CPEG
Chicago Political Economy Group

CPEG Notes

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With this first issue of ***CPEG Notes***, members of the Chicago Political Economy Group begin a new series of quarterly analyses of current economic reality. This publication, which has evolved out of CPEG's regular *Commentary of the Monthly BLS report*, is directed at scholars, students, activists, journalists, policymakers and all others interested in economic trends, theory and issues confronting the world economy.

Comprised of academics, activists, retirees, writers and policymakers, CPEG provides research, writing and speaking to advance economic and social justice. We believe deep structural problems in the U.S. and world economies are producing the contemporary crises that since September 2008 have comprised the Lesser Depression.

In each issue of ***CPEG Notes***, CPEG members will discuss national, regional and international issues, review books and cover other topics. This edition begins with the *Quarterly Review* on the state of the US economy, written by Joseph Persky, Professor of Economics at the University of Illinois at Chicago. Persky continues with a *National Note* discussing factors keeping state and local governments from contributing to an economic recovery, and the economic costs of their inaction. Ron Baiman, Assistant Professor of economics at Benedictine University and former long-time member of the Editorial Board of the *Review of Radical Political Economics,* then contributes a *National Note* on the continually bleak US employment picture. Bill Barclay PhD, who worked 22 years in financial services, explains in a *National Note* how taxing financial transactions can help rebalance our political economy. The issue closes with an *International Note* in which Chicago writer (and ***CPEG Notes*** Editor) Luis Diaz-Perez summarizes competing explanations for the recent, dramatic drop in oil prices.

The members of CPEG welcome opportunities to collaborate with others. We encourage readers to both freely distribute ***CPEG Notes*** and to share their feedback via social media, or directly with us at cpeg@cpegonline.org.

--- LD-P

Quarterly Review *by Joseph Persky*

The fourth quarter 2014 real Gross Domestic Product (GDP) growth rate came in at 2.6 percent, disappointing all those talking about the recovery finally taking off. Despite rapid growth in the second and third quarters, 2014 finished with a moderate 2.4 percent growth rate for the year.

…the employment scene continues to be sluggish…

The quite modest performance in the real GDP occurred against a background of price movements bordering on deflation, with the GDP deflator actually falling in the fourth quarter. Similarly, in January the Consumer Price Index showed a decline for the first time in years. Part of this downward trend is clearly due to oil, but in part this trend reflects the various corrections (perhaps over-corrections) that the Bureau of Economic Analysis and the Bureau of Labor Statistics have now built into their indexes.

What's going wrong? Consumption growth remains sluggish, imports increased and government spending actually decreased. Second to the third quarter growth was largely dependent on a drop in imports due to a

fall in oil prices and a short-term increase in government spending that wasn't maintained into the fourth quarter. Although bright spots persist – private investment rose 6 percent, there was an 8 percent rise in non-residential building construction, and inventories have grown strongly. Nonetheless, the employment scene continues to be sluggish, with job expansions averaging about 250,000 per month, just a bit better than what's required to maintain the employment-to-population ratio at its dismally low level. The official unemployment rate stays at 5.8 percent only because workers have been slow to return to the labor force. Large numbers still remain underemployed.

National Note *by Joseph Persky*

State and Local Governments are Failing the Economy

For the past five years of the Lesser Depression, state and local governments have been a drag on the macro economy. Through the second quarter of 2009 federal transfers offset declines in state and local tax revenues, helping expand state and local expenditures. But, since then, real state and local expenditures have fallen sharply and then landed at a plateau well below their 2009 peak. (See Figure 1.)

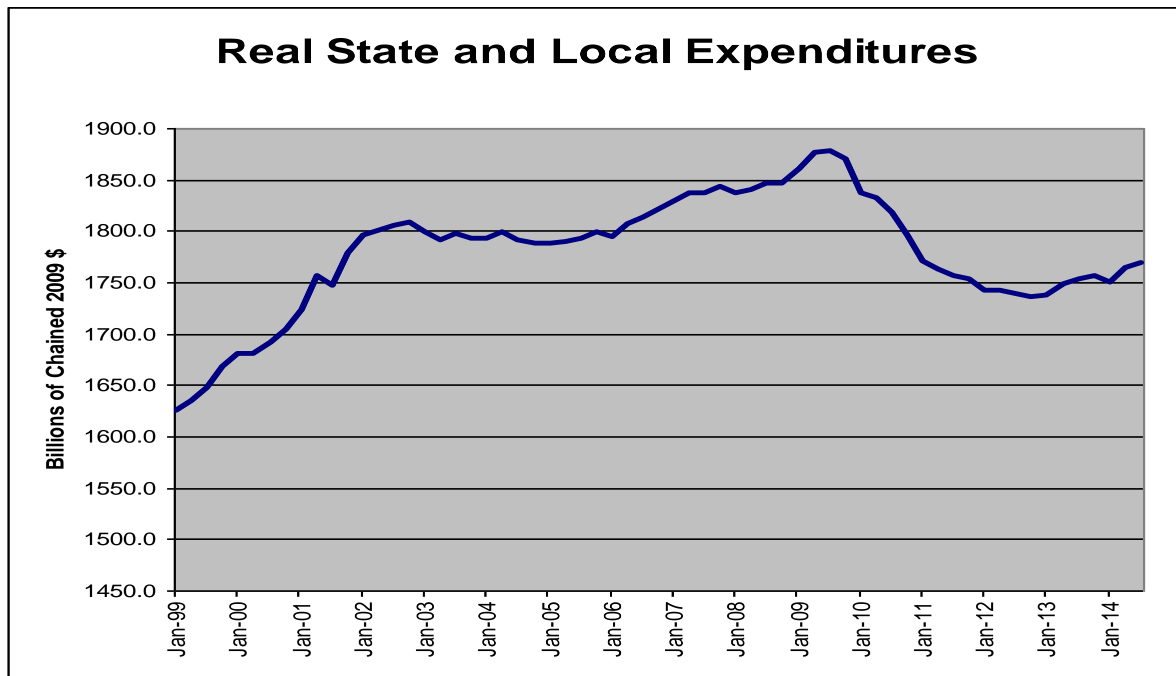

Figure 1: Table 3.9.6. "Real Government Consumption Expenditures and Gross Investment, Chained Dollars" of National Income and Product Account Tables, produced by the Bureau of Economic Analysis of the Commerce Department, Last Revised: Jan. 30, 2015

Public spending on investment for things like road construction, computers, hospital equipment and the like, declined more than on consumption such as spending on police, school operations, health care, etc.

This is a time for building roads, new schools and addressing infrastructure depreciation. Rather than cutting back on these efforts, states and localities should be empowered to take advantage of the slack economy so that their spending helps to restore prosperity.

The logic of anti-cyclical policy requires public sector expenditures to rise in periods of recession so as to off-set the decline in private spending. With infusions from the federal government this was the case in

2008 and early 2009. However, states and local governments are moving toward austerity, trying to cut their expenditures and balance their budgets. After 2009, the federal government has been unwilling to transfer sufficient funds to states and communities to maintain their overall spending levels.

During a recession, resources are in abundant supply and the true opportunity cost of public investment falls far below the monetary price tag. This is a time for building roads, new schools and addressing infrastructure depreciation. Rather than cutting back on these efforts, states and localities should be empowered to take advantage of the slack economy so that their spending helps to restore prosperity.

Instead, this country has moved inexorably in the direction of austerity. Over the entire period 2008-2014 real GDP first fell and then rose. The economy has been forced to wait on the slow expansion of the private sector, now up only 3 percent in real terms since the beginning of the recession. State and local expenditures have been left to lag far behind this sluggish recovery.

Focusing on employment, the number of state workers declined from a peak of 5.2 million in 2008 to 5.1 million at the end of last year. Local government employment however decreased even more, from 14.6 million to 14.1 million. Of that change, some 300,000 employees were lost from local education. Over the same period, private employment, after first declining, increased by about 6 percent.

Here in the East North Central region (Michigan, Ohio, Indiana, Illinois and Wisconsin) Michigan was especially hard hit. Michigan's state and local governments' contribution to state product fell dramatically. The results have been even worse in the state's large cities. Most notably, as part of this trend, has been the bankruptcy of Detroit's municipal government. The federal government's forcing Detroit's government to essentially forego its responsibilities during these hard times is strikingly similar to the European Union's deaf ear to the crisis in Greece.

Rather than mobilizing resources for public uses, the nation's states and cities have been left to struggle through budgetary constraints. A federal injection of $100 billion per year could have kept state and local spending levels at their 2009 highs. Another $100 billion could have been easily put to work.

National Note *by Ron Baiman*

Employment Woes

Economists measure "Business Cycles" from "peak to peak" or "trough to trough" where a "peak" is that point at which a new "recession" or "contraction" begins, and a "trough" the point at which the "expansion" or "upturn" out of a recession starts. The NBER Business Cycle committee is the official body that designates the starting and ending points of U.S. recessions (see: http://www.nber.org/cycles.html). Figures 1 and 2 graph post-war recessions from "peak to peak," and are based on the "Current Population Survey" (CPS) of household employment. They both starkly illustrate the massive job loss and lack- luster recovery from the Lesser Depression. In both Figures below, post-war business cycles are labeled, and centered around their NBER designated "troughs." In Figures 1 and 2 June 2009 is the official NBER designated "trough," or start of the expansion phase of the Lesser Depression. The peak of this cycle will occur when the next contraction begins.

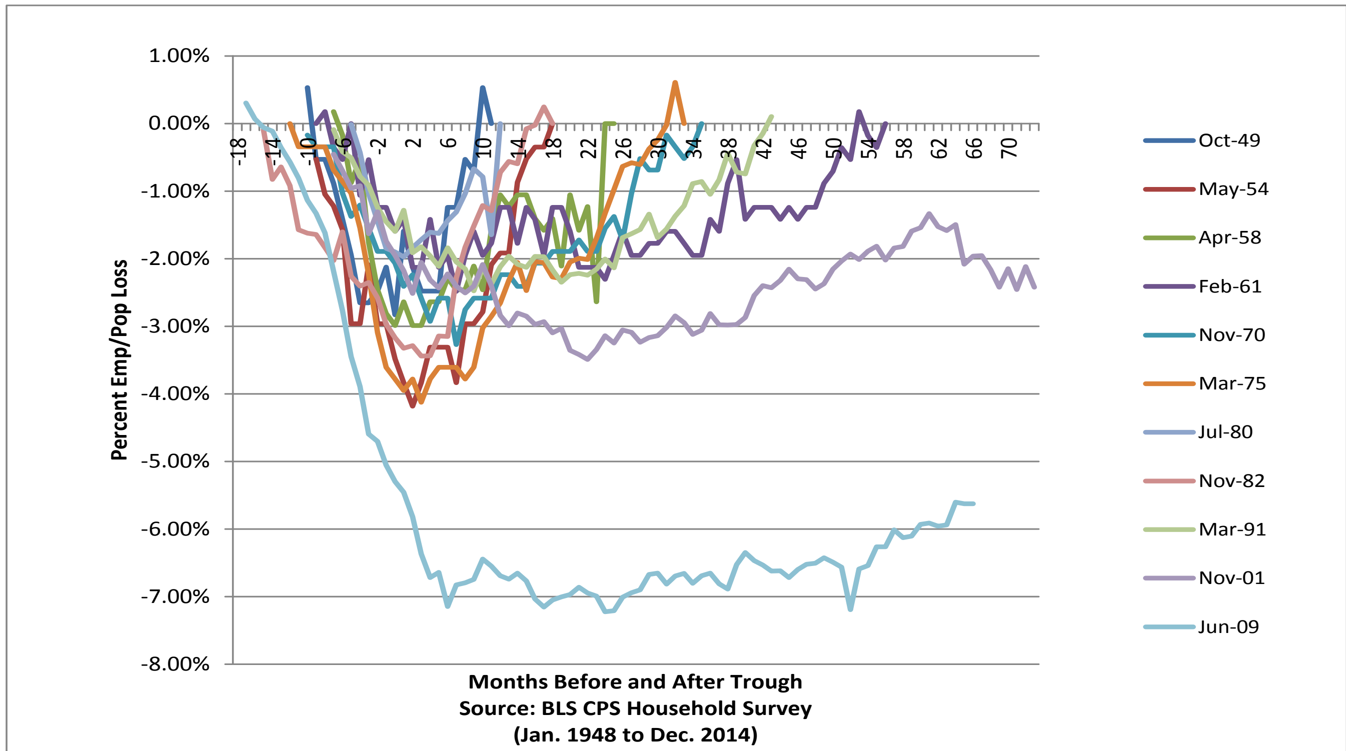

Figure 1: Percent Decline in Employment to Population Ratio from Start of Recession for Post War Business Cycles (Business Cycles Labeled and Centered Around Official Trough Date at "0" Marker on Horizontal Axis)

Figure 1 shows there has been little improvement in regaining the employment share that prevailed in November 2007 before the start of the Lesser Depression. It shows that all post-war recessions regained their pre-recession employment-to-population share within at least 56 months of the official "trough" of the recession, except for the most recent post 2000 recessions. However, the employment-to-population ratio starting point for the current June 2009 Lesser Depression was already about 2 percent below where it had been before the November 2001 recession began. In contrast to every other post-war recession, there was no employment-to-population recovery before the beginning of the Lesser Depression which, to date, has lowered the employment-to-population ratio by another 5 percent or more.

…since 2000 the middle class has continued to narrow, with more households falling "to the bottom."

Some commentators argue Figure 1 does not accurately illustrate the relative health of the labor market because it fails to account for labor force aging, which has led to a trend reduction in labor force participation relative to past years (see: http://www.nytimes.com/interactive/2013/11/01/business/Job-Picture-May-Be-Better-Than-It-Appears.html?ref=economy&_r=0). Figure 2 takes labor force aging into account by doing the analysis by population age cohorts (16-24, 25-54, and 55 and over), and holding the shares of the age cohorts constant in the population at December 2014 levels.

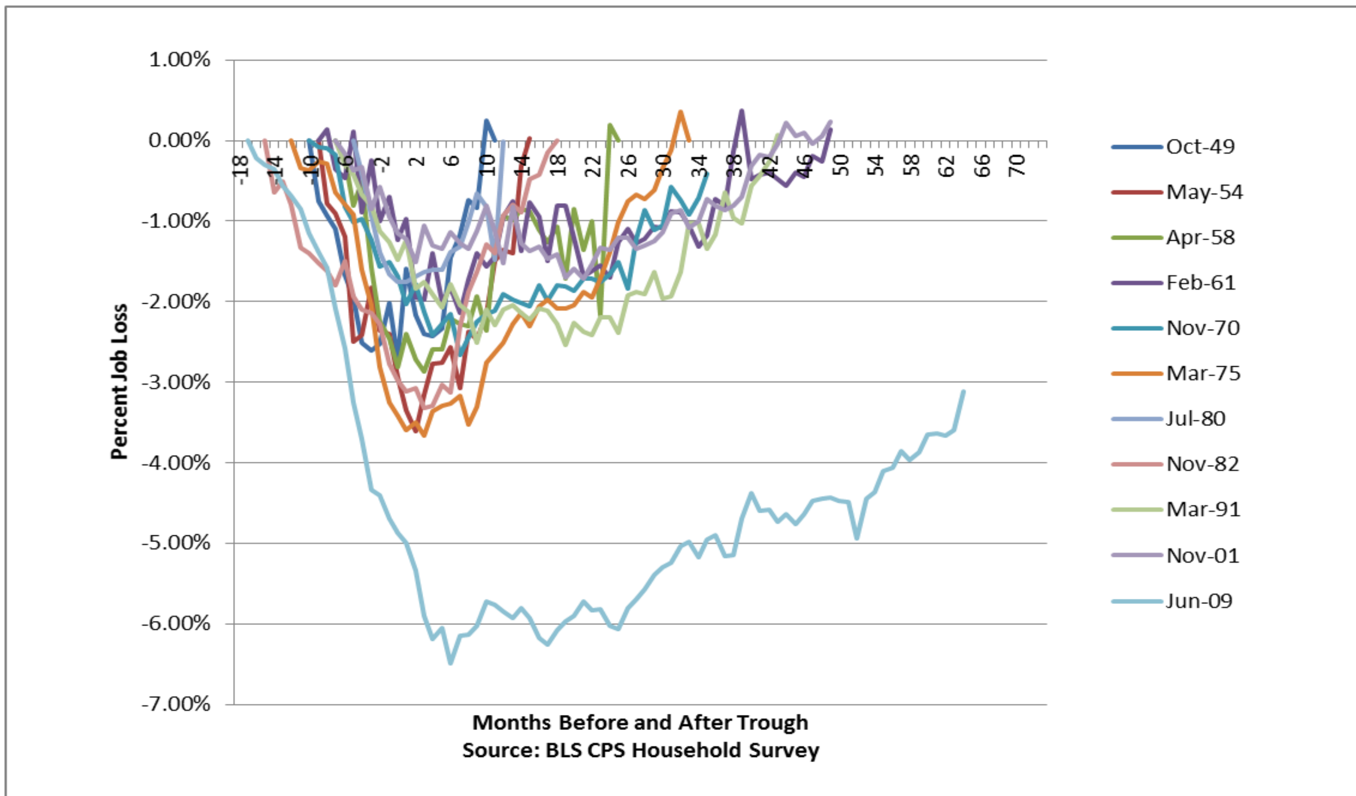

Figure 2: Same as Figure 1, but Using Employment to Population Ratio by Population Age Cohort (16-24, 25-54, 55 and over) and Assuming that these Population Age Cohorts are Fixed at their December 2014 Population Shares.

Figure 2 shows what a deep hole we are in simply in terms of overall employment, without considering the quality of the jobs, relative to post-war standards. Taking demographic shifts into account, the November 2001 recession (and every other post-war recession) recovers its pre-recession *demographically adjusted* employment-to-population ratio within 49 months, except for the current June 2009 Lesser Depression. As can be seen, labor force aging can account for about 2.5 percent of the decline in employment-to-population ratio which is still far greater than in any prior post-war recession.

However, in terms of per-person productive employment the adjusted graph of Figure 2 presents a false picture, unless declines shown in Figure 1 are offset by productivity, income improvement and redistribution within age cohorts so that Figure 2 offers an alternative means to obtain the result of Figure 1, which is not occurring in the U.S. economy.

The picture presented by these Figures is confirmed by reports that since 2000 the middle class has continued to narrow, with more households falling "to the bottom." At the same time, a larger proportion of those who remain in the middle class (defined as $35,000 to $100,000 per household) are made up of households headed by older adults (over 65) whose median income has increased by 14 percent thanks largely to better retirement and the social security cushion. All this while median household income declined 9 percent since 2000 (http://www.nytimes.com/2015/01/26/business/economy/middle-class-shrinks-further-as-more-fall-out-instead-of-climbing-up.html). The shift in the adjusted graph reflects higher employment-to-population ratios for the growing 55-and-over cohort coupled with smaller employment-to-population shares for the shrinking shares of younger (16-24) and prime age (25-54) workers.

Moreover the implications of these trends are particularly serious when considering the status of households with children. In the late 1960s, 60 percent of households (i.e. those earning between $25,000 and $100,000 in real dollars) were composed of married families with children, today such households account for just a quarter of US households. Currently, far fewer children are growing up in middle class households, and more and more are growing up in economic distress. This reality is reflected in the fact that half of US public school children qualify for free or subsidized school lunched (see: http://www.nytimes.com/2015/01/17/us/school-poverty-study-southern-education-foundation.html). Still, such facts remain invisible from the perspective of wealthy suburban districts on the other side of our Bantustan-like, separate and unequal public school funding systems.

National Note *by Bill Barclay*

Taxing Finance – The FTT and Rebalancing the US Economy

Yes, as through this world I've wandered
I've seen lots of funny men;
Some will rob you with a six-gun,
And some with a fountain pen.

[But] You won't never see an outlaw
Drive a family from their home.
--- Woody Guthrie, *The Ballad of Pretty Boy Floyd*

CPEG and other supporters of taxes on finance often rely on two propositions in making their arguments. The first is based on economic justice: the financial sector was the driver of the 2008 financial panic and subsequent Lesser Depression, therefore they should pay. Second is the "Willie Sutton Argument." When asked why he robbed banks, Willie responded: "because that's where the money is." Today, we face significant revenue shortfall and the financial sector is "where the money is." Both are sound. But, we have sometimes neglect a third, very important proposition: the financial sector, especially in the US, is simply bad for the overall political economy. The sector is too big and too inefficient. Its very inefficiency provides the revenues to finance the sector's political power.

The size of the US financial sector is out of proportion to the larger political economy. There are a many ways of making this point but the simplest illustration is that finance, a sector that employs only a little more than 5 percent of the total labor force captures almost 30 percent of total profits. Yes, that is down from its 45 percent share in the run up to the 2008 financial panic, but it is still much higher than the long term average of 12- 18 percent that prevailed from the 1930s until the late 1970s. There is no evidence that financial sector employees are six to nine times as productive as the rest of us. Rather, from 1980 to 2013 the financial sector in effect transferred $750 billion, or about $1500 per person in the US from the rest of us into its coffers.

Of course, the financial "product" par excellence is derivatives: total derivative traded value in the US exceeds $900 trillion – in a $16 trillion economy.

How did this happen? This takes us to the inefficiency of finance. The financial sector's primary function is to raise and allocate capital to borrowers: businesses, households, governments. Doing this efficiently requires a low cost dollar of capital raised. In the late 19th/early 20th century period of rapid US industrial growth, the dollar cost of capital raised was about $0.0015 – 0.0017, very low indeed. This ratio grew in the

1920s then declined, until the late 1970s, after which it grew again to 1920s levels. Today the cost per dollar of capital raised is about double that of the early 1900s.

Why has the sector become less efficient?

Finance has gained efficiencies in some activities: payment collecting has been automated, resulting in more rapid funds' transfers from purchasers to sellers: Think credit and debit cards vs. checks. Finance efficiently stores depositors' assets. Finance efficiently moves money in and out of bank accounts much more rapidly and at less cost than five decades ago. Both the payments and the assets storage functions of the sector have benefited from IT investment.

However, the biggest growth in finance IT spending is for trading - and it is high levels of trading that have driven the increased costs of both financial intermediation, and economic instability. Trading is also the source of much of the profit growth in finance. Consider stocks, one of the major financial markets. Today, their annual total traded value is almost twice the GDP. In 1975 it was less than 5 percent of GDP in size. Of course, the financial "product" par excellence is derivatives: total derivative traded value in the US exceeds $900 trillion – in a $16 trillion economy.

Finance's political power is not simply a US phenomenon – it is much the same throughout the wealthy countries of the world.

Like any rentier sector, financial firms and financial elites use the political arena to maintain and increase their power and to thwart any challengers. Finance is among the top three industrial groups by contributions to political campaigns, in terms of both lobbying expenditures, and by the sheer number of their lobbyists. In December 2014 the political power of finance was again demonstrated when Congress repealed provisions in the Dodd-Frank Act that prohibited most derivatives trading in FDIC insured bank operations. Wall Street banks can return to freely trading the securities that brought Lehman Bros. down in 2008 — and obtain access to the benefit of insurance and loans from the federal government.

Finance's political power is not simply a US phenomenon – it is much the same throughout the wealthy countries of the world. This is being demonstrated in the confrontation between the Greek people and Eurozone creditors. In the January 2015 elections, the Greek electorate said "enough" to creditor demands that servicing the debt – paying ransom to creditors – takes precedence over health care, jobs, electricity, life itself. Of course, almost 90 percent of the so-called Greek bailout has not gone to support the Greek economy or restart growth, but instead to irresponsible lenders and these lenders continue demanding more.

What is to be done?

A policy that would lessen trading would: a) reduce the profits share of finance; b) reduce the ability of finance to extract rents from the real economy; and c) thus reduce the political power of the sector.

That is the beauty of the financial transaction tax (FTT). There has been a long and, for many, frustrating struggle to establish such a tax but, in the past few weeks, two very promising breakthroughs have occurred. The first is in Europe and second is in the US.

Although 11 European nations – representing about 75 percent of total European GDP – have agreed in principle on an FTT, the negotiations that would define the scope and level of the tax were stalled over most

of the past year by the French finance minister even though in Francois Hollande's campaign, the candidate promised such a tax.

Well, as we all know, campaign promises are not always honored. Throughout 2014 the French finance minister had urged only a small and asset-limited tax as opposed to the German and others' desire for a broader tax with higher rates. However, in late 2014 more than 120 deputies from Francois Hollande's Socialist Party demanded he support the tax.

Perhaps developments in the US are more encouraging. On Jan. 12, Rep. Chris Van Hollen (MD-8), a leader of the Democratic house caucus, proposed an FTT as one of the key taxes that would be used to "raise wages, increase personal savings, and grow the economy." Details are scarce as to what products are to be taxed and at what rates. But it appears Van Hollen is seeking to track the tax as it is being crafted in Europe. Although the "Progressive Caucus" has expressed support for the FTT in the past, this is the first time support has emerged from elements of the party establishment. The significance of Van Hollen's proposal was recognized immediately by finance: within hours the Securities Industry and Financial Markets Association (SIFMA) attacked the proposal.

And in Illinois we have a chance to take the first steps on this path to tax finance. Several legislators are proposing a very small FTT – a "LaSalle Street Sales Tax" – on the trading of derivatives at the large Chicago exchanges.

International Note *by Luis Diaz-Perez*

Deflationary Drifting Across a Sea of Oil?

We are as free from the grip of foreign oil as we've been in almost 30 years... We believed we could reduce our dependence on foreign oil and protect our planet. And today, America is number one in oil and gas… And thanks to lower gas prices and higher fuel standards, the typical family this year should save $750 at the pump.
--- Barack Obama*, 2015 State of the Union Address*

Within the past year, world oil prices have declined 50 percent. At the end of January 2015, West Texas Intermediate sold at $48.35, only five dollars above its 52-week low, and Brent oil futures closed at $52.42, Last June, prices in both markets exceeded $100. Americans are finding this decline reflected in prices at the pump not seen since prior to the Lesser Depression.

Policymakers might be eager to take credit for this apparent consumer bonanza as the President seemed to last month. But today's oil prices are not simply the result of policies to reduce US reliance on foreign energy, save the earth or ease the financial burdens on households. Other features of the world scene are at play.

These days the planet would seem to be swimming in cheap petroleum. Hydraulic fracturing to exploit shale oil and natural gas reserves in North America has something to do with the oil market glut. Since 2008, domestic oil production in the US increased about 80 percent, from 5 barrels per day to 9 million bpd, mostly because of the Bakken shale play in North Dakota. Most observers believe US shale production can only be profitable when the price per barrel is at or above $70. Below this price, exploration companies, service companies, development, transportation and the entire range of firms involved in this capital-intensive industry risk failure as credit dries up and their ability to service ongoing debt withers. Once they

can no longer add to or service their debt, via commercial paper and junk bonds, lenders will experience heavy losses that can be expected to spread across the entire, precarious, financial system. Such are the potential implications of the current situation. As oil companies go under, other businesses will face increasing difficulty financing ongoing operations, while the value of all reserves will consequently decline. This is how a contagion in financial markets might form. As market observer Raúl Ilargi Meijer put it recently:

> *If prices fall any further (and what's going to stop them?), it would seem that most of the entire shale edifice must of necessity crumble to the ground. And that will cause an absolute earthquake in the financial world, because someone supplied the loans the whole thing leans on. An enormous amount of investors have been chasing high yield, including many institutional investors, and they're about to get burned something bad.*
> (http://www.theautomaticearth.com/will-oil-kill-the-zombies/)

While we can expect lower oil prices will soon be reflected in reduced US oil production, there is at least one likely upside to this industry's sudden loss of viability: A slow-down in fracking won't come soon enough for the planet and her friends who've watched this practice devastate rural lands across North America.

Provided they are sustained, low commodity prices could help boost economic activity. But until effective demand is stimulated, any economic recovery under such circumstances would be halting at best.

US foreign policy may have helped to foster the paradoxes of today's low oil prices. In September 2015, amidst of the rise of ISIS, John Kerry allegedly struck a deal with King Abdullah under which the Saudis would sell crude at below the prevailing market price. Then, despite last fall's intensification of Middle East instability, oil prices plummeted when they might have been expected to rise. This quote from *The Guardian* website last November speaks of a US-Saudi attempt to drive down the oil price:

> *… according to Middle East specialists, the Saudis want to put pressure on Iran and to force Moscow to weaken its support for the Assad regime in Syria…*
>
> *The Saudis are gambling that they can live with a lower oil price for longer than the Russians and the Iranians can, and that therefore the operation will be relatively short-lived.*
>
> *There is no question that this new manifestation of cold war muscle is hurting Russia. Oil and gas account for 70% of Russia's exports and the budget doesn't add up unless the oil price is above $100 a barrel. Moscow has foreign exchange reserves, but these are not unlimited. The rouble fell by 10% last week. That adds to the debt servicing costs of Russian firms, and the central bank is under pressure to push up interest rates, which should help stabilise the currency, but only at the expense of a deeper recession.*
> (http://www.theguardian.com/business/economics-blog/2014/nov/09/us-iran-russia-oil-prices-shale)

Under this set of explanations, the fall in oil prices is being orchestrated by some form of Saudi-OPEC-US collusion. The objectives would be to pressure Iran to drop its nuclear program and force her to fall in line more broadly with US and Western policy. Fifty dollar oil also weakens Putin and, in this scenario, coerces Russia into giving NATO a freer hand in Ukraine. Cheap oil also serves to destabilize Venezuela's economy and government. But, this policy would likely imperil other expensive oil plays that compete with Middle East production such as deepwater drilling in the Arctic and elsewhere, tar sands and fracking. It doesn't seem

likely the US would willingly sacrifice a significant domestic industry on the altar of the US-Saudi petrodollar recycling operation. Nonetheless, geostrategic benefits of $50 oil do accrue to the US.

Beyond US domestic overproduction and The Great Game, other explanations point to the slowing global economy. In addition to oil prices, those of other key commodities have also nosedived. In fact, according to the World Bank's latest Commodity Markets Outlook released last month, this year could produce a rarely experienced decline in all nine key commodity price indices. To illustrate, let's look at copper.

> *For money managers handling billions of dollars of clients' cash, the sell-off that has pushed copper into bear territory is a turning point, reinforcing fears of a prolonged downward spiral – concerns already fueled by the collapse in the price of crude oil.*
>
> *"They don't call it "Dr. Copper" for nothing," said Jeffrey Gundlach, co-founder of DoubleLine Capital, which oversees US$64 billion in assets under management. "The drop in copper simultaneous with the collapse in crude oil can only be interpreted as an indication of slowing global growth."*
>
> (http://business.financialpost.com/2015/01/15/why-coppers-price-plunge-could-be-an-ominous-sign-for-the-world-economy-or-not/)

This commodity is a principal construction and manufacturing material, and therefore, to some, a bellwether, a leading indicator. Today, copper is at a five-and-a-half year low.

> *That is why the copper crash is so scary — it's like a canary in the macroeconomic coalmine, but we do not know which danger it is trying to warn us about (oversupply because of cheap oil, or declining demand because of economic weakness).*
>
> (http://www.businessinsider.com/copper-drops-january-13-2015-1#ixzz3QXOQDckF)

While indeed US (over-?) production via fracking and geopolitical intrigue are among the contributing factors, a slowing world economy seems to be having the greatest influence upon the decline of commodity prices, including oil's.

By situating oil prices in the context of declining prices across a range of strategic commodities, the picture becomes a bit clearer. Provided they are sustained, low commodity prices could help boost economic activity. But until effective demand is stimulated, any economic recovery under such circumstances would be halting at best. As a consequence, the world economy limps into 2015, weighed down by bundles of deflationary pressures.