Transformations of entrepreneurial capitalism, crises and the need for a radical change in economic policy

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The 2007 economic and financial crisis is by many measures the most serious since the 1930s. It cannot, however, be analysed as an isolated event separate from the series of crises that has characterized the capitalist system. Indeed, even though the current crisis shows some specific characteristics, its main causes are similar to those that triggered previous crises. In this study, we argue that we are experiencing a generalized economic crisis, as opposed to a financial crisis whose impact is felt on the real side via the traditional Keynesian transmission mechanism. As such, we identify the development of a number of both real and financial factors, whose combination should be recognized by any astute observer as a recipe for financial turmoil and recessions. In particular, we consider two parallel and ongoing practices that have transformed the entrepreneurial capitalist system and rendered it much more fragile and prone to crisis: (i) the financial deregulations-cum-innovations since the late 1970s have fundamentally changed the basic role of banks and financial institutions and created the possibility for financiers to (artificially) increase their wealth independently of the real production sector – thus resulting in financial bubbles; and (ii) at the same time, prolonged austerity measures in most advanced capitalist economies have kept the productive capacity of these economies below full employment and therefore directly contributed to engineering recessions. We conclude that there is a need to rethink not only the type of economic policies in place but also the economic model.

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1 INTRODUCTION

The recent history of capitalism indicates the system is riddled with numerous crises, both financial and real (Reinhart and Rogoff 2009a), some of which were so serious that they threatened its very foundations and brought it to near-collapse. Perhaps the best known of these is the Great Depression of the 1930s, which has thus far become a benchmark for gauging the seriousness and severity of subsequent crises. Indeed, since the end of the Second World War, there have been at least 18 such crises in industrialized countries alone (Reinhart and Rogoff 2008; Kaminsky and Reinhart 1999), and a great many others in the developing world (Duttagupta and Cashin 2011). However, the most serious crisis by far in the post-Depression era is the latest one that broke out in 2007–2008 and has been dubbed the Great Recession or alternatively the Lesser Depression.
Depending on the severity of the crisis in each case, economic performance has typically slowed down, with growth of real GDP sometimes becoming negative and unemployment reaching unprecedented levels. In some studies, the average duration of the downturn for output has been estimated to be around 2 years, and about 5 years for unemployment (Reinhart and Rogoff 2009b). The economic and social costs of these crises are obviously high but are particularly severe for the more vulnerable segments of society.

In spite of the widely held belief that crises are only random and transitory and the claim that these play a corrective role when they occur, there is now strong empirical evidence pointing to the structural nature of crises. Moreover, this new evidence indicates that the causes of these crises are embedded in the institutions of the capitalist system itself (Gatti et al. 2012; Bellofiore and Halevi 2010–2011; Crotty 2009). Also, while it is true that some crises are shorter than others, the fact remains that real and financial crises tend to recur at regular intervals and their effects on some sectors of the economy linger for a long time, thereby making them ‘protracted affairs’ (Reinhart and Rogoff 2009b). Scholars who have studied the long-term evolutionary tendencies of capitalism came to the conclusion that the recent history of the major industrialized countries was marked by a series of successive (long) waves of upswing and downswing, each lasting 2 to 3 decades. Hence the last wave would have run from the 1940s to the 1970s for the upswing, and from the 1970s to the 2000s for the downswing (O’Hara 2006).

Now, whether the current crisis that began in 2007 will mark the end of the downswing or prolong it depends on a number of factors. Among these, and certainly the most important, is the types of policies governments choose to put in place in order to instigate a positive change and stimulate the economy. However, given the almost universal obsession with fiscal austerity measures, it is quite certain that the crisis will worsen, particularly in the eurozone, which will then affect the rest of the world through trade and financial linkages. Therefore, it is very likely that the current downturn will last for a few more years, until a policy reversal becomes possible (perhaps when the mandate of present policymakers comes to an end, or sooner if the present governments are brought down by popular revolts).

There is now a considerable number of studies, of various theoretical backgrounds, attempting to explain the causes and consequences of the recent crisis. Because the crisis first appeared in the US subprime market, the general view among mainstream economists is that this was a banking crisis, which quickly spread to the rest of the financial sector and then – as time went on – to the real side of the economy via the traditional mechanisms.

The main argument in these studies is that bankers, or rather some ‘rogue loan officers’, either because they were too greedy or nonchalant, extended loans to people who did not have the necessary creditworthiness usually required (that is, the ability to pay back). Other economists blamed the whole thing on the lack (or the lax implementation) of strict regulations in the financial sector and speculated that an effective regulatory system would ease the consequences of such crises in the future (Hoshi 2011). Regardless of the precise reason, the explanation is the same: the cause of this crisis is financial in nature and is traced back to the behaviour of the banking system.

In this paper, we argue that even the presence of the strictest regulations (the Dodd–Frank or the Glass–Steagall Acts, for instance) would not have averted the crisis, for the simple reason that its causes lie in the core institutions that command the functioning of the capitalist system. In other words, this was not so much a financial crisis as a crisis in the institution of capitalism. While there was certainly a financial dimension to
this crisis, to argue that it was the sole cause of the crisis does not fully convey the intensity and true nature of those causes. As we argue below, the financial nature of this crisis, though an important element, was a consequence of the increased inequality in income and wealth. Together, they reinforced each other and contributed to the 2007 crisis.

This paper is divided as follows. In Section 2, we discuss the economic environment that prevailed during the 3 decades prior to the crisis and show that all the warning signals were present and pointing to a coming crisis. Section 3 offers alternatives to current policies. Concluding remarks are given in Section 4.

2 CURRENT POLICYMAKING, WEALTH CONCENTRATION AND THE INSTABILITY OF FINANCIAL MARKETS

As is the case with previous crises, evidence shows that, prior to crises, standard leading indicators such as output and employment are usually the first to exhibit low growth or clear downward trends. This is documented for instance in the study by Reinhart and Rogoff (2008, p. 343), who find that real GDP growth per capita in the US and other industrialized countries in their sample starts to decline 4 years before the onset of a crisis.1

Gatti et al. (2012) provide an interesting explanation of the decline of real GDP growth and the rise in unemployment. Their research focuses on the structural transformations of the capitalist system and the authors argue that – just as happened in agriculture before the Great Depression – large productivity increases in manufacturing between 1980 and 2007 led to a rise in unemployment and a decline in real wages, which translated into a fall in aggregate demand.

In turn, prolonged periods of unemployment lead to a widening gap between social classes and to important increases in income and wealth inequality. Under these circumstances, the problems of falling demand would be exacerbated. Evidently, this scenario could be forestalled under two conditions: first, governments could implement expansionary fiscal policies; or, second, the private sector could borrow to finance its spending on consumption and investment. As Seccareccia (2005) and others have shown, it was the latter solution, particularly the increase in households’ indebtedness, that has temporarily sustained growth during the 25 years or so prior to the crisis. In other words, the fragility of the capitalist system was masked by consumers sustaining consumption through increased borrowing and debt.

Increased inequality has had other effects as well, as the other side of the inequality issue is the considerable wealth that has been accumulated by some individuals and financial institutions. This is where we contend the financial component to this crisis arises, as this wealth needs to be recycled and reinvested in order for it to grow – it cannot rest idle. It is always searching for higher yields. And so, new instruments that can increase its value must be created for this purpose, which contributed for instance to the birth of markets for asset-backed securities (ABS). In turn, banks responded to the need of financiers for new financial instruments by packaging their loans into various types of financial products, labelled collateralized debt obligations (CDOs), with different risk notations ranging from triple-A to ‘toxic waste’. As a result, the share of short-term securities in

1. Demirgüç-Kunt and Detragiache (1998) studied the period 1980–1994 and showed that a decline in real GDP growth, a deterioration in the terms of trade, and a rise in the real short-term rate of interest tend to hurt banks by increasing the share of nonperforming loans and by affecting banks’ balance sheets adversely.
institutional investors’ asset portfolios grew exponentially between 1980 and 2006 (see below). This further encouraged banks to find an increasing number of borrowers, particularly in the housing market, thus contributing to the inflation of housing prices and creating a bubble.

Because it is practically impossible to dissociate the monetary/financial sector from the real production sector, we argue that the current crisis has its origins in the interaction between the two sectors. Our argument can be summarized in three intertwined steps: (i) prolonged fiscal austerity measures created the conditions for unequal distribution of wealth and its concentration; (ii) in their search for higher yield, holders of the accumulated wealth need new financial instruments where to ‘invest’ their funds, to which the banking system responded by creating a market for ABSs, including CDOs of the subprime grade; and (iii) when the borrowers were unable to meet their payments, largely as a result of continued austerity measures, the CDOs became toxic and the bubble burst; this then created fear and panic among ‘investors’ who rushed to dump the toxic waste in an attempt to protect the value of their wealth.

2.1 The monetary circuit and crises

Our summarized description of the events that precede a crisis is quite consistent with the views espoused by the proponents of the monetary circuit. As we argue here, the origins of a crisis can indeed be provided by the circuit approach.

In the standard, albeit simplified, description of the functioning of monetary production economies, the source and origin of money is found in the banking sector, including the central bank. To carry out their activities, firms, households and the state must first obtain the necessary financing, which is advanced to them in the form of credit (loans) by the banks, including the central bank. These loans are deposited in the receiving agents’ bank accounts, thus giving them the purchasing power necessary to begin spending.

During this first phase of the circuit, money flows from banks to households in the form of loans and salaries and to firms in the form of loans. If we consider firms as a sector, it is easy to see that money flows from firms to households in the form of wages. Acting as entrepreneurs, firms set their production plans and use the loans to hire labour. When the production process is finished and goods and services are made available, households then spend their income by consuming and acquiring these products (as well as paying their dues to the State). At this point, the reflux phase begins (see Graziani 2003). The funds captured by firms through the sale of these traditional commodities allow firms to realize their profits and to reimburse, at least partly, the debt they have previously incurred toward the banks.

The above discussion is a very basic description of the monetary circuit. But it does offer us an idea of the potential source of crisis, as a potential source of problems arises precisely when households’ saving rate is positive and they express a certain preference for liquidity. In this case a portion of the amount they initially received would remain with them as bank deposits. As a result, firms will remain indebted toward the banks. So in order to capture as much as possible households’ financial savings, firms as a sector must compete with the banks by encouraging households to give them their savings rather than keeping them as deposits. This is achieved by offering, on financial markets, high-yield securities. Under these circumstances, firms would obviously have to pay interest on the remainder of their debt to the banks and interest on the securities, which they have issued. As shown by Graziani (ibid., p. 116), this situation would be
beneficial to firms so long as households do indeed choose to increase the share of their wealth held in corporate securities. Of course, if households choose to hoard part of their savings, firms will be unable to recapture the totality of their outlays.

It is this constant need for liquidity and dependence on external finance that forces entrepreneurs (assumed to be the owners of firms) to gradually relinquish an increasing portion of the firm’s total assets to outside financiers. Regardless of the bargaining strategies that financiers and entrepreneurs might develop during the course of their interactions (see Rajan 2012), the important point is that, in the end, financiers might have the final say because they can always jeopardize the firm’s activities by refusing to extend finance. This necessarily places entrepreneurs (the industrial capitalists) at a disadvantage and, at the same time, explains the increasing power gained by financiers over the decades since the rise of industrial capitalism, what many now refer to as financialization, which carries two very important components.

First, as discussed above, there is this apparent hold by the financiers over material production, coupled with the introduction of various financial innovations. Second, there is the more recent but quite successful inclusion of the middle- and lower-income classes into the borrowing chain, which in turn has resulted in two important phenomena: increased household indebtedness, and asset price inflation, such as in the case of the subprime market.

Our central contention is that these two components of financialization represent the most dramatic changes in the institutional structure of modern capitalism and, as we shall see, they bear in them the seeds of crises because each one of them has its own intrinsic limitations. In what follows, we will focus on the limitations and problems posed by each of these developments and show their role in generating crises. In addition, we note that even though these inner contradictions tend to manifest themselves in separate areas and sectors of the economy, in reality they are intertwined at the source and exacerbated by the fact that wealth has become increasingly concentrated in the hands of a tiny minority.

2.2 Finance and financial innovations

In the era of what can now be considered the classical entrepreneurial capitalist system, the emergence of financial markets and their raison d’être was to offer firms producing goods and services the opportunity to raise funds to finance their long-term investments. In terms of the monetary circuit, there is no new injection of liquidity but only a transfer of savings from the bank accounts of some private agents who have succeeded in accumulating wealth. This is true even when these agents are commercial banks because in this case banks would be using their earned profits to acquire corporate bonds and/or shares and cannot create money for this purpose for obvious reasons. In the primary market, firms issue debt (bonds) and equity securities (shares) and sell them to investors who are looking to earn a higher return on their financial wealth (higher than the interest on bank deposits). Investors could easily monitor firms’ performance and decide on the composition of their portfolios based on their assessment of risk and return. Profitable firms attracted investors searching for a higher yield but particularly equity investors who were eager to realize a capital gain, which meant that – at this stage of classical capitalism – finance was still linked to the real production side of the economy.

Over time, important changes were progressively introduced to the workings of financial markets. The most dramatic developments occurred only during the last 50 years or so. Indeed, the 1970s and 1980s marked the beginning of a new era in financial trading with the growth of the so-called leveraged buyouts in which the buyer (usually an institutional
investor) acquires a company essentially by using that company’s assets as collateral to borrow funds (either from a bank or by issuing bonds). This is in sharp contrast with previous practices in which the classical investor collateralized only his own assets or actually parted with his own money in exchange for ownership of the company or shares of it. In the new model, as very little capital needs to be committed by the so-called investor, this opened the door wide for wild bets and speculation, particularly when the targeted company could be re-sold before even completing the initial takeover transaction.

This type of speculation is well known and has been widely practised, perhaps for centuries, for example in urban land ownership. In this sense, it is no surprise that it has spread to financial markets. But in this specific situation, the traded commodities (shares) are still in a way ‘real’ in the sense that they correspond to parts of, or entire, existing companies. Their value might be inflated due to the use of various schemes but that is another matter.

The serious trouble in financial markets arose, however, when traders started dealing in derivatives like asset-backed securities (ABS), including CDOs and CDOs squared, which are, to put it bluntly, nothing more than fictitious assets. Because of this, it is impossible to know either their quality or their value, or even how to price them. This represents the first major transgression of a basic law of capitalism – the law of exchange by which the commodities in the marketplace must exhibit transparent information about their characteristics so as to facilitate the interaction of their supply and demand.

In most jurisdictions, the law of exchange has been now codified under contract law, which governs the exchange of property. As observed by Prasch (2010), all our important transactions (for example, purchase of automobiles, home mortgages, etc.) take the form of long-term relational contracts precisely because the characteristics of the property being exchanged are not readily verifiable – that is, they cannot be ‘inspected’ on the ‘spot’. These contracts are relational and non-tradable. They are designed to overcome problems of asymmetric information and to offer the parties involved in the transaction some credible guarantees and ensure a certain transparency regarding the characteristics of the commodity being exchanged. In this way, the buyer can form an idea about the commodity in question and even make an estimate of its value. The buyer is also relatively ‘covered’ if, for example, the automobile brakes down while it is still under warranty.

By contrast, in financial markets these relational contracts are transformed into tradable commodities that also serve as a reason and become a basis for the creation of new financial products: the asset-backed securities (ABS). Financial commodities of the ABS type are extremely opaque, thereby making it difficult not only to price them but, more importantly, to know what they actually are. Financial commodities in the

2. Speculation is nothing new to financial markets. It has actually appeared immediately with the emergence of secondary markets for assets. In Marxian terms, the commoditization of financial assets truncates the circuit M–C–M’ by bypassing the C stage and exchanging M for M’, a sheer speculation.

3. In this regard, Bellofiore and Halevi (2011, p. 15) wrote that: ‘With the onset of stagnation in the 1970s the political and economic response gravitated towards the transformation of debt into a source of financial rents and of support to effective demand through household indebtedness. In this context, throughout the 1980s and 1990s the required institutional space was created by abolishing the safeguard provisions of the Roosevelt era and by changing pensions’ financial flows from funds tied to specific entitlements into funds available for financial markets in which benefits came to depend upon market capitalization’.

4. According to Das (2006, p. 126), ‘The lack of transparency lies at the heart of derivative profitability. You deny the client access to up-to-date prices, use complicated structures that are hard for them to price, and sometimes just rely on their self-delusion’.
form of derivatives such as CDOs, CDOs squared and CDOs cubed are indeed wealth created out of thin air! It must be emphasized here that as the commodity, which is the central element in the exchange relation, becomes ever more obscure and abstract, all the other parameters of the market (for example, risk, return) gradually lose their familiar meaning and become erratic. In this situation, it becomes difficult to value assets or trust the volatile market valuations (Foley 2010). The logical consequence of this destabilizing force is the emergence of a wedge, a separation between the supply of and the demand for securities, followed first by a breakdown of trust in ‘market forces’, then a need to exit the market and finally a panic characterized by mass selling. At this point, the crisis arises. It is true that the presence of additional triggers such as the increase in interest rates by the Fed (June 2004 and after) played a role in speeding up the process leading to the crisis but the collapse was already coming (see also Wray 2011). Schematically, the scenario is as shown in Figure 1.

Focusing closely on the financing aspect of relational contracts, Wray (ibid.) argues that even when banks are not initially involved – that is, even when relational contracts arise separately in the products market – they still make their way to financial markets when the IOUs sanctioning these relationships are presented to the bank, which accepts them and issues its own IOUs to finance its position.5 Hence, according to Wray (ibid., p. 13), ‘This is the essence of financialization – or/pyramiding – layers of debt that represent commitments of prospective future income flows. … Yet, when the crisis hits, the shadow financial institutions find they cannot refinance positions – in other words, they cannot reissue liabilities to cover their positions in assets’.

The marketing and sale of securities are typically handled by nonbank financial intermediaries (brokers, financial advisors, different types of funds, etc.), who are now managing various types of collective investment schemes on behalf of institutional investors. The growth of these financial institutions since the 1980s has been impressive.6 In the US, for example, data indicate that their financial assets, which are essentially securities, grew by nearly 8000 per cent between 1980 and 2007, reaching almost US$12 trillion – that is, about 84 per cent of GDP (see Figure 2). A similar trend is observed in other major industrialized countries. How can we explain this explosive growth in financial markets?

As already mentioned, the source of the supply of these securities resides primarily with the banking sector, which packages the various relational contracts (mortgages,
corporate debt, etc.) into securities and offers them for sale to the so-called ‘investors’ on financial markets. These packages or portfolios are then organized into different tranches with varying degrees of risk ranging from the safest (super senior tranche) to the most junior tranche or toxic waste. The phenomenal growth of financial assets documented in Figure 2 indicates that the demand for these securities has been extremely high. Such high demand can only be justified in two cases: (i) if the return is relatively high compared to the risk involved; and (ii) if the investors have accumulated large amounts of liquidity that need to be recycled. With the benefit of hindsight, it is now clear that both of these factors prevailed during most of the last 2 decades of the twentieth century (Credit Suisse 2011), which explains the euphoria that preceded the crisis.

In the first case, this was a period of speculative bubbles and the return was almost ‘a sure thing’, in part due to the rise of credit default swaps (CDS), which allowed the buyers of these securities to insure themselves against the risk of default. In fact, even without buying anything, speculators could simply place a bet against the possibility of default of certain securities (such as bonds issued by the government of Greece) and purchase credit default swaps. Speculators would pay, for example, a monthly fee to the insurer in exchange for a payment in case their bet materializes. On the other hand, the need for recycling the accumulated wealth, and the quest for a higher yield, is imperative for its growth and expansion; otherwise it must necessarily be withdrawn from circulation. There is therefore a disproportionate pressure coming from the demand

7. These are also known as ‘structured products’ whereby the senior tranche, usually with higher credit ratings (AAA–A), pays a relatively low interest rate but it is the first to be paid out of the cash flows of the portfolio in case of a default, followed by the mezzanine tranche and then the most junior tranche (also called the equity tranche, the first loss piece or toxic waste), which is unsecured but offers a higher risk–return profile.

8. As Marx (1887) put it, ‘The restless never-ending process of profit-making alone is what [the capitalist] aims at. This boundless greed after riches, this passionate chase after exchange-value, is common to the capitalist and the miser; but while the miser is merely a capitalist gone mad, the capitalist is a rational miser. The never-ending augmentation of exchange-value, which the miser strives after, by seeking to save his money from circulation, is attained by the more acute capitalist, by constantly throwing it afresh into circulation’.

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Figure 2  Financial assets of institutional investors in the US

Source: OECD database.
side of the market for financial securities, particularly when we consider the historic low returns on government bonds.\(^9\) But having now discovered that a higher supply of these securities hinges on the expansion of relational contracts, the suppliers – namely the banks – rationally responded by pushing for an increase in the number of these contracts, which was done by including additional borrowers, even of the NINJA type; hence the emergence of the subprime loans. This leads us to examine the second aspect of financialization.

### 2.3 Increased household indebtedness and the demand for securities

The imperative need for recycling the accumulated wealth is the driving force behind the rise in demand for financial securities in general and ABS in particular. However, as the supply of this type of securities proved to be, at least initially, somewhat inelastic, the logic of the system led to the ingenious invention of the imaginary ‘sovereign consumer’ or the ‘enterprising consumer’ whose decisions, such as wanting to expand the stock of his assets, must now be regarded as an entrepreneurial activity that warrants all the financing needs (Payne 2012; Bougrine and Vihanto 2010; Foucault 2008). Consequently, banks are called upon to meet the consumers/households’ borrowing needs by extending credit for consumption purposes or mortgages for house purchases.\(^10\) Obviously, these consumers/households are not the High Net Worth Individuals (HNWI) but rather the great majority of middle-class and poor families who willingly accepted their subordinate inclusion into financial markets because they believed in the illusion of making important capital gains. This explains the rising levels of households’ indebtedness observed in many industrialized economies since the 1980s.

Looking at the same process from a different angle, Bellofiore (2011, p. 98) has labelled this transformation in capitalism as ‘the real subsumption of labour to finance’ under the umbrella of what he called ‘pension funds capitalism’ (or what Minsky (1993) called ‘money manager capitalism’).

Moreover, bank credit was not the only means by which consumers/households were successfully included in financial markets. Their savings and pension contributions

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\(^9\) The Credit Suisse Global Investment Returns Yearbook (Credit Suisse 2011, p. 5) reports that in ‘the USA, over the period from the start of 1980 to the end of 2010, the annualized real (inflation adjusted) return on government bonds was 6.0%, broadly matching the 6.3% long-term performance of equities. Over the preceding 80 years, US government bonds had provided an annualized real return of only 0.2%. Similarly, for the UK, from 1980 to 2010 the annualized real return on government bonds was 6.3%. Over the preceding 80 years, UK government bonds had provided an annualized real return of just –0.5%.

\(^10\) Wray (2009, p. 817) explains how the promotion of the idea of an ‘ownership society’ in recent decades served the interests of money managers and how it has led to higher inequality in the USA. In a sharp and eloquent criticism of the ideology behind this policy, he wrote: ‘It is ironic that the 30-year mortgage brought to us by New Deal government guarantees – making home ownership possible for working Americans for the first time – morphed into a speculation-fuelling, debt-pushing casino that buried homeowners in a mountain of liabilities. Creditors emerge as owners of the foreclosed houses and with claims on debtors, who will be subject to a form of perpetual debt bondage … Many “home owners” merely occupy, manage and improve homes really owned by the true owner class – those with lots of wealth, particularly financial wealth’.
were also channelled through pension funds. Indeed, as Bellofiore and Halevi (2010–2011, pp. 7–8) have argued,

A system of compulsory savings became formalized with wage earners’ pension contributions deposited in private funds. With the crisis of the golden age and the ensuing curtailment of the social role of the public sector, a growing proportion of the legislated employee/employer contributions to social security was compulsorily directed toward these funds, which therefore came to absorb a great deal of household savings.

They add:

The placement (‘investment’) of these sums in securities, shares, and other kinds of investments created a commonality of interests between the managers of financial institutions and those of productive firms. The latter were co-opted to the strategies of the first group directly through salaries linked to stock options and economically by increasingly partaking in the objectives of maximizing dividends and share values.

In conclusion, if the subsumption of labour to capital can be described as a situation in which the entrepreneur-capitalist succeeds in asserting his domination by establishing a set of contracts with independent workers who are now ‘bound only by the need to make contracted deliveries at the stipulated time’ (Rajan 2012, p. 6), the subsumption of labour to finance would be quite simply a situation in which money managers succeed in developing clever ways to get a hold of those contracts and transforming them into new financial products – thus ensuring at the same time that workers’ income receipts are diverted back to financial institutions in the form of debt payments, potentially serving as income streams for the holders of these assets. On this account, financialization is the exploitation of the poor.

3 TOWARD A RADICAL CHANGE IN ECONOMIC POLICY

Given our diagnosis of the crises, we propose that economic policy should be focused on achieving two main goals: (i) full employment; and (ii) making finance at the service of the economy. Our justification is quite obvious: while the so-called investors in financial markets may buy CDS and other types of insurance, the real issue is whether the loans will be paid back. This in turns hinges on whether people are employed. Employment in turn depends on how the real economy is performing, so, in the end, it is clear that the source of the problem is real and not financial. The 2007 crisis was first and foremost a crisis deeply rooted in aggregate demand failures, with an important financial element. It is clear that policies that need to be adopted must have an eye on repairing the problems with aggregate demand, and another on regulating the financial sector.

The objective of full employment implies that the government must abandon austerity policies and stand ready to finance nationwide programs offering jobs to all those who cannot find employment in the private sector. Job creation and long-term employment ensure that the working class will have a steady income and would ease the pressure on the need for household debt. Such a policy will contribute to reducing income inequalities, although on its own, it is not sufficient. This is where the ‘traditional measures’ of tax and transfers will play a complementary but important role. Transfers in the form of unemployment benefits, welfare payments and so on have long been recognized as automatic stabilizers because they strengthen aggregate demand and dampen the effects of a downturn. But in the neoliberal era, it was the
indirect transfers on social programs such as health and education that have been cut severely, and it is here that we must seek a policy reversal if we are serious about regenerating economic growth. The tax component of the traditional measures is no less important but it should have teeth. That is, in addition to progressive taxation on incomes we should also have taxes on all forms of wealth.

As the national or federal government does not rely on the proceeds from these taxes to finance its spending, it can still collect them, but through various accounting procedures it can make them accrue to local and regional governments whose role of a Robin Hood cannot be contested. Government actions seeking to reduce inequalities and achieve full employment imply an increase in government debt, but that is exactly what is needed. In other words, we must substitute public debt for private debt because, as heterodox economists are well aware, only government debt is sustainable (see Bougrine 2004). This is what we mean by abandoning austerity policies. On this point, there is now considerable research confirming the deflationary bias of austerity (see Sawyer 2015) and in fact, even the IMF is nowadays critical of austerity measures, arguing that attempts to reduce fiscal deficits have slowed growth and contributed to larger budget deficits (see IMF 2012).

On the financial side, we maintain that regulations are important but they must be considered as part of a greater strategy. As we have argued elsewhere (Bougrine and Seccareccia 2013), some specific regulations are urgent. These include the need to prohibit securitization and the sale of debt (relational contracts), ban practices like originating and distributing, and separate commercial banking from investment banking. The purpose of these regulations is to maintain some integrity of the financial system by preventing excessive speculative behaviour and reducing or eliminating fraudulent financial practices.

However, a more effective change in policy is for the government to regain or ascertain its sovereignty in issues of money and finance. Reversing austerity policies and increasing public debt and deficits is only one aspect of such sovereignty. The other aspect is to decree that finance should be an instrument to promote growth in the real economy and increase the welfare of the whole society. The charter for commercial banks should be rewritten to acknowledge the social responsibility of private banks and to redefine their mandate. And since leadership is by example, the government must set the standard by providing such services through its own banks. Experience from the postwar era shows that, prior to their privatization, public banks have played an effective role toward this objective in several industrialized countries (see Bougrine and Seccareccia 2013).

4 CONCLUSION

In this paper, we tried to offer an analysis of crises consistent with the teachings of the monetary circuit. Our analysis focused on two important aspects of financialization, namely the growing importance of finance’s influence over material production and the accompanying introduction of various financial innovations on the one hand, and the successful inclusion of the middle and lower-income classes into the borrowing chain on the other. It is in this sense that financialization has resulted in an increase of households’ indebtedness and gave a greater possibility to financiers to increase their wealth independently of the real production economy. We argued that household debt is not sustainable in the long run, particularly when we know that austerity policies lead to more unemployment. As for the second aspect, and in order to remedy the
increasing separation between finance and real production, we proposed a set of policies, including a return to social and public banking.

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