

Wall Street Will Drown Alone

By Casey B. Mulligan

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There was a time when people believed that the Sun and stars revolved around the Earth. Of course, now we know that the Earth is not the center of the universe, or even the center of our little solar system. In the somewhat more recent past, economists thought that the non-financial sector in a modern economy revolved around financial markets, despite the facts that only 4 percent of the workforce was employed in the financial sector (including insurance and real estate), and even today that sector employs only 6 percent of the total. President Bush and supporters of the recent massive Wall Street bailout plan still believe Wall Street to be the center of the entire economy.

Economic research over the last couple of decades rejects this belief. It has shown that the financial and non-financial sectors experience quite independent changes, especially over the short and medium term. Take for example the promised yield on the best commercial paper. Fluctuations in this yield are critically important to persons in the financial sector (such as money market traders), but have hardly anything to do with activity outside of that sector. Since World War II, the correlation between the inflation-adjusted commercial paper yield and subsequent inflation-adjusted growth of GDP per capita is zero. That is, GDP growth has been high following high yields just as often as it has been low. It is equally hard to detect a correlation between stock returns, long term bond returns, or commodity returns and subsequent GDP growth. Quite simply, history has shown that the non-financial sector can do well when the financial sector does poorly, and vice versa.

In order to find good predictors of non-financial sector performance, and GDP growth generally, we look to the non-financial sector itself. One of those predictors is the profitability of non-financial capital, or the “marginal product of capital” as we economists call it. The marginal product of capital after-tax is a measure of how much profit (revenue net of variable costs and taxes) that each unit of capital is producing during, say, the last year. When the marginal product of capital after-tax is above average, subsequent rates of economic growth (and subsequent marginal products of capital) also tend to be above average.

Since World War II, the marginal product of capital after-tax averaged between 7 and 8 percent per year. During 2007 and the first half of 2008 – exactly the time when financial markets had been spooked by oil price spikes and housing price crashes – the marginal product had been over 10 percent per year: far above the historical average. Compare this to the marginal product of capital in 1930-33 (the years of Depression-era bank panics): 0.5 percentage points per year less than the postwar years and significantly less than in 1929. The marginal product of capital was also below average prior to the 1982 recession (in this case, far below average) and prior to the 2001 recession. Thus, the surprise was not that GDP continued to grow 2007-8 despite the bleak outlook from Wall Street’s corner of the world, but that GDP growth failed to be significantly above the average. More important from today’s perspective is that much capital in America continues to be productive, and that this will likely permit Americans to advance their living standards as they have in years past. The non-financial sector today looks nothing like it did in 1930.

The weak correlation between asset prices and non-financial sector performance and the strong profitability of today's non-financial capital are two good reasons to scoff at the idea that the non-financial sector will collapse because of the recent events on Wall Street, and even better reasons to scoff at the Bernanke-Paulson-Bush idea that a massive bailout of financial firms is the key to avoiding a non-financial collapse. Wall Street's woes are and will be largely limited to Wall Street. The Bush administration should not use the power of the IRS to force the rest of us to board Wall Street's sinking ship.

Of course, six percent of the workforce is bigger than zero, so a Wall Street mess has indirect effects on the non-financial sector as it absorbs former Wall Street employees and finds alternatives to the financial services Wall Street once provided. But, as long as the government does not get in the way, the marketplace will quickly react to provide the non-financial sector with financial services, even if the main players in that marketplace are no longer named Lehman, Merrill, or Goldman.

There are two basic obstacles that Washington might create in this process, both of which are included in the Bernanke-Paulson-Bush proposal. One is to pile on regulation and further impede entry by new firms that might provide financial services to the non-financial sector in the years ahead. The second is to impose a heavy tax burden on the non-financial sector to pay for Wall Street subsidies. The Treasury and the Fed should let Wall Street drown alone, to be replaced by new financial service providers who can swim as robustly as are non-financial American businesses.

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