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Ethics in the Time of Financial Capitalism

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Abstract: The 2007/8 financial crisis revealed fragilities in the international banking system. The degeneration of financial instruments and products signal the failure of current regulations to maintain stability in the financial systems of developed economies. This article first presents Minsky's theory, which argues capitalism is endogenously unstable. Second, it examines the evolution of management incentive schemes demonstrating how they no longer accomplish their functions of reducing moral hazard and transaction costs. To establish a bond between finance and ethics, this paper proposes the implementation of two sources of ethics: extrinsic public regulations and intrinsic moral auto-regulation.

Introduction

The financial crisis revealed the fragility of the capitalistic system. This article returns to theoretical basics to examine the role of ethics in capitalism's foundations observing that capitalism, as practiced today, is in need of an infusion of ethics. Two potential sources for ethics are proposed, one extrinsic and one intrinsic: public regulations controlling the financial sector, and moral auto-regulation amongst bankers and traders.

Keynesian theorists argue market disequilibrium is the result of a failure of aggregate demand. The Marxist approach instead claims a cyclical crisis is perpetuated by the contradiction between the development of productive forces and the relationships of production. The degeneration of the financial system, however, encourages us to contemplate the recent economic crisis and its roots. Sapelli (2011) talks about "financial nihilism" to explain worldwide contemporary economics, in which banks are more sales entities than lenders.

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The descent of the financial sector can be traced back to the 1990s, when great liquidity started flowing to finance instead of the real economy. Another crucial moment was in 1989, when the Stock Exchange Commission (SEC) allowed banks to produce derivative financial instruments, transforming banks from enterprises, which gained profits by lending, to supermarkets hawking financial products.

"*E' saltato il nesso fra economia e morale. L'economia, anche se appare come un universo reificato, è frutto di infinite scelte di comportamento personale* (The link between the economy and morality is broken. The economy, even if it appears as a reified universe, is led by endless personal behaviors)" (Sapelli 2011, p. 14). This paper explores the link between morality and the financial crisis through (i) Minsky's theory and (ii) the evolution of manager's incentive schemes. Flanders (2015) argues, "It is not a Minsky moment, it's a Minsky era, or: inevitable instability." The first section presents Minsky's theoretical approach. Financial fragility is not due to endogenous instability, as neoclassical thinkers propound. Instead, the weakness is due to (i) inadequate institutional regulations and (ii) money manager capitalism. The second section demonstrates the degeneration of the manager stock options system. Employee stock option schemes originated to mitigate moral hazard and opportunistic behaviours. However, these days the character of incentives takes a different form. Current stock option incentives encourage managers to look for short-term profits rather than long-term prospects.

Our economic system suffers under the tyranny of stock market capitalism. Financial actors and entrepreneurs are not judged by their ability to generate national wealth or jobs. Performance is judged by trends of companies' stock prices. Financial markets have lost their moral auto-regulation, devolving into systems without ethical brakes. Finance is not inherently evil. Whether finance is good or bad depends on human agency. As Levy says "the purpose of an economy is to produce consumer goods and services efficiently and to distribute them in accordance with some principle of fairness" (Levy 1984, p 14). To escape the era of financial alchemy, as Mervyn King (2016), former governor of the Bank of England, labels current financial practice, we need to re-establish a bond between ethics and finance. Implementation should combine public and auto-moral regulations. The former implies (i) re-enabling a legal separation between commercial and investment banks and (ii) limiting the power of what Marx called, the financial aristocracy. The latter suggests the need for self-enforcing moral constraints.

Section I: Minsky's Theory of Financial Degeneration

Paraphrasing Marx, financial capitalism contains the seeds of its own destruction. Our economic system was close to collapse after the 2007/8 financial crisis as the spectre of a new Great Depression terrified the public.

Yet, nearing its ten-year mark, politicians and economists still struggle to tackle economic recession, unemployment, and financial instability. The global elite promised to install strong mechanisms to prevent or halt financial speculation. Swarup (2014) titled his book on the financial crisis, *Money Mania* because it was the mad lust for money that caused the great calamity. Sadly, little has been done to reduce opportunism and unethical behaviour in finance. Speculative finance is still pulling the world economy along.

Orthodox economic theories work with "equilibrium models," which means the models assume a market economy as fundamentally stable and economic crises are caused by exogenous factors. In contrast, Minsky argues that capitalism, due to its very nature, tends toward instability. Financial services do not seek production of physical outputs. Their aim is to accumulate monetary wealth through revenues from financial speculation. Money manager capitalism underestimates risks, creating a high level of liquidity in the stock market with the goal of maximum total returns. Financial services have three different financial structures that depend on the ratio of future cash flows to liabilities: (i) units with covered finance – the ratio is always non-negative; (ii) units with speculative products – when institutions are sometimes unable to cover their current liabilities; (iii) units with Ponzi products – in which units bet on positive variations in the market.

Walter Bagehot (1987) wrote "The peculiar essence of our financial system is an unprecedented trust between man and man…and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it." The logic of exchanging present money for future money dominates the financial capitalistic economy. According to Minsky, economic actors, households, entrepreneurs, banks and states, establish financial relationships. In the current capitalistic system, the relationship between banks and entrepreneurs plays a dominant role. The allocation for investments and for funding of production depends on expectations: first, what entrepreneurs expect from available loans from banks; and second, expectations bankers have about their clients' solvency. Economic trends are determined by how these expectations bear out.

Minsky states that in times of economic success, financial actors forget the possibility of failure such that borrowers and lenders tend to take higher risks in investing. His celebrated line is that "stability is destabilizing." In a euphoric environment, speculative borrowers, described as "those whose income would cover interest payments but not the principal", gain power. The overall economic system becomes fragile because its economic players depend on borrowed money and freely available credit instead of solid business plans. In this context, the failure of a firm or a crisis of trust can cause a collapse of the entire economic structure. At first, speculators and Ponzi borrowers will lose access to credit, essential for their survival. Then, even sound economic actors will need to sell their assets in order to repay debts. The entire economy will suffer the consequences of the now-collapsing financial system. Minsky's "Financial Instability Hypothesis" describes an inexorable cycle. Capitalism is not a force of stabilization but "it is a system that created the illusion of stability while simultaneously creating the conditions for an inevitable and dramatic collapse" (Minsky 1978, 1982 and 1995).

Minsky's theory may sound pessimistic but it is not fatalist. He believes the degeneration of financial capitalism is controllable. As Cicero said, "*Historia magistra vitae. (History is Life's Teacher)*" We can learn from the past. Minsky observes the New Deal reduced uncertainty and provided a more solid financial environment. To tackle the 1929 financial crisis, the US government enabled "a structure of regulation of and intervention in financial practices which provides a spectrum of lender of last resort protections" (Minsky 1982 p. viii). Indeed, governments can intervene to stabilize a financial crisis by: (i) refinancing firms that are at the core of the crisis, and (ii) holding aggregate demand of business profits stable. Therefore, capitalism's process of degeneration can be contained by (i) imposing regulations which "prevent the need for units to make positions by selling out positions" (ii) making public interventions to sustain aggregate cash flows, and (iii) providing a transparent legal framework. We need to "definancialize" the economy (Minsky 1982 p. 8).

In particular, Minsky studies US history and how the financial sector evolved in the 20th century. After World War II, an economy based on the pursuit of pure profits found an institutional environment unable to regulate and supervise its growing excesses. In 1999, the US government decided to give up the functional separation, enabled after the Great Depression, between commercial banks and other financial institutions. The consequence was to allow banks to use credit belonging to households to invest in highly risky products. Minsky argues "the aim of policy is to assure that the economic prerequisites for sustaining the civil and civilized standards of an open liberal society exists. If amplified uncertainty and extremes in income maldistribution and social inequalities attenuate the economic underpinnings of democracy, then the market behaviour that creates these conditions has to be constrained" (Minsky 1996, p. 3).

Section II: Money Manager Capitalism and Stock Option Schemes

Management incentive schemes are an instrument to reduce transaction costs resulting from moral hazard and opportunistic behaviours. An asymmetry of information exists between managers and owners of assets, *e.g.*, shareholders. In aligning corporate performance to executive board performance, companies are trying to solve two basic problems: (i) "the creation of incentives for efficient behaviour among its members" and (ii) "the efficient allocation among those members of the resources available to and produced by the organizations" (Segal and Whinston, 2010 p.2). Currently, top corporate executives do not earn their income through wages alone. A significant portion of income consists of stock options and performance based bonuses. Theoretically, management incentive schemes compel managers to optimize their companies' performance. However, the incentives may either be counterproductive or useful, depending on the allocation mechanisms.

Pierre du Pont, who was President of General Motors during the 1920s, first developed management incentive schemes. Comparing the original schemes with the current system of employee stock options, it is easy to understand why this instrument degenerated. Modern incentive schemes are criticized for several reasons. First, stock options are bound to the short-term performance of a business, encouraging short-term perspectives. Second, managers are tempted to take higher risks to maximize their gains from stock ownership. Third, the value of options to managers may be far less than the cost of such options to the company. Finally, stock price fluctuations are highly correlated to general stock market trends. Indeed, managers gain or lose income due to factors unrelated to their companies' performance (Holden 2005).

According to Holden, du Pont developed a system of executive incentives in 1909. The system had two types of bonuses: (a) non-performance-based bonuses for non-executive employees and (b) performance-based bonuses for executive managers. Both forms of bonuses consisted of cash that had to be invested in company stock. The scheme was improved in 1927. It became a systematic executive incentive scheme: "common stock of the company have been sold from time to time to such eligible employees, the company receiving in payment interest-bearing notes running from seven to ten years, with the stock so purchased deposited as security for the payment of the notes" (Holden 2005, p. 138). Simply put, managers borrowed money from the company in order to buy common stocks at market value. This structure of incentive compensation combines effects on awards from long-term performance of the company and stock price trends, reducing moral hazard.

Today, it is commonly held that managers should have their compensation linked to the company's performance. Since the financial crisis, the public has been alarmed by the startling size of many managers' undeserved bonuses. Even when banks recorded negative performance, top executives kept bonuses in the form of stock options. Current stock option schemes have two basic differences from du Pont's system. First, the failure to link performance and awards breaks the positive virtue of stock option schemes. Second, the gap between top managers' income and the average workers' income is scaling a peak in social and economic inequality that is unsustainable. According to the Economic Policy Institute, the average wage of CEOs of the 350 biggest companies in the US rocketed up by 997% between 1978 and 2014. The wage gap between average employees and CEOs increased from 1:30 to more than 1:300.

Wray (2011) suggests four developments that led to the 2008 financial crisis. Three of them may be linked to the evolution of managers' roles. The first development is measuring managers' performance on the basis of price appreciation and total return. Managers excelled in taking risks for higher returns. The second was the growth of hedge funds, pension funds, sovereign wealth funds and insurance savings managed by money managers. Third was the increasing hazard of creative financial products. Managers at financial services firms encouraged their brokers to sell speculative and deceptive financial options to raise profits.

Minsky rightly observes "The total return on the portfolio is the only criteria [sic] used for judging the performance of the managers of these funds, which translates into an emphasis upon the bottom line in the management of business organizations. It makes the long view a luxury that only companies that are essentially owned by a single individual and that are not deeply dependent upon external financing can afford." (Minsky 1996 p.358-359) In other words, the logic of profits at any cost destroyed moral auto regulation in financial activities.

The Du Pont Scheme

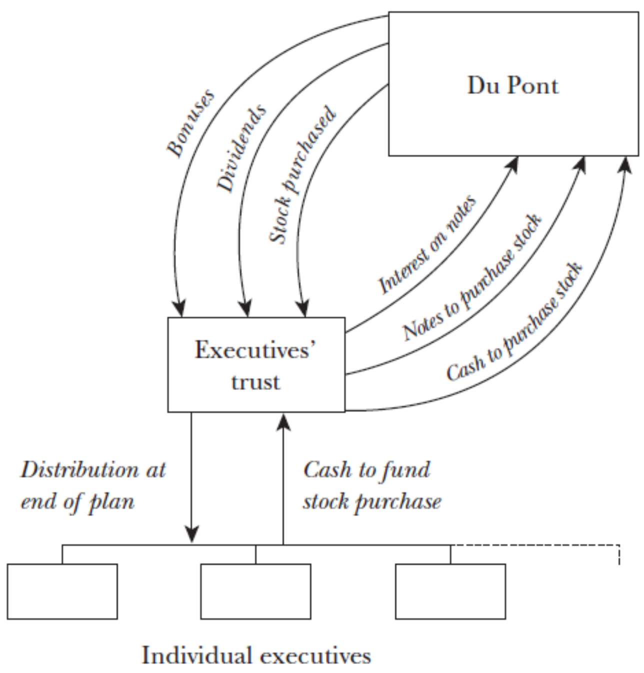

Figure 1: The Du Pont Scheme (Holden 2005 p. 139)

Conclusion

Minsky argues money and finance change economic systems. "The monetary system is at the centre of the debt creation and repayment mechanism. Money is created as banks lend – mainly to business – and money is destroyed as borrowers fulfil their payment commitment to banks. Money is created in response to businessmen's and bankers' views about prospective profits and money is destroyed as profits are realized" (Minsky 1996 p.11). Capitalism is far from being a force of stabilization. On the contrary, a predetermined and inexorable cycle is natural as borrowers and lenders lose sight of risk when the economy is going well and expectations are satisfied. In such environments, Ponzi borrowers and speculative financial products arise, rendering the economic system fragile. Volatility and mistrust are the seeds of financial capitalism's auto-destruction.

Minsky's core question, "Can it [The Great Depression] happen again?" has a clear answer. Yes, it happened in the past. Yes, it is happening in the present. And, yes, it will happen in the future. But great recessions or depressions need not happen. Our system requires two levels of regulation to avoid its own ruin. First, public regulations should limit banks' speculative but unproductive activities. Second, moral self-regulation should ensure bankers avoid hazardous and opportunistic behaviours.

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