinanced over and over and over, sometimes several times in one year until their equity is gone and they lose the house."

"The reason why the money gets allocated into consumer and mortgage debt," says Hyman, "is because it actually pays as a better return than investing it in businesses, than investing it in factories or things that make things. And it's this simple banal calculation that's behind all of this, it's not some greedy Wall Street banker. Wall Street bankers and all capitalists are always greedy, that's the basis of our entire system. It's that the opportunities for investment are different than they used to be."

This fall in the share in the bottom 90% represents a transfer upwards of roughly one and a half trillion dollars each year to the top 1%, calculates Professor Robert Wade of the London School of Economics. "This enormous upwards redistribution of American income took place in a stable democracy with governments that were promoting this upwards redistribution being re-elected time and time again. It's a very interesting question of how was the American elite able to get away with it. You have roughly one and a half trillion going up and a roughly one trillion a year coming down in the form of house equity refinancing. If the American population had been receiving something like the same income share as in the 1950s and 60s then they would have been able to increase their consumption in a sustainable way out of rising income. But that's not what happened." Instead, we masked a lack of income growth by the fact that people supported their living standards with more debt.

We all know what happened when the bubble burst. The film ends with Nobel-prize winning economist Joseph Stiglitz's pithy summary. "What we are doing in effect is transferring money from people who would spend it to people who don't need all that money and don't spend it; hundreds of people getting more than a million dollars a year, even when their company makes a loss. When you have growing inequality, typically your level of consumption goes down. In the United States we said to those whose income was not going anywhere don't worry continue to spend as if your income was going up. But the only way you do that is through debt and that particular model has been broken."

*The Flaw premieres on 4 November at the Sheffield International Documentary Festival. It will be launched in United States early next year.*

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