

## HOW WE GOT IN OVER OUR HEADS<sup>1</sup>

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*President Obama met on April 23 with representatives of the credit card industry to encourage them to curtail what some have called abusive lending practices. Lawrence Summers, his chief economic advisor, recently accused the firms of encouraging Americans to become “addicted” to their products. That metaphor is half-right, in that the companies can be viewed as both addicts and suppliers. That’s the conclusion of a pointed critique Miller-McCune originally posted last October. Political economist, Johnna Montgomerie, called the issuing of credit cards and other forms of consumer debt a “pyramid scheme” in which banks and other lenders made money by issuing more and more cards to people who went further and further in debt. Consumers whose wages had stagnated indeed became addicted to this source of credit, but so did the companies which relied on those revenue streams. The report, which remains a remarkably clear explanation of why the economic system came close to collapsing, is reposted below.*

Suicidal bankers jumping from their office windows is an indelible, if largely apocryphal, image of the Great Depression. Johnna Montgomerie jokes that if any group of professionals is considering making the plunge this time around, it should be the economists. She’s kidding, of course, but she argues few practitioners of the “dismal science” foresaw the current financial meltdown, and fewer seem to truly understand it. “It’s often portrayed as a crisis in the financial services sector,” she noted, “and there’s a lot of discussion of how much spillover it will have in the ‘real economy.’ My take is the ‘real economy’ is the cause of the crisis.”

A native of Canada now living in England, Montgomerie is a political economist and a research fellow at the University of Manchester’s Centre for Research on Socio-Cultural Change. She has just published a timely paper titled “Financialization and Consumption: An Alternative Account of Rising Consumer Debt Levels in Anglo-America.” As we’ve been reminded periodically over the past two decades and insistently over the past two weeks, American (and, for that matter, British) households have long been spending more than they take in. A 2004 *Washington Post* piece warned of the “alarming surge” in consumer debt — which had just topped \$2 trillion — and quoted one expert as saying “our standard of living has to go down.”

Four years later, that bleak prospect seems increasingly likely. But did things have to play out this way? Not at all, according to Montgomerie, who argues the debt problem resulted from a mixture of stagnant wage growth, the increased availability of credit and a culture built on consumerism. She notes the decisions to tamp down wages and create new ways of borrowing money were political ones, made by leaders going back to Ronald Reagan. This mess, in other words, was a long time coming. Consumer debt is only one small facet of the current financial crisis; as Montgomerie notes, it is dwarfed by mortgage debt.

But she argues that looking at what has been happening in that market — credit cards, car loans and the like — gives us a much better idea of how far we have gotten off course over the past three decades. “Consumer credit is a small-scale version of what is happening with mortgages, in terms of how credit is created and recycled,” she said. “The current crisis was instigated in the

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<sup>1</sup> Miller-McCune newsletter, April 23, 2009

mortgage market; that was the flame that lit the fuse. But by looking at consumer credit, we see a microcosm of the financial processes involved. It allows us to see there are much bigger problems in the economy that relate to the household sector.”

To understand what she’s talking about, we need to start with a definition of “asset-backed securities,” which were invented in the 1970s and came into widespread use in the 1980s. “To a lender, when you have an outstanding debt, your interest payments are their revenue,” she noted. “The credit that they have is their capital — like a machine (in a factory). How they use their capital, their ‘machine,’ is to lend it. The revenue they get back is the interest payments. “If you’re a manufacturer and you have a stable order of T-shirts from Sears every six months, you can go to the bank and say, ‘This is my order book. I have a three-year contract, where I deliver this many T-shirts every six months, and this is the revenue I get.’ The bank will then lend you money based on that future revenue stream.”

Similarly, banks approached other, larger financial institutions and showed they had reliable “revenue streams” in the form of interest payments on credit cards, auto loans and the like. They then sold these “assets” to the larger organizations, which bundled them and sold them to still larger ones — with fees being collected each step of the way. The odd loan that went sour didn’t matter since it was submerged in a pool of good loans. “Yes, it is a pyramid scheme,” Montgomerie said. “Loads of people made money — insurance companies, investment banks. In describing this new practice, they talked a lot about ‘risk dispersement,’ but it wasn’t really being used to disperse risk. They were making money off of fees.”

As long as individuals kept taking out additional loans or credit cards, the banks could keep accumulating new “assets” in the form of projected interest payments. It all worked beautifully ... for a while. “What becomes problematic is: How do you keep this recycling going?” Montgomerie said. “The only thing you are selling is a reliable stream of interest payments — ‘reliable’ being the key word. What you need to do is find people you are sure to get interest payments from. “It’s a delicate game. From their (the lenders’) perspective, paying off all your debts is bad. But you (the lenders) need them (individual borrowers) to not default.

So you need to offer them all kinds of different products — adjustable rates, introductory rates and so on. “This is why if somebody is hugely in debt and is struggling to get by, they get offers for new lines of credit in the mail. If you have a huge amount of debt, you are considered a reliable stream of interest payments (since you are unlikely to get into good enough financial shape where you can pay off what you owe). It’s called ‘behavioral scoring.’ They’re monitoring your accounts all the time.”

To summarize: In a rational system, if you were in a huge amount of debt, you would be considered a bad risk and wouldn’t have access to still more credit. In our system, the opposite was true. This situation was not sustainable — although our greatest financial minds seemed to think it was.

“Alan Greenspan (longtime chairman of the Federal Reserve) was pressured over and over again to form some type of oversight of what was going on, but he would not do it,” Montgomerie said. “It was his political belief that regulation would hinder the market. He believed these finance people would never be too foolish.” At the same time that banks, mortgage brokers and lightly regulated non-bank lenders were offering loans to nearly anyone with a pulse and selling bundles of these loans to investors eager for the higher interest such loans generated, incomes

were stagnating. *The New York Times* noted that after adjusting for inflation, the average American family's income actually decreased from \$61,000 in 2000 to \$60,500 in 2007. Montgomerie argues the trend dates back to the 1980s, when President Reagan and Paul Volcker, Greenspan's predecessor at the Federal Reserve, decided it was imperative to crack down on inflation (which was a major economic problem in the 1970s). "The idea was inflation needed to be busted as a way of maintaining economic stability," she said. "But when they said 'inflation has to be low,' that meant 'wage inflation has to be low.'" Thus began a major shift in government policy in both the U.S. and the U.K., de-emphasizing the goal of full employment in favor of price stability. Regulations were changed to allow companies more flexibility in employment practices. Many chose to outsource, move operations overseas or employ contract workers, part-timers and others not covered by health insurance and other benefit programs.

"The long-term effect of that has been a decline in real wages," Montgomerie said. "Productivity has been rising in the U.S., but wages have not. We ended up with low inflation but diminished purchasing power. Prices continued to increase for certain things, such as medical bills, even as wages stayed stagnant. This was a political choice, but it has been obscured by all this economic language." Montgomerie argues it is this combination of factors that has proved so toxic, creating the current debt explosion. With wages stagnating and certain unavoidable costs (such as health care) increasing, people were looking for new sources of revenue to maintain their standard of living; these new sources of credit gave them the means to do just that. They were, in effect, an efficient way to postpone the pain.

"This has been going on since 1989," she said. "The Clinton administration, like Tony Blair's government in the U.K., had its heart in the right place, but it was unwilling to address the issue that needed to be addressed, which was: How do you maintain a standard of living based on everybody getting regular wage increases while controlling inflation? They couldn't square that circle. Cheap credit provided a way of smoothing over that conflict." Of course, we could have bitten the bullet, thrown away those tempting credit-card offers and cut back on our purchasing. There are early signs that may be happening at last: On Wednesday, the Federal Reserve reported that consumer borrowing fell in August at an annual rate of 3.7 percent — the first time total borrowing had fallen since January 1988.

Nevertheless, Montgomerie believes the urge to hit the mall remains lodged deep in our national psyche. "Any concept of prosperity and material well-being is bound up in consumerism," she said. "You don't un-ring that bell." Unless, of course, there really is a new Great Depression. "That's a very real possibility — so real it frightens me," she said. "But there is a growing awareness that this is not a temporary problem, and major changes are needed."

And what big changes would she recommend? "Proposals for a new regulatory framework need to start happening now. It needs to be an open framework for regulating the entire financial-services industry as a series of interrelated markets." In a larger sense, "The real pinch that is going to happen both in the finance industry and the business community is they're going to have to let wages rise," she said. "They're going to have to do it for the good of the American economy. The household sector cannot take any more pressure. More defaults will only lead to more instability. "The government cannot really do anything to make that happen, but it can set that tone. If (a new president and Congress) said, 'This is an idea we support,' that would be a really radical change. It would say maximizing profits is not sacrosanct. It is not in the Bill of Rights! The corporation is not a person — it's a legal entity. Legal entities don't need to be protected above people."