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The Vested Interests and the Common People:
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PANEL SESSION:

VESTED INTERESTS, FINANCIALIZED CAPITALISM AND REGULATION

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FINANCIALIZATION AND VESTED INTERESTS: THE IRRELEVANCE OF SELF-REGULATION AND FINANCIAL STABILITY AS A PUBLIC GOOD

Abstract: This study proposes an institutionalist analysis of financialization through the lens of Veblen, built on some peculiar characteristics of money and related financial relations in a market-based capitalist economy. Following the case of the overcapitalization of farmlands, studied by Veblen in *The Vested Interests*, the analysis argues that modern capitalism is a financialized society dominated by vested interests that rely on financial liberalization-led speculative overcapitalization that often leads to a perverse accumulation process and results in systemic catastrophes. Consequently, one of the major constituent institutions of liberal finance, market-dependent self-regulation, reveals to be unable to deal with society-level issues such as financial stability. This latter must be handled at a systemic level as a public good. Therefore specific public regulation and action mechanisms must be designed to maintain society (and dominant vested-interests) within some viability limits to ensure a smooth functioning of the economy.

Keywords: Financialization, financial crisis, financial regulation, institutionalism, monetary economy, public good, Thorstein Veblen

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1. Introduction

This study builds on some peculiar characteristics of money and related financial relations in a market-based capitalist economy and proposes an institutionalist analysis of financialization through the lens of Veblen. I argue that liberalized finance-based capitalism transforms itself into a financialized society which is dominated by vested interests that rely on speculative activities to feed their net return expectations. As in the case of Veblenian overcapitalization of farmlands, financial liberalization leads to a speculative overcapitalization of every aspect of Common Man's life and results in economic-financial and social catastrophes.

An accurate analysis of the monetary nature of the capitalist economy shows that financial stability is a core condition for the smooth functioning of society. However, given the very specific characteristics of money and financial operations in such an economy, privatized self-regulatory mechanisms are unable to provide global solutions to macroeconomic concerns like financial (in)stability. This latter must be handled at a systemic level and considered as a public good. Therefore specific "extra-market" public regulation and action mechanisms must be designed to organize, manage and supervise financial stability.

In this aim, drawing on Veblen's work, I review first the financialization process of capitalist society that radically transforms the production relations among different economic/social groups and results in an unsustainable economic/financial structure. I then develop a monetary framework to catch the structural characteristics of a market-based capitalist economy whose smooth working relies on the stability of financial operations at a macro level. This framework shows that micro-rationality-based self-regulation is unable to ensure a viable functioning of the economy. Finally, in logical connection with the previous arguments, I argue that financial stability is a systemic public concern and matches with the characteristics of a public good that implies a specific system-consistent organization and supervision. Therefore its production, reproduction and regulation must rest on non-market-led rules and mechanisms to be provided and implemented under public control.

2. The rise of finance and vested interests

Veblen (1919) studies the evolution of capitalism from the 18^{th} century till the 1920s and notes that the economy switched from a small-sized units competition to a huge investment bankers-dominated large corporations. Veblen states that in the eighteenth century, along with certain principles (equal opportunity/self-determination/self-help) that were based on the rule of "Live and Let Live", the ownership of property became a founding social rule. However, things changed as capitalism moved toward oligopolistic/monopolistic/transnational corporations with large control power over society such that the network of ownership over holdings controls the conditions of life for the common man. More accurately, Veblen (1921: 34) defines the entrepreneur as an investment banker in this "new capitalism" -whose social characteristics changed by the 19^{th} century with the expansion of the capital[2]:

> "progressively the cares of business management grew larger and more exacting, as the scale of things in business grew larger, and so the directive head of any such business concern came progressively to give his attention more and more exclusively to the "financial end". At the same time and driven by the same considerations the businesslike management of industry has progressively been shifting to the footing of corporation finance",

such that "corporation finance on a sufficiently large scale had come to be the controlling factor in industry" (Ibid: 38) and "the discretionary control of industrial production is shifting still farther over to the side of finance" (Ibid.: 41).

Parallel to this evolution, the close structural linkages between banks and industrial activities, mainly relying on financial efficiency criteria[3], were built up and gave a dominant position to financial actors in the economic decision process:

> "no large move in the field of corporation finance can be made without the advice and consent of those large funded interests that are in a position to act as investment bankers; nor does any large enterprise in corporation business ever escape from the continued control of the investment bankers in any of its larger transactions; nor can any corporate enterprise of the larger sort now continue to

[2] Veblen (1921: 31) states that: "This captain of industry, typified by the corporation financier, and latterly by the investment banker, is one of the institutions that go to make up the new order of things…".

[3] That is, the objective of a higher net return on investment.

> do business except on terms which will yield something appreciable in the way of income to the investment bankers, whose continued support is necessary to its success" (Veblen, 1921: 47).[4]

This new order generates its own vested interests. Indeed, Veblen (1919: 160-161) states that under the "new order", social structures were modified and resulted in a new separation between two classes, the vested interests and the common man:

> "Invested wealth in large holdings controls the country's industrial system (…). So that the population of these civilised countries now falls into two main classes: those who own wealth invested in large holdings and who thereby control the conditions of life for the rest[5]; and those who do not own wealth in sufficiently large holdings, and whose conditions of life are therefore controlled by these others."

Veblen (1919) then argues that the vested interests are the defenders of the status quo since they draw their interests from the continuance of the existing economic relations[6].

However, Veblen maintains that the financial captains of industry -who have to do with the higgling of the market and not with productive efficiency[7]- have not been proving their industrial competence[8]. The proponents of financial liberalization argue that government regulatory restrictions-freed markets would work at optimum since the financial repression is removed and the competition gains ground and pushes market actors toward efficient strategies. So those approaches ignore that the liberalization process usually leads to financialization such that the main decision criteria then rest on higher and quick financial profitability of operations without any real long-period engagement of market makers. In such an environment, the incentives are perverted, and vested interests are directed toward short-sighted speculative strategies. Though rational from a microeconomic perspective (individual financial gain efficiency) those strategies prove to be inefficient and system destructive from a macro-stability

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[4] Veblen (1921: 48-50) argues that the power of investment bankers over the real economy also determines the traffic in credit and then the level of economic activity and the direction of industrial evolution according to the objective of the largest net return on investments.

[5] Those are the vested interests, the "kept classes", whose income "depends on the good will of those controlling vested interests whose power rests on the ownership of large invested wealth" (Veblen, 1919: 164).

[6] "they are staunch defenders of that established order of law and custom which secures the great vested interests in power and insures the free income of the kept classes" (Veblen, 1919: 164).

[7] Veblen (1919: 89).

[8] Veblen (1921: 41).

perspective. An illustration of such a perverse evolution with respect to the banking behavior in markets is provided by the prevalent incentives in the last decades that made regulatory arbitrage and speculation the most profitable market strategy leading up to the 2007-2008 crisis.[9]

3. Structural characteristics of a monetary economy and regulatory weaknesses

In his numerous works Veblen points to the peculiar nature of money and credit in capitalist development[10] without supplying a detailed analysis of financial systems. Several studies (Raines and Leathers, 1996; Toporowski, 2005; Wray, 2011; Argitis, 2013; Forges Davanzati and Pacella, 2014, among others) state that those works could give relevant insights into how the capitalist monetary/financial system develops and changes social structures. In line with these studies and to provide further robust foundations to the analysis of financialized capitalism, I now focus on some monetary/financial characteristics of the economy.[11]

In a private individuals' decisions-based market economy, the monetary system –as a social coordination process- allows individuals to undertake decentralized actions. It basically rests on two constraints: financing of private plans on debts (credit-allocation) and repayment of debts (establishment of monetary equivalence in individual balance sheets).[12] In this framework, the monetary/financial system plays a vital role since banks/financial institutions fund real/financial activities and thus directly affect the path of capital accumulation. This gives money and related financial relations a specific social/societal nature making them *ambivalent* and *transversal*.

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[9] Acharya and Richardson (2009, 206) document that: "In the period leading up to the crisis, bankers were increasingly paid through short-term cash bonuses based on volume and on marked-to market profits, rather than on the long-term profitability of their "bets." Thus, they had no incentive to discount for the liquidity risk of asset backed securities if their bets were wrong and nobody wanted to buy these securities. Nor was there an incentive to discount for the "maturity mismatch" inherent in structured investment vehicles—which funded long-term assets through short-term debt that had to be rolled over frequently, generally overnight. Nor, apparently, did their managers assess the true skills of those who were generating these large "profits."

[10] See especially Veblen, 1915, Chapter V; Veblen, 1919, Chapter V; Veblen, 1921, Chapter II and Chapter III. Some parallels might also be drawn between this approach and Polanyi's "fictitious commodities" (money, labor and land). See Ülgen (2016) for further developments.

[11] This is the *Monetary Approach* which rests on numerous analytic developments of Evolutionist, Institutionalist, Post-Keynesian and (some) Marxian approaches within the framework of "endogenous money" models. See Ülgen (2013).

[12] From this perspective, in market economies money is a threefold social rule: a nominal unit of account, a minting process, and a clearing/settling procedure. Transactions are then decentralized and do not require any central clearing *à la* Debreu.

Ambivalent because the creation(issuance)-circulation-annulment(repayment) process of money/credit/debt and related financial assets/liabilities are generated through private profit-seeking plans which nevertheless require public support to receive institutional-social recognition. More precisely, money is endogenously generated through the private debt-financing and circulation process. But some super-individual common rules are required to give this twofold constraint-based decentralized process its social aspect and society-wide validity within a given payment system (Ülgen, 2013). Therefore, monetary/financial relations rely on private market decisions as well as on extra-market public rules, and develop through a permanent tension between those two sides (Ülgen, 2014).

Transversal because monetary/financial relations involve every individual, directly (if enrolled within market activities) or indirectly (if affected by others' activities) within market operations since the economy operates on money-creation-debt-repayment relations. Although related to private decentralized decisions, financial relations have societal consequences and no economic agent, living within capitalist society, can avoid those consequences. Those who initiate and control monetary/financial operations control the faith of the economy. This is capitalism and the "barons" of such a society are financiers and their (economic-political-social) relatives.

Given this crucial role of the financial system, the evolution of institutions and subsequent regulatory schemas such as the scope of public supervision, private rating agencies and banks' internal ratings based models, among others, must be considered relatively to the problem of sustainable organization of economies and systemic stability. This latter continuously requires presence, supervision and intervention of public institutions (central bank, public agencies).

Therefore, three remarks can be stated to argue that market-dependent self-regulation (micro-prudential regulation) is not a relevant way of organizing sound financial systems. First, self-regulation consists of improving the safety of individual operations and relies on private information and profit/rent-seeking rationality while information and actions required to ensure society-wide stability are beyond the reach of individuals. The aim and the relevant scope of the former is not the same than the prerequisites of the latter. Second, in self-regulation, the necessary separation between the regulator and the regulatee does not hold. This then provokes conflicts of interests since the external objectivity of the regulator loses ground in favor of the interests of the regulatee. The assertion consisting of the possible confusion between the judge and the judged is not consistent with financial stability as a macro-economic concern. Third, such a confusion does suffer the fallacy of composition since micro-rational behavior does not obviously generate macro-rational outcomes. Even though one could assert, on the basis of efficient markets hypothesis, that private individuals do behave in a rational way searching for improving their own situation, such a behavior does not result in an optimal situation at society's level and may harm society by weakening the soundness of financial markets.

The growth process of the last decades mainly rested on speculative attraction that gained ground through enlarged vested interests as it included the ordinary and low-income people involved into rent-seeking speculative operations through popularized financial investment possibilities or housing bubble-related mortgage engagements. This relied on loose market-friendly regulation that supplied to the banking/financial system (very) bad incentives in their operations of repackaging mortgages into mortgage-backed securities though offering huge rent areas. This allowed them to reduce the amount of capital they held against securitized mortgages (that remained on their balance sheets) if those assets were AAA-rated (Acharya and Richardson, 2009). This came to concentrate the risk of mortgage defaults in the banks rendering them excessively vulnerable against market turmoil. When the housing bubble popped, the money market dried up and the entire banking system along with the real sector became insolvent causing the economy to falter. Consequently, in the wake of the 2007-2008 crisis, self-regulation-led financialized economy proved to be an unstable accumulation regime[13] whose systemic outcome was an economic/social catastrophe with increasing poverty and inequalities.[14]

[13] Although beyond the scope of this article, it is worth noting that the 2007-2008 turmoil pointed out the crucial role of institutional framework with regard to financial stability but also the global nature of financial stability in light of increasing number of interconnected transnational financial institutions and banks around the world. Financial stability concerns must then be dealt with at a global systemic level and without any private-interests-related mechanisms.

[14] It is worth noting that financialization generates bad incentives for market actors and puts them up to prefer short-term speculative rent-seeking activities at the expense of the real economy, resulting not in growing income and sustainable demand, but in growing inequalities. Indeed, evolution of property share and the Gini ratio over 1950-2010 points to a worsening of the inequalities from the 1980s. Giovannoni shows that from the late 1970s, the Gini ratio for families and the property share with the 1% share in the US economy grow together to reach high levels, up to 0.46 for the former and to 40% for the latter:

In the face of such an experience, some urgent questions are: how to reorganize financial regulation to ensure financial stability and what could a possible relevant financial macro-regulation, alternative to market-dependent self-regulation, be?

4. Implications for financial stability

In the aftermath of the 2007-2008 "financialization crisis", numerous scholars and analysts did use Minsky's ideas on the financial fragility of a capitalist economy, and called the crisis "a Minsky moment" with emphasis put on system-wide securitization and speculation processes. However, as the monograph published by the Levy Economics Institute of Bard College (2011: 5) documents, in response to this crisis, the crucial discussion of the hypotheses and results of Minsky's work with respect to the endogenous fragilities of capitalism and to necessary reregulation framework, alternative to financial liberalism, has virtually disappeared and "replaced by more pragmatic lobbyists seeking to defend vested interests". So going beyond the popularized slogans such as "Minsky moment" and "exuberant finance" requires a rigorous analysis of the systemic nature of financial stability.

From this perspective, Claessens (2014) notes that macroprudential policies (caps on loan to value ratios, limits on credit growth and other balance sheets restrictions, countercyclical capital and reserve requirements, etc.) have become part of the policy paradigm. Although much remains to be studied -including tools as well as the relevant institutional design- macroprudential regulation is motivated by market failures and externalities. In this vein, a specific institutional feature of capitalism might be designed through the assumption that financial stability is a public good which should be produced, managed and supervised by public authorities in order to direct markets toward common-welfare objectives and system-consistent strategies. As a public good, financial stability is needed and used by everyone without being excludable (its use by some individuals cannot prevent the others from using it) and rival (its use by some individuals cannot reduce its availability for the others). Moreover financial stability is always "consumed" simultaneously by everyone as it makes the continuous working of the whole economy possible. Since every economic agent needs it but nobody could produce it at the individual basis, the provision of financial stability cannot be ensured

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"Unbalanced economic growth is mostly manifested through the rise of top incomes, with rising property shares on one side and increasing inequality on the flip-side." (Giovannoni, 2014).

by local, separate private decisions and actions, and needs to be organized and implemented by a common/collective agency. It is worth noting, however, that asymmetrically, *financial instability as a bad* can be provided by decentralized individual decisions and actions when those latter have a systemic importance (such as the "too-big-to-fail banks and financial institutions). Indeed, financial operations involve the whole society within the payments network (they are transversal) and their sustainability (financial stability) is a prerequisite for all economic relations in a market economy. Therefore, financial stability cannot be regarded only at a micro-safety level such as the individual insurance schemes. It matters for the entire economy while its production remains beyond the reach of individual micro-prudential frameworks.

Financial stability is related to the stability of the monetary system which is the set of rules and practices that govern the way(s) debts could be created, used as money within the economy and finally repaid/honored in the aim of ensuring the viability of economic relations. When the system works in a smooth and stable way, all individuals get gain from economic operations, but when it breaks down, they are unable to individually sustain social and economic relations. All have an interest in regulatory reforms that would improve the system for the public benefit but not many people care for, and even fewer are prepared to pay for (Camdessus, 1999). To ensure a sustainable provision of financial stability, reframing of finance and financial activities in markets is a necessary step. One must then consider finance in a hybrid/ambivalent way (as money is): a public good to be organized and managed by the public power and agencies, and a private means of undertaking economic activities. This kind of ambivalence is inherent to capitalism and calls for the public will to be managed in a coherent way.

5. Conclusion

Almost a century after its publication, the work of Thorstein Veblen is a relevant source to dissect the evolution of capitalism, particularly in its financialized version. Drawing liberally on numerous works of Veblen, this article analyzed the characteristics of the financialization process of capitalism and its consequences for financial regulation and stability. As Veblen states in his long-term economic and social analysis of capitalism, the expansion of credit relations and the ascendancy of financial relations and vested interests over society characterize the modern business.

In this line, I developed some core characteristics of the capitalist monetary/financial system focusing on the ambivalence and transversality of monetary rules and financial relations, and then argued that liberal market-dependent self-regulation was not a relevant way of organizing sound financial systems. Three arguments were provided to support such an assertion: first, the aim and scope of self-regulation are not consistent with the prerequisites of society-wide macro stability; second, self-regulation provokes conflicts of interests, weakens the capacity of the regulatory system to deal with stability concerns and then falters the social reproduction schema; and third, micro-prudential self-regulation suffers the fallacy of composition such that micro-rational behavior does not lead to an optimal macro situation since it contributes to weaken the soundness of financial markets.

Provided that appropriate regulation and supervision of financial activities at the global level is required for a viable and sustainable (global) working of the economy, the article pointed to a core question: how to reorganize financial regulation to ensure financial stability and what could a possible relevant financial macro-regulation, alternative to market-dependent self-regulation, be?

A judicious angle of analysis can be given by the system-wide public character of money and related financial operations. In this aim, the direction suggested is a specific approach to financial stability and required macroprudential regulation. This approach maintains that stability must be considered at a systemic level as a public good that should be produced (organized), managed and supervised by a specific public structure. This latter that must be designed and framed as a neutral "extra-market" framework according to collectively and publicly implemented rules and constraints. It must seek systemic coherence and be able to direct financial activities through collective objectives. Therefore it must remain out of market relations and incentives.

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