Economic Science
or Economic Subjectivity?

Investors have complete confidence in their decisions and in markets when the boom of real estate and stock assessments continues. Apprehension even from risk is clearly modified. Operators multiply actually speculative investments, even quite frankly dubious, since their level of optimism is pumped up and their suspicion anesthetized by euphoria. They even begin to buy securities and carry out all types of investments thanks to contracted borrowing which logically lead to an acceleration and intensification of the “boom”. It is the blessed era of profit for the entire chain of stakeholders. And with good reason, since the markets are only practically appreciating, knowing that any slide is considered a “correction” from which one should benefit by charging higher prices. However, the pinnacle is only attained when certain stakeholders buy conscientiously very risky assets – putrid – by focusing on the fact that the virtuous action of markets will assist in “normalizing” them, that is to say transforming them into so-called assets, while allowing them to cash in in the meantime a handsome added-value. In short, optimism and confidence reign supreme, so much so that investors, even the most reluctant and the least likely for losses, end up having their cake and eating it. Cash starts to flow freely, cash increases endogenously/internally since each purchased asset is resold with a profit: it is the characteristic of a bubble. This period is further marked by relatively low interest rates and by easy credit, fueling exactly all this reckless risk-taking. This almost uninterrupted soaring valuations and markets lead to a feeling of intoxicating wealth among the stakeholders since their portfolios and accounts reflect potentially very substantial profits. Hence there tolerance to increasingly heightened risk, itself comforted by an almost invulnerable feeling afforded by sham profits. Was it not Minsky who was the first to elaborate a theory according to which stable markets and economic and financial conditions would the source itself of instability! Exactly as described, speculators and investors in the financial markets indeed take much more risks that the context in which their bets are made is calm. In other words, the collapse of the macroeconomic volatility encourages risk-taking, knowing that the fall will be harder! Excessive ambient widespread deregulation and laxity like
relaxation exert adverse effects in an environment where the protections and guardrails fall one after the other and while bubbles form and speculation grows. Hence Minsky’s famous understandable conclusion that stability is itself generating instability. Even worse because more the numbing context of stability will have lasted longer and more violent the subsequent stall will be. Dilemma – or headache – for economic and financial leaders as for central banks because these repetitive sequences of “boom and bust”, ie bubbles and collapse of these bubbles, greatly affect the economic fundamentals. This is what Minsky called the smoothing action of the state which, through its budget deficits, is able to neutralize these upheavals by compensating for the interruption of private investment. This is actually a fundamental psychological component. Operators and stakeholders are pumped up by instilled confidence in favor of stable and flourishing conditions which, together with their lure for profit, always lead ultimately to a crisis situation and erratic volatility. Safety measures implemented yesterday and today in a nuclear station and having avoided until now a catastrophe are not absolute guarantees against an accident tomorrow… it must be acknowledged that a boom or a bubble is in reality a spiral which feeds itself: like a tornado sucking up everything in its way since comprised of loans taken out and granted with the single objective being speculation, a drastic increase in leveraging, inexistent risk management, a virtual increase in purchasing power and euphoric stock market appreciations for all stakeholders, including financial establishments which lend amounts intended to inflate the bubble further…

The interconnection between financial markets and the real economy has become such that economic activity, investment, growth, consumption and hiring improve and advance when optimism reigns in the stock markets. The dependence of the economy on finance makes it benefit from cash flow and constantly increasing profit margins when stock market valuations are on the upward trend. It is easy: this boom seems to start a new era which is, nevertheless, only a headlong rush, since the economy must be “financially fragile” to borrow from Minsky. However, a tiny pebble can – at a fateful moment – seize up the machine. Indeed, a wave of cash shortage appears due to a spontaneous freeze on credit or profits which become more complicated to rake in. Suddenly, investment is increasingly scarce, income falls, corporate profits are feeling the pinch, stock markets drop, and agents punctuating the whole food chain suddenly discover that their predictions were too optimistic… and therefore their positions were too high risk. As stock market valuations had been aligned with levels completed disconnected from the reality of economic data and the health of corporations, forecasts are reviewed downward and stock market adjustments begin to occur. Thus banks stop lending out of fear of default on payments at any time where
interest rates rise and an inverse spiral starts to feed itself with forced liquidation of their positions on behalf of those who speculated with credit. Thus, sales accelerate while under pressure from those who can no longer hold for having abused important leverage and markets collapse altogether under the weight of good securities which were themselves also “balanced” by those which now cannot be liquidated. The credit crush is thus implemented since banks no longer lend at all, not even to one another.

Financial crises and, even more serious, economic instability, are owed entirely to the Friedman school of thought, which concocted a theory on totally absurd assumptions. In view of regulatory agencies having done even less homework almost all the economists welcomed enthusiastically this theory of perfect markets. This notion of risk, presumably always quantifiable and therefore possible to identify, replaced the uncertainty cherished by Keynes. Suddenly, financial institutions could take more risks, with the approval of their regulatory authorities. Gradually, the system became so complex, financialization so sophisticate, banks so entangled, never ending sprawling institutions and regulators so overwhelmed by the events that it became completely impossible at the dawn of the 2000s to assess – even if only briefly – the overall risk incurred. In fact, certain financial products had reached such a degree of complexity (such as collateralized debt obligations or mortgage-backed securities, respectively insurance against default payments of a debtor or a real estate securitization) that it was outright impossible to deal with them – therefore to buy and sell them – on a regulated market. As the process consisting of attributing a price to them was incredibly opaque, these products were negotiated between a buyer and a seller at a mutually agreeable fixed price. This negotiation, called “over the counter”, benefited from a steep rise since its volume leapt from a total of $157 billion in 2004 to half a trillion dollars in 2006 and 2007, according to the Securities Industry and Financial Markets Association! It goes without saying that the total lack of transparency was good news for banks which could freely multiply their profits thanks to dealing in OTC (over the counter) products and therefore outside regulatory control, even limiting, profit margins. So finance pushed logic so far from efficient and optimal markets that it even saw fit to do without it… Whatever the situation, the temptation was strong among bankers to concoct highly complex products – always more complex – with the single objective of avoiding all control from obsolete and benign authorities. A Financial Times article in September 2010 quoted a U.S. government authority who had disclosed that only two “over the counter” transactions had created the panic in the markets on a fateful day in 2008!
Acknowledging the shameful and inadmissible fact that the main regulatory agencies lacked the technical and intellectual ability to comprehend the inherent risks of the portfolios of the largest banks, the Bank for International Settlements suggested in 1998 that they delegate these responsibilities… to banks themselves, more capable, according to the BIS, of managing their own exposure! Banks were therefore authorized to evaluate and reevaluate independently their risks, which in other words meant leaving them to determine themselves their own capital quotas which must counterbalance these exposures. Unsurprisingly, they conducted logically an assessment a minimizing of their risks – what is more – by using very recent historical data with the objective of predicting future performance. How can we not be shocked by such a lack of lucidity – and honesty – from these banks which calculated their risk based on statistics often dating less than a year knowing that, furthermore, the last analyzed period was that of regular appreciation of the markets? No adverse or negative weighting was effectively introduced in their risk management since banks were not concerned with taking into consideration troubling episodes in the life of markets… This technique of evaluating banking risks was therefore based on the principle that the risk of default was confined at all times, that volatility would remain relatively low, that interest rates would be favorable… in short, that the term “crisis” had simply disappeared from the vocabulary. All was therefore for the best in the best of worlds for these financial establishments which delivered their very lucrative “business as usual” under the lax watch of the regulator. The temptation was therefore immense to step up the leveraging used and to commit to all types of loans in favor of all debtors in all sectors. After all, the models backed by general management identified the maximum risk incurred and, furthermore, the bonuses were there to encourage profits.

Economic science therefore required absolute surrender of prudence, weighting and decency – in short, morality – as the price for ensuring economic growth. The multiplication of productivity and growth and rise in purchasing power could not actually be deployed without a decline in traditional morality. The “Love one another” and the “no coercion in religion” have been abandoned in favor of the golden goose which is finance and to the cult of stock markets. Ancient religions were replaced by the efficiencies of the market whose dogma teaches that everything has a fair price. The invasion of this finance, which gradually came to occupy public and private spaces, turned us into zombies. Because we are only concerned, even obsessed, with arbitration – and the verdict – of the markets. Since financial innovation, derivatives and securitizations shot and killed prudential rules, by enshrining the advent and domination of securities. Ancestral morality effectively ceased to reign when risk disappeared. To commit a mortal sin once ran the risk of...
rushing into hell. Today, all risk is likely to be controlled, “hedged”: mathematics taught us to manage risk which reduces the degree of simple technical consideration. By abolishing uncertainty, modern finance killed morality.