FINANCIALIZATION OF CAPITALISM

Comments by **Cliff DuRand** on *Bad Money: Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism* by Kevin Phillips (Viking, 2008).
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On page 29 Kevin Phillips gives us the following quote: "The money that's made from manufacturing stuff is a pittance in comparison to the amount of money made from shuffling money around. 44% of all corporate profits in the U.S. come from the financial sector compared with only 10% from the manufacturing sector."

This points to a major conclusion he carries over from an earlier book in which he identified financialization as heralding the end of both the Dutch and the British empires. Decline set in when the main economic activity became financial transactions rather than those that created new wealth. The U.S. is clearly in that stage now and, as he tells us, "no leading world economic power has enjoyed a full fledged manufacturing renaissance after becoming unduly enamored of finance." p. 208

So what exactly is financialization? Let me try to unravel its meaning.

With financialization, profits come <u>not</u> from investment in production that increases value, M **->** C **->** M' . Instead profits come from money itself, M **->** M´. How is this possible? M does not have generative power to create value. It is labor that creates value, and can increase value. v + c **->** v + c + s . That is how the value that profit, p, represents is created. That is the real economy.

Financialization involves the use of M to realize a profit without producing any new value. E.g. currency speculation. Suppose a Mexican bought usd last summer at 10:1. Now he can turn around and sell those usd at 15:1, thereby ending up with 50% more pesos than he started with. Of course, today's pesos are worth less than last summer's pesos. But with inflation still less than 6%, he still comes out ahead by a big margin. This is what international currency traders like George Soros do all the time. And even though they usually gain not 50% but only a fraction of 1%, it can make them immensely rich without having increased the world's wealth one iota.

With financialization no new value is created. Value is just redistributed. It's like gambling: winners get money from losers. But nothing is produced –except entertainment perhaps – and no value is created.

MONEY, M

There is money, and then there is money. That is, there are different types of money. We usually think of money as currency, the bills we carry around with us, M0. That has value because it represents a definite quantity of goods and services we can buy with it. Thus the value of that money is stable if the sum total of M0 in circulation equals the sum of goods and services produced. This is the real economy.

But then there is money that doesn't represent existing goods and services. There is the money that banks create when they give a loan. That's right, it is not just the Treasury Department's printing presses that create money, private banks do it too. Consider what happens when a bank makes a loan. The bank's accountant enters two numbers in the records: the borrower's promise to repay the loan is entered as an asset and the amount the bank puts into the borrowers account is entered as a liability. With the accountant's bookkeeping entries, the bank created new money from nothing and caused the total amount of money in the economy as a whole to increase. Banking regulations don't even require that the bank actually have the full amount of money loaned in hand. It only has to have a % of it.

Nevertheless, some of the banks funds are tied up with that loan. Suppose now an investor comes along and buys that loan from the bank. That then frees up its funds to make additional loans, thereby

creating more money. The investor now has a security with a certain value. So the original amount of money that represented value in the real economy, has now been expanded. Olah! By the magic of financialization, M has been increased to M' without any additional value having actually been produced. This is what is called fictitious capital.

Of course, you might argue, don't there have to be goods and services there somewhere for this fictitious capital to have value? What happens if someone wants to spend it? Aye, there's the rub. As long as it doesn't get spend on goods and services there's no problem. But if it does get used that way, then there will be too much money chasing too few goods, and that's the prescription for inflation. So instead, use that money to create more money – financialization! This Ponzi scheme works as long as there are new players willing to risk their money in what is an increasingly risky game.

Go back to our gambling simile. Financialization is like gambling in that it doesn't create any new value, it only redistributes existing value. Consider a gambling casino. You buy chips and play with them in various games of chance. When you leave you cash in the chips you have at the same rate you originally bought them for, only now you have more or less depending on your luck. But suppose the casino operated like a bank and kept putting more and more chips into circulation. And suppose the players started buying chips from each other in securitized packages. As demand grows for chips, the price goes up. There is a bubble in the chip market. Speculators ride the bubble up as high as they can before cashing them in. But what happens when the bubble bursts, as all bubbles must eventually? Speculators are left holding chips whose value is dropping. And the casino –the bank—is left with a load of liabilities as players demand to redeem their chips. Meanwhile, outside the gambling halls of the casino the real economy goes on unaffected – as long as there is a firewall between it and the financialized world of the casino.

However, as we see with the current economic crisis, there was no such firewall. Financialization came to replace the real economy that produces stuff. The housing market is a prime example. One's house was no longer a home, it was an asset with which to speculate as real estate prices went up and up. Kevin Phillips tells us that during the peak 5 years of the bubble in the housing sector, this accounted for 40% of the growth in the U.S. GDP. That is 40% of economic growth was fictitious capital. We can see now that it was fictitious because it has simply disappeared. When we thought the economy was expanding, we now know we were just blowing bubbles.

The ideology of our bubble blowers is expressed in a 1996 article in Foreign Affairs by John Edmunds. He wrote:

> "Securitization – the issuance of high quality bonds and stocks – has become the most important engine of wealth creation in today's world economy…. Historically, manufacturing, exporting, and direct investment produced prosperity through income creation…. Now many societies, and indeed the entire world, have learned how to create wealth directly. The new approach requires that a state find ways to increase the *market value* of the stock of productive assets…. An economic policy that aims to achieve growth by wealth creation therefore does not attempt to increase the production of goods and services, except as a secondary objective." [quoted in Agenda for a New Economy: From Phantom Wealth to Real Wealth by David C. Korten (Berrett-Koehler Publishers, 2009), pp. 15-16.]

We can now see that such bubble blowing can make some gamblers in the casino wealthy, but it does not create wealth for the society as a whole. It just creates the illusion of wealth and a lot of bad money.

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Changes in % Share of GDP, 1950-2005

	1950	1960	1970	1980	1990	2000	2003	2004	2005
Manufacturing	29.3	26.9	23.8	20.8	16.3	14.5	12.7	12.1	12.0
Financial Services	10.9	13.6	14.0	15.0	18.0	19.7	20.5	20.6	20.4

-- Kevin Phillips Bad Money, p. 31.

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in 2001 the turnover of financial transactions in international markets totaled $40 trillion. Of that, only $800 billion represented international trade and productive investment flows. --Dicken Global Shift, ch. 13.

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"We are coming off a 20-year credit binge. As a country, too many of us stopped making money by making "stuff" and started making money from money — consumers making money out of rising home prices and using the profits to buy flat-screen TVs from China on their credit cards, and bankers making money by creating complex securities and leverage so more and more consumers could get in on the credit game."

-- Thomas Friedman "Obama's Ball and Chain" NYT, March 4, 2009