The Wealth Delusion

How Americans forgot the meaning of investment

By Tom Streithorst

IN THE PAST YEAR, over $20 trillion in wealth has disappeared. Wages are stagnant, unemployment rising, consumer confidence gone. We have awoken from a dream to find the prosperity we imagined was our birthright merely an illusion. Our borrowing, public and private, was the world's engine of growth for the last quarter century, and now we see the fate of the things we borrowed to buy: rapidly depreciating stock certificates, houses worth less than their mortgages. When we looked at our brokerage account statements and thought ourselves rich, we were confused about the meaning of the word "investment."

When you buy a stock or a bond, you are usually purchasing the right to income in the future, either a share of profits or interest payments. All finance is a trade between present and future: money now or the right to money later. Since the Industrial Revolution, we have generally been correct in assuming that the future will be more prosperous than the present. Improvements in technology and increases in capital expenditures have made workers more productive. That is our true wealth: if you can produce more with less work, you will be richer. But buying houses does not make us more productive.

In the past four years, America's 500 largest corporations made a profit of $2.4 trillion, more than 4 percent of GDP. Did they use it to increase productive capacity, improve quality, or strengthen their balance sheets? No, $1.7 trillion went for stock buybacks and $900 billion for dividends. Of the $2.4 trillion they made, they passed on $2.6 trillion to their shareholders. They gave away more than they made and invested nothing.

Investment, as defined by Adam Smith, Max Weber, and most economics textbooks, is the use of deferred consumption for the purchase of capital goods, which create a cash flow in the future. For the past generation, however, when most of us used the word "investment," it meant that a greater fool could be found to buy our house or share of a derivatives contract for more than we paid.

When the bore at a cocktail party says, "My house is the best investment I ever made," he means he paid less than it is now worth. But his house does not create a cash flow. It is merely a consumption item whose value has gone up. We have a semantic problem: the word "investment" has come to mean two different things, and this confusion played a part in creating the bubble whose explosion will end up costing many of us our jobs.

Look at the archetypal "investment" of the past 30 years: the leveraged buyout. Private equity firms find a company with a steady cash flow, put up a little money, borrow lots more, and then use that company's own cash flow to fund its takeover. They load a healthy firm with tons of debt, using existing cash flow to pay the interest. Retained profits, which the firm could have used for R&D, building new plants, hiring new workers, or productive investment, are sacrificed to service new, unproductive debt.

These leveraged buyout artists call themselves investors, but what they do is the opposite of investment. They are asset strippers. Traditional investors take savings created by deferred consumption and use it to create productive capacity for the future. Private equity firms take existing productive capacity, monetize it, and use it to fund their luxurious current consumption. Investment is supposed to mean sacrificing now to make the future richer. These pirates sacrifice the future to consume more today.

It didn't used to be this way. In the 17th century, suppose an Amsterdam burgher restrained his desire for luxury, didn't commission a Rembrandt portrait of his wife, and instead bought shares in the Dutch East Asia Company. The company used his money to outfit a ship bound for the Spice Islands. With a little luck, it returned two years later, sold its pepper for a profit and paid our burgher a dividend. His earlier restraint increased world trade, seasoned food all over Europe, and made him money. That is what we have always called an investment.

Or suppose a London rentier in 1880 bought bonds for a proposed railroad from Buenos Aires deep into the grasslands of Argentina. His money allowed the railroad to buy land, import workers, lay track. Worthless land became valuable. Cattle grazing there, previously slaughtered for their hides and left to rot, became a valuable export crop. The landlords cheerfully paid the railroad freight rates, the railroad paid the rentier his interest, and for the first time

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meat regularly appeared on the dinner tables of Europe's urban poor.

Of course, real investment still occurs today. An immigrant saves some money, borrows more, and opens a curry shop. A software engineer with a brilliant idea finds a venture capitalist to back him and invents Google. But these investors, who create jobs and increase productivity, are generally not funded by investment banks or financial markets. They borrow from commercial banks or perhaps sell equity to venture capital firms. The huge profits once made at Goldman Sachs, Lehman Brothers, and Bear Stearns had little to do with funding productive investment. Casino-style trading, mergers-and-acquisition work, highly leveraged arbitrage—shorting the 30-year bond while going long on the 29-year—made big bucks for financiers. But it did nothing for the economy as a whole.

Central banks battled any threat to the financial economy by increasing liquidity. This huge pool of new money sloshing around, chasing things to buy, created spectacular asset-price inflation. Three decades ago, houses on my London block cost £3,000. Last year, they went for £1 million. Back then, share prices traded at six to eight times earnings. Today, despite the huge fall in stock prices, P/E ratios are still considerably higher than they were in the early '80s. Why save when the value of your house goes up more than your annual salary? Why invest in new plants when firing workers makes your stock price—and thus your bonus—go up?

With asset prices rising for over a generation, investment lost its Calvinist roots. An investment no longer demanded sacrifice of current pleasure. Indeed it was the great borrowers who made fortunes. With CEO bonuses linked to short-term stock price increases, corporations spent retained profits to buy back shares, using their money to drive up stock prices instead of investing in things that would strengthen the firm in the long run.

Barry Eichengreen, perhaps the leading economic historian of the Golden Age, tells us that much of the growth in Europe after World War II was due to a social pact. Labor agreed to restrain its wage demands, and in return, capital agreed to reinvest most profits into the business. As productive investment rose, so did worker productivity, and between 1950 and 1970 real wages more than doubled. Investment in productive capacity works: it makes the entire society richer—entrepreneurs, bankers, and workers alike.

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That compact has broken down. As finance has grown to dominate the rest of the economy, with interest payments as a share of GDP rising from under 1 percent to over 16 percent, real productive investment has declined. If you build a factory or invent a new product using borrowed money, you create a cash flow that allows interest payments to be paid no matter what happens in the financial markets. But when "investment" creates no new productive capacity, when the link between financial investment and the real productive economy is broken, finance becomes a faith-based enterprise in perpetual asset-price increases. When that faith begins to crumble, the debt structure has no foundation to hold it up.

Hyman Minsky, the Cassandra of this financial crisis, described three types of financial structure. The first, and safest, he called "hedged." All borrowing—interest and principal payments—is covered by cash flow. Minsky defines a "speculative" financial structure as one in which, in certain periods, cash flow will not be sufficient to fund interest payments but the value of the investment remains greater than the interest and principal payments due. The third and most fragile structure he calls "Ponzi." Not only are interest payments less than cash flow, but the present value of the discounted cash flows generated by the investment are less than the money owed to fund it.

A Ponzi structure can only be maintained, Minsky said, by further borrowing, and this borrowing is only possible if interest payments do not rise while asset prices do. We have been deep into Ponzi finance for some time. Central bankers, recognizing the fragility of our financial architecture, have kept interest rates low. But the stability of the system required asset prices to keep going up so that the value of collateral grew, keeping banks confident enough to allow further borrowing. If asset prices stagnate, causing banks to reject the further loans necessary just to pay existing interest, the structure falls apart. That is why a relatively minor decline in American home prices brought the entire financial system to its knees.

The current crisis gives us an opportunity to rethink the link between the financial and real economies. For too long, those working in the productive economy of goods and services have subsidized bankers and traders who have done little to make the rest of us richer or more productive. Since we are bailing out their stupid bets, let us insist that from now on their investments serve our common future. We can no longer afford paper "investments" that merely represent a hope that since asset prices have gone up in the past, they will continue to do so forever. ■

Tom Streithorst writes from London.

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Sticker Shock and Awe

Our defenses should get smaller and smarter, not more expensive.

By Jeff Huber

PENTAGON OFFICIALS SAY that Secretary of Defense Robert Gates will soon announce up to a half-dozen weapons-system cancellations. If that's true—and I'm not convinced it is—Gates will probably meet more resistance than the Allies ran into at Normandy.

The time-honored adage says that generals always plan for the last war. American generals, taking things a step further, always plan for the last World War. As strategy analyst William Lind notes of our weapons-acquisition practices, "most of what we are buying is a military museum." For all the Pentagon's lip service to "transformation" and "revolution in military affairs," today's force looks like a Buck Rogers version of the force we defeated the Axis Powers with: aircraft carriers, destroyers, submarines, armor, infantry, bombers, fighters, special forces, and so on.

Our "Good War" military was suited to symmetrical enemies whose political behavior could be compelled by defeat of their armed forces. We haven't had a foe like that since the Berlin Wall came down; arguably, the Soviets ceased to be a serious military threat years if not decades before then. Yet the preponderance of our defense budget is spent on gee-wizardry to deter or fight a peer competitor that will never emerge.

At the low-tech end of the spectrum, the Obama administration intends to continue increasing the size of our ground forces to conduct the "long war" against "radical extremists," despite analysis by Rand Corporation that concludes the best way to proceed in our misnamed war on terror is "with a light U.S. military footprint or none at all."

Neoconservatives weep that their paisley sky will fall if America's defense budget drops below 4 percent of GDP. If that metric were a true indicator of military might, America would be at the mercy of juggernauts like Burundi (5.9 percent), Eritrea (6.3 percent), and Qatar (10 percent). As for percentages that mean something: America accounts for more than half of the world's defense expenditures. Iran's defense budget is less than one percent of ours. The defense budgets of Russia and China are no more than a tenth of ours. The U.S. and its Western allies supply more than 95 percent of global arms sales; anybody who wants a military that can compete with ours will have to buy it from us.

If Gates is serious about eliminating the fat from the defense budget, he can start by amputating the Pentagon's wild blue extravagance.

Air-power fanatics still argue that the atom bomb was the decisive factor in ending the war with Imperial Japan, but the judgment of history is that strategic bombing is a proven dud. The $2 billion B-2 stealth bomber is albatross enough, but the Air Force wants to replace it by 2018 with an even costlier manned bomber that will have the same combat radius but carry fewer bombs. By 2035, the Air Force plans to field a "transformational advanced technology capability" for long-range strike using an "advanced system-of-systems approach." "System of systems" is network-centric warfare-ese for a weapons program that will transform into a system of economic systems. We already bomb Pakistani weddings and Somali villages with robot airplanes controlled from Nevada and cruise missiles launched from nuclear submarines. Our "global reach" is systematic enough.

At $338 million per copy, the F-22 Raptor is the most expensive fighter jet ever made, but the F-35 Joint Strike Fighter program cost is on schedule to surpass the Raptor project's total tab. The planned production run of 183 Raptor airframes will cost $62 billion. The Joint Strike Fighter comes cheaper by the pop, but the planned 2,458 aircraft buy will cost upwards of $1 trillion in acquisition and maintenance costs. Moreover, the Government Accountability Office says the JSF estimate is "not reliable for decision making" because "certain key costs were excluded." How convenient.

Stealth technology drives the sticker price of these fighters into the stratosphere, but avionics, not radar-evading airframes, is what gives them superiority in air-to-air combat. The F-22's missile, radar, identification, and communications gear can be retrofitted into the F-16 Viper, which is still in production and comes in at under $20 million a copy. The multi-role Viper is a far better tactical bomber than the F-22, and when the fog of air-war forces a visual dogfight, the Air Force asserts that the "F-16's maneuverability and combat radius exceed that of all potential threat fighter aircraft."

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