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“FINANCIAL LIBERALIZATION AS A PROCESS OF FLAWED INSTITUTIONAL CHANGE: INSTITUTIONAL COGNITIVE DISSONANCE AND SYSTEMIC CRISIS”

Faruk ÜLGEN

Head of the Branch Campus of Valence
Director of the Department of International relations and conventions, Grenoble Faculty of Economics
Centre de Recherche en Economie de Grenoble (*CREG*), University Grenoble Alpes
1241, rue des Residences BP47 – 38040 Grenoble Cedex 9-France
faruk.ulgen@upmf-grenoble.fr ; ulgenfa@gmail.com

Abstract

This article argues that the financial liberalization of the last decades that resulted in a worldwide crisis relied on an institutional change which ill-shaped actors’ behavior so as to let them enter into unsustainable speculative activities at the expense of macro stability. To support such an assertion the article draws upon a specific Veblen-Minsky approach to a credit-money economy and its endogenous fragilities. It maintains that when financial markets are liberalized and private-interests-related self-regulation replaces public macro-prudential supervision, the financial system undergoes institutional deadlock and the ensuing confusion is transformed into a market gridlock. Markets then become unable to recover without public rescue operations of banks. The subsequent negative economic and social consequences are beyond the limits of any acceptable liberal ideology and scientific understanding. Therefore systemic stability calls for a tighter macro-regulatory framework to remove the domination of speculative finance over economic decisions and activities.

Keywords: Cognitive dissonance, financial crisis, financial liberalization, institutional change, institutional deadlock, regulation

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Introduction

In the aftermath of the 2007-2008 crisis, numerous analyses pointed to several weaknesses of financial markets and related incentive mechanisms. This article suggests an alternative view to examine the institutional roots of this crisis. It draws upon the analyses of Veblen and Minsky on credit-money economies and argues that financial liberalization in the last decades was an ill-shaped/flawed institutional change since it deformed market incentives and put actors up to leave time-taking engagements in favor of short-sighted strategies. The so-called rational individual behavior is naturally prone to instability as stated in Veblen's putative earnings-related values and sabotage behavior, and Minsky's financial instability hypothesis (FIH). Furthermore, when supervision mechanisms are left to private-interests-related self-regulation, financial systems undergo institutional deadlock. The ensuing confusion is transformed into a market gridlock, unable to recover without public rescue operations. Therefore a tighter macro-regulatory framework is required to remove the domination of speculative finance over economic decisions.

In this aim, the first section presents an appraisal of the seminal works of Veblen and Minsky on credit-based capitalist economy and its endogenous fragility. The second section argues that market fundamentalism[1] leads actors/authorities astray since it results in cognitive dissonance that provokes regulatory deadlock and systemic gridlock. Seeking sustainable capitalism the third section points to the leading role of institutions in economic stability. It then advocates toughly macro-regulated and reframed financial markets. The last section draws some conclusions.

I. Credit economy and financial instability: Veblen-Minsky nexus

Wray (2014) suggests that the Veblen-Minsky nexus might be rooted to their Keynesian monetary approach since they regard capitalism as a credit-money economy and both develop relevant analyses on the links between finance, economy and cycles, and offer insights on systemic instability.

Veblen and Minsky both adopt an institutionalist and evolutionist stance in their respective analyses and regard the modern business as a result of a peculiar evolution of

[1] i.e. total reliance on decentralized free markets in the organization of economic operations.

capitalism through development and the extensive use of loan credit, somewhat in contrast with the features of "earlier business traffic".[2]

Veblen and Minsky explicitly develop "a monetary approach" that puts the emphasis on the credit-financing process through the relations between enterprises and banks. This enlarges the capacity of accumulation since credit-funding does not rest on accumulated wealth but on private expectations about future profits. Veblen defines capital as a capitalized presumptive or putative earning capacity of the business[3], an expected magnitude related to credit extensions.[4] From the same perspective, Minsky (1982)[5] states that in a capitalist economy, economic activity is function of expected profits and that financial instruments are created by exchanging "money today" for commitments to pay "money later". This makes capital market the modern economic feature which is the higher "credit economy": "Trading under the old régime was a traffic in goods; under the new régime there is added, as the dominant and characteristic trait, trading in capital" (Veblen, 1904: 151). This fits well with Schumpeter's (1934) analysis of money markets as the headquarters of the capitalist system. One of Schumpeter's PhD students, Minsky (1982: 206) also focuses on the money-capital market that determines on what terms productive units' financial needs are to be satisfied but also how available surpluses within the economy are to be utilized.

Veblen (1923: 326) then states that "The pivotal factor in the business enterprise of this new era is the larger use of credit which has come into action during the last few decades (…) This volume of credit is more widely detached from all material objects and operations, and increasingly so."

Two factors play a determining role in capitalist evolution and its stability. First, capitalism is a credit-money based accumulation process that develops through uncertainty of decentralized private actions. Second, such an economic structure is

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[2] The chapter VI of *The Theory of Business Enterprise* gives an account of the major arguments developed by Veblen in opposition to the Classical economists' vision of the economy. This opposition takes the form of a confrontation between Minsky approach and the neoclassical real (nonmonetary) equilibrium vision of the world (Minsky, 1982; 1986).

[3] (1904: 89-91; 127 and 131).

[4] Veblen (1904: 152-153) notes the discrepancy between the meaning of capital as a real-physical means of production and its modern sense in capitalist economy: "(…) the value of capital is a function of its earning-capacity, not its prime cost or of its mechanical efficiency".

[5] Especially pp. 19-20 and 99-101.

prone to pervasive behavior and often fuels speculative short-sighted engagements resulting in systemic inconsistency.

Veblen argues that when finance rules over economic expectations the short-termism becomes determinant in economic decisions. This ascendency goes together with the absentee owner in economic development as it leads to a strategic withdrawal of businessmen from long-term engagements in favor of rapid gains, used to assess the performance of corporations.

This is the "paper world of Wall Street" (Minsky, 1982: 63) which develops through uncertainty: "Underlying all financial contracts is an exchange for uncertainty. The current holder of money gives up a certain command over current income for an uncertain future stream of money" (Minsky, 1982: 20). Therefore credit expansion can easily result in a swelling of market valuation of activities. Veblen then speaks of "the buoyancy" which a speculative inflation of values and the expansion of business capital through credit extension without any aggregate industrial effect: "This secondary effect of credit inflation may be very considerable and is always present in brisk times. It is (…) the chief characteristic of a period of 'prosperity'" (Veblen, 1904: 100), that is the period of relative tranquil growth of Minsky (1986: 193) leading to a speculative boom. It appears therefore that the Veblenian expansive *credit financiering* and the *FIH* of Minsky are very close to each other.

Toporowski (2005: 48-49) documents that in Veblen's analysis financialized capitalism through the credit financiering leads to robber barons' dominated economy. In the same vein than Minsky (1986: 201) - who states that "Investment and ownership of capital assets are undertaken in the expectation that they will produce money"- Veblen (1919: 89), points to the dominant role of monetary/financial relations in the operations of the businessman who entrusts his administration, not to the industrial engineers but to the captains of finance who have to do with the haggling of the market: "[b]y historical necessity the discretionary control in all that concerns this highly technological system of industry has come to vest in those persons who are highly skilled in the haggling of the market, the masters of financial intrigue".

Such evolution can be noticed in the swelling of subprime mortgage market-based financial expansion of 2003-2006. Speculative expectations feed engagements that involve the whole business community but also low-income households and the real

sector: “Since the credit instruments involved in modern capitalization may be used as collateral for further credit extension (…), the aggregate nominal capital in hand at a given time is, normally, larger by an appreciable amount than the aggregate value of the material properties involved; and at that time the current value of these material properties is also greater than it would be in the absence of that credit financiering for which corporate capitalization affords a basis” (Veblen, 1904: 149-150).

To Minsky (1986:196) also the financial characteristics of capitalism make the divorce between the real world and the financial world[6] possible and may result in instability: “The financial structure is a cause of both the adaptability and the instability of capitalism. Since our economy has corporations and stock exchanges, which deal in the ownership of capital assets, the financial dimension of a corporate capitalist economy is much greater than for an economy dominated by partnerships and proprietorships.”[7]

II. Market fundamentalism: Regulatory deadlock and systemic gridlock

In most market-based economies public authorities initiated/encouraged structural changes in favor of financial liberalization in the name of free market efficiency. This New Keynesian/Neoclassical/New classical consensus asserts that external restrictive regulation is useless as markets are assumed to self-adjust.[8] This movement *erased* the regulatory framework built up in the 1930s in the aftermath of “It”[9] and reversed the

[6] Minsky develops a two-price analysis to point to discrepancy between economic and financial magnitudes: “A basic characteristic of a capitalist economy, then, is the existence of two sets of prices: one set for current output, the other set for capital assets variables and are determined in different markets. The prices however are linked, for investment output is part of current output. Even though the technical characteristics of capital assets are the cause of basic money-now-for-money-later relationships in our economy, the existence of a complex financial system magnifies the number and the extent of money-now-money-later relations” (1986: 195).

[7] Minsky (1986: 199) also argues that “ in a capitalist economy that is hospitable to financial innovations, full employment with stable prices cannot be sustained, for within any full-employment situation there are endogenous disequilibrating forces at work that assure the disruption of tranquility.”

[8] Criticizing the neoclassical synthesis, Minsky (1986: 113) maintains that: “Both monetarists and Keynesians are conservative in that they accept the validity and viability of capitalism. Neither are troubled by the possibility that there are serious flaws in a market economy that has private property and sophisticated financial usages. The view that the dynamics of capitalism lead to business cycles that may be thoroughly destructive is foreign to their economic theory.”

[9] i.e. the great collapse of the 1930s (Minsky, 1982: vii).

regulatory dialectic studied in the 1970s-1980s by Goodhart and Kane[10] since the new regulation has been resting –from the 1980s- not on further restrictions but on a kind of deregulation/de-supervision. Thus the role of the new (de)regulatory framework was not to put actors up to innovate in order to eschew regulation but rather to imagine super-speculative and super-returns expecting operations to protect/enlarge their market shares/profits in face of a system-wide competitive-conflictual-uncertain environment. In this sense, the *market-friendly institutional change* was an ill-shaped framework.

This phenomenon relied on two policy measures: the independence of central banks from the elected-governments and withdrawal of central banks from the supervision of markets. Those measures rather put the monetary/financial decision and supervision process out the social control mechanisms. The central bank independence led central bank to focus on price stability/inflation targeting and reduced the scope of monetary policies. Financial development[11] was related to market liberalization and seen as a necessary condition for economic growth.

The evolution of institutions under the free-market-efficiency hypothesis gave rise to the privatization of regulation mechanisms and transformed systemic financial supervision into a micro-prudential private-assessment mechanism. Monetary authorities[12] related macro-stability of financial relations to self-regulation models without any interrogation about the relevance of such models with regard to the characteristics of monetary capitalist economies. The institutional transformations resting on neo-liberal doctrinal beliefs were fed through a process of institutional cognitive dissonance that made institutions inconsistent with market's endogenous dynamics and requirements of systemic viability. Reforms linked with vested interests -augmented by sabotage

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[10] It is argued that further regulatory constraints imposed by authorities in financial markets would provoke bypass strategies as banks would avoid the profit-reducing consequences of such restrictions through innovations. This would imply new regulatory reforms to "catch" the regulation-preventing effects of bank/financial innovations.

[11] Usually related to the length (high number of transactions, agents and products in markets), the depth (large variety and diversity of products in markets) and the liquidity (ability of the market to make large transactions possible without any payment limits) of financial markets.

[12] Just a few months before making official the subprime crisis in the US, the Fed Governor Bernanke (2007) reiterated his belief in market's self-adjusting capacity: "As I noted, markets are adjusting to the problems in the subprime market, but the regulatory agencies must consider what additional steps might be needed. (…) Markets can overshoot, but, ultimately, market forces also work to rein in excesses. For some, the self-correcting pullback may seem too late and too severe. But I believe that, in the long run, markets are better than regulators at allocating credit."

behavior- resulted in a flawed systemic framework unable to contain market actors' strategies within the viability limits.

In the process of privatization and commodification of financial supervision policy makers played the role of predicators and apostles of market liberalism. This sharply reduced the scope and consistency of public institutions in financial regulation: "(I)t seems that, although the forerunner signs of an increase of the potential systemic risk became perceptible (…), regulatory schemas remained attached to the principles of self-regulation" Ülgen (2015: 380).

The consensual efficiency approach fails to provide a coherent framework to describe how the real-world economies operate, how they interact with the policy instruments and what would be the systemic flaws that markets could exhibit in their development (Argitis, 2013: 485). Sotiropoulos et al. (2013: 173) maintain that financial markets development "appears as a further disengagement from capitalist production: as new means for profit seeking to the benefit of the absentee owner and the institutions that secure his dominance (financial intermediaries)".

The 2007-2008 systemic crisis may be thought as a complete failure of a set of values/beliefs resting on market fundamentalism. An in-depth Veblenian analysis by Raines and Leathers (1996) points to the irrelevance of the efficient market hypothesis and to the unstable character of deregulated markets since the markets usually evolve through "habit buoyancy" that leads to reckless finance. Indeed the rise of finance[13] makes capitalism dysfunctional since "It comes with the dominance of the parasitical absentee owner (Veblen) or rentier (Keynes) and sabotages the 'real creation of use values" (Sotiropoulos et al. 2013: 136).

Ülgen (2015) puts the emphasis on the crucial role that the institutional frame of financial markets plays in the occurrence of crises and then shows how the new institutional design of financial markets was an ill-fitted environment that sharply resulted in a regulatory deadlock, globally reducing stability of the financial system. Kern (2012: 2) documents that with the change of financial markets/intermediation rules and practices, "(F)inancial crises are now manifest in markets rather than

[13] The Veblenian "credit financiering".

institutions. (…) The collective rush for liquidity produces the market gridlock characteristic of market based systemic crises."[14]

The close link between the regulatory deadlock and the market gridlock is quite obvious.[15] In a financialized economy, continuous queues of speculative positions block an entire network of intersecting activities and potential alternative strategies and bring strategies in all directions to systemic standstill; a systemic fear keeping actors in a wait-and-see and almost lifeless position. In a fiercely speculative rentier economy, most banks and firms cannot engage in long-term activities since the rationality puts them up to seek rapid short-term returns *according to the rhythm of the music that the regulatory environment let play*.

The immediate impact is actors' fear and frustration and activity delay leading to growth reduction, unemployment and impossible repayment of previous engagements (and generalized failures of firms/banks). Another impact might also come from increasing exposure of healthy institutions to systemic failures and subsequent recession that would prevent them from continuing to finance productive long-term projects. Given those devastating effects of liberal finance, alternative institutional/regulatory reforms are required in order to guarantee less speculative and more sustainable capitalism.

III. Keeping markets within systemic sustainability limits: Institutions and relevant regulation

Institutional economics supplies roots of a relevant analysis of the working of financialized capitalism and its systemic crises (Ülgen, 2014). It asserts that behavior within a community is subject to social prescriptions or proscriptions. Especially in the case of vital concerns to the stability of the community, behavior patterns evolve through the process of habit formation which "is the mechanism by which socially prescribed behavior is internalized" (Bush, 1987: 1077). Institutions contribute to

[14] Kern (2012: 8) argues, for instance, that in the case of Northern Rock the bank run was not a cause of the failure of this institution but a result of the funding crisis in the monetary market related to the negative response of the Bank of England to the refinancing need of the bank.

[15] A gridlock, borrowed to the analysis of traffic-jam situations in major metropolis, is a general paralysis of all intersections that prevents actors from either moving forwards/backwards to exit the congestion. See, for instance, Llewellyn (1999).

framing society's major constituents.[16] But they are also forged/supported by individuals who try to strengthen their vested interests through the institutions they control.

Veblen (1915: 191) states that the scheme of life is made up of the aggregate of institutions in force at a given time and the development of these institutions is the development of society[17]: "The institutions are, in substance, prevalent habits of thought with respect to particular relations and particular functions of the individual and of the community (...) The situation of to-day shapes the institutions of tomorrow through a selective, coercive process, by acting upon men's habitual view of things (…)." Veblen then regards institutions in a dialectic/dynamic way and argues that institutions evolve through time in continuous contradiction with the requirements of the present.

In the same vein, Minskian FIH is the study of capitalism as an evolutionary economy through institutional changes. FIH maintains that economic/financial stability and growth rest on the consistency of institutions[18]: "(t)he financial instability theory points out that what actually happens changes as institutions evolve, so that even though business cycles and financial crises are unchanging attributes of capitalism, the actual path an economy traverses depends upon institutions, usages, and policies." (1986: 194)

To Minsky, the core issue authorities and economists have to deal with is the management of unstable capitalism (1982: vii). It is then asserted that what we need is a twofold institutional evolution to shape and accompany banking and financial systems. First, a big government to sustain capital accumulation and employment in period of stress and, second, a central bank apt to intervene as a lender of last resort in financial turmoil to ensure banking system's integrity and also act as a support of employer of last resort.[19]

Minsky (1986: 116-117) mentions that markets cannot self-adjust and need public institutions to contain instabilities: "(I)t is necessary to inquire if policies can be adopted or institutions created that are able to constrain or offset the processes that would lead to incoherence. If the pricing mechanism of a decentralized capitalist economy can lead to coherent results *only if* proper policy or institutions rule, then

[16] such as beliefs, markets, rules, etc.
[17] our italics.
[18] See also Minsky, 1982: 92 and 1986: 349.
[19] See, for instance, Minsky (1982: xxi, and 1986, pp. 324 and 326).

intervention is necessary even though the market mechanism can be relied upon to take care of details. Once such conditional coherence is accepted as a characteristic of a capitalist economy, blind faith in and acceptance of the results of market processes can no longer be sustained. (…) Policy cannot be a once-and-for-all proposition: as institutions and relations change so does the policy that is needed to sustain coherence. »

Therefore tough and "serious" macro-regulatory frameworks must be designed to remove the domination of the speculative finance over economic decisions and activities. Financial regulation is part of the habituation process and then rests on predetermined rules and values that depend on social choices and objectives. The relevance of the regulatory framework with regard to systemic stability must be firmly and toughly assessed and protected against vested interests to prevent regulatory deadlock and economy-wide gridlock that often result in systemic crises.

IV. Concluding remarks

This article documented that Institutional economics supplied analytical tools and references to understand the working of financialized capitalism and its systemic turmoil. In this vein, it drew upon the works of Veblen and Minsky to suggest a specific analysis of the financial deregulation/liberalization process of the 1980s-2000s as an efficient-markets-doctrine-based institutional-change. Market-friendly reforms implemented by Authorities since the 1980s resulted in a degenerated financial regulation and led to the 2007-2008 crisis that exhibits the malfunctioning of free markets and points to the interconnectedness between loose/weak regulation and systemic instability.

From this perspective, this is the value system of institutions which provides the functional interrelationship of behavior patterns within the institutions (Bush, 1987: 1078). Consequently, the correlation among individuals' behavior and the correspondence between individuals' strategies (micro-rationality) and societal consistency (macro-stability) lie down on the values of society. Cognitive-dissonance-based flawed institutional evolution led to financial liberalization and regulatory privatization that resulted in degenerated financial markets and provoked the 2007-2008 crisis. This systemic catastrophe clearly illustrates how much the liberal financial

doctrine/values are spurious and must be abandoned in favor of alternative and systemically consistent models.

With regard to the crucial final aim, Minsky announces: “The final aim is to “develop a theory explaining why our economy fluctuates, showing that the instability and incoherence exhibited from time to time is related to the development of fragile financial structures that occur normally within capitalist economies in the course of financing capital asset ownership and investment.” (Minsky, 1986: 112)

Institutionalism is one of the most relevant approaches for such an alternative theory/policy to ensure a macro-stable working of capitalism in the name of societal welfare and social progress.

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