It has long been recognised that Thorstein Veblen and John Maynard Keynes share a common approach to the nature of ‘business enterprise’ or ‘monetary production’ in the modern capitalist economy. While the influence of Keynes on Hyman Minsky’s ‘investment theory of the cycle and financial theory of investment’ is obvious and well known, this chapter demonstrates that Veblen’s approach is in some ways closer to Minsky’s. Further, Veblen’s approach is in many important respects more informative, and still relevant for developing an understanding of modern business practice. On the one hand, this is not surprising as Keynes had let many of the monetary details ‘fall into the background’. However, it is surprising that most followers of Keynes have not mined Veblen’s 1904 The Theory of Business Enterprise for arguments that nicely complement and extend Keynes’s better known approach. This chapter concludes with an assessment of these theories in light of the global financial collapse.

Veblen and the Distinction between the Money Economy and the Credit Economy

Probably following his teacher Richard Ely, Veblen distinguishes the ‘natural economy’ from the ‘money economy’ and the ‘credit economy’. The first refers to an economy in which distribution is ‘in kind’ without reliance on markets. The money economy refers to a system in which there is ‘ubiquitous resort to the market as a vent for products and a source of supply of goods. The characteristic feature of this money economy is the goods market.’ This is the sort of economy addressed by classical political economy, in which ‘the welfare of the community at large is accepted as the central and tone-giving interest,
about which a comprehensive, harmonious order of nature circles and gravitates. The end of production is consumption; the means is ‘monetary’ in the sense that money is used in markets. While the conventional theory can be criticised for misunderstanding the nature of production even in the money economy, Veblen argues that regardless of the ‘merits of such a point of view’, they ‘need not detain the inquiry’ because ‘[m]odern business management does not take that point of view’. By the 1870s, the money economy had been displaced by the credit economy.

Veblen’s main purpose in *The Theory of Business Enterprise* was to examine the operations of the credit economy. His distinction between industrial and pecuniary pursuits and his argument that ‘the motive of business is pecuniary gain’ are too well known to require explication. What is more interesting is his argument that in the credit economy, it is not the goods market that dominates, for ‘[t]he capital market has taken the first place […] The capital market is the modern economic feature which makes and identifies the higher “credit economy” as such.’ By ‘capital’ he means the ‘capitalized presumptive earning capacity’, ‘comprised of usufruct of whatever credit extension the given business concern’s industrial equipment and good-will will support’. This is different from ‘effective industrial capital’, the aggregate of the capitalised material items engaged in industrial output, as ‘business capital’ adds goodwill plus the credit that can be obtained using industrial capital and other non-industrial property as collateral. The key to his analysis is the divergence between the value of industrial capital and the value of business capital, because this is the basis for credit extension that ultimately generates liquidation crises, as well as trust formations.

The ‘putative earning-capacity’ is subject to fluctuation (and, as we will see, manipulation) because it is the outcome of many surmises with respect to prospective earnings and the like; and these surmises will vary from one man to the next, since they proceed on an imperfect, largely conjectural, knowledge of present earning-capacity and on the still more imperfectly known future course of the goods market and of corporate policy.

When presumptive earning capacity rises, this is capitalised in credit and equity markets, with the ‘[f]unds obtained on credit […] applied to extend the business; there is thus ‘in the nature of things a cumulative character’ because ‘the money value of the collateral is at the same time the capitalized value of the property, computed on the basis of its presumptive earning-capacity’. In this manner, credit fuels capitalised values, which fuels more credit and further increases the discrepancy between industrial and business capital values.

Management’s interest is to maximise this differential, to increase capitalised value. This then encourages the concentration of ownership through two processes. First, credit expansion will normally proceed to ‘abnormal’ levels as putative earnings are ‘over-capitalised’. The inflation of the value of the business capital as collateral will rise faster than prospective earnings that ultimately depend on final sales, the majority of which is constituted by sales to consumers (see below). Eventually the over-capitalisation will
be recognised, credit will not be renewed, loans will be called-in and assets will be sold. Because in a period of ‘buoyancy’ ‘not only is the capitalization of the industrial property inflated on the basis of expectation, but in the making of contracts the margin of security is less closely looked after’, hence there will be a general reliance on an extensive network of ‘contracts for future performance’. A general liquidation crisis can follow – all it requires is the realisation by one large creditor that the earning capacity of some debtor is not as great as the capitalisation requires. When credit is cut off, the debtor is forced to default on contracts, and to call-in others, with forced sales of assets following. This snowballs into a general liquidation that allows creditors to accumulate and concentrate industrial capital; however, the nominal value of the business capital must shrink to effect concentration of ownership along these lines.

Second, credit is used in reorganisation through corporate takeover, as industrial capital plus ‘goodwill’ created through concentration of ownership serves as collateral for loans. Further, there is something of a ‘widow’s curse’ to goodwill, as ‘it is of a spiritual nature, such that, by virtue of the ubiquity proper to spiritual bodies, the whole of it may undividedly [sic] be present in every part of the various structures which it has created’ – it is never diminished but rather can augment the capitalised value ‘of the next corporation into which it enters’. The business capital is packaged and sold at a price based on the discrepancy between the putative and actual earning capacity. Increasing this discrepancy is the prime motivation driving the ‘business interest’ of the managers – ‘not serviceability of the output, nor even vendibility of the output’, but rather ‘vendibility of corporate capital’. They are ‘able to induce a discrepancy […] by expedients well known and approved for the purpose. Partial information, as well as misinformation, sagaciously given out at a critical juncture, will go far […] [i]f they are shrewd business men, as they commonly are.’ Note that like liquidation, trusts achieve concentration; however, they do it without diminishing capitalised values.

Trust formation, in turn, is impelled by rising efficiency of industrial capital, which destroys the actual earning capacity of business capital. Technological advances ensure that newer industrial capital will reduce the pecuniary capacity of older industrial capital that is burdened with the credit that was advanced based on the discrepancy between capitalised presumptive earning-capacity and industrial capital – a discrepancy that now cannot be maintained. However, recapitalisation based on lower prospective earnings is not possible due to credit obligations – interest must be paid. The only solution is to prevent rising industrial efficiency from lowering price, but so long as competition exists this is not possible. As prices fall, production becomes unprofitable and chronic depression sets in. Veblen argues that while this is frequently described as a situation of ‘over-production’ or of ‘under-consumption’, it is really due to a ‘malady of the affections’ – earnings will not cover contracted commitments with a net profit that ‘bears a reasonable relation to the current rate of interest’. While a burst of temporary ‘wasteful’ spending (on wars, colonies and the ‘employment of the courtly, diplomatic and ecclesiastical personnel’, for example) can maintain sales and prices, waste cannot long keep up with rising industrial efficiency. The solution is ‘a business coalition on such a scale as to regulate the output and eliminate competitive sales and competitive investment […] to neutralize the cheapening of goods and services effected by current
industrial progress’.22 Thankfully, ‘[t]he higher development of the machine process makes competitive business impracticable, but it carries a remedy for its own evils in that it makes coalition practicable’ through collateralised credit expansion that can finance trust formation.23

**Similarities with Keynes**

Those familiar with John Maynard Keynes’s *General Theory of Employment, Interest and Money* will recognise many similarities in the previous discussion. These include:

1. Both make a distinction between historical epochs based on the role played by money. In his preparation of the *General Theory*, Keynes spoke of the ‘monetary theory of production’, that would deal with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a knowledge of the behavior of money between the first state and the last. And it is this which we ought to mean when we speak of a monetary economy.24 He distinguishes this from a ‘real-exchange economy’ that might use money, but ‘does not allow it to enter into motives or decisions’.25 Like Veblen, Keynes insists that in the modern economy, ‘the firm is dealing throughout in terms of money. It has no object in the world except to end up with more money than it started with.’26 Keynes’s ‘monetary economy’ is thus similar to Veblen’s ‘credit economy’ stage.27

2. Both emphasise the spending decisions of business, rather than consumer sovereignty. Investment is the critical variable in Keynes’s approach and, as in Veblen’s theory of business enterprise, it is forward looking, a function of expected future profits. In both approaches, expected profits are weighed against ‘the’ current interest rate. Because the future is uncertain, investment fluctuates with changes to confidence or ‘affections’. In both approaches, new capital competes with old investments. While Veblen focuses on the improved efficiency of the new industrial capital, Keynes emphasises the importance of different interest rates: if interest rates have fallen, the newer investment goods are satisfied with a lower profit rate – a point Veblen also recognised.28

3. Finally, both recognised a tendency toward insufficient aggregate demand. Where Veblen attributed this to a tendency for the nominal value of the capitalised firm to rise faster than prospective earnings that depend largely on final sales for consumption, Keynes argued that a ‘demand gap’ opens because the marginal propensity to consume is less than unity. By distinguishing between two kinds of spending, one (mostly, consumption) a function of income and the other (mostly, investment) autonomous, Keynes created the possibility that aggregate demand (D curve) would not rise as fast as aggregate supply (Z curve). The ‘special properties’ of money are then invoked in Keynes’s argument that investment will not normally be at the level required to generate the point of effective demand at full employment.29 Still, both blame the unemployment of productive resources on the profit-seeking behaviour of entrepreneurs. Further, both find a temporary expedient in ‘wasteful spending’ to prop up demand. In spite of the tendency of ‘Keynesians’ to present Keynes’s theory...
as ‘fine-tuning’, Keynes was as sceptical as Veblen concerning the use of wasteful spending to resolve problems of effective demand.\(^{30}\)

**Differences from Keynes**

Let us turn to an assessment of the areas in which Veblen’s analysis provides more insight into the operation of the modern capitalist economy.

1. Because Keynes was most concerned with demonstrating the determination of the point of effective demand, he primarily focused on the demand side (or multiplier) effects of investment and ignored the supply side (or, capacity) effects. This led, of course, to the extensions by Roy Harrod and Evsey Domar, which then spurred growth theory – unfortunately, mostly down a neoclassical synthesis path – and the Cambridge/capital theory debates. Work by Harold Vatter and John Walker shows how accounting for the capacity effects of investment leads to an explanation for the chronic stagnation that grips modern capitalism: capital-saving technological advance causes the capacity effects of investment to continually outstrip multiplier effects on demand, generating an excess capacity that depresses investment and growth.\(^{31}\) This is closely related to the argument made by Veblen in *The Theory of Business Enterprise* that technological advance affects all production, increasing capacity faster than potential pecuniary earnings, thus ‘chronic depression, more or less pronounced, is normal to business under the fully developed regime of the machine industry’.\(^{32}\) Again, Veblen is pessimistic that increasing ‘unproductive consumption’, including that by a deficit-spending government, will allow demand to keep pace with growth of industrial efficiency.\(^{33}\)

2. Veblen’s discussion of the role played by credit in financing growth of capitalised values not only provides insight into the important distinction between industrial capital and business capital (less important in Keynes and in those extensions made by Vatter and Walker), but it is also critical to his description of the business cycle and the crisis phase that leads to liquidation. While Keynes provides a chapter titled ‘Notes on the Trade Cycle’, *General Theory* does not really provide a theory of the cycle. By contrast, Veblen ties his theory of the business enterprise to the theory of the cycle and links this to his theory of growing concentration of ownership. Keynes does address the distinction between ownership and control of the production process, arguing that the modern corporation’s owners know little about operations, forcing management to focus on the short term out of fear of possible adverse impacts on stock prices.\(^{34}\) However, unlike Veblen, Keynes is not wholly critical of the increasing corporatisation of the economy. Indeed, his call for increased ‘socialization of investment’ (explicitly in Chapter 24 of *General Theory* and less directly in his earlier essay on ‘The End of Laissez-Faire’) could be interpreted as a call for greater concentration of decision-making that would allow concerns with the long term and social interests to play a bigger role.

3. Chapter 12 of *General Theory* is famous for its discussion of ‘whirlwinds of optimism and pessimism’, speculation and uncertainty, and for its criticism of the operation
of the stock market, likened to a game of ‘Old Maid, [or] of Musical Chairs’, or in which ‘each competitor has to pick, not those faces which he himself finds prettiest […] nor even those which average opinion genuinely thinks the prettiest […] [but rather] what average opinion expects the average opinion to be’. While Veblen agrees that there is uncertainty and speculation involved in business enterprise, he emphasises pecuniary initiative in manipulating stock values to increase differential valuation between industrial and business capital. Keynes does address the distinction between ownership and control of the production process, arguing that the modern corporation’s owners know little about operations. The ignorance of owners forces management to focus excessively on the firm’s short term performance out of fear of possible adverse impacts on stock prices. While the manipulation does carry risk, it is ‘not so much to the manipulators as such, as to the corporations […] [and to] the business men who are not immediately concerned in this traffic’. Veblen’s preference for an explanation based on ‘capitalisation’ over ‘speculation’ would seem to apply much more readily to the dealings of the Milkens and Enrons of the world. While Keynes’s description might have captured the experience of many who were duped by the NASDAQ ‘buoyancy’, those who actually produced the discrepancy between putative earnings on an imaginary scale versus actual earnings capacity in mostly negative territory did quite well.

None of this is meant to be a critique of Keynes’s General Theory. Keynes’s purpose there was narrower – to present an alternative to the neoclassical theory of the determination of the point of equilibrium. Further, Keynes wanted to provide an ‘internal’ critique, exploding neoclassical theory from within by adopting, where possible, some of the neoclassical assumptions. By contrast, Veblen was the eternal outsider, attacking ‘on several fronts at once: nationalism, the business system, war, de facto political oligarchy, a corrupted educational system, and, most generally, irrationality’. The purpose of this section has been to draw out some of the similarities between Keynes and Veblen and to point the way toward improving our understanding of what Keynes called the monetary production economy and what Veblen termed the credit economy.

Minsky and the Institutionalist Tradition

There are a number of traditions that have attempted to reject the self-adjusting vision of the system. Keynes, of course, had doubted that vision at least since his essay on the end of laissez-faire. Others within the institutionalist tradition, including Veblen and Minsky, share a similar framework of analysis that rejects the notion of an equilibrium-seeking system and sees money and finance as the major source of problems with capitalist systems – the pecuniary interests dominate. Minsky calls this a ‘pre-analytic vision’ of the operation of the financial markets and their role in directing the evolution of the economic system. In contrast to the ‘efficient markets’ approach, this pre-analytic vision concerns decision-making in a system in which dynamics are not equilibrating, indeed in which rational behaviour by individuals leads to systemically irrational results. This goes beyond the acceptance of ‘radical uncertainty’, as in Shackle’s approach or in the Austrian approach.
Instead, as Minsky put it, ‘agents in the model have a model of the model’ but they know their models are wrong. Their behaviour is based on a model they know to be incorrect and thus subject to revision; when their model changes, they change their behaviour.

In Minsky’s financial instability hypothesis, uncertainty is the result of engaging in commitments to make future financial payments with financial receipts that are uncertain because they, too, will occur in the future. In turn, those future receipts will not be forthcoming unless, at that future time, there is a willingness to enter into additional financial commitments (since spending in the future will determine future receipts). Hence, what one does today depends on what one expects others to do today, as well as into the future. Since commitments made in the past may not be validated today, and those made today may not be validated tomorrow, the movement of the system through time need not be toward equilibrium. Minsky argues instead that behaviour will change based on outcomes, in such a manner that instability will be created. For example, a ‘run of good times’ (in which expectations are at least met) will encourage more risk taking, which increases financial leveraging that creates more risk. While many accounts of Minsky’s work focus on the behaviour of non-financial firms (as in the investment decision of a manufacturing firm), Minsky argues that behaviour within financial institutions also evolves with innovations that stretch liquidity.

This provides an endogenous, rational explanation of the possible, volatile behaviour of asset prices, which is not self-equilibrating. Indeed, financial crises are usually the result of the impact of decisions taken within organised financial institutions – outside the market process – on the balance sheet stability of financial institutions. The ‘run of good times’ leads to changes of the rules of thumb guiding practice within financial institutions, leading decision makers to test the limits of acceptable practice. Minsky’s theory explains the evolution of the balance sheet positions of financial institutions and the impact on financial markets through financial layering. In particular, financial institutions find it rational to increase leverage; and rising leverage plays a crucial role in the financial instability hypothesis.

Minsky argues that the endogenous process of profit-seeking innovation will be not only a source of instability, but also make it impossible to design financial reform proposals that produce financial stability. The search for such regulations only makes sense within a theory of self-adjusting equilibrium – where ‘getting prices right’ is all that is necessary. In an evolutionary theory of innovation and instability, the concept of stability and the regulations that would be required are completely different. It requires a completely different view of the operation of financial institutions.

In the next section, I quickly review the transformation of the financial system over the post-war period as fragility rose. In many ways, the trends up to the GFC of 2007 simply replicated the processes that Veblen had discussed before the 1929 crash.

**The Transformation Away from Banking to Money Managers: Finance Capitalism Reprised?**

Rudolf Hilferding identifies a new stage of capitalism characterised by complex financial relations and domination of industry by finance. He argues that the most characteristic
feature of finance capitalism is rising concentration which, on the one hand, eliminates ‘free competition’ through the formation of cartels and trusts and, on the other, brings bank and industrial capital into an ever more intertwined relationship. Veblen, Keynes, Joseph A. Schumpeter and, later, Minsky also recognised the new stage of capitalism. For Keynes, it represented the domination of speculation over enterprise; for Schumpeter, it was the command over resources by innovators with access to finance; while Veblen distinguished between industrial and pecuniary pursuits.

By the 1870s, plant and equipment had become so expensive that external finance of investment became necessary. External finance, in turn, is a prior commitment of future gross profits. This creates the possibility of default and bankruptcy – the concerns of Minsky – while at the same time it opens the door for the separation of ownership from control. From this separation Keynes derives the ‘whirlwinds of optimism and pessimism’ addressed by Chapter 12 of his *General Theory* (attributed to the precariousness of valuing firms based on average opinion), while Veblen’s analysis points to management’s manipulation of the value of business capital to dupe owners. Schumpeter’s view was obviously more benign, as his ‘vision’ of markets was much more orthodox, but he still recognised the central importance of finance in breaking out of a ‘circular flow’ where money merely facilitates production and circulation of a given size through the finance of innovation that allows the circular flow to grow. With the rise of finance capitalism, access to external finance of positions in assets was necessary. This fundamentally changed the nature of capitalism in a manner that made it much more unstable.

As discussed above, Veblen designated the early twentieth-century version of capitalism the ‘credit economy’, wherein it is not the goods market that dominates, for ‘[t]he capital market has taken the first place […] The capital market is the modern economic feature which makes and identifies the higher “credit economy” as such’. Keynes also distinguished between ‘speculation’ and ‘enterprise’ and discussed the transition from nineteenth-century capitalism where enterprise dominated toward the twentieth-century domination by Wall Street of business decision making. Recall Keynes’s famous warning: ‘the position is serious when enterprise becomes a 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.’ And, as discussed, Veblen insisted that from the view of Wall Street’s traders, this was not high-risk activity.

As John K. Galbraith makes clear, stocks could be manipulated by insiders – Wall Street’s financial institutions – through a variety of ‘pump and dump’ schemes. Indeed, the 1929 crash resulted from excesses promoted by investment trust subsidiaries of Wall Street’s banks. Since the famous firms like Goldman Sachs were partnerships, they did not issue stock; hence they put together investment trusts that would purported to hold valuable equities in other firms (often in other affiliates, which sometimes held no stocks other than those in Wall Street trusts) and then sell shares in these trusts to a gullible public. Effectively, trusts were an early form of mutual fund, with the ‘mother’ investment house investing a small amount of capital in their offspring, highly leveraged using other people’s money. Goldman Sachs and others would then whip up a speculative fever in shares, reaping capital gains. However, trust investments amounted to little more than pyramid schemes (the worst kind of what Minsky called Ponzi finance) – there was very
little in the way of real production or income associated with all this trading in paper. Indeed, as Galbraith shows, the ‘real’ economy was long past its peak – there were no ‘fundamentals’ to drive the Wall Street boom. Inevitably, it collapsed and a ‘debt deflation’ began as everyone tried to sell out of their positions in stocks, causing prices to collapse. Spending on the ‘real economy’ suffered and we were off to the Great Depression.

For some decades after World War II, ‘finance capital’ played an uncommonly small role. Memories of the Great Depression generated reluctance to borrow. Unions pressed for, and obtained, rising compensation – allowing rising living standards to be financed mostly out of income. In any case, the government guaranteed mortgages and student loans (both at relatively low interest rates) – so most of the household debt was safe, anyway. Jimmy Stewart’s small thrifts and banks (burned during the Depression) adopted prudent lending practices. The Glass-Steagall Act separated investment banks from commercial banks, and various New Deal reforms protected market share for the heavily regulated portions of the financial sector. Military Keynesianism provided demand for the output of industry, often at guaranteed marked-up pricing. Low debt, high wages, high consumption and big government promoted stability.

The 1960s and 1970s saw the development of an array of financial institution liabilities circumventing New Deal constraints as finance responded to profit opportunities. After the disastrous Volcker experiment in monetarism (1979–82), the pace of innovation accelerated as many new financial practices were adopted to protect institutions from interest rate risk. These included securitisation of mortgages, derivatives to hedge interest rate (and exchange rate) risk and many types of ‘off balance sheet’ operations (helping to evade reserve and capital restraints). Favourable tax treatment of interest encouraged leveraged buy-outs to substitute debt for equity (with the take-over financed by debt that would be serviced by the target’s future income flows). Another major transformation occurred in the 1990s with innovations that increased access to credit and changed attitudes of firms and households about prudent levels of debt. Now consumption led the way as the economy finally returned to 1960s-esque performance. Robust growth returned, now fuelled by private deficit spending, not by the growth of government spending and private income. All of this led to what Minsky called money manager capitalism.

While many point to the demise of Glass-Steagall separation of banking by function as a key mistake leading to the crisis, the problem really was the demise of underwriting. In other words, the problem and solution are not really related to functional separation but rather to the erosion of underwriting standards that is inevitable over a run of good times when a trader mentality triumphs. If a bank believes it can offload toxic assets before values are questioned, its incentive to do proper underwriting is reduced. And if asset prices are generally rising on trend, the bank will be induced to share in the gains by taking positions in the assets. This is why the current call by some for a return to Glass-Steagall separation, or to force banks to ‘put skin in the game’ by holding some fraction of the toxic waste they produce are both wrong-headed.

Minsky argues that the convergence of the various types of banks within the umbrella bank holding company, and within shadow banks was fuelled by growth of money manager capitalism. It was also encouraged by the expansion of the government safety net, as Minsky remarks: ‘a proliferation of government endorsements of private
Indeed, it is impossible to tell the story of the current crisis without reference to the implicit guarantee given by the Treasury to the mortgage market through its GSEs (Fannie and Freddie), through the student loan market (Sallie), and even through the ‘Greenspan Put’ and the Bernanke ‘Great Moderation’, which gave the impression to markets that the government would never let markets fail. In the aftermath of the crisis, the government’s guarantee of liabilities went far beyond FDIC-insured deposits to cover larger denomination deposits as well as money market funds and the Fed-extended lender of last resort facilities to virtually all financial institutions (with bailouts also going to automotive companies and so on). This really was a foregone conclusion once Glass-Steagall was gutted and investment banking, commercial banking and all manner of financial services were consolidated in a single financial ‘big box’ superstore with explicit government guarantees over a portion of the liabilities. It was always clear that if problems developed somewhere in a highly integrated system, the Treasury and Fed would be on the hook to rescue the shadow banks, too.

In the 1990s the big investment banks were still partnerships, so they found it impossible to directly benefit from a run-up of the stock market, similar to the situation in 1929. An investment bank could earn fees by arranging initial public offerings for start-ups and it could trade stocks for others or on its own account. This offered the opportunity to exploit inside information, or to manipulate the timing of trades, or to push the dogs onto clients. But in the euphoric irrational exuberance of the late 1990s that looked like chump change. How could an investment bank’s management get a bigger share of the action?

In 1999, the largest partnerships went public to enjoy the advantages of stock issue in a boom. Top management was rewarded with stocks – leading to the same pump-and-dump incentives that drove the 1929 boom. To be sure, traders like Robert Rubin (who would become Treasury secretary) had already come to dominate firms like Goldman Sachs. Traders necessarily take a short view – you are only as good as your last trade. More importantly, traders take a zero-sum view of deals: there will be a winner and a loser, with the investment bank pocketing fees for bringing the two sides together. Better yet, the investment bank would take one of the two sides – the winning side, of course – and pocket the fees and collect the winnings. Why would anyone voluntarily become the client, knowing that the deal was ultimately zero-sum and that the investment bank would have the winning hand? No doubt there were some clients with an outsized view of their own competence or luck; but most customers were wrongly swayed by investment banks’ good reputations. But from the perspective of hired management, the purpose of a good reputation is to exploit it for personal gain – what William Black calls control fraud.

Before this transformation, trading profits were a small part of investment bank revenues – for example, before it went public, only 28% of Goldman Sachs’s revenues came from trading and investing activities. That is now about 80% of its revenue. While many think of Goldman Sachs and JP Morgan (the remaining investment banks since the demise of Lehman, Bear and Merrill, which all folded or were absorbed) as banks, they are really more like huge hedge funds, albeit very special ones that now hold bank charters, granted during the crisis when investment banks were having trouble refinancing positions in assets – giving them access to the Fed’s discount window and to FDIC insurance. That in turn lets them obtain funding at near-zero interest rates. Indeed, in
2009 Goldman spent only a little over $5 billion to borrow, versus $26 billion in interest expenses in 2008 – a $21 billion subsidy thanks to its access to cheap, government-insured deposits. The two remaining investment banks were also widely believed to be ‘backstopped’ by the government – under no circumstances would they be allowed to fail – keeping stock prices up. However, after the SEC began to investigate some of Goldman Sachs’s practices, that belief was thrown into doubt, causing share prices to plummet.

In some ways, things were even worse than they had been in 1929 because the investment banks had gone public – issuing equities directly into the portfolios of households and indirectly to households through the portfolios of managed money. It was thus not a simple matter of having Goldman Sachs or Citibank jettison one of its unwanted trust offspring – problems with the stock or other liabilities of the behemoth financial institutions would rattle Wall Street and threaten the solvency of pension funds and other invested funds. This finally became clear to the authorities after the problems with Bear and Lehman. The layering and linkages among firms – made opaque by over the counter derivatives such as credit default swaps – made it impossible to let them fail one-by-one, as failure of one would bring down the whole house of cards. The problem we faced is that total financial liabilities in the US amounted to about five times GDP (versus 300% in 1929) – so that every dollar of income must service five dollars of debt. That is an average leverage ratio of five times income. That is one way to measure leverage, for as Minsky and Mayer argue, this is, historically, the important measure for bank profitability – which ultimately must be linked to repayment of principle and interest out of income flows.48

Another measure is the ratio of debt to assets. This became increasingly important during the real-estate boom, when mortgage brokers would find finance for 100% or more of the value of a mortgage, on the expectation that real-estate prices would rise. That is a trader’s, not a banker’s perspective because it relies on either sale of the asset or refinancing. While a traditional banker might feel safe with a capital leverage ratio of 12 or 20 – with careful underwriting to ensure that the borrower would be able to make payments – for a mortgage originator or securitiser who has no plans to hold the mortgage what matters is the ability to place the security. Many considerations then come into play, including prospective asset price appreciation, credit ratings, monoline and credit default swap ‘insurance’ and ‘overcollateralization’ (markets for the lower tranches of securities).

We need not go deeply into the details of these complex instruments. What is important is that income flows take a back seat in such arrangements, and acceptable capital leverage ratios are much higher. For money managers, capital leverage ratios are 30 and reach up to several hundred. But even these large numbers hide the reality that risk exposures can be very much higher because many commitments are not reported on balance sheets. There are unknown and essentially unquantifiable risks entailed in counter-parties – for example, in supposedly hedged credit default swaps in which one sells ‘insurance’ on suspected toxic waste and then offsets risks by buying ‘insurance’ that is only as good as the counter-party. Because balance sheets are linked in highly complex and uncertain ways, failure of one counter-party can spread failures throughout the system. And all of these financial instruments ultimately rest on the shoulders of...
some homeowner trying to service his or her mortgage out of income flows – on average with $5 of debts and only $1 of income to service them. As Minsky argues, ‘National income and its distribution is the ‘rock’ upon which the capitalist financial structure rests.’ Unfortunately, that rock is holding up a huge financial structure, and the trend toward concentration of income and wealth at the top makes it ever more difficult to support the weight of the debt.

Moving away from income flows and to prospective asset price appreciation opened the door to Veblenian ‘manipulation’, just as it did in the late 1920s. A clever investment bank can always assign any price desired, pumping up fictitious ‘goodwill’ in the 1920s or using ‘internal proprietary models’ in the 2000s. Thus, we had a series of speculative bubbles (e.g. dot-com stocks, commodities, real estate) that allowed capital gains to dominate over income flows in price determination. The whole thing was fuelled by heavily leveraged lending. Collapse was a certainty, indeed desired by insiders who planned to get out first. And when it came, government intervened to save Wall Street. So unlike the 1929 crash, this time around there was no lesson learned, no cleaning of the financial house on Wall Street. Another bubble and bust awaits. But that is a story for another day.

Conclusions

In many important ways, the 2007 crash resulted from processes that replicated the problems analysed by Veblen and Keynes. While I think that Keynes’s analysis provides the best theoretical framework from which to analyse the modern ‘monetary production economy’, Veblen’s ‘theory of business enterprise’ provides a much more critical analysis of the actual processes. Minsky always argued that he stood on the shoulders of Keynes, borrowing the ‘investment theory of the cycle’ and adding ‘the financial theory of investment’. But Minsky had been raised in the Chicago institutionalist tradition and it is obvious that institutional detail plays an important role in Minsky’s approach. Indeed, Minsky was much less willing than Keynes to attempt to produce a ‘general theory’ – his theory was always specific, concerning the capitalism he observed. In that respect, he was much more like Veblen. His analysis of the transformation of US capitalism provides the insights we need to study the GFC. Unfortunately he died in 1996 so he cannot provide for us a study of ‘the Great Crash’ like the analysis that Galbraith provided for the 1929 crash. However, he does point the way.

Notes and References

3 In Evolution of Industrial Society, Richard Ely quotes German economist Bruno Hildebrand, founder of the German Historical School on this sequencing: truck economy (i.e. barter economy), money economy, credit economy. See Richard Ely, Evolution of Industrial Society (New York: Chautauqua Press, 1903).
5 Ibid., 69.
6 Ibid., 16. Veblen argues that ‘[l]ooking at the process of economic life as a whole […] [as if it were] a collective endeavor to purvey goods and services for the needs of collective humanity […] need neither be defended nor refuted here, since it does not seriously touch the facts of modern business’ (ibid., 196, 11n).

7 Of course, orthodoxy remains fixated on developing theory for the hypothesized economy dominated by the sovereign consumer and ‘in which all things should work together for the welfare of mankind’ (ibid., 69) – a theory that was not even appropriate to nineteenth-century capitalism.

8 Ibid., 16.

9 Ibid., 75.

10 Ibid., 65.

11 Ibid., 77.

12 Ibid., 55. Veblen goes on: ‘competing business men bid up the material items of industrial equipment by the use of funds so obtained […] the aggregate of values employed in a given undertaking increases […] but since an advance of credit rests on the collateral as expressed in terms of value, an enhanced value of the property affords a basis for a further extension of credit’ (ibid., 55). See also Patrick J. Raines and Charles G. Leathers, ‘Veblenian stock markets and the efficient markets hypothesis’, Journal of Post-Keynesian Economics 19.1 (Fall 1996): 137–51; Matthew C. Wilson, ‘Budget Constraints and Business Enterprise: a Veblenian Analysis’, Journal of Economic Issues 40.4 (December 2006): 1029–44, for discussions of use of collateral to support credit.

13 This is where the divergent interests of owners and managers become important, because ‘the business interest of the managers demands, not serviceability of the output, nor even vendibility of the output, but an advantageous discrepancy in the price of the capital which they manage’ (Veblen, Business Enterprise, 79).

14 Ibid., 56.

15 Ibid., 97.

16 This goodwill includes ‘[v]arious items, of very diverse character […] the items included have this much in common that they are “immaterial wealth”, “intangible assets”; which […] are not serviceable to the community, but only to their owners’ – precisely because it can be collateralised and thereby increase the divergence between the values of industrial and business capital (ibid., 70). Also, see Wilson, ‘Budget Constraints’ for discussion of market evaluation of goodwill.

17 Veblen, Business Enterprise, 85.

18 Ibid., 79.

19 Ibid., 77–8.

20 Ibid., 114; 105–6.

21 Ibid., 122–3.

22 Ibid., 115–16.

23 Ibid., 125.


25 Ibid., 408–9.


27 Interestingly, both Keynes and Veblen addressed the stability of the purchasing power of money. For Keynes, relatively stable value of money (especially in terms of the nominal wage) is essential to maintaining its liquidity (John Maynard Keynes, The General Theory of Employment, Interest, and Money (London: Harcourt Brace Jovanovich, 1964), 240–41, 270). For Veblen, the presumption of stability of nominal values is important for business practice (as opposed to
industrial pursuits): ‘Capitalization as well as contracts are made in its terms, and the plans of the business men who control industry look to the money unit as the stable ground of all of their transactions’, even though they know ‘the value of money has varied incontinently throughout the course of history’ (Veblen, *Business Enterprise*, 45).

28 ‘[A] low or declining rate of interest is effective in the way of depressing the business situation […] What gives effect to this drawback for the business enterprises which have such fixed interest charges to meet is the fact that the new investments […] come into competition with the old. These new or rejuvenated concerns are not committed to a scale of fixed charges carried over from a higher interest level’ (ibid., 107). As Vining emphasises, in both Veblen and Keynes interest is eminently a pecuniary or monetary phenomenon; see Rutledge Vining, ‘Suggestions of Keynes in the Writings of Veblen’, *Journal of Political Economy* 47.5 (October 1939): 692–704.


30 For a discussion of similarities in Veblen and Keynes on this score, see Vining, ‘Suggestions’. However, it is undoubtedly true that the policy recommendations in Chapter 24 of Keynes’s *General Theory* are more optimistic than the prognosis of the ‘natural decay of business enterprise’ in Chapter 10 of Veblen’s *Business Enterprise*.


33 Ibid., 122–3.

34 As ‘human nature desires quick results […] remoter gains are discounted by the average man at a very high rate’ (Keynes, *General Theory*, 157).

35 ‘And there are some, I believe, who practice the fourth, fifth and higher degrees’ (ibid., 156).


37 Ibid., 82–3.


43 Keynes, *General Theory*, 159.


45 Minsky defined it as follows: ‘Capitalism in the United States is now in a new stage, money manager capitalism, in which the proximate owners of a vast proportion of financial instruments are mutual and pension funds. The total return on the portfolio is the only criteria 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’; see Hyman Minsky, ‘Uncertainty and the Institutional Structure of Capitalist Economics’, *Working Paper 155* (April 1996), Levy Working Papers.

46 Hyman Minsky, ‘Reconstituting the Financial Structure: The United States’ (prospective chapter, four parts) (13 May 1992), manuscript in Minsky Archives at Levy Institute, 39.

