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## **From real capitalism to finance capitalism and (hopefully) back – the role of the navigation map**

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### **Real capitalism and finance capitalism**

There exist three types of participation in the production process, labour, real capital and finance capital, and, hence, three types of interests (table 1). The “purely” economic interests of real and finance capital stay in direct conflict with one another. High profitability of real investments call for low interest rates and exchange rates, and for stable financial markets, by contrast, financial speculation profits from exactly the opposite conditions. Even though the interests of real capital and labour are different as regards the distribution of income, both factors have a common interest in generating a high overall income and, hence, in a strong and stable production growth.

One cannot identify “classes” of “real capitalists” and “finance capitalists” in modern society: Non-financial corporations as well as employees own financial assets and have therefore also finance capital interests. It depends on the framework conditions of the system if striving for profit concentrates on investment and innovation in the real sphere or in the financial sphere. In the first case, real capitalism prevails, in the second case finance capitalism (table 2).

Real capitalism consists of many conditions which complement each other like a (tacit) coalition between the interests of labour and real capital (against the interests of finance capital). As a consequence, industrial relations are shaped by close cooperation (“social partnership”). Market and government, competition and cooperation are regarded as complementary.

During real-capitalistic periods (e. g., ~1890 to 1914; ~1950 to the mid-1970s; China since the early 1980s) those economic theories dominate or are at least influential which underline the crisis-prone nature of capitalism (Marxian or Keynesian theories). These theories legitimize a strong government, an active economic policy and market regulations. Stable exchange rates and low interest rates focus striving for profits on the real economy (figures 1 and 2).

The ideological basis of finance capitalism is provided by (neo)liberal theories which call for liberalizing financial markets, for weakening the welfare state and for breaking the “monopoly power of unions”. These theories (“navigation maps”) legitimate a (tacit) coalition between the interests of real and finance capital against the interests of labour. These theories become popular among entrepreneurs in reaction to the political developments

during the preceding real-capitalistic period: Persistent full employment shifts power from business to trade unions and from conservative to social-democratic parties (as over the 1960s – figure 1). In this sense, the success of real capitalism lays the ground for its fall.

Under a finance-capitalistic regime, the volatility of exchange rates and commodities prices as well the high level of interest rates (figures 1 to 5) dampen the activities of non-financial business in the real sphere of the economy and make financial speculation and accumulation more attractive.

The weak growth of real investment causes unemployment and the public debt to rise which in turn strengthens the game "let your money work". The discrepancy between the market value of financial assets and their underlying in the real economy widens during "bull markets" more and more, it is "corrected" in the subsequent "bear markets". If several "bear markets" coincide as 2007/09 (figure 5) or 1929/33, the related wealth devaluation leads into a deep crisis and, consequently, into the process of self-destruction of finance capitalism.

### **The two key problems: Unemployment and public indebtedness**

The dynamics of job creation depends on the dynamics of real capital accumulation and of technical progress. The latter is to a large extent the result of (basic) innovations stemming from the "world of engineers" (interacting with the economic system). The dynamics of real capital accumulation depends primarily on the (expected) profitability of activities in the goods markets as compared to those in the financial markets. Hence, real-capitalistic conditions foster the process of job creation, finance-capitalistic conditions dampen it.

Hence, the essence of persistent unemployment can be sketched by analogy to the musical chair game: There are 100 chairs, 110 people want to get one, and those persons who do not get a chair are the least qualified. If they are (re)qualified they might get a chair in the next rounds, yet, at the expense of others.

From this perspective, high unemployment and persistent unemployment is due to a shortage of jobs. To overcome the problem, job creation must become less risky and more profitable for entrepreneurs. This calls for real-capitalistic framework conditions. Lower wages can't do the job.

The ratio of public debt to GDP was declining in (Western) Europe for 20 years from 70% to 40% when the welfare state was strongly built up, and it has been rising to almost 90% since the late 1970s in spite of consolidation efforts (figure 1). These developments cast doubt on the mainstream belief that the government has control over its fiscal stance, independent of the macroeconomic conditions.

From a systemic perspective one has to analyse the interaction between the financial balances of all sectors of an economy. If, e.g., the business sector reduces its deficit in a recession then the government suffers from a rising deficit due to the operation of the automatic stabilizers. If the business sector increases its deficit again for financing real

investments, then the government can easily improve on its balance during the recovery (figure 6). The recession in Germany in 1967 and the subsequent recovery are a good example (figure 6).

Over the medium and long run these conditions ensure that the business sector takes over household saving in the form of investment credits and transforms it into real capital and jobs (figure 7). As a consequence, the government's budget remains in balance and the debt-to-GDP ratio declines since the rate of interest lies below the rate of economic growth (figure 1).

Finance-capitalistic conditions change the dynamics of debts/assets in three respects. First, recessions occur more frequently than in a real-capitalistic regime. Second, recoveries become progressively weaker as financial instability dampens real investments. Third, the rate of interest is higher than the rate of growth.

Hence, finance-capitalistic conditions inevitably lead to a fundamental inconsistency between the (planned) financial balances and creditor/debtor positions of the different sectors. This conclusion is in line with the empirical evidence. Since the 1970s, the incentive conditions induced non-financial business to reduce its deficit and to become a surplus sector in the 2000s (figure 6).

In other words: Real investments were reduced in favour of financial investments, the stock of real assets has been declining relative to value added whereas the accumulation of financial assets has risen dramatically (figure 7). As a consequence, job creation and economic growth has slowed down, unemployment rose so that even stability-oriented countries like Germany have been running persistent budget deficits (figure 6). Given the positive interest-growth-differential, the public debt-to-GDP ratio has risen steadily (figure 1).

## **A New Deal for Europe**

The transition from "finance-capitalistic" to "real-capitalistic" framework conditions usually takes many depressive years as governance according to the old navigation map makes things only worse. Such a transition phase calls for a New Deal which changes the direction of the course even without guidance by a new theory.

A similar challenge was met after WW II (and in part already earlier through Roosevelt's New Deal): By learning the lessons from the Great Depression, economists and politicians were able to design new framework conditions which formed the basis for the "golden age of capitalism". Why shouldn't we be able to learn the lessons before a depression takes place?

The most urgent challenge concerns the euro crisis. It can only be overcome if interest rates in all euro countries are stabilized at a sustainable level. To this end, the ESM should be transformed into the European Monetary Fund (EMF). Its scope is fourfold (*Schulmeister, 2013*):

- The EMF provides euro governments with financial means by selling Eurobonds in the capital markets and by offering to deposit money at a Euro-Account at the EMF. Both types of liabilities of the EMF are guaranteed by all euro countries to an unlimited extent.

- The EMF stabilizes Eurobond interest rates at a level below the level of medium-term economic growth (in nominal terms).
- The EMF provides funds for the euro states according to clear criteria ("conditionality") which are not exclusively restrictive.
- The EMF overcomes the split between euro countries caused by widening interest rate differentials and strengthens thereby the cohesion and credibility of the EMU.

Real-capitalistic incentive conditions, also call for stable exchange rates. As a first step, the central banks of the US, the euro area, Japan and China should commit themselves to stabilize their exchange rates within tight target zones (taking the Swiss National Bank as example.....).

As regards crude oil prices (and all other fossil combustibles), one has to take into account two peculiarities. First, crude oil is an exhaustible resource. Second, the use of crude oil is the most important cause of climate change. Economic theory suggests therefore that oil prices should become permanently more expensive than all other goods. In reality, however, the wide fluctuations of crude oil prices bring about a waste of this resource, a deterioration of the environment and hamper investment in energy saving technologies.

To give a concrete example: OECD studies conclude that the price of greenhouse gas emissions should rise to 370€ per ton CO<sub>2-eq</sub> if the increase in climate temperature is to be restricted to 2°C. These additional costs would translate into an oil price for users of 248\$. If this target is to be reached by 2020, the oil price needs to rise by roughly 12% per year. Such a stable and reliable price development could be brought about in the EU by introducing a flexible tax which amounts to the difference between the world market price and the target price according to the long-term price path. It might trigger a wave of investments in energy saving, from isolation of buildings to new forms of mobility.

A New Deal for Europe should include many other components, in particular as regards the additional regulations of financial markets/actors and public investments in infrastructure, education and environment. As I have already written more than 1500 words, I stop here and can only refer to an paper on the need of a new "navigation map" (*Schulmeister, 2012*) and to a book on the New Deal for Europe (*Schulmeister, 2010*).

## References

Schulmeister, S. (2010), *Mitten in der großen Krise – ein ‚New Deal‘ für Europa*, Picus Verlag, Wien, 2010.

Schulmeister, S. (2012), *European Governance – Do We Need a New Navigation Map?* Download: [http://stephan.schulmeister.wifo.ac.at/fileadmin/homepage\\_schulmeister/files/Navigation\\_Map\\_WP\\_07\\_12\\_A.pdf](http://stephan.schulmeister.wifo.ac.at/fileadmin/homepage_schulmeister/files/Navigation_Map_WP_07_12_A.pdf)

Schulmeister, S.(2012), „The European Monetary Fund – A systemic problem needs a systemic solution“, *Revue de l'OFCE, Débats et politiques*, 127, 2013. Download: <http://www.ofce.sciences-po.fr/pdf/revue/127/revue-127.pdf>

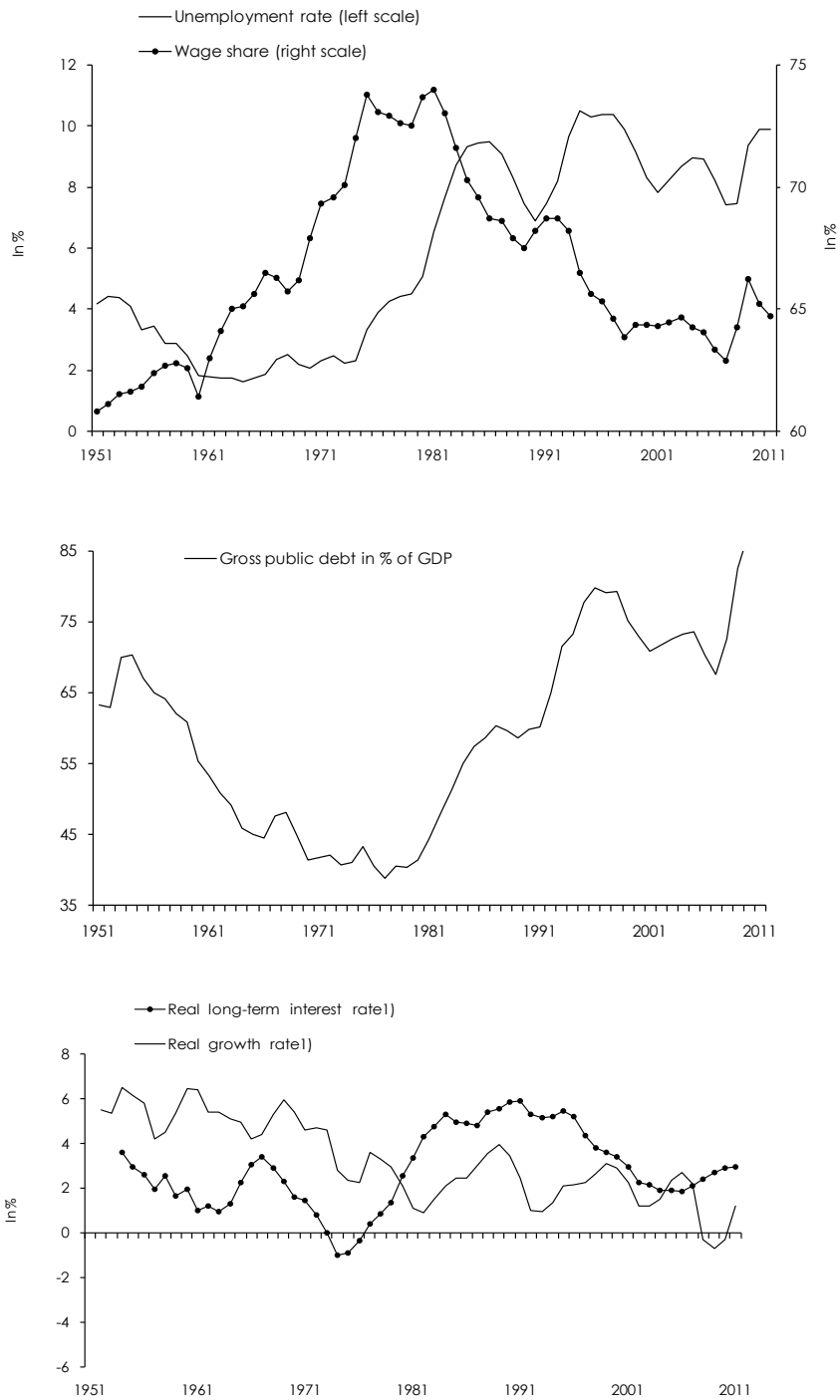
Table 1: Labour, real capital, finance capital

	<b>Labour</b>	<b>Real Capital</b>	<b>Finance Capital</b>
Economic interests	Full employment Real wage increases	High Profitability of real investments: - Low interest rates - Low exchange rates - Stable financial markets	High profitability of financial investments: - High interest rates - High exchange rates - Unstable financial markets
Conflicts of interests	Rising wages	←-----→	Rising interest rates
Potential coalition partners	Real capital	Labor or finance capital	Real capital
Economic interest in state/government	Full employment policy Social security Education Public services	Anticyclical policy Growth policy: Infrastructure Education, etc.	Strong central bank Restrictive monetary policy Privatisation of social security
Political interests	Strong welfare state Strong trade unions	Weak welfare state Weak trade unions	No welfare state No trade unions

Table 2: Real capitalism and finance capitalism

	<b>Real capitalism</b>	<b>Finance capitalism</b>
Implicit coalition	Labour & real capital	Real capital & finance capital
Business/unions	Corporatism	Conflict
State/market	Complementary	Antagonistic
Targets of economic policy	Many: From full employment, high growth to social security and „fair“ distribution	Price stability, „sound“ public finances, regulation of policy, de-regulation of markets
„Power center“ of economic policy	Government	Central bank
Economic paradigm	Keynesianism	Monetarism/Neoliberalism
Diagnosis/Therapy	Systemic	Symptom-oriented
Financial conditions	Interest rate < growth rate, „calm“ stock markets, stable exchange rates and commodities prices	Interest rate > growth rate, boom und bust on stock markets, unstable exchange rates and commodities prices
Striving for profits focuses on	Real economy (Positive-sum game)	Finance economy (Zero-sum game)
Economic model	Social and regulated market economy	„Pure“ market economy
Technical/social innovations	Coherence	Incoherence
General objectives of policy	Equality of chances, free development of the individual, social coherence	The individual as architect of his/her own fortune

Figure 1: Long-term economic development in Western Europe



<sup>1</sup>) 3-years moving average.

Figure 2: Dollar exchange rates and global economic growth

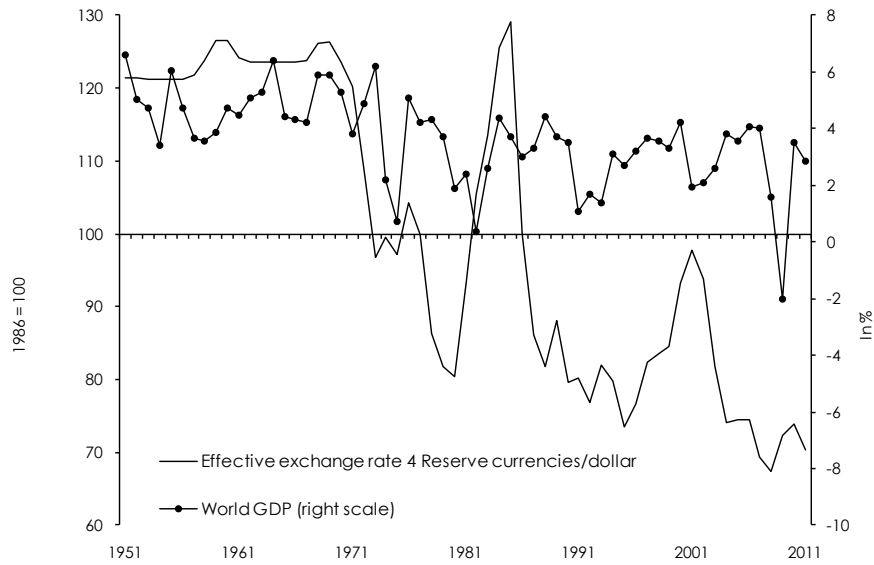


Figure 3: Financial transactions in the world economy

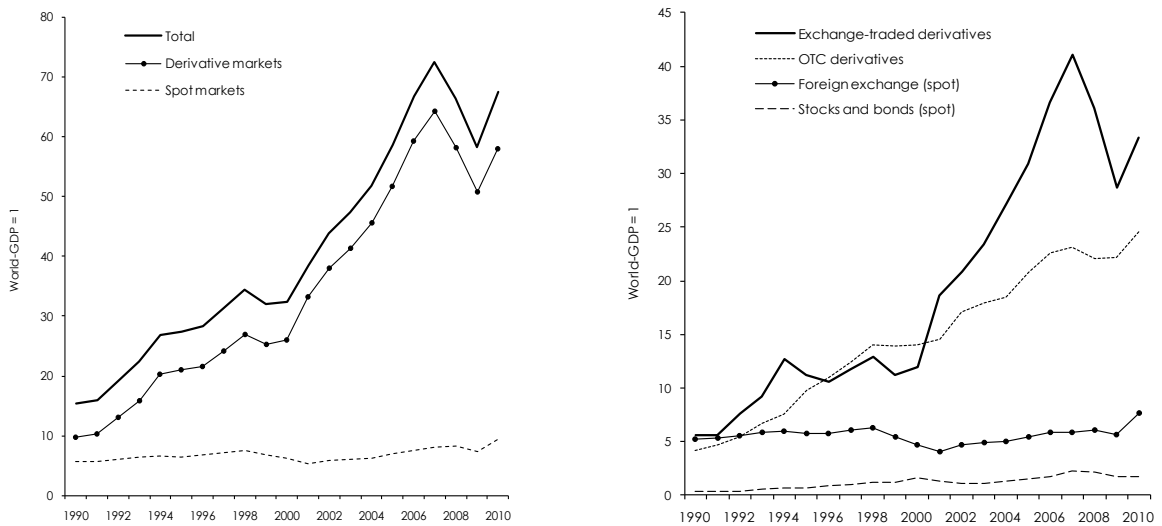


Figure 4a: Asset price dynamics

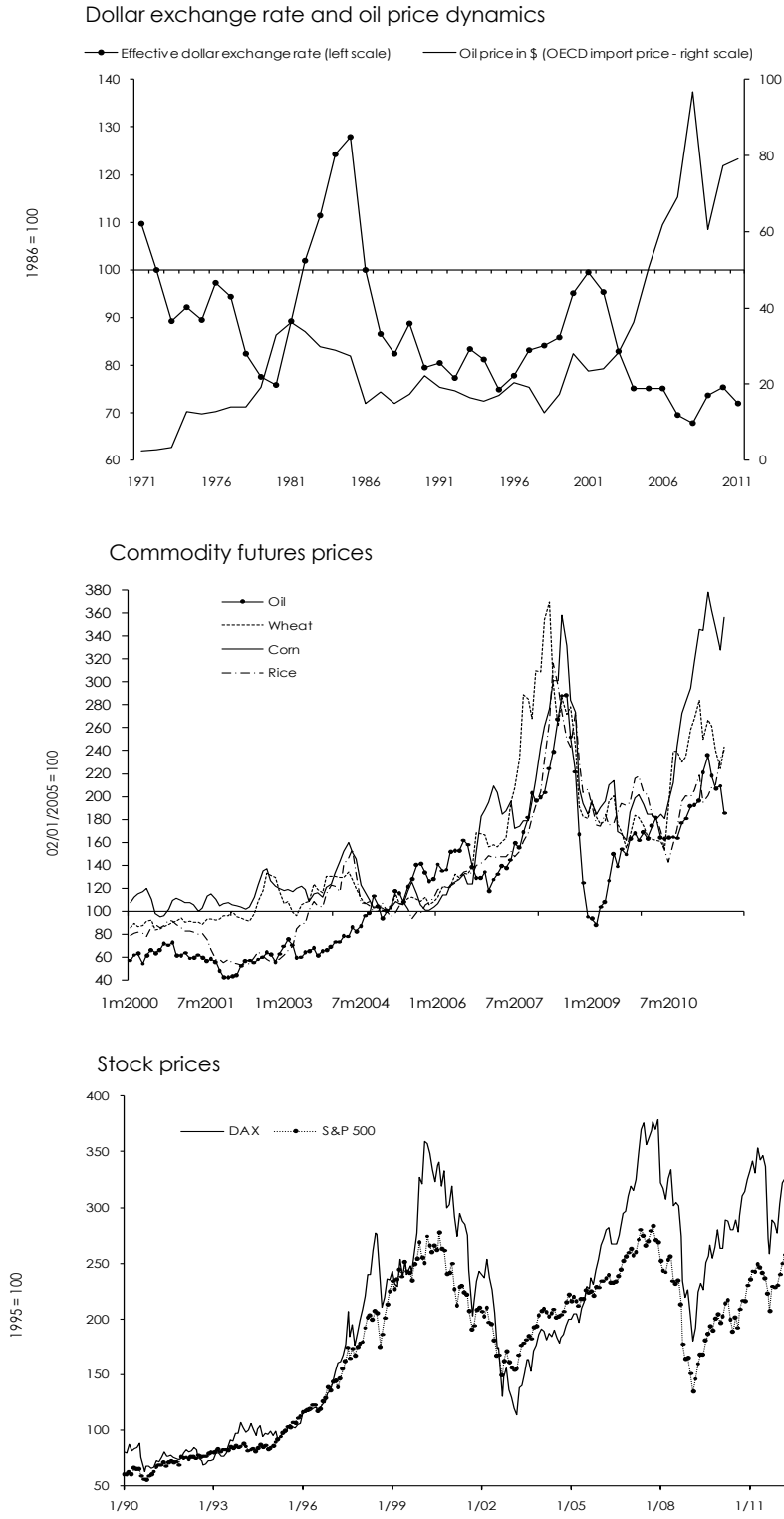


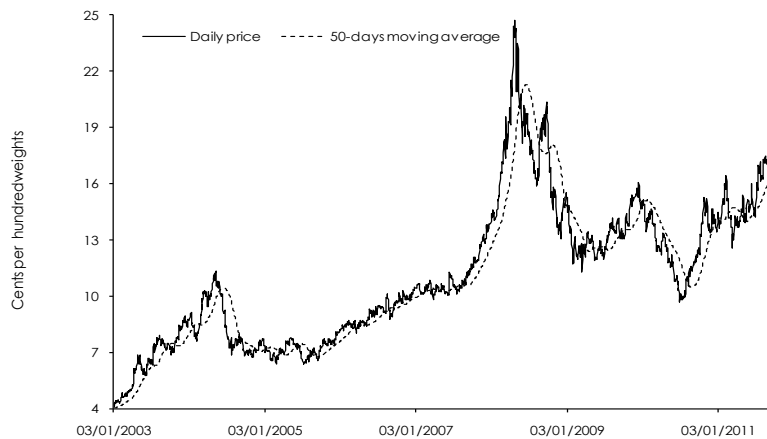


Figure 4b: Asset price dynamics

Daily US dollar/euro exchange rate



Trading systems for rice futures



Italy

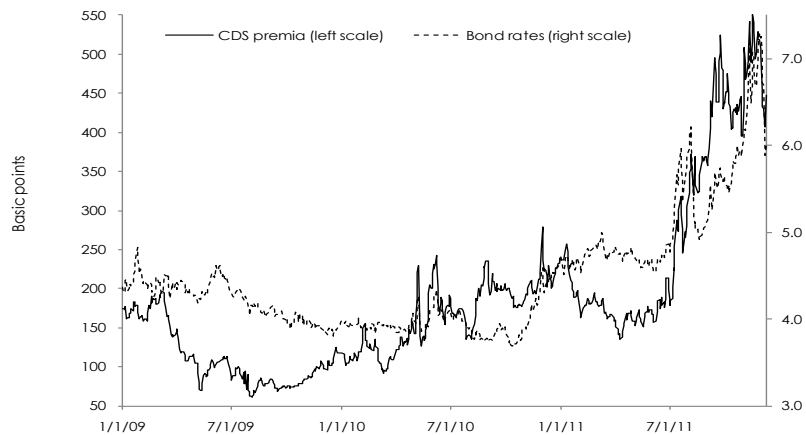


Figure 5: Asset price dynamics

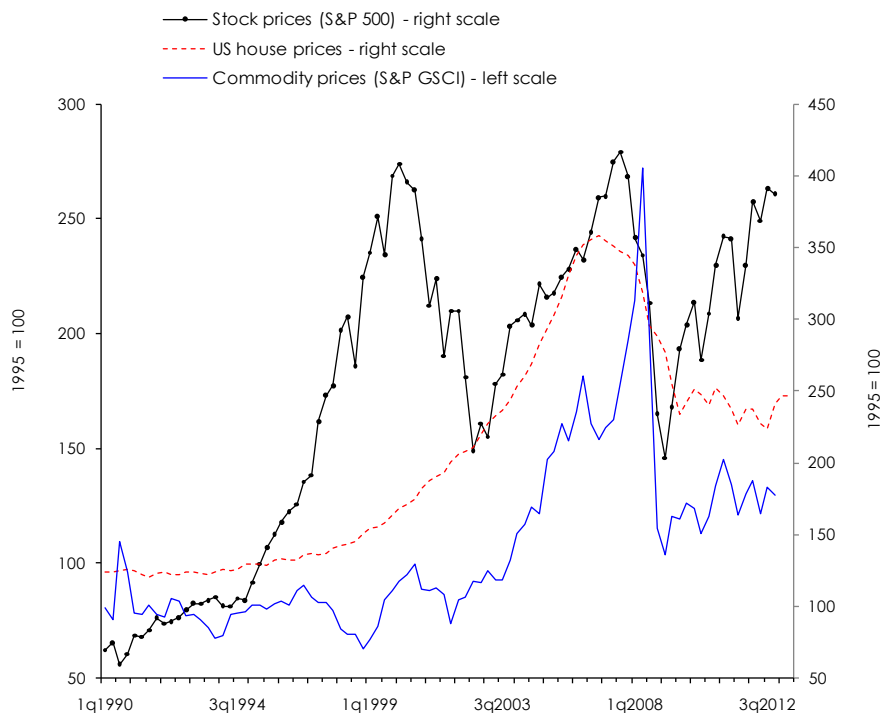
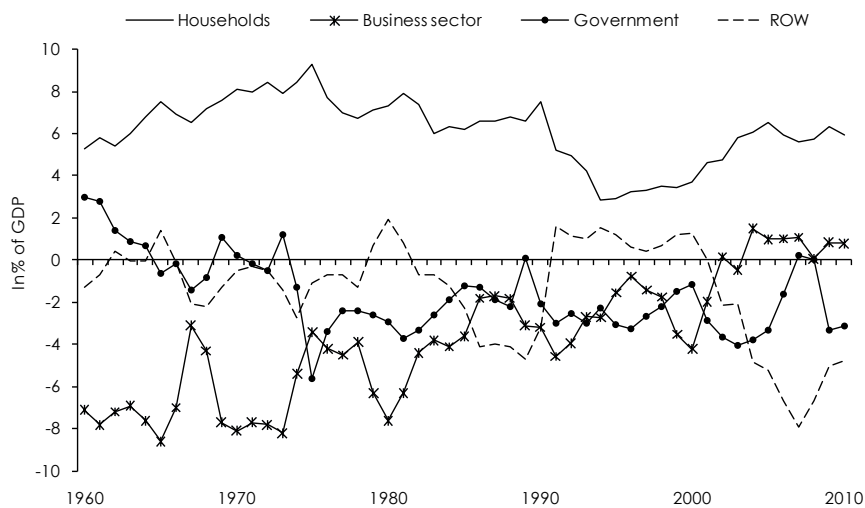


Figure 6: Financial balances in Germany



Source: Deutsche Bundesbank (corrected for unwinding the "Treuhandaustalt" in 1995 and for proceeds of the UMTS licence auction in 2000).

Figure 7: Real and financial accumulation of non-financial business in Germany

