

BOOK REVIEW

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Paul H. Dembinski, Finance: Servant or Deceiver? Financialization at the Crossroads, Observatoire de la Finance 2009, Palgrave Macmillan ISBN -13:978-0-230-22037-9.

Paul H Dembinski has produced a profound book on finance and the financial system that should be used at all business schools in the western world. He is a finance research scholar, able to think out of the box using a multidisciplinary approach with a keen eye ‘for history and society at large’. His well-timed book thoroughly decomposes the financialization of our modern society by providing an historical review and new perspectives and insights. The book consists of three parts, respectively representing the past, the present and the potential future of finance. The first part is an in-depth description of the historical development of money and the financial system, including all relevant players. The title of this part, ‘The Financial Iceberg’, shrewdly points out a hardly recognized and underestimated danger in our current economic process. The second part of the book deals with the actual transformation process, and, more specifically, the way in which financialization is permeating and taking control of various aspects of the economy and society thus imposing a new pattern on them. It examines the processes that have enabled the expansion of the financial process at the expense of other organizing principles, in other words, the mechanisms that have created the financial iceberg. The third part looks to the future and asks the impossible question, ‘What kind of society do we want?’ By analyzing the limits of the financialization process itself and the limits inherent in human nature, Dembinski ends his challenging book by encouraging long term relationships, promoting change in the current system of remuneration, and by warning us of the dangers involved in accumulating money. The book clearly promotes a virtue ethical approach to changing the financial system by emphasizing the role of frugality and prudence instead of individualism and greed. In this bottom-up approach, there is no explicit role for financial supervision and government intervention to improve the current system. In other words, the role of ethics in finance is a decidedly challenged one.

The birth of the financial iceberg

Let us examine each part of the book in more depth and first take a closer look at the analysis of the historical development of finance, its players, its institutions and the efficiency ethos as its financial world view (part I). Crucial in the history of economics - and the core subject of the book - is how to cope with the role of money. Referring to a classical book on money by Simmel¹ Dembinski considers two elements to be the essence of money through time and space (p.28). Firstly, the essential function of money is to establish exchange relations between objects, and thus between subjects or institutions that exchange objects for the sake of the economic process. Second, money did not necessarily need a substance through which to perform this function – it could simply be a sign. Dembinski then concludes that two complementary aspects of what enabled money to function could be identified: a) its form, and b) the social institution within which it circulated and which helped to give it meaning. These two ‘dual anchors of trust in money’ are the basis of Dembinski’s historical analysis in finance.

¹ Simmel, 1978, *The Philosophy of Money*, Routledge, London, ISBN 0 7100 8874 4.

The philosophical approach to money as simply a sign did not strike Simmel as realistic, since substanceless money was barely conceivable under the technical conditions that prevailed at that time (the early 20th century). Nowadays, the concept of substanceless money is probably even less plausible. The dematerialization of money and its confinement to impermeable technological areas changed the very nature of the payment system. Dembinski's historical analysis departs from the Bretton Woods institutional approach, which was set up in the first part of the last century to prevent a second Great Depression on a scale matching the one in the 1930s. Dembinski argues that the US dollar became an international means of exchange and a reserve currency. From the 1960s onwards, commercial banks introduced a radical financial innovation called Eurodollars (dollars kept by institutions outside the US) and later Eurocurrency. Together with the ICT euphoria of the late 20th century, the form of money changed from a relatively homogeneous good into a very heterogeneous entity. Due to the developments in worldwide interbank financial telecommunication (SWIFT), international financial markets developed rapidly. As a result of many innovations, for example in the derivatives markets and the securitization of interest products, liquidity in the financial markets increased drastically and encouraged the financial sector to develop even more new products to generate arbitrage profits. Considering the former process, it is concluded that the form of money changed drastically from a homogeneous production factor to a heterogeneous profit maker towards the end of the 20th century.

Another drastic change was the form of the social institutions within which the changing role of finance took place. Building on markets such as the trust building mechanism of our modern economic process, its role and performance is crucial in facilitating the inherent participants and institutions. Today's markets are dominated by mega players. The prosperity of the late twentieth century enabled western society, and households in particular, to save a great deal of money. These savings were increasingly channelled into specialized financial institutions, burdening the financial system with an unprecedented mission: to maintain value in a relatively liquid form and to make most of the world's savings yield a return. Pension funds, insurance companies, state investment funds and major banks are the main backbone of the 'savings silos'. The inherent asset management deserves a special mention. The total worldwide assets involved are a multiple of the world product (see the expansion of the 'saving silos'; figure 1.2; p.45). Asset management used to be the prerogative of the Swiss private banks. However, with the growth of worldwide financial reserves, all the major banks became involved in private banking and asset management. While bankers used to make their money from the interest margin, the tendency over recent decades has been for lending to move out of the traditional banking sector and be taken over by specialized financial players. Risk management fees and investment banking have become substantial elements of banking income. Then there is the influence of public deficits and the way they are financed. Dembinski shows (p.52) that the net financial commitments of governments in OECD countries increased from 20% of GDP in 1981 to 43% in 2006. Despite the Maastricht criteria and the stability pact rules for public debt, the increasing public deficits are creating more and more public debt and in this way burdening future generations of taxpayers with increasing future interest payments. The 2008-09 banking crisis caused this process to deteriorate even further. Although the financial iceberg shrank drastically during this crisis, we saw taxpayers getting more involved in the financial markets through inevitable bank intervention. Governments are obviously the best rated institutions; the question, however, is how long such a situation can last. If we realize once more that debt should be repaid and interest must be paid, the question will arise as to whether there will be enough successful direct investments projects to generate the necessary cash for the required interest payments in the near and longer-term future. The claim of modern finance that it is able to control financial risk proved misleading

during the last crisis. This section concludes that the changing form and culture of the financial institutions encouraged risk taking rather than sustainable development.

The actual transformation process

The crux of financial activity is the relationship between two supposedly autonomous parties, one of which has temporally idle liquidity while the other has a plan to make use of it. Two problems are raised: the problem of trust and the problem of remuneration. Dembinski argues that transactions used to be the by-product of relationships, whereas today the reverse is true. Many anonymous transactions are made at the cost of relationships. The securitization of financial products in particular is causing an alienation of human relationships in the virtual financial world as represented by dealers such as Kerviel and Leeson. Dembinski's methodology of a 'multi-model causation framework' refers to Aristotle, who argues that a cause is not what transforms A into B, as is the dominant perception of causality. From an Aristotelian perspective, there is no antecedence between A (the cause) and B (the effect); they are both part of the same transformation – the process itself. In the Aristotelian tradition, the material mode of causation is an objective fact and a kind of raw material out of which the new reality arises. In the case of the transformation process of financial markets, Dembinski argues convincingly that the bank-based economy has changed into a financial market model that undermines the neutral, intermediary role of finance. Figure 2.3 of the book, for example, shows that the stock-market growth in terms of capitalization per GDP in Switzerland increased from approximately 130% in 1995 to 260% in 2005, and that the volume of financial transactions per GDP increased from 100% to 240% in that same period. In that ranking, Switzerland appears to have the highest relative capitalization and transactions volume of OECD countries before the United Kingdom and the United States. Countries like Spain and Italy also showed a stunning increase in relative financial transactions volume and capitalization of their economies in that 10 year period. Together with the impressive increase in derivatives traded on organized markets and over the counter (resp. from 5% to 113% and 5% to 460% of GDP in the 1987-2005 period, see figure 2.5 p. 96), Dembinski presents a quantitative underpinning of the process of financialization. Perhaps most convincing is the cumulative return of one dollar invested in stocks in the United States in 1964, which showed a growth factor of 59 in 2006, whereas the US BNP, bonds and the internal growth of quoted businesses increased by a growth factor of approximately 20 (figure 2.7, p. 102). This suggests that the financialization process has driven quoted securities up to levels that hardly bear any relationship to the countries' real economy.

So what explanation can be presented for the estimated transformation process described above? First of all, Dembinski describes very large cooperations (VLCs) as vehicles of financialization. The 800 largest businesses with a 1% share of the worldwide active population represent 59 % of the world stock-market capitalization in the year 2000, whereas the 144 poorest countries with a 33% share of active population represent only 6% of the world stock-market capitalization. These numbers reveal the huge difference in labour productivity between developing countries and the economically developed part of the world. Another element in the process of financialization is the change in company valuation from the ex post accounting approach (intrinsic value) to the ex ante mantra of shareholder value. The global economy is valuing new types of economic goals such as return on equity (ROE). As a result, the number of mergers and acquisitions has skyrocketed in the last twenty years, together with debt financing and financial engineering, which has also encouraged growth and volatility in financial markets. In the same

timeframe within which the technological changes described above took place, Dembinski also noticed the marketing process of tying customers to enterprises by the planned obsolescence of products, 'personalized' virtual customer relations, dissolving products into services and ending up with what is called 'the alienation of the anaesthetized consumer' (p.130). As products become fragile and short-lived, and are ultimately dissolved into services, the relationship between human beings and things becomes fundamentally changed. Humanity is becoming caught in the grip of financialization, which also means that working relationships and all jobs tend to be regarded in terms of 'career prospects'. Modern finance, which is rooted in the efficiency ethos, presents capital as a virtual and timeless object with a supposedly inalienable right to remuneration, and one full of promises. Dembinski presents a different conclusion and states that finance is unable to present a metaphysical response to the existential anxiety of its participants: 'All finance can offer is the promise of purchasing power in an intangible future (p137)'.

What is to be done?

Based on the former analysis and the perception that the nature of modern finance has become more an end in itself rather than a means to an end, the book concludes in part three that finance in its current form is a deceiver rather than a servant. The relevant question now is, 'What is to be done? How can personal relationships be restored in this virtual world of financialization and distrust?' The proposed answer to this question is threefold. Firstly, the case is made to encourage long term relationships by increasing transaction costs in financial markets through some type of Tobin tax². Increasing the transaction costs would limit the progressive 'savings silos' and hence the financial iceberg. Together with 'solidarity finance' like micro credits and loyalty dividends, sustainability in financial relationships could be encouraged and established. Secondly, a change in the system of remuneration is needed, as the 2007-08 crisis has already shown. Higher remuneration for taking short term risks is not a sustainable situation. Thirdly, but certainly not least important, Dembinski emphasizes the importance of virtues, improvidence and frugality, above legal or regularity action. The financial process needs to be revisited by its professional participants; virtue ethics dominating deontological ethics. It is the financial sector itself that needs to purify its customs and culture. The consequence of encouraging virtues is that business ethics professors in particular have a mission to fulfil in the near future. The role of the supervisor is hardly mentioned, neither in the problem analysis nor in the solution to the financial iceberg. Being critical, it is precisely this aspect that deserves further attention. Virtue ethics in particular need guidelines and regulation. It's not just the financial sector itself that has failed; regulators and society are just as much to blame. So what can be added to Dembinski's exhaustive and integrated analysis? I will first focus on the role of finance as a specialized, academic topic, and subsequently on the role of the methodology implied.

The limits of finance as a discipline

Financial theory has been treated for many centuries as an inseparable part of economics and the market economy. However, since the mid 20th century, it has evolved into a mature discipline in itself. Based on the strong neoclassical roots of microeconomic theory, modern finance expanded rapidly and developed

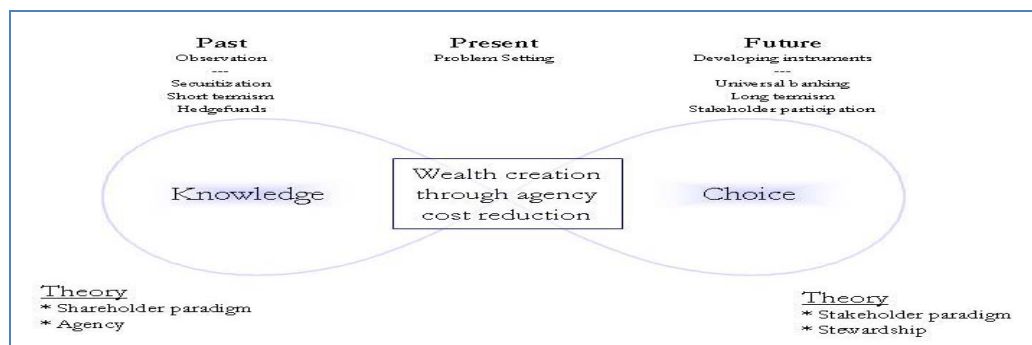
² Proposed is a tax not just on currency transactions but on all financial transactions

into a discipline with a strong mathematical emphasis. Since financial data agencies can easily generate extensive samples of market prices, these datasets were successfully used to develop empirically valid asset-pricing models. The most influential of these are the Capital Asset Pricing Model (CAPM) as developed by Sharpe (1964) and Lintner (1965), and the Arbitrage Pricing Model (APM) by Ross (1976). The option-pricing model of Black and Scholes (1973) was also path-breaking. More recently, financial theory has been heading in the direction of a game theoretic approach where behavioural finance and the agency theoretical approach dominate. Finance has become an independent science unrelated to other disciplines. It can be argued that the primary function of money and capital — its role as the unit of account and exchange — is threatening to become subordinate to the creation of financial wealth as a goal in itself. In contrast to the early 20th century, the neutrality of money in a national economic system has, in recent decades, rarely been chosen as a topic for scientific financial research. Koopmans (1900-1958), for example, dedicated his entire academic research life to studying the relationship between the economy and the neutrality of money. During the high inflation period of the 1970s and 1980s, the FED and the major European central banks applied a strict monetary policy to curb the clearly negative influence this monetary phenomenon was having. In recent decades, however, a clear global monetary policy is no longer considered necessary in the absence of substantial observed inflation. I have noticed that Aristotles' 'making money for the sake of making money'³ has become a standard in the corporate cultures of most successful market economies. This, I think, is the basic conceptual and essential limit to finance as a discipline. If there is no sustainable relationship between the growth of the assets in the real economic sector and the assets in the monetary sector, the resulting imbalance will undermine the quality of the financial assets as described impressively by Dembinski.

The danger of treating finance as an independent science rather than as an integrated element of trust can be traced back to methodological origins. Contrary to the process of finance becoming a specialized discipline, Figure 1 presents a lemniscate of theory development indicating that new theoretical paradigms are implicitly based on a permanent process of historical knowledge-gathering. Similar to the 'multi model causation framework' used by Dembinski, this figure emphasizes that the development of new theories should be based on integral normative choices with which to build positive models that can be transformed into new instruments of analysis. This holistic view of wealth creation links traditional knowledge of the shareholder paradigm to the normative choice for the stakeholder view, and emphasizes the role of stewardship theory as an alternative for agency theory.

³ See Meikle etc.

Figure 1: A holistic view of wealth creation



Dembinski’s interdisciplinary approach to the financial system is perfectly in line with the holistic approach to the financial system shown above, in which the future, the present and the past are reconnected by the lemniscate. To elaborate on the previous paragraphs, it is argued that finance as a discipline needs to return to its most basic goals: to be a unit of account and a measure of exchange. The 18th century Francois Quesnay, who along with Adam Smith is considered to be one of the founding fathers of the capitalist economy, compared the economy to a human body. Extending this metaphor, we compare finance to the blood of a physical human body. Blood transports and connects every single part of the body, from head to toe. In this metaphor, finance can be thought of as the transportation mechanism used in distributing and redistributing wealth among economic agents.

Concluding remarks

The primary function of money and financial capital — its role as a unit of account and exchange — is threatening to become subordinate to the creation of financial wealth as a goal in itself. Collective trust in financial markets, the major issue in finance, is at stake. The very moment that the neutrality of money and long-term capital is attacked by moral hazard and adverse selection, the financial system loses its scientific objectivity. In metaphorical terms, the quality of the heart and the health of all the other organs of the human body are at stake if the blood becomes an independent substance in itself. In other words, finance as a discipline needs to change its ultimate aim from being an end in itself to becoming a means for helping the real economic and social process. The modern anthropocentric view of man in the economic process is endangering a stable financial system, which is driven by the adage: ‘making money for the sake of making money’. In the reviewed book, a strong case is made for changing financial institutions in such a way that virtues like moderation and frugality act as incentives to curb the remuneration system and the corporate culture. Together with increasing transaction costs through capital taxes, the community would be better equipped to profit from a growth of financial markets. The traditional approach of external regulations and strong top-down legal constrictions of states are not considered part of the solution to the financial markets crisis. In the light of this conclusion, I consider Dembinski’s book a valuable contribution to the long term enrichment of literature on financial ethics.

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