

# “Isms” and “Zations”: on fictitious liquidity and endogenous financialization \*

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## Abstract

Financialisation has been represented as a recent phenomenon linked to the deregulation and globalization of the international trade and payments system that has been in progress since the opening of the Chinese economy in the 1980s. It is often represented as the dominance of finance over production or of monetary over real variables. This essay challenges the usefulness of this dichotomy, arguing in the tradition of Keynes, Schumpeter and Minsky that it is impossible to separate the financing of production into separate categories since a production decision always requires finance to be implemented. It instead suggests that it is the process of innovation in the creation of liquidity by the financial system that provides a more insightful analysis of the implications of financialisation.

**Keywords:** Financialization; Minsky, Hyman, 1919-1996; Financial crisis; Liquidity; Ponzi, C. 1882-1949.

## Resumo

**“Ismos” e “Zações”:** sobre a liquidez fictícia e a financeirização endógena

A financeirização tem sido representada como um fenômeno recente ligado à desregulação e à globalização do comércio internacional e do sistema de pagamentos que tem ocorrido desde a abertura da economia chinesa na década de 1980. Esse fenômeno é geralmente definido como a dominação das finanças sobre a produção ou do monetário sobre as variáveis reais. Este artigo questiona a utilidade desta dicotomia, argumentando na tradição de Keynes, Schumpeter e Minsky, que as finanças e a produção são categorias que não podem ser separadas, já que uma decisão de produção sempre requer a presença das finanças (ou seja, de financiamento) para se concretizar. Em contrapartida, sugere-se que o processo de inovação na criação de liquidez pelo sistema financeiro fornece uma análise mais profunda das implicações da financeirização.

**Palavras-chave:** Financeirização; Minsky; Crise financeira; Liquidez; Ponzi.

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## Introduction: definitions and descriptions

In political science systemic discourse is organized in “isms”: capitalism, communism, socialism, imperialism, corporativism; economists on the other hand have recently become fascinated by “zations”: first it was globalization, and today it is financialization. The two are often confused, and certainly there are linkages between these “zations”. Most would agree that Globalization is clearly not a new phenomenon. Indeed, it appears as a new form of an earlier “zation”: colonialization.

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Initially driven by nascent nation-states seeking to create larger, more integrated sources of natural resources and labor to support expansion, as in “lebensraum”, in the modern era it is more closely linked to nations’ corporations seeking to organize their activities to capture globally integrated markets to lower production costs, ensure high levels of demand and dominance of market share. Globalization, apart from short-periods of financial crisis and armed conflict, has been constantly present in the organization of economic activity since the 17<sup>th</sup> century.

One of the major characteristics of globalization has been the role played by the movement of international capital. From the early sea-faring trading companies in Holland, England and Portugal, globalization was clearly driven by the expansion of domestic trade and finance to encompass speculation on an international scale. Thus, while modern economists have tended to describe the modern global economy as one characterized by “financialization”, the earlier periods of globalization were also led by the financialization of the global economy through the use of international capital to finance colonial conquest.

To what extent then is financialization a particular expression of the role of international finance in the modern period? Most responses to this question reply on simple descriptions, rather than analytical explanations, of the phenomenon.

The most common is a generic definition that is based on the size of a particular definition of the “financial sector”, usually by the acronym FIRE: Finance, Insurance and Real Estate, and its size relative to overall GDP. Thus, financialization is an increase in the size and importance of the financial sector relative to the traditional sectors of the economy such as agriculture, manufacturing and non-financial services, with reference to the fact that in the United States the share of the financial sector in national income has approximately tripled since 1950 and a 70% increase in incomes for FIRE sectors’ labor relative to workers in other sectors since 1980. From this point of view, however, it would be nothing exceptional; after all, in the presence of technical progress a developed economy might be expected to evolve from industrialization to financial services. It could be just another aspect of the post-industrial society, and hardly anything exceptional.

A recent EU funded research project (FESSUD) dedicated to the subject has provided a more expansive definition: “Financialisation involves the growth of the financial sector in the economic, the social and the political spheres. The processes of financialisation have major consequences for economic performance, social well-being and the environment. The term ‘financialisation’ is designed to refer to the roles of finance in and of itself and also the economic, social and environmental embedding of finance in the system as a whole. The term also relates to the growth of finance and of the financial sector (relative to the economy). The study notes that while financialisation has long been a central feature of capitalist economies, each

period of financialisation had its own characteristics and effects. The most common characteristic is the rapid expansion of financial institutions and financial markets. In the recent period, the growth in the relative importance of financial markets has been driven by the rapid expansion in the range and trading turnover of financial assets such as derivatives and securitization and the rapid rise in the ratio of financial assets to GDP and financial liabilities to GDP. An enabling feature has been the deregulation and liberalisation of financial markets and institutions. Mainstream economics and finance theories have also promoted financial liberalisation by representing regulation as 'financial repression' constraining the ability of the market to efficiently intermediate saving to support investment. At a systemic level, financialisation represents the dominance of finance over industry, or in Keynes's terms, speculation over enterprise that has driven many nonfinancial corporations to seek profitability from their financial as opposed to their productive activities" (Fessud, 2016).

A more analytical explanation builds on the business response to the profit squeeze of the 1970s and the impact of the petroleum crisis generated by the Arab-Israeli war. In response to the crisis, policies were implemented to depress wages in order to offset terms of trade losses imposed by the rise in oil prices; wage bargaining to keep the growth of nominal wages below the rate of productivity growth. These two factors operated to depress domestic demand, and instead of the expected response of an increase in profit-led investment driving growth, the ensuing stagnation was offset by expansionary monetary policies that generated a series of financial bubbles, first in real estate in the 1980s and then in the form of the dot-com boom in the 1990s. It culminated in the recovery of consumer spending even in the absence of real wage growth with the pass through of rising residential housing prices to consumer debt-led financing of demand. In this scenario, the inflation of the 1970s disappears, only to be replaced by asset price inflation, and spurious growth driven by capital gains, punctuated by periodic crises as the bubbles collapsed. In this explanation, financial manipulation of asset prices to generate demand replaces real wage growth as the driver of the economy and the consequent repetitive financial crises.

There is a variation on this theme that characterizes this process as one in which manufacturing firms, seeking to augment their profits on manufacturing activities, turned their treasury functions into profit centers; the Chief Financial Officer became responsible for adding to bottom line profits through innovative management of the company finances, and then to engaging in outright speculation in financial markets. The best-known example of this scenario is the financing of Hallmark cards and Procter and Gamble at below benchmark market interest rates through the use of structured financial instruments. Bankers offered financing in which the firms effectively wrote derivative contracts on interest rates. When Alan

Greenspan, after substantial market guidance that tightening was to be expected, surprised the market by actually doing so, the short options produced losses far in excess of the premiums that were being used to reduce interest rates and eventually exceeded the equity of the corporations, leading to the possibility of bankruptcy. In the end, the corporations' defaults on the contracts and the lending bank ended up skirting bankruptcy and eventually being taken over. Obviously, it is impossible for the entire manufacturing sector to borrow at below market interest rates since over time the structures lead to the equivalent of the bursting of the bubble, in the form of default or bankruptcy.

A more nuanced definition refers to the development of finance capitalism that emerged as part of the process of the deregulation of the US financial system starting in the 1980s which provided the possibility for increased leveraged lending and the development of trading in a wider variety of assets generated by the unbundling income flows and risks of all real and financial assets.

An excellent description of this process is provided by Guttman (1994: 293) who notes that "In the early 1980s, deregulation triggered a revolution in our hitherto highly structured and regulated credit system. Financial institutions introduced a vast array of instruments and created whole new markets around them. This combination of deregulation and innovation benefited almost anyone who held excess cash, from small savers finally earning the going market rate of interest to the giant pension funds hedging risk in the futures markets. But that very revolution also helped to turn our nation into a "casino society" of investors who are engaged in high-stake financial maneuvering as a shortcut to wealth. During the Reagan era a get-rich-quick mentality took hold in our country and soon provided the securities markets. With the onset of recovery in late 1982, the volume of financial transactions in the United States soared to unbelievable levels, and securities trading became the fastest growing activity in our economy.

It is surely no coincidence that the United States possesses the world's largest economy as well as its most developed capital markets. The two went hand-in-hand. However, the advent of the casino society has thrown this symbiotic relationship out of whack. Trading stocks, bonds, and other kinds of securities and financial markets, amounting nowadays to several tens of trillions of dollars per year, represent mere shuffling of paper assets. This is not a productive activity and is therefore excluded from our GNP, except for brokerage commissions and service fees generated in those trades. Moreover, it is by no means clear that our economy needs these huge financial transaction volumes to produce the current level of GNP. On the contrary, a strong case can be made that the spread of financial maneuvering has diverted resources from productive enterprise. After all, even though securities trading is going explosively, industrial investment activity has remained relatively stagnant and productivity growth has continued to lag."

This same history has been cast as one of a revolution in corporate governance by recent Economics Nobel Prize winner Bengt Holmstrom and co-author Steven Kaplan (2001, p. 1), as the response to the negative impact of rising oil prices and policies to dampen the ensuing inflation on the US stock market in “the 1980s ushered in a large wave of takeover and restructuring activity. This activity was distinguished by its use of leverage and hostility. The use of leverage was so great that from 1984 to 1990 more than \$500 Billion of equity was retired on net, as corporations repurchased their own shares, borrowed to finance takeovers, and were taken private in leveraged buyouts (LBOs). Corporate leverage increased substantially. Leveraged buyouts were extreme in this respect with debt levels typically exceeding 80% of total capital. The 1980s also saw the emergence of the hostile takeover and the corporate raider. Raiders like Carl Icahn and T. Boone Pickens became household names. Mitchell and Mulherin [1996] report that nearly half of all major US corporations received a takeover offer in the 1980s. In addition, many firms that were not taken over restructured in response to hostile pressure to make themselves less attractive targets.”

### **No dichotimization in analyzing financialization**

This approach has led to the idea that just as inflation distorts economic efficiency, one of the major implications of financialization has been to blur the distinction between real decisions and decisions over nominal variables. Thus, financialization distorts the traditional support of industry played by finance in the sense of diverting it from playing the role of the “handmaiden of industry” to become the motive determining “real” decisions in a similar way that Veblen decried the dominance of investment banker representatives of absentee owners over engineers.<sup>1</sup> The idea that there has been a shift in dominance or direction from real to monetary or from industry to finance to the opposite is thus implicit in this approach. This also implicitly accepts the idea that there was once a state of affairs in which decisions were taken in real terms (i.e. in the absence of inflation) or that industry dominated finance served as its “handmaiden”.

But, on both the analytical and theoretical level these dual dichotomies may not be the most enlightening way to approach the problem of financialization and its

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(1) “The material welfare of the community is unreservedly bound up with the due working of this industrial system, and therefore with its unreserved control by the engineers, who alone are competent to manage it. To do their work as it should be done these men of the industrial general staff must have a free hand, unhampered by commercial considerations and reservations; for the production of the goods and services needed by the community they neither need nor are they in any degree benefited by any supervision or interference from the side of the owners. Yet the absentee owners, now represented, in effect, by the syndicated investment bankers, continue to control the industrial experts and limit their discretion, arbitrarily, for their own commercial gain, regardless of the needs of the community” (Veblen’s. *The engineers and the price system*, p. 69-70. Available from: <https://archive.org/details/engineersandpri01veblgoog>).

peculiar characteristics, ancient or modern. As noted, the idea of the “nominal-real” distortion emerges from the monetarist analysis of inflation informed by the quantity theory of money. There is, however, an alternative approach which is inherent in the work of Schumpeter on economic development and Keynes’s conception of a monetary production economy, also present in the work of Hyman Minsky. This approach rejects any distinction between the real and monetary analysis as well as between finance and industry. It rather recognizes an intimate relation between finance and production. In contrast to the simultaneous exchange of the quantity theory’s barter economy with given resources, it recognizes that production in a capitalist economy takes time. This means that production requires financial commitments undertaken today to acquire the means of production that can only be verified by sales of produced output at some future date, contingent on the realization of the expectations which motivated the decision to initiate production. Thus, the first step in any production process is the issue of a liability by the producer to a supplier of inputs in production. Since the private liabilities of producers are not generally acceptable to suppliers, the initiation of production requires the provision of a generally acceptable means of acquiring goods by their recipients. This is the role of finance, and in particular of the banking system: to convert the private liability of the producer into an asset which the supplier of goods and services may use in turn to acquire and produce goods and services.

This is achieved via the acceptance of the producer’s liability by a bank in exchange for the bank’s own liability, either a banknote or coin, which can be used by the supplier to acquire goods and services. This is what Minsky calls the acceptance function of the banking system. But, the point to be made here is that “real production” cannot take place, goods in progress cannot be created, without the simultaneous creation of a generally accepted means of payment in the form of a financial liability of the financial system. There is no way to bifurcate, or dichotomize this process, or contest the fact that the creation of real goods and services and financial assets occur as a combined, simultaneous process.

### **Excessive creation of fictitious liquidity and financialization**

Starting from this conception of the production process led Schumpeter, Keynes and a series of German and Austrian (Hahn, Mises, Hayek) as well as Cambridge economists (Lavington, Robertson, Hawtrey) to the logical conclusion that if banks’ issue of their own liabilities could create purchasing power for producers before the output had reached the market, while it was in the process of production, then the only constraint over the level of output was the willingness of businessmen to formulate production plans and the banks to finance them. This reasoning extended to the financing of working capital (which was a major focus of

cyclical movements in Keynes' *Treatise*) as well as to investment expenditures leading to the creation of capital equipment.

This is reflected in Minsky's definition of capitalism as a system in which the "ownership or control of capital equipment is acquired by the issuance of debt." The implication of this line of reasoning was that savings had nothing to do with the financing or with providing a constraint limiting investment, as both Keynes and Schumpeter and others never tired of repeating. Of course, some, such as Hayek, believed that this was a fatal flaw in the capitalist system that produced its cyclical behavior and that measures should be taken to limit investment to a priori saving, by means of regulation of what Hayek called a "neutral" monetary policy. Virtually all prudential regulation is the result of the impossible attempt to ensure that banks only create the amount of purchasing power equal to the amount that households would voluntarily choose to save – the limit being the radical proposals for 100 per cent reserve banking.

However, in this alternative view, once it is recognized that finance and production are co-determinants of the growth process, the problem is not to limit investment to the real resources not committed to consumption output, but rather how the unlimited ability to create purchasing power will be used to finance acquisitions of capital goods or financial assets in the economy.

This is the source of Keynes's famous dictum that "speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" (1936, p. 159). Rather than seeking regulations to limit investment to saving, Keynes sought to direct finance to enterprise and to limit speculation. This is the source of Keynes's initial *Treatise on Money* ideas of an industrial and financial circulation as well as his assessment of the crucial role played by finance in providing liquidity to equities which allowed individual investors to hold positions because of the liquidity that the financial institutions provided to the market. "Investments which are 'fixed' for the community are thus made 'liquid' for the individual" (1936).

Following Minsky, this approach recognizes that all positions in assets are financed by the issue of liabilities whether they are in "real capital" or financial assets, so the problem is really not financing investments in excess of voluntary saving, but of what is being financed. This in its turn raises the question of why positions in financial assets represent more attractive returns than investments in real assets. This is, in essence, the question posed by Keynes in his concept of liquidity preference. From this point of view financialization could be defined as the result of financing becoming self-referential or in Keynes's terms a preference for holding

financial assets resulting in the dominance of speculation over enterprise. In Minsky's terms this would be described as an increase in financial layering. The simple explanation is then that financialization is determined by expected relative returns on alternative assets favoring finance over industry.

Schumpeter was generic in his description of how innovative destruction was financed by the "ex nihilo" creation of purchasing power – he did not restrict his discussion to the issue of notes or deposits by fractional reserve banking as Hayek had done. Minsky has also looked upon the creation of liquidity by commercial banks as the primary form of liquidity creation. However, he did allow for liquidity creation in the form of innovations originating in other financial institutions. "Our complex financial structure consists of a variety of institutions that lever on owners' equity and normally make on the carry, that is, borrowing at a lower rate than their assets can earn. In order to make on the carry, these liabilities have to be viewed as embodying more of Keynes' liquidity premium than their assets. A crisis increases the cost of funding by reducing liquidity premium. ... although financial innovations are common, their acceptance depends upon an attenuation, however trivial, in the subjective evaluation of the liquidity premium embodied in holding money.... financial institutions can experiment with new liabilities and increase their asset equity ratios without their liabilities losing any significant credence," (Minsky, 1986, p. 277-278). Which is to say, there are institutions that engage in the same type of activity as banks but without the ability to borrow from the central bank, and thus without the ability to offer insured liabilities as a substitute means of payment. Since they are at a disadvantage in offering payment services to the public, their fundamental activity is borrowing and lending to one another, thus increasing what Minsky called "financial layering"; that is, the issue of financial liabilities to acquire the liabilities of other financial institutions in the expectation of profiting from price appreciation.

The liquidity of a liability issued by any non-insured financial institution will then be determined by its ability to finance it—that is, to borrow in order to hold the position. For Minsky, a condition of "financial distress" will occur when any individual financial institution "cannot meet its obligations on its balance sheet liabilities." This may evolve into a "financial crisis" when "a very significant subset of the economy is in financial distress" and "a slight disturbance' in money flows creates such widespread financial distress that financial crisis is threatened" and financial fragility is transformed into "financial instability." At each stage in the evolution toward instability, financial intermediaries become more reliant on other financial institutions, and ultimately banks, to refinance their liabilities. As Minsky noted, "a key to the generation of financial crisis is whether the holders of marketable securities who have large scale debts outstanding can refinance or must liquidate their positions when they need cash" (Minsky 1964, p. 266). "The worst thing that



could happen to the solvency of any financial institution is a forced sale of its assets in order to acquire cash. Imagine what would happen to asset values, if there were a need to liquidate government bond positions by the government bond dealers or if the sales finance companies were suddenly to try to sell their portfolios of consumer installment paper on some market. In order to prevent this type of forced liquidation of assets, the financial intermediaries protect themselves by having alternative financing sources, i.e., by having 'de facto' lenders of last resort. These de facto lenders of last resort ultimately must have access to the Federal Reserve System in times of potential crisis" (Minsky, 1964, p. 376).

This is the basis of the recognition of competitive innovation in providing for what I have called "fictitious liquidity" created by shadow banks (Levy Institute, 2012). Thus, there is an alternative explanation of financialization: When the creation of liquidity exceeds the requirements of the real economy to absorb it in productive investments then competition will inevitably lead to the creation and innovation of financial assets which offer the possibility of price appreciation and thus higher returns than investing in industry. This understanding of financialization is a profit-driven competitive-innovative process of creation of fictitious liquidity. Our understanding of this process of excessive and innovative liquidity creation is clearly historical, and it is on this basis that leads to the dating of the expansion of financialization at the end of the 1980s as the US and global economy emerges from the inflationary recession that accompanied the oil crisis of 1973.

The response to these events has been crucial for the subsequent evolution of the global economy – indeed monetarism is the child of this period, as is the pressure for increased competition and liberalization in financial markets. This, in its turn, was a major source of the ability of financial institutions to create unlimited liquidity to meet the rising demand for liquidity in the period. This approach only differs in perspective to the use of the term "fictitious capital" used by Guttmann in his previously cited description of the period – the only difference is his emphasis on the fictitious capital financed by the fictitious liquidity. Here it is the fictitious liquidity that led to what we now call financialization. Just as Schumpeter recognized the importance of banks' ability to create purchasing power ab nihilo to fund investment as the source of economic development, it is here argued that the ability of the financial system to create fictitious liquidity ab nihilo led to the appropriation and destruction of shareholder value for industrial corporations and the decline in real investment.

### **The recent history of financialization**

Indeed, the historical record suggests that this process is inherent in the operation of competition in the financial system. As is now well known, the US regulatory system under Glass-Steagall sharply proscribed the activities of deposit-

taking financial institutions. In particular, commercial banks' dealings in securities markets were sharply constrained and the activities of other non-bank institutions were subject to equally restrictive regulations, providing for both a monopoly over their respective activities. The commercial banks controlled the creation of liquidity with a monopoly on the creation of insured deposits while the non-regulated investment banks were limited to private partnerships with low capitalization providing intermediation services in the form of underwriting and advice on secondary distribution and market acquisitions.

While the ideologically driven Reagan administration deregulation phase of the 1980s sought to remove the deposit monopoly of commercial banks, it was also driven by the non-regulated financial institutions search for revenue in the face of their own deregulation in the form of the suspension of fixed commissions for broker-dealers (Mayday in 1975) and the breakdown of relationship banking formed by the non-compete gentleman's agreement amongst white shoe investment bankers leading to competition on fees for both initial and secondary offerings in equity markets and in secondary market trading. The result was a push by commercial banks to enter investment banking and investment banks to enter into liquidity creation via the creation of non-regulated deposits.

An additional factor was the growth in the size of the corporate sector which produced pressure on the small capital base of partnerships on the one hand and the magnitude of funds intermediated and managed by institutional investors such as pension funds and other managed funds, which relied on trades in large blocks which were usually discounted and executed in an upstairs market. This tendency was exacerbated by the increase in merger and acquisition activity during the decade. These trades were incompatible with the fixed commission structure (a 100-share trade and a 1000-share trade did not have a ten-fold difference in costs) while a 50000-share trade required large amounts of capital to execute. And as corporations expanded globally, they looked for large bought deals for primary distributions and IPOs which also required a larger capital base for the underwriting firm.

The partnership structure of most investment banks soon became a restriction on the ability to compete in these markets, leading to the transformation of private partnerships into joint-stock quoted public companies. This had a profound impact on the growth of leverage in the markets since ownership and liability control were now severed and individual partners were no longer personally liable for their losses while they controlled the distribution of gains. In a sense, the ability of commercial banks to create purchasing power was acquired by the non-regulated non-commercial banks through equity issues. And there was no Hayek or regulator equipped to argue that their ability to create purchasing power should be limited to private saving. It is here that the "shadow banking" starts.

However, the ability to raise capital requires meeting market returns, which in turn generates pressure to increase leverage. It is a basic rule of financial markets, that they are driven by spreads and fees which are maximized by scale, which means maximizing leverage. By the time of the commercial bank deregulation, most regulated commercial banks had lost their ability to service corporate clients' transactions requirements and were limited in their ability to provide capital market services, which meant that brokers/dealers, investment banks, hedge funds and others had free reign in dealing with corporations. And they set about rapidly engineering a merger mania.

Minsky has provided a very neat explanation of this process. Noting that the return on bank capital will be driven by the net return on its assets multiplied by its leverage:  $ROE = ROA * Leverage$ . We can thus engage in a very simple exercise. Presume that ROE on bank equity given by the market or by management seeking to maximize shareholder value or the value of their option linked remuneration is 25 per cent per annum and the return on assets is 5 per cent. Then leverage will be 5 which means that the bank must multiply its asset book by 5. Where are these assets to come from? If we are to avoid financialization, then investment as a share of GDP must be sufficient to provide the required growth of assets. What if it does not do so? Then institutions will seek alternative means of expanding their assets – in the form of increasing their positions in financial assets – financialization. Now, introduce the ability of banks to increase their ROE by means of innovation in liquidity creation, so that leverage becomes an endogenous variable in the equation. Again, the outcome will be an increase in layering that we call financialization. Thus, this is the analytical framework – during the 1980s, structural changes occurred which allowed for substantial increases in both bank and non-bank leverage which created fictitious liquidity which expanded at a rate far in excess of the financing needs of the productive sector of the economy. The increased lending via a Ponzi scheme was needed to generate the capital gains necessary to create the required returns – until the rate of expansion of liquidity stopped, and crisis intervened.

Compare the financial history of the period with this analytical framework. The recovery from the OPEC induced inflation and poor profitability of the 1970s was reversed in the 1980s as the stock market recovered and then boomed under Reagan supply side policies creating another form of fictitious liquidity – booming share prices provided liquidity for firms to use no-cash takeovers by using accelerating stock prices as collateral or direct funding. Thus “a new type of takeover activity emerged as the leading force in the merger-driven stock market boom, the hostile takeover bids by so-called corporate raiders” (Guttman, p. 307). For the investment banks this was a quadruple opportunity, serving as advisers to the corporates, providing funding to the acquirers and the opportunity to set up risk

arbitrage desks to speculate on the outcome of the acquisition and finally doing the underwriting for taking the company public.

Finally, the beginning of the 1980s saw the development of derivatives markets which were widely used in products such as portfolio insurance, index arbitrage and interest rate management. However, as important as these activities were in generating revenue their importance was mainly due to the massive leverage they introduced into the system allowing purchasers to take long positions as much as 20 times the initial margin.

The best example of this period is the operation of Michael Milken at Drexel, Burnham. Milken discovered and popularized the idea that the risks in non-investment grade debt (in particular “fallen angels” i.e. companies that had been recently downgraded) was over-priced, i.e. their prices were lower and their returns higher than justified by their default performance) suggesting an arbitrage opportunity for money managers to increase their returns without increasing risks.<sup>2</sup> But what was a very sensible idea was eventually converted into an illegal shadow banking operation in which Milken offered to issue new junk bonds to finance hostile takeovers, ensuring the sale of the bonds by alerting risk arbitragers and money managers with inside information on the impending takeover bid, allowing them to profit by buying before the bid in exchange for a commitment to purchase the junk bonds, thereby ensuring the success of the bid.

It is operations such as these that represent the beginning of the massive expansion of liquidity creation outside the regulated banking sector, with no effective limit, requiring a market return to justify its existence. And institutional investors together with the newly capitalized financial institutions found ways to employ their virtually unlimited ability to expand liquidity by the creation of additional leverage. It is not necessary to recount the entire experience of the 1980s, which is done very well by Guttman, nor the subsequent “dot-com” boom which was fueled in a similar way, or the sub-prime crisis of the 2000s. They all have the same characteristics in the ability of financial institutions to create fictitious liquidity to produce fictitious capital. It was the ability to create unlimited liquidity that made financialization inevitable.

Building on the early work of Robin Marris (Marris, 1964) and others on managerial capitalism, the stock market was no longer viewed as simply providing

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(2) See Kornbluth for a more extensive discussion of Milken’s research on junk bonds which subsequent to his advocacy came to be called “High Yield” assets. He notes that “At Berkeley in 1967, Milken had an insight that would, in time, support an entire firm, overthrow conventional wisdom, and put a great many outsiders in executive offices – the bond services’ seal of approval was less than accurate. All Moody’s and Standard and Poor seemed to factor into a company’s rating was its past performance, as reflected by the ratio of debt to equity on its balance sheet. The rating services didn’t seem to care much about cash flow, which as Milken saw it, said everything about a company’s ability to service its debt” (Kornbluth, 1992, p. 41). This was very similar to Minsky’s approach.

the liquidity Keynes suggested was required to allow individual investors to hold illiquid stocks in the belief that they could always be sold. Instead it became the market for the trade and evaluation of corporations; mergers and acquisitions imposed market discipline on companies that were performing below market benchmarks. The idea was that inefficient managers would lose their jobs and new ones would come in and eliminate inefficiencies. If the takeovers led to increasing debt ratios, this was positive because the threat of default and the need to meet high interest burdens led to cost cutting and to labor shedding to raise profitability.

Instead a process started that was closer to what in the UK was called "asset stripping". A corporation holding a large cash reserve was a target for takeover; it could be taken over by using the debt created by a financial institution, the acquired company would then issue its own debt to repay the acquirers debt and the available cash transferred to the acquirer, leaving the corporation with an unsustainable debt service burden, often leading to bankruptcy proceedings. This process was initially called "value extraction", and did little to improve corporate efficiency and usually led to unsustainable debt burdens that required sharp reductions in operations and loss of employment. In those cases where insolvency was avoided, the corporation could be resold to shareholders via a public offering which generated additional funds for the private owners. As managements were displaced by the acquirers, who came to be called "corporate raiders", they sought defenses in the form of "poison pills", the creation of golden parachutes for managements which, if implemented on a successful takeover, would generate payments that would leave the company with no assets, or the issue of massive amounts of debt on the rumor of a takeover in order to make further issue of debt by the acquirer to fund the acquisition unprofitable. Usually, shareholders were offered prices to sell their shares in the takeover at a substantial multiple of the pre-acquisition market price, while management were offered golden parachutes, in what came to be called "greenmail".

Eventually managements resolved the threat to their tenure by convincing shareholders that they were best off by keeping management in place. Thus, managers argued in favor of compensation supplemented by options linked to the share price performance to align the objectives of the principals and the agents. This was presented as a form of operating in the interests of maximizing shareholder value – but it led to the same results as the corporate raiders, only now it was in the interests of the management and equity holders to maximize leverage and reduce employment levels.<sup>3</sup> Thus, the advent of private equity fueled by Milken's liquidity led to a basic shift in managerial strategy. For example, after the first takeover threat "the Business Roundtable – an association of 200 CEOs who form a kind of corporate version of the College of Cardinals, noted in its 1981 Statement of Corporate Responsibility that a corporation 'must be a thoughtful institution which rises above the bottom line,

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(3) Much of this experience is recounted in Guttman's more recent book *Finance-Led Capitalism*

to consider the impact of its actions on all, from shareholders to the society at large.' In other words: Don't judge us on our quarterly earnings, because management – “which doesn't own much of its own stock – isn't going to do anything to drive the stock price up just to satisfy shareholders we've never met.” (quoted in Kornbluth, 1992, p. 85). This changed radically after options linked to stock price became the major component of managerial compensation and any and all measures to boost stock prices were implemented in the name of “maximizing shareholder value”.

## Conclusion

In conclusion, we should not be surprised by financialization since it is the natural result of competition and innovation in which liquidity is allowed to be determined by the market; the result of an obsessive concentration of monetary policy on the control of money to stop inflation rather than liquidity that drives the creation of fictitious liquidity that funds fictitious capital which periodically is destroyed via financial crisis.

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