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“Financialization” of The Real Economy: The Final Phase of Capitalism

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Abstract

The technical culture bonded inseparably with economics as we know it leaves the door wide open to ancestral greed and limitless hunger for profit realizable only through material goods. In this way it creates the system we feel prisoners of today, which is the source of the risk of an asocial society.

In the late 1940s philosopher Romano Guardini gave a series of lectures that were published in a book entitled *La Fine dell’Epoca Moderna* [The End of the Modern World] in which he commented that modern man is of the opinion that each acquisition of (technical) power is simply “progress” in terms of increased security, utility, wellbeing, vital force, fullness of values. In reality power is something absolutely multipurpose – it can create good and evil, build or destroy.

But growth of our knowledge about things in nature, their use and how to dominate them has not been accompanied by a similar growth in our sense of responsibility and the necessary seriousness to govern the technical power we have created. We have not been educated to do this because our emotional sphere has been alienated. So there is a very real risk that we will make the wrong use of this technical power, also because we have “mislaid” the meaning of ethics. We may have acquired a certain power over things in nature but not the ability to use them. And sadly the means by which problems are resolved is, systematically, violence; so the wrong use of knowledge risks becoming the rule.

People are becoming objectivised and so are losing their ability to understand the meaning of his life. This leads to considering as mere biological facts outstanding events such as pregnancy, birth, illness and death, which become the domain of a science and technology that is becoming more and more self-assured. Italian philosopher Emanuele Severino believes that people end up by appealing to this science and technology and entrusting their destiny to it, just as in past times they entrusted it to mythology, philosophy and religion. Severino is convinced that, ‘The end result is that natural sciences replace religion, theology and also speculative philosophy’. So once more the real challenge facing us in order to avoid chaos is to rediscover the meaning of life and humanity and make this the key focus of our interest.

"Financialization" of the real economy

With the end of the Soviet empire, expressed symbolically by the fall of the Berlin Wall, the capitalist sociocultural model was declared, superficially, as being the determining factor for victory. But in effect real socialism imploded for the very same reasons that are making capitalism as intended in the United States implode too. The idea of being immersed in a domain of absolute truth, as that type of Marxism was considered to be (although Marx himself never indicated models of how to implement his ideas), ended up with it progressively losing touch with reality and so ignoring the real problems and needs that its immutable model had to face in a changing world. Failure to perceive all this meant that things dragged on until the system suddenly collapsed. And the US model is perpetuating its immutable ideal in the same way even though faced with a reality that clearly highlights its critical aspects. As in the case of real socialism, delaying the response to problems due to fossilization of its philosophy risks making it implode.

The process of "financialization" of the real economy may well mark the end of the road. As mentioned in the previous pages, the sociocultural model that has progressively asserted itself in the USA, and to lesser degree in Europe, is a form of capitalism focused on maximizing individual profit. And as always, the aim determines what the optimum method is to achieve this. Severino clarifies the sense of this statement very well by reminding us that Aristotle emphasized the possibility of a reversal whereby the means becomes the end and the end, the means. In chrematistics, instead of being a means wealth becomes the aim of life and, in fact, saying "one makes money to live" is very different from saying "one lives to make money". In the capitalist model 'the aim is internal, namely, it is an economic aim, as opposed to the traditional concept of economics from Aristotle to Hegel in which the purpose of producing wealth is outside the economic process, or rather, life is good, worth living; so where the aim of the economic aspect is the ethical-religious aspect'. (E. Severino, *La bilancia. Pensieri sul nostro tempo* [The Balance. Thoughts concerning our Times]).

Once the purpose has been defined it must be achievable in the best possible manner. So when Reagan took office a form of deregulation was launched to achieve the purpose concerned. Those years were marked by a social model that expressed a sense of omnipotence. At the end of that decade, on 9 November 1989, the Berlin Wall ceased its role of interrupting communication between the two German republics and so the model was elevated to that of a dogma. Without wasting time the following year the Swedish Royal Academy of Sciences inaugurated the "financial era" by awarding the Nobel Prize for Economic Sciences to Harry M. Markowitz, Merton M. Miller and William F. Sharpe for their pioneering studies in the field of finance – finance became the real economy's best tool for maximizing profit in the shortest possible time. But its legitimation as an exact science needed to be established quickly and so in 1995 the Nobel Prize was awarded to Robert Lucas, who held that markets are rational and in them the general public never makes a mistake, and because of its rationality it guarantees the best possible allocation of resources. This is false; five thousand years of our history say just the opposite. But it suited the purpose of finance that Lucas' premise was never questioned. In finance small is never beautiful. And so there was an unprecedented, inexorable move towards a concentration of wealth and power, with the result that a form of oligarchy prevailed that was systematically passed off as democracy. The USA, equipped with its clearly oligarchic social model, decided, based on false proof, to declare war on Iraq in 2003 in order to give it that form of "democracy". A democracy that was given to a country divided and in ruins at the end of a war that cost almost 5,000 billion dollars, with an unacceptable number of civilian deaths and suicides in the US army that, in certain periods, exceeded the number of those killed in battle.

In the meantime the financial culture began to suffocate the real economy. In fact consultancy companies roamed the USA to sell a product, that is, to "create value for shareholders" with the aim of increasing the value of stocks. Managers had very challenging but well-rewarded short-term goals, for instance, to triple stock prices in one year. Of course, the rise in stock prices should have corresponded to an increase in the value of the companies concerned. However, in the case of manufacturing companies a strict correlation between the two trends was impossible, because such growth in the real economy takes a long time, much longer than the financial world was prepared to wait. So the answer was to play on emotions in a game of throwing something out of the door that would later come back in through the window! The game plan was simple: each quarterly outlook always had to be better than actual results in the previous one. But to do this meant recording pre-billings from the first days of the next quarter in the quarter coming to an end, and so on until the end of the year. Then what? To reconcile the figures company inventories were transferred and billed to custom-

ers – although not really sales in a strict sense, formally they figured as such in company financial statements. Analysts highlighted company performances and promoted stock purchases based on the (inflated) data, which fuelled a rise in stock prices. But year after year sales reported no longer corresponded to real performance and in the end the bubble burst and companies failed. Outsourcing was yet another move to increase profits promoted during this period, especially as regards manpower costs. This meant work was transferred to countries where wages were lower. In ten years almost 35% of manufacturing sector jobs have been lost, jobs that today are indispensible if the US is to remedy its devastating level of unemployment. But reconstructing the real economy takes a long, long time. The question that should have been asked is: if the stock price of a manufacturing company goes up by 400% in one day does this depend on the fact that market conditions have changed radically? Or was leverage achieved by playing on people's emotions? What did the company's CEO know that he or she didn't know the day before?

The stock market has been transformed into a casino where people can speculate by continually buying and selling shares. High volume trading has become an e-commerce in which mathematical models take the decisions. Competition is based on the speed at which transactions are made, so one operator, by acting a fraction of a second before other operators, can make a profit even by holding the stock in question for just a matter of seconds. The cable linking the New York and London Stock Exchanges exists for this very purpose. Its aim is to speed up transactions, so in essence operators compete with each other based not on company performance but on the timing of their buy or sell orders. Markets no longer look at the long term because they are made up of investors focused on short-term gain who participate daily in a frenzied buy-sell game.

Private equity firms have played a significant role in this game and have even been responsible for causing the closure of what were previously sound companies. Their aim in buying a company has often been to "skin a fatted calf" – asset stripping – then to resell it using the financial lever. In such cases the targeted company is a necessary evil to make money and the more impoverished it becomes the higher the profit. The MBO (management by objectives) culture has a lot to answer for in this game as in many cases managers have been asked to achieve the objectives concerned at any cost, often without any regard for quality and safety.

Lastly, the financial world, in its infinite greed to grow indefinitely, promoted a market involving gambling on gambles. And promptly the Swedish Royal Academy awarded the Nobel Prize in 1997 to Robert C. Merton and Myron S. Scholes for their theory on derivatives. One year later these Nobel Prize winners were to participate in the default of Long Term Capital Management, a firm built on their theories. But this didn't seem to bother anyone as what was at stake (maximizing profit) was far too important. One decade later, the errors of this financial game had clearly contaminated countries within the US sphere of influence. Greenspan's answer was to swamp the market with liquidity until, that is, everything started to collapse. Hence the 2008 financial crisis. Today it would seem that Ben Bernanke's exit strategy is following the same script.

As a consequence of financial deregulation and after the Nobel Prizes at the end of the 1990s the financial system, which once welcomed companies and consumers, became a game played in a casino. A game in which bets are not covered and where it seems that the croupier rules the game as opposed to the apparent rationality of the roulette wheel. The fault of this is mainly attributed to Bush and in effect he did much to deserve this reputation. However Bill Clinton has much to answer for too as in 1999 he approved the Gramm-Leach-Bliley (GLB) Act, also known as the Financial Services Modernization Act. De facto this cancelled all regulatory controls on banks enacted in 1933 after the Great Depression and known as the Glass-Steagall Act. Passing the GLB Act brought down barriers that had previously separated retail banking, merchant banking and the insurance system. Derivatives were completely deregulated. Then after the toughest phase of the crisis during which merchant banks seemed to have recognized the error of their ways, their sponsors once more waded into the fray (as Paul Krugman wrote in an article mentioned in Chapter 2). Among these were Robert Rubin and Larry Summers, both prestigious representatives of Harvard University, who together with Greenspan voiced their unconditional support for the model based on rationality of markets, for them an absolute truth despite all the evidence to the contrary.

The difference between factual evidence and the rationality hypotheses can best be explained by a simple example. Imagine there are ten companies – really the number is irrelevant – that start up in business at the same time, in the same sector, in the same market and all make identical products. Let us also assume they have the same economic, financial and technical resources, and workforces

with the same skills. In spite of this equal start the results the ten companies manage to achieve will always be different. The most successful will be those with a greater creative ability and that are better organized in social terms (factors that are not measurable like sensitivity, an awareness of what is happening in the world, the organizational wellbeing that produces a focus on the common good).

In the financial world it is assumed that individuals, in conditions identical to those of our ten companies, will always achieve the very same results: clearly this will never be the case.

The real economy is profoundly different from the financial economy for the following reasons:

- Objectives in the real economy are long term whereas the financial world wants short-term results, which justify the considerable bonuses of managers that achieve them, even at the cost of normalizing unlawful behaviour;
- The financial economy favours individual interests, while the real economy has to face the social debate in a world where finance tends to operate oligarchically in a context marked by a concentration of power contrary to the common good;
- In the financial economy decisions are taken without regard for their social and/or moral consequences, whereas in the real economy there is an ongoing debate among the various parties in the system;
- The real economy has to operate within a system of limited resources – the financial economy within a system of unlimited resources: the financial economy is built on the basis of mathematical formulations that have a limitless horizon and an undefinable size. An uncontrollable system with transaction volumes light years beyond the value of true wealth and so on the road to self-destruction;
- The financial system has erected a kind of Tower of Babel that in the end will create a disaster because it sets everyone against everyone else; in essence the system is a game of chance based on unlimited, abstract values that in no way correspond to or are covered by real capital;
- Mathematical tools are essential in finance because exact science attributes legitimacy to the tool and certainty to the method: this in turn increases the self-serving level of finance that cuts it off from the real world;
- Acquiring knowledge in the two fields is therefore completely different because they speak two different languages; the real economy cannot be studied sitting behind a desk because it is based on human relationships and so needs to be experienced to be understood;
- Financial equilibrium always depends on economic equilibrium and not vice versa; it is impossible to evaluate a complex reality like a company or a nation based solely on cash flow;
- In this way the real economy that generated wealth is subordinated to the financial economy, which becomes its parasitic system. The solid economy becomes liquid (see Zygmunt Bauman) (money only generates money);
- Unlike the real economy, finance exasperates human weaknesses, accentuating euphoria or depression – that, instead, contact with the real world reduces – and "lets the tiger out of the cage", namely, that ancestral, limitless greed;
- The cultural world drifts away from reality and lives its own independent life, creating a social model that takes root in that culture, one which promotes individualism and conflict as factors of success that are, instead, the real causes of the crisis of our times;
- Attributing a moral value to finance has developed a social model consistent with these non-values; so we have ended up by repressing human nature, making it an object that no longer has a clear sense of life.

Lastly, returning to the issue of means and ends and how they can be turned upside down, as Severino emphasized, finance is legitimated by exact sciences as a tool used to support the truth. But at a certain point the mathematical tool becomes an end and so it must be fiercely legitimized, because if it weakens this would coincide with the death of the culture erected to support it. So the means becomes an end, inspiring a sense of omnipotence. It moves further and further away from the substance of the real economy and people, and ends up by dictating the rules of dependence to those who use it.

This way of thinking has built an economic and social world contrary to what should inspire the life of society. We have become prisoners of its potency and dominance, even in terms of culture – many experts have even attributed a god-like quality to it – to the point that it conditions the life and survival of individual societies.

In this sense it is easy to understand how the aim of those who have been awarded the Nobel Prize for Economic Sciences in recent years continue to legitimize that model. A stance taken even when history shows it to be inadequate to respond to the social interests of everyone, as it should be, instead of the interests of the few that use it as a tool to acquire wealth and power.

The growth of finance has exploded, especially in the United States where the economy has been financialized, whereas employment in the manufacturing sector, that is, in the real economy, has slumped by 35% in ten years. As we will see in the next chapter the progressively widening gap between the real economy and financial economy, to which it has been subordinated, has contributed to a concentration of wealth and high unemployment. But above all it has driven society away from the real economy, leaving the door open to what seem to be irrepressible social ills.

Today finance is concentrated in just a few organizations that use it for their own ends. And they intend to play the leading role in redefining the global balance of power, using finance as a weapon instead of bombs. This is now clear for all to see.

The financial game is played using increasingly sophisticated mathematical tools. Use of derivatives has created business volumes the extent of which is totally obscure, although it seems that derivatives held by five American merchant banks – Goldman Sachs, Morgan Stanley, J.P. Morgan, Bank of America, Citybank – are of the order of 230,000 billion dollars that, if true, would represent 15 times the US GDP. But in any event the total volume of transactions involving these products is highly concentrated (some sources report up to 95%) in a small number of banks. Transactions that have little to do with the real economy but that determine decisions concerning the nation's future. Is it possible that because of a lack of transparency in financial reporting systems there is no way of knowing who is really involved in these transactions? And what if these were, de facto, intercompany transactions – which only a deregulated control system allows – therefore making it impossible to understand true mark to market positions?

In this way finance becomes a game of mirror images in which external parties are unable to understand if all the financial flows seen are nothing more than an enormous superstructure destined to collapse. This issue will be addressed specifically in the next chapter.

While finance and the obscure use that can be made of it have always encouraged the growth and dominance of one country over another, this tendency has really prevailed in the past few decades. The first true evidence of this dominance was when in 1971 the USA withdrew from the Bretton Woods agreement. As a consequence the dollar abandoned the gold standard, an event that inaugurated a new way of waging war, a third world war and the first fought with the weapon of finance. Nixon announced this move because the US system had become unsustainable on the wave of the Vietnam War and social problems that had arisen starting 1968. The US had been forced to reduce its gold reserves to pay creditors, who had ceased to believe in the real value of the dollar and insisted on payment in gold. As a next move the US began to print dollars but there was not enough market demand to absorb this growing quantity of dollars. Then, unexpectedly, the Yom Kippur War gave the US some respite as during this war Arab countries decided to ration crude oil production. And so in the space of ten years the price of this vital commodity rose from 1.90 to as high as 40 dollars a barrel. This price increase for oil paid in dollars created a demand that matched what had been an excessive offer of that currency. Although the consequent inflationary and monetary storm also hit the USA, the impact on other countries was even more dramatic. In Italy, for instance, inflation rose from 5.7% in 1972 to 21.2% in 1980. During that period the country was forced to borrow heavily in order to alleviate social tensions. Not being used to facing similar, unexpected and violent inflationary pressure, either organizationally or culturally, it tackled the financial trend by issuing bonds with a 3-month maturity that gave subscribers an annual yield of up to 20%. Many years passed before the country was able to replace short-term bonds with longer maturity issues, during which time the public debt grew to a point that it became uncontrollable.

The crisis sparked off by subprime lending can be considered the fourth world war, the second fought using finance. Today this has truly become a global war in a situation where equilibria are unstable because no one player, fortunately, has the strength to dominate the others and where all are reciprocally linked.

The world of finance continues to exercise its dominant, antisocial role and is based on a cultural model that is incapable of explaining what is happening. As seen previously, rating agencies are a prime example of this. Just look at what happened in Italy in 2012, with an asymmetrical trend between decreasing ratings at country level while the spread on its government bonds continued to improve. But no one seems to have asked themselves why this happened. In reality we must stop considering markets as independent, precise situations that operate based on rational mechanisms.

As markets are highly concentrated, to understand how they function we must look at the interests of those parties that dominate them and who try to steer them towards achieving objectives that are often outside of the market itself. Parties who are not about to change the rules of the game as long as they are the ones who establish them. So, paraphrasing Ernst Bloch, we could say that social wellbeing prospers in the reign of this financial capitalism like a lamb would in the home of a butcher! (E. Bloch, *The Principle of Hope*, 1959).

Conclusion

Sophocles, in the first stasimon of *Antigone* states that man, 'absolute master of the subtle secrets of technical matters can do both evil and good'. Yes, man himself, that wondrous creature who 'beyond all hope possesses the inventiveness of art', can do great things, both good but also evil. And when he gives rein to this power he becomes terrible: as Sophocles warned, 'Many things are terrible but none are more terrible than man'.

The time has come to ask ourselves if the hypotheses on which studies of economics and finance are based are sound and indisputable. Is it still right not to question dogmas stating that people are rational and never make mistakes, that as a consequence markets are rational, that economic decisions can ignore people's emotional state? Are measurable facts and events that ignore people's emotional dimension all that economic sciences need when defining their models? Reality belies the absolute, unquestionable truth of these principles. The natural world, as Galileo observed, is written in mathematical formulas, but not human nature. Economics is not an exact science because it is a social science.

In the book *L'Ipotesi nella Dottrina e nelle Determinazioni dell'Economia d'Azienda* [Hypotheses in the Doctrine and Decisions of Business Economics, 1961] this is how Carlo Masini tackled the issue of the use of hypotheses in the various sciences, distinguishing social sciences, like economics, from the others.

'While scientific methodology is common to all sciences as far as the basic elements are concerned, there are also differences depending on the specific subject matter of each science. As regards the subject matter considered here we propose the following framework:

- Social sciences: relationships between human beings (or groups of human beings or societies) interwoven with relationships with other things as a result of their life in human society;
- Other sciences: relationships between things and things (or groups of things), including human beings but only as regards material aspects.

Social sciences have the following major characteristics:

1. The greater weight of constraints posed by the unity of human nature and the supernatural, comprising living and spiritual matter with ultimate supernatural aims;
2. The influence of human will (subjectivism with vast areas of unpredictability);
3. Continuous changes in relationships, even in the short term, interwoven with lasting relationships;
4. Great difficulties for classic experiment as used in physical sciences;

5. Hypotheses are essential factors in many phases of the overall progress of economic science [...]

Certain very general hypotheses are proto-postulates that, before stating their problem, researchers take as given without even specifying them. [...] But an investigation of proto-postulates is, however, indispensable and it follows that for every researcher the methodological approach must be to reduce these to the minimum unless, of course, they are extremely general ones’.

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