DEBT, CLASS AND ASSET INFLATION

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Abstract

The paper examines the social and economic impact of debt in a society in which a property-owning middle class accounts for the bulk of household saving. The analysis therefore rejects a Ricardian view of saving and income distribution, based on notions of usury and a class structure with only workers and capitalists. Changes in asset values are closely linked with income and wealth inequality. Inflation of asset values allows a property owning middle class to generate cash flow from asset markets, making property owners independent of state systems of welfare for which that class pays in taxes. The result is a growing middle class hostility towards social welfare paid for by the state. With saving determined by middle class debt behaviour, a 'post-modern' business cycle emerges in which the working class pays the debts of the middle classes.

1. Introduction

The mainstream view of household consumption and saving is based on the idea of a 'representative' household endowed with more or less perfect foresight, according to whether the theory is New Classical or New Keynesian. The traditional Keynesian view had household saving and consumption determined by income, with Post-Keynesian innovations in the form of differentiated propensities to consume on the part of workers or capitalists and, following Minsky, increasing indebtedness of firms. The analysis below in section 4, based on the theories of Kalecki and Steindl, bears some relationship to the financial accelerator theory of Bernanke and Gertler, in using a similar 'net worth' factor in the analysis. However, it should be pointed out that Bernanke and Gertler do not provide any rationale for changes in net worth other than the observed fluctuation in net worth over the business cycle.

In the twenty-first century, in particular following the financial crisis that broke out in 2007, more radical economists have tried to link financial instability with inequality of incomes. A number of studies (e.g., those of Dumenil and Levy, Brenner) have argued that the crisis is the outcome of rising household indebtedness at a time of stagnating or falling wage income, combined with a rising share of profits being paid to financial intermediaries. The increased share of profit paid to financial intermediaries is supposed to squeeze investment and inhibit the economic growth necessary to generate the incomes needed to service debt.

Implicit in this approach is a view of saving that may be regarded as ‘Ricardian’ in at least three senses. In the first place, the criticism of the rising share of profits being paid to financial intermediaries echoes the critique of usury in the era of mercantile capitalism. At the time capitalist traders regarded the interest that they paid to wealthy partners who financed their cargoes, as a deduction from profits, rather than recognising the expenditure out of that interest income of rentiers as contributing to profits.

Secondly, the analysis presupposes that debt may only be serviced out of income. This too is a feature of the critique of usury in the 17th and 18th centuries. The flaw here is that it does not allow for the servicing of debt from inflation of asset values, where assets may be traded in markets to generate capital gains that may be used to service debt that is usually fixed in money terms. Behind the notion that debt may only be serviced out of income is a crude notion of credit that involves the lending out of commodity money, rather than the modern practice of credit that involves creating new credit against assets.

Finally, the approach is Ricardian in the sense that the authors classify incomes solely into those of capitalists, rentiers and workers, corresponding to the three great classes of David Ricardo’s analysis, the capitalists, the landowners and the workers. It is inadequate for the purposes of analysing the modern capitalist economy in which the middle class, broadly defined as the members of the free professions, public services and financial and managerial bureaucracies, now constitute a large proportion of households, even the majority of them in, for example, the U.S. and the U.K.

The failure of economic theory to give a distinctive analysis of the role of the middle class is an important lacuna in macroeconomics. Not only does this class account for the majority of household consumption and saving. The incomes of this class are also largely independent of industrial conditions, including the distribution of industrial income between wages and profits. The Ricardian approach is therefore thoroughly inadequate for the analysis of the modern capitalist economy in which the expenditure of the middle class makes up the bulk of household consumption, and the saving of the middle classes makes household saving impervious to the business cycle affecting industry. More striking is the failure of any major macroeconomist, with the exception of Joseph Steindl, to theorise adequately the middle class in the modern economy.

A feature of the modern middle class is its distinctive contribution to inequalities of income and wealth. The second part of this paper puts forward an analysis of how such inequalities are intrinsically linked to asset inflation. The third part of the paper shows how asset inflation combines with debt to produce a new political economy of the middle classes. The fourth part of the paper argues that this new political economy generates a new industrial cycle driven not by changes in distribution between wages and profits in industry, or innovation or new opportunities in industry, nor even by the rising indebtedness of firms, as supposed by many Post-Keynesians, but by the net saving of middle class households.

2. Asset inflation and inequality

Asset inflation and income and economic inequalities are intimately linked. Asset inflation means rising values of financial assets and housing. Such inflation allows owners of such assets to write off debts against capital gains, buying an asset with borrowed money, and then repaying that borrowing together with interest and obtaining a profit when the asset is sold. Hence, active trading in assets held by middle class households supports the proliferation of borrowing by households and consumption ultimately financed by debt. When the asset is housing, its inflation leads to a very particular social and economic pathology. The profit that accrues to the owner of an asset from the appreciation in its value depends to a great extent on how long that asset has been owned. The older owners therefore benefit most from an appreciation. The housing market then redistributes income and wealth from young people earning less at the start of their careers and indebting themselves hugely in order to get somewhere decent to live, to people enjoying highest earnings at the end of their careers. But housing inflation is also like a pyramid banking scheme because it requires more and more credit to be put into the housing market in order to allow those profiting from house inflation to be able to realise their profits.

Nevertheless, even those entering the system with large debts hope to be able to profit from it. In the period before the financial crisis broke out in 2008, governments and society in general became dependent on asset inflation: governments because it facilitated the sale of public assets and of public debt, regarded as ‘risk-free’ in portfolios containing inflating (and hence ‘risky’) assets. The prevailing political consensus became ‘intensely relaxed’ about the regressive redistribution of income that arose from such inflation. That consensus encouraged the belief that the best that young people can do to enhance their prospects is to indebt themselves in order to ‘get on the property ladder’, i.e., enrich themselves (or at least improve their housing) through housing inflation, or ingratiate themselves with wealthy elders in their family.

Those at the bottom of the income distribution inevitably suffer most from rising house prices because, living in the worst housing, they have the least possibility to accommodate their house purchase to their income by buying cheaper, smaller housing. Having little other option but to over-indebt themselves in order to secure their housing, default rates among households in this social group are also most likely to rise with house price inflation. This inequality lies behind the problems in the sub-prime market in the U.S. and the equivalents of that market in the U.K. and elsewhere.

Paradoxically, a more equal distribution of income and wealth is more likely to keep the housing market in equilibrium. In a society in which all incomes and wealth are more or less equally distributed, any increase in house prices above the rate of increase in income and wealth results in a fall in demand for housing. The fall in demand for housing brings house prices back down. Where income and wealth are already unequally distributed, and house prices rise faster than incomes, the housing market becomes stratified according to income and wealth. The movement of households between the strata prevents house prices, except those at the bottom of the market, from falling. Thus, if house prices in general rise, a fall in demand from those who can no longer afford a given class of housing is off-set by the increased demand for that class of housing among households that previously could afford better housing. In this way, the redistribution of income and wealth from those with more modest incomes to those with on higher incomes also facilitates asset inflation in the housing market.

Thus asset inflation makes inequalities of wealth and income even more extreme, and those inequalities further feed that inflation. Such inflation is therefore a self-reinforcing pathology of financial markets and society, rather than, as the economics establishment tells us, a temporary disequilibrium in the markets. It is certainly not a 'bubble' because when the so-called housing 'bubble' burst, it did not do so in that part of the housing market in which market value had risen most, i.e., in the markets for luxury housing, but in that part of the housing market that had risen least, that is in the poorest end of the housing market. Financial stability therefore rests not only on sound banking and financial institutions. It also requires a much more equal distribution of income and wealth. In the modern capitalist economy, in which a large asset-owning middle class comes to depend on asset inflation, that dependence needs to be confronted and reduced.

3. The assets of the middle classes

The central fact of changes in the distribution of income and wealth since the start of the twentieth century has been the rise of the middle class, a property owning class whose members are not strictly capitalists or workers. From the 1970s, the growing prosperity of the middle classes in the 'financially advanced' countries, such as the United States and Britain, was associated with a switch in their asset holdings, from modest holdings of residential property and direct ownership of stocks and shares, to residential property that was increasing in value, and indirect ownership of stocks and shares in the form of funded pension entitlements and insurance policies. In the early 1960s, the majority of stocks and shares in both countries were owned by wealthy private individuals. A decade later, the majority of stocks and shares were owned by pension funds and insurance companies. This does not mean that such funds were not active before the 1960s. They were, but had only a limited market because their use-value was just that they provided pensions and insurance. After the financial crises of the 1970s, financial inflation gave such intermediary funds a new use-value: that of financial enrichment.

Pension funds and insurance policies are relatively illiquid, and the cash flow that they provide is restricted to circumstances provided for in the terms of the policies: pensions in retirement, or payments defined by the terms of an insurance policy. However, the long boom in the housing market, with its growing liquidity, allowed additional borrowing against capital gains in that market. In the United States, from the 1970s, so-called ‘401’ pension funds allowed contributors, under certain circumstances, to draw out of those funds before retirement. As credit going into asset markets increases, the values of those assets increases too. The system of secured lending then allows owners of assets to generate cash from the markets. Financial inflation and the conversion of capital gains into income change the credit operations of the middles class. The use of debt by the middle class household becomes more closely linked to transactions in asset markets.

This change in credit operations by the middle class affects not only the frequency and value of tedious banking transactions. The change also changes the way in which capitalism is experienced, and hence the mentalities of those living in that system. That changed experience in turn alters the culture, preoccupations, and hierarchy within the propertied classes. The following features have come to dominate the political economy of the middle classes and resulting economic cycle of the economy dominated by those classes.

a) *An enhanced delusion of successful thrift among the middle c*lasses. In any scientific study of economic behaviour in market economies, it is necessary to distinguish the experiences or perceptions that people may have, from the market process that gives rise to such experiences or perceptions. Individuals who enjoy the benefits of asset inflation only directly experience the purchase of the financial asset which gives them a claim on a capital gain, rather than the money coming into asset markets that allows that gain to be realised. Capital gains are therefore ‘naturally’ attributed to provident and well-calculated asset purchase, perhaps even to some intrinsic characteristic of a given asset, rather than generalised asset inflation. In this way the propertied classes succumb to a comforting illusion, carefully cultivated by their financial advisers and intermediaries, that their foresight and financial acumen have secured them their gains.

   In fact, the situation is quite the reverse. The benefits which the propertied classes obtain from inflated property and financial asset markets are increasingly capital gains on wealth rather than accumulated saving out of income. As property markets inflate and pension funds mature, it is the propertied classes who dissipate on their own consumption the capital gains that they are able to take out of property and financial asset markets through the enforced saving of the young buying accommodation at prices that swallow up most of the incomes of the young, or lower paid workers obliged to subscribe to pension funds[1]. The delusion of thrift reinforces a growing sense of financial self-reliance and independence of the state welfare system.

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[1] In early years of the century, before the financial crisis gripped the United States and Europe, the households in the US and Great Britain had reduced its saving virtually down to zero. An implication of this recent zero net saving in the household sector is that households forced by debt to consume less than their incomes have their counterpart in households that consume in excess of their incomes.

b) *The emergence of inflated property and financial asset markets as a 'welfare state of the middle classes'*. Inflated asset markets act as a welfare state in that such markets socialise the financial risks of those owning such assets. Asset markets afford asset owners unconditional access to money through the sale of an asset typically to another asset owner with spare liquidity. Inflated asset markets allow owners of such assets to cross-insure each other in this way against extraordinary liabilities for health care, holidays, school fees, the purchase of housing, or the repayment of inconvenient debt. Such extraordinary liabilities may be accommodated by taking out of those asset markets money that is being put into them by those acquiring such assets. The use of asset markets as a fund to pay for the social welfare expenses of the middle class alienates that class from the state welfare system. In most countries, and especially the advanced capitalist ones, the middle class pays the majority of taxes on households, taxes that support public consumption financed by the state welfare system. Deriving little direct benefit from state welfare middle class taxpayers are more inclined to demands that the cost of that welfare state is reduced by concentrating state benefits more narrowly on 'those in need'. This reduces the benefit that the middle class obtains from the state system and, since 'those in need' usually pay least taxes, such concentration reinforces that middle class alienation from the state system. The reduction of state welfare in this way marginalises still further those who do not own assets.

c) *The marginalisation of those without appreciative wealth*. They may be home-owners in places where wealthy property-owners do not wish to buy housing, for example in rural areas far from urban middle class concentrations; or those who do not own inflating assets, such as housing, in places where wealthy property-owners are buying housing. Where property-owners transfer capital into the housing market, the increase in house prices obliges the young and migrant workers to live in over-crowded conditions, because housing has become a perquisite of property-owners, rather than being available to all. Not having property denies marginalised sections of society the opportunity to operate balance sheets actively, and therefore denies them access to that welfare state of the middle class that the housing market becomes when it is inflated. For those without property, debt is more likely to finance current consumption, rather than the acquisition of inflatable assets. These are the lower class counterparts of those among the propertied classes whose possession of inflated assets allows them to consume in excess of their incomes. An unequal distribution of income is thus enhanced by a growing economic, social and political distinction between the 'balance sheet' rich, and the 'balance sheet' poor.

d) *State-administered social welfare as a system for prosecuting the poor*. While the official welfare state may provide some minimum income for those without means of support, this is at the cost of taxpayers predominantly among the middle classes. Such minimum income is increasingly delivered with a degree of institutional bullying and menaces, designed ostensibly to make welfare claimants more active in securing their financial independence. But, in reality, bullying and menaces are supposed to reassure propertied tax-payers that those claimants are being penalised for their improvidence in not having property to support them. Right-wing politicians and economic advisers repeatedly assert that maintaining an unpleasant and inadequate system of income support is necessary as an ‘incentive’ to keep up the ‘willingness to work’ of the poor. However, in reality it is their lack of saleable property that is being punished. No-one threatens, with removal of their income, the propertied classes for their improvidence in living on unearned income from property or capital gains on that property. The selective penalisation of those without property or income is a natural consequence of a state welfare system that is no longer comprehensive because the middle class is increasingly opting out of it.

4. The ‘post-modern’ business cycle

The ‘modern’ business cycle is the cycle identified with fluctuations in fixed capital investment, whose theory was developed for the most part in the first half of the last century, from Aftalion and Wicksell, through Hawtrey, Hayek, Schumpeter, Keynes and Kalecki, to Hicks, Samuelson and Kaldor. With the emergence of asset inflation in the 1980s, a new kind of business cycle has appeared, based on a combination of wealth effects, due to asset inflation, stimulating the consumption of the middle classes. The debts incurred as credit is attracted into inflating asset markets, cause debt deflation when asset prices fall. The debt deflation is expressed as rising net saving which reduces business liquidity and causes industry to go into recession, until middle class consumption can be stimulated again.

The ‘post-modern’ business cycle is based on an economic and social structure that includes a middle class whose demand for goods and services is large in relation to the economy as a whole. In an economy in which income and wealth are unequally distributed, the share of the middle class in aggregate demand will typically be greater than the proportion of the population that is middle class. The relative demographic size of the middle class will therefore underestimate the economic significance of that class.

The economy may therefore be divided into two sectors. The first is the industrial sector in which capitalist firms employ workers to produce goods and services that are consumed by all classes. The workers are assumed, as a whole, not to save, that is the saving of those working class households that save is balanced by the dissaving of other working class households. The second sector is the middle class, consisting of those employed in the free professions, public services and the salaried employees of business and financial services. The middle classes own assets, in residential property and financial claims on capitalist firms.

Among the capitalists a sector of rentier capitalists also own assets in the form of claims on property and capitalist firms. The difference between rentiers and the middle classes is that the rentiers do not work, but live off the revenue from their rents and financial claims. By contrast the middle classes work, producing professional and other services for each other and for capitalists and workers. Producing professional services, the middle class is isolated from the conditions of distribution and industrial demand that determine returns in industry. The middle classes therefore are not affected by industrial fluctuations. For the middle classes, their income from assets is supplementary to their income from their work. In the case of rentiers, their income from assets represents their only income.

For the economy as a whole, the identities of the circular flow of income apply, i.e., in a given year, $\boldsymbol{t}$, total Income ($\boldsymbol{Y_t}$) minus Consumption must be equal to Total Gross Fixed Capital Formation ($\boldsymbol{I_t}$) plus the fiscal deficit, plus the foreign trade surplus. If, for the sake of simplicity, it is assumes that the fiscal deficit is balanced by the trade surplus, and further dispensing with time subscripts, we have Income minus Consumption equalling Saving ($\boldsymbol{S}$) which is equal Fixed Capital Formation ($\boldsymbol{I}$).

Saving can further be divided up into the saving of firms ($\boldsymbol{S_f}$) plus the saving of rentiers, ($\boldsymbol{S_r}$) plus the saving of the middle classes ($\boldsymbol{S_m}$). The saving of firms is the retained profits that firms keep after all payments on their financial obligations.

The equality of saving and investment may therefore be written as:

$$\boldsymbol{S = S_f + S_r + S_m = I}$$

Rearranging this gives the following equation for the retained profits of firms:

$$\boldsymbol{S_f = I - S_r - S_m} \qquad (1)$$

This is the Steindl equation showing that firms' total additions to their liquid reserves are equal to firms' investment, minus the saving of rentiers and the saving of the middle classes(Steindl 1982). This means that a portion of firms' investment effectively finances itself through the additions that it makes to firms' retained profits. However, a further portion, corresponding to rentiers and middle class saving requires credit from outside firms, that is the addition of financial obligations of firms to rentiers and the middle classes that corresponds to their saving.

So far the analysis has consisted of definitions and the fundamental macroeconomic principle of the circular flow of income. Some dynamics can be introduced by making some plausible behavioural assumptions about saving behaviour.

In the case of rentiers' saving, it is convenient and plausible to suppose that this does not change very much over the cycle[2]. In other words, increases or decreases in rentier incomes are matched by increases or decreases in consumption. This is plausible because at a very high standard of living, it becomes very easy to spend additional income conspicuously on luxuries. If income falls, then more or less the same standard of living

[2] '*Rentiers' saving* is the least elastic of all. … rentiers' saving will change only very sluggishly, and will prove completely inelastic below a certain minimum.' Steindl 1952, p. 115.

may be maintained through consuming the same articles of consumption, but in a less luxurious style or version.

In the case of middle class saving, this may be expected to vary with difference between debt (***D***) and asset values (***A***) so that:

$$\boldsymbol{S_m = \delta (D - A)}$$

This equation would give negative net saving by the middle class when asset values exceed total debt. This would be because the middle class could extract capital gains from asset markets and use those gains to pay for additional consumption or service their debts. This would correspond to the well-known 'wealth effect' on consumption. By contrast, when the value of a middle class household's debt exceeds the value of its assets, the household would find that further borrowing is restricted by the lack of unmortgaged security value. In such a situation, assets become less liquid for their owner and less likely to be sold, because such sale would not pay off all the debt, and holding onto the asset at least offers the possibility that in the future its value may exceed the debts held against it. These restrictions on the credit operations and assets sales limit the ability of the middle class household to extract capital gains out of asset markets forcing that household now to service debt solely out of income. The middle class household in this situation would find its consumption squeezed below its income by debt service payments.

Substituting this middle class saving function into equation (1) gives:

$$\boldsymbol{S_f = I - S_r - \delta (D - A)} \qquad (2)$$

This equation summarises how a post-modern business cycle, that is a business cycle driven by fluctuations in assets values, might work.

With capital market or residential property inflation, asset values would rise faster than middle class indebtedness. This would stimulate middle class consumption (the wealth effect) which, for a given value of firms' investment, would result in higher retained profits in non-financial businesses. These in turn would stimulate business investment. The economy would enter a boom phase, with rising middle class indebtedness, to acquire assets and facilitate extraction of capital gains from asset markets. The increase in net credit entering the markets for residential property or financial assets would increase the values of residential and financial assets, stimulating further middle class consumption.

The boom would proceed until debt values exceeded asset values. The rise in middle class saving would now result in a fall in firms' saving or their retained profits. With reduced inflow of liquidity, firms will cut back or postpone their investment. In turn this will exacerbate their situation by reducing those retained profits still further.

In small open economies, and in developing economies, the discretionary part of middle class consumption that is stimulated by the ‘wealth’ effect, may have a high import content where foreign exchange controls permit such expenditure. Imported luxury goods, travel abroad, residential property and financial held abroad, and foreign health and educational services, frequently offer superior quality and bestow distinction upon households otherwise distinguished only by having more income and wealth. In such a situation, a boom based on middle class consumption will result in a rapid deterioration of the foreign trade balance. In such countries the boom is therefore more likely to end in a foreign exchange crisis (this was a feature of the Argentine crisis in 2001).

A decline in middle class consumption of domestically-manufactured goods reduces the revenue of domestic manufacturers. If they respond to this by cutting back on production and investment, then this may reduce firms’ investment below the threshold ($\boldsymbol{S_r} + \boldsymbol{\delta}\,[\boldsymbol{D} - \boldsymbol{A}]$) that investment has to exceed if firms are to have a positive cash flow, that is retain profits from their productive activities (see equation (2) above). If firms have negative cash flow then they will tend to reduce production and investment further. At this point the relative inelasticity of middle class saving becomes a factor in exacerbating the industrial situation. Since their incomes are relatively independent of the industrial business cycle, and their saving is determined by balance sheet considerations, the saving of middle class households will not be reduced by an industrial recession. On the contrary, the debts incurred during the previous asset inflation will, when asset prices fall, have to be serviced out of income, causing a rise in household saving (that is the difference between household income and expenditure). The rise in household saving will have its counterpart in the reduced income of those workers made unemployed in industry, and the rise in debt, or reduction in reserves, of industrial firms, forced by their negative cash flow or retained earnings to borrow or run down their savings.

Conclusion

With greater economic inequality and active asset markets, the middle classes come to rely on active asset markets to manage their debts. More active debt management allows property-owners to generate cash flow from inflating asset markets. In turn this alters the attitudes of even owners of modest property towards public consumption, the state welfare and the taxation that is necessary to support the welfare state. Where asset inflation gives rise to a ‘wealth effect’ on consumption, this may give rise to a new type of economic fluctuation that does not depend on either the increasing indebtedness of firms, or Keynesian speculative bubbles. In a boom asset inflation allows the middle class to provide a net ‘external’ market for the output of industry, stimulating industrial output. In a recession, faced with an excess of debt over asset values, the middle classes engage in net saving in order to manage their debts, forcing the industrial sector into financial deficit. This deficit is managed by reducing investment and output. In the traditional Keynesian analysis, unemployment would continue to rise until saving is reduced. However, the middle classes are unaffected by falling output or returns in industry, so that rising unemployment does not reduce their saving that is causing the financial deficit in the industrial sector. Net middle class saving in the form of debt repayment, at the expense of unemployment in industry, continues until the middle classes start borrowing again to invest in assets, causing asset prices to rise again. In this way the working class pays the debts of the middle classes, reinforcing those inequalities of income and wealth that are so congenial to asset inflation.

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