

1. BANK LENDING, INTEREST, AND MONOPOLY: PRE-KEYNESIAN HETERODOXY IN MACRO-MONETARY DYNAMICS

Guido Giacomo Preparata and John E. Elliott

ABSTRACT

There are two sides to the lending of money: the 'micro' and the 'macro'. The microeconomic side comprises various routines performed by bankers in assessing the profitability of an investment. The macroeconomic side reflects the impact of such institutional banking routines on the rest of the economy. This chapter examines the repercussions of a few generally accepted bank precepts on the overall dynamics of the economic system by unearthing the monetary theory of Silvio Gesell and applying it to three important 'macro' scenarios: Schumpeterian innovation, Veblen's absentee ownership and technically productive investment, and Malthus's theory of market gluts.

Il denaro e un credito; il credito e un' idea,
a cui soltanto la fiducia da esistenza.*

Geminello Alvi (Uomini del Novecednto)

* Money is a credit; credit is an idea, whose existence is warranted only by trust.

INTRODUCTION

There are two sides to the lending of money, that may be characterized roughly as ‘micro’ and ‘macro’. The microeconomic side comprises the various routines performed by bankers (and other lenders) in assessing the profitability of an investment. Part I of this chapter discusses briefly this microeconomic dimension of bank lending, preceded by introductory comments.

The macroeconomic side, by contrast, focuses on the impact of such institutional banking routines on the rest of the economy. Part II of the chapter examines the repercussions of a few generally accepted bank precepts (identified in Part I) on the overall dynamics of the economic system. We began with the vision of the ‘monetary crank’ Silvio Gesell, and the associated argument that interest constrains investment. We then turn to three important ‘macro’ scenarios. Thus, the first routine of bank lending (the evaluation of the expected profitability of a project) is cast in a macro context via Joseph Schumpeter’s theory of the innovative entrepreneur. The second precept (the alleged separation of banks and industry) is juxtaposed to Thorstein Veblen’s conceptualization of trusts and absentee ownership. The theme of socially productive investment (the third and last desideratum) is revisited in the light of Thomas Malthus’s characterization of the theory of market gluts and C. H. Douglas’s views on inadequate purchasing power.

Chronologically, of course, we should begin with Malthus and close with Schumpeter. But analytically, we reverse the organization of Part II and, after an examination of Gesell’s views on money, lending and interest, we commence with Schumpeter because his theory of the macrodynamics of money, interest, and cyclical fluctuations is set in the simple and most general context of competitive entrepreneurship and innovation. Veblen comes next because his focus is on an oligopoloid economy characterized by collusion, trusts, and monopoly control over prices. Douglas and Malthus round out the discussion because of their broader emphasis on inadequate aggregate demand and interconnections between investment and consumption.

Hence, the issues broached in this chapter are all current; yet the discussion that follows – bank lending from a ‘macro’ perspective – hinges on the reflections of several pre-Keynesian heterodox figures in the history of economic thought. What is the motivation behind this ‘antiquarian’s’ mix? First, the unearthing of dusty classics in these times of narrowed expertise and *ahistorical* pedagogy is wholesome *per se*. Second, the ‘re-staging’ of quietly dismissed polemics on banking testifies to the undaunted obscurity that has always inked the subject of *money* (and to the inconclusive drift of modern, dominant, theories). Third, *common to the thinkers reviewed herein is the*

belief that the economics of Mother Nature and that of Money – as it has popularly been conceived – are essentially different and distinct. More specifically, all of these figures (each according to his idiosyncrasies) depicted capitalism as a system wherein money, by dint of its institutional and physical properties, once it encroaches upon Nature, is able to bend her cycles to its logic, and is bound thereby to dictate the pace of production.

Finally, the writers whose ideas are examined and compared herein are all heterodox figures, outside the mainstream of classical/neoclassical economics, to a greater or lesser extent. Like many other critical figures in the history of economic thought, their heterodoxy lay not primarily in the answers they provided to questions but in the alternative questions they posed. Specifically, why are there economic crises, gluts, and cyclical fluctuations, in market capitalist, money-using economics, especially in the context of late nineteenth-early twentieth century oligopoly and monopoly? Thus, whereas Knut Wicksell, for example, incorporated money into an equilibrium framework, the economists studied herein may best be interpreted from the perspective of macrodynamics. And, whereas neoclassical economics, in general, may be understood as asking, ‘how are resources allocated’, economic heterodoxy asks, ‘how can we go about freeing resources that have been made artificially scarce?’

One surmizes that because of the heterodoxy of the questions the economists under review here raised, as well as the answers they provided to these questions, their contributions were and have been relatively neglected. But questions and issues such as interest as a tax on profits, insufficiency of aggregate demand, monopoly power in financial and industrial sectors of the economy, and depression and unemployment are interesting and important, today no less so than in the nineteenth and early twentieth centuries. Thus, per-Keynesian (but non-Marxian) heterodoxies in the historical evolution of economic ideas provide valuable entry points for scholarly investigation and critique of contemporary as well as earlier perspectives. Moreover, earlier heterodox economists in the arena of macro-monetary dynamics have had their (albeit modest) influence on subsequent economic thinking, such as that of Irving Fisher and John Maynard Keynes. Keynes, for example, characterizes Malthus and Gesell as writers who, “following their intuitions, have preferred to see the truth obscurely and imperfectly rather than to maintain error, reached indeed, with clearness and consistency and by easy logic, but on hypotheses inappropriate to the facts,” and cites Douglas as “a private, perhaps, but not a major in the brave army of heretics” cognizant of “the outstanding problem of our economic system” (Keynes (1936): p. 371).

Part I

THE MICROECONOMIC DIMENSION

What makes Banks Different?

“What’s different about banks?” (Fama (1985)); what makes banks so special that a creditor is willing to place his money in bank deposits which, compared to any other form of savings (or security) available on the market of equivalent risk, actually pay a lower return?

A peculiarity of demand deposits, and thus *bank* security, lies in the mandatory or customary reserve requirement the bank (typically) seeks to satisfy. A percentage of the borrowed sum is withheld, thereby acting as a tax, largely borne by bank depositors. Other securities (commercial, industrial or financial) of equivalent risk are not subject to this ‘tax’, and thus, the *bank* service should be systematically discarded. Yet, this doesn’t happen. Therefore the initial question may be reformulated: ‘what are the benefits, offered by the bank, which make savers willing to forego the higher effective return (that is, ‘untaxed’) of a generic security?’

Banks derive their strength and relative attractiveness from two fundamental sources. First, banks have the privilege to create money *ex nihilo* and thereby provide customers with access to the vast network of essential payment services (the checking system for transferring claims on wealth) managed by the banking system. Second, the banking system closely interacts with industry. In the language of ‘asymmetrical information theory’, agents are willing to pay a higher price for the bank service since the bank – institutionally – has the faculty to monitor the performance of those firms to which it lends money. This amounts to saying that the creditor would rather entrust the bank (with his savings) which, on the basis of ‘insider’ information, will choose to finance the most promising firms, than try himself to select the firm to bet on: the remunerative differential (the nominal interest minus the implicit reserve tax) accounts for the price of the information preserved by banks (similar to the commission paid for agency contracts).

These two ‘virtues’ of the banking system, especially the second one, lead to the crucial issue of what behavioral patterns banks follow in the transition from the micro- to the macroeconomic sphere. Given a set of operational routines, which punctuate the daily activity of the bank (the ‘micro’ dimension), one wonders what sort of aggregate dynamics emerge when the interaction between banks and the other components of the productive system (firms, consumers, workers, etc.) are taken into consideration. The presence of other, fundamental,

economic agents obviously has a great impact on the conduct of banks. Consequently, their practices (loans, management of funds, etc.) are constantly permeated by the ongoing evolutionary process staged on the market. This kind of inquiry tries to shed light on the type of trajectories and *collective* economic behaviors that emerge when agents who, *individually*, perform simple and definite tasks, are aggregated and find themselves acting as members of a *group*. More specifically, in this study, we shall try to describe how bank lending routines, which have an articulation of their own, influence and are influenced by the joint action of the banking system as a whole and the productive apparatus.

The following section discusses bank lending from the ‘micro’ perspective, by expounding some of the basic principles that constitute the essential articulation of the money-lending business.

Bank Lending Routines

What governs bank lending? There doesn’t seem to be a golden rule. Leaving aside semantic nuances, such as bankers’ declarations that ‘lending is truly an art’, one can easily subsume the set of bank lending practices – in the wake of the Neo-Schumpeterian tradition (Nelson and Winter (1982)) – under the heading of *firm routines*. Routines are ways of ‘doing the thing’, which, in any firm represent the most technologically advanced solution to a given problem. A routine is a procedure that agents perform mechanically; it is based on a long learning process, of which it represents the last point along in time as well as the synthesis.

The operational procedures adopted for evaluating the ‘credit worthiness’ of the clientele, especially of those firms that need financing, are meant to guarantee the ‘stability of financial intermediaries and their contribution to the allocation of resources’ (Ciocca (1983): p. 128).¹ From the inception of credit transactions to the complex operations of our time, the economy can be thought of as having functioned like a vast and intricate reticulation of ‘promises’ (Scherman (1938)), whose regular fulfillment ultimately depends on the *reliability* of agents. Thus, ‘credit worthiness’ becomes the fundamental requisite for the success of banking policies that, in the great fabric of promises, play a crucial role. In fact, the division of labor and the increasing complexity of commercial and productive interrelations have made deferred exchange (goods or services in exchange for a ‘promise’ of money to be delivered at a given future date) one of the key instruments of modern economic activity. And to feed a system whose pace is set by the scansion of deferred exchange, agents have systematically resorted to the ‘catalyzing’

powers of banks: powers that allow them, with a loan, to ‘coin into dollars’ not easily exchangeable goods, by granting to the owners a *drawing right* in return for the goods secured as collateral;² accounting powers that allow the customers of the bank – whether merchants, entrepreneurs or consumers – to compensate with one another their mutual credits and debits.

A fabric of promises, whereby the good fortune of a project is bound to rely on a lengthy chain of performances: the breaking of a link, an unhonored commitment, could seriously jeopardize the whole structure of production. At this point, one is led to discern whether there are links that are more important than others and where crises may originate from, that is, what are the links that would tend to break first. The banking system is certainly not an ordinary agent within such a flow of promises, and its routines, at a purely notional level, give an inkling of some of the essential mechanisms that animate the allocation of resources.

The saver, whenever he decides to deposit his money in a bank, and accepts, in exchange, a simple promise (neither oral nor written) to repay the same sums upon request, discovers that he has to trust the banker blindly; likewise, the banker, before he can loan the money he is entrusted with, will have to ascertain whether the client can keep his promise, faithfully: “Here lies the real secret of modern banking. . . The banker’s relation to business, indeed, is that of the critic of literature. If he is perspicacious, he is able to assay the nature and merits of an economic enterprise more truly, certainly more dispassionately, than its creator” (Scherman (1938): p. 125). As we have said, the yardsticks the banker will use in order to gauge the worthiness of the client are an important part of the basic set of routines adopted; the latter evolve, by definition, very slowly and reflect a long sequence of intuitions, errors and refinements.

Manuals and studies in the field of bank lending³ focus on a few general principles allegedly forming the skeleton of bank lending.^a These are:

(1) *The evaluation of the expected profitability and risk of a project*

“The theory of portfolio choice has generalized and formalized the traditional bank approach. According to the theory, the relationship with a client that has

^a We say ‘allegedly’ because we do not claim here that these precepts were/are actually followed in practice. Indeed, there is a degree of tension among them, notably between the second and the third; on the other hand, these ‘micro’ principles generally presuppose macro-stability – a presupposition that is denied by the heterodox economists under review here.

an associated risk higher than that of another relationship, can be taken into consideration only if the expected return is also higher than it is in the other case” (Ciocca (1983): p. 931). In the portfolio selection theory, the risk associated with each investment opportunity is measured by a specific variance that indicates ‘the volatility of potential results’ (according to a definition from a survey of *The Economist*);⁴ intuitively, a high variance must be associated with a high return, and thus with a high rate to charge to the client. In other words, the banker is presumed to be *risk averse*.

(2) *The alleged separation between banks and industry*

This principle propounds that banks should be as neutral as possible in making important decisions, and thus, not to tie their fate – and that of their customers – to the vicissitudes of some industrial clan. With a providential tone, Schumpeter adds to this precept that banks must also be independent of politicians (and bureaucrats): their meddling with the creation and direction of new purchasing power would eventually undermine that disruptive process of technological innovation that has characterized, through ups and downs, the development of western capitalism.

In practice, this rule has been – and still is – regularly broken. Banks frequently discontinue their standard evaluation of credit riskiness when political parties, trade unions, and boards of TV Channels ask them for their services.

(3) *The evaluation of the firm, with regard to the type of project it intends to achieve*

This aspect is crucially important for it singles out bank capability to channel money flows in specific directions, and thus shapes mightily the process of economic development. The choice of a particular *type* of project (technological innovation, infrastructure, transportation, communication, construction, etc.) is decisive in delineating the economic and social configuration of the interested country. According to the logic of bank lending routines, “the essential and specific function of the bank is indeed that of selecting those firms pursuing projects that are deemed compatible, from an economic and social standpoint, with the price system or with the list of priorities set forth by public planning” (Ciocca (1983): p. 932).

Summing up, banks must cautiously calibrate the risk of each candidate project, they must not ratify incestuous alliances with industry, they must bet on the potentiality of the entrepreneur and, possibly, they should convey the

mass of private savings – through the leverage of deposits – toward investments devoted to increasing the productive potential of the economy, provided that these projects ‘are deemed compatible. . . with the price system’.

In principle, according to these microeconomic principles, the duty of banks does not appear to be more arduous than that of a generic firm: once certain essential efficiency conditions have been satisfied, the secret of the craft would be that of tracking down the winning (that is, profitable) investment: so much the better if it is also socially useful.

Therefore, the banker’s challenge, given the catalyzing powers at his disposal (creation of the means of payment and knowledge of the industrial territory), should be all the more stimulating since, on the one hand, he competes daily with other capitalists, and on the other, he has the opportunity to influence the productive dynamics of the system as a whole, supposing that investments have passed the ‘acid test’ of the price system.

What does this mean? Would this condition imply that certain kinds of projects, even if socially useful, cannot be approved because they have been stamped as ‘not profitable’, or ‘too risky?’ Why does the banking system, which should be a ‘coherent’ center of organization of community resources, complain – especially in recent years – that it is continually threatened by risk? And why is the banker constantly haunted by the inexorable reaction of the price system?

To these important questions, which cast the ‘short-range’ interactions of bank lending routines on the complex texture of macroeconomic trajectories (that combine the actions of all involved agents into one trend), necessarily tentative answers will be given. Our goal is mainly that of raising a number of topics whose further investigation is necessary for the understanding of certain critical economic processes.

Of all these topics, the problem of **interest** – which will serve in Part II below as a preamble to the discussion of ‘macro’ implications of the three routines outlined above (expected profitability of the customer, separation between banks and industry, usefulness of the financed project) – bears the palm.

The idea behind the next section of the present study is that of isolating bank-lending routines from their microeconomic context, of abstracting them from their formal integument of ‘precepts’ or ‘simple firm behaviors’, and entwining them within the great wheels of the economic system, so as to analyze the ways in which banks – through these routines – move and are moved, direct and are directed, by the other momentous forces stalking the economic arena.

Part II

THE MACROECONOMIC DIMENSION

(1) Basic Interest: The Vision of Silvio Gesell

Bankers, in order to assess the profitability of a project in terms of the canons of bank lending, will have to convert the project into monetary flows and thus try to anticipate the dynamics of the *price system*. Obviously, the investment must be remunerative; that is, it must be compatible with the price system. To put the matter in simpler terms, the banker hopes that the selling price of the good he is actively supporting does not fall, or better still, that it increases, so that he may be able to recoup his slice of surplus, known as *interest*.

Interest: what seems to be, from time immemorial, following the benign and sober digressions of British classicism, one of the most 'natural' exchanges, is truly the outcome of the power emanating from the 'prince' of all exchanges: money.

Silvio Gesell – the forgotten monetary crank – saw in money the most powerful form of capital and defined it as 'the archetype of death'. As he put it: 'In the substance of money we seek negative, not positive properties. The minimum of material properties is what all men demand of the material part of money' ((1920): p. 52). Gold, for instance, owes its success to the fact that it 'neither rusts nor rots, neither grows nor decays, neither scratches, nor burns, nor cuts. Gold is without life, it is the archetype of death'.

The diffusion and evolution of the monetary medium had closely followed the buoyant effects triggered by the division of labor. Technological progress has flooded markets with enormous quantities of goods, and has simultaneously injected liquidity in the system to let the cycle of exchanges run smoothly. Thus, two opposing forces have always wrestled: on the one side, we find the supply of goods – which immediately translates into the demand for money – and on the other, the demand for goods – which is represented by the supply of money. Yet, the type of configuration markets lock in when these two forces encounter one another has really little to do with the neoclassical equilibrium scenario. The notion of a 'real' economy in equilibrium, where money is only the 'veil' of exchanges which, at the margin, satisfy the entire community, is little more than mystification. Instead, the relationship that comes about between the holders of money and the producers of goods and services is of a very peculiar sort. The demand for money – that is, the supply of goods – consists of an aggregate of goods, material, tangible, perishable; the supply of money, instead, is not even 'grazed' by the erosion of time: the

former is like a swollen river which, by its very nature continually floods the market looking for buyers; the latter can afford to wait, imperturbable, for more advantageous conditions. The goods comprised in the supply deteriorate every day, and consequently, fresher merchandise will be sold at a higher price; for the supply of goods, postponing the exchange is lethal. Money, however, by dint of its negative properties, not being prodded by 'impulses' inherent in the substances that compose the goods, has no fear of procrastinating the transaction with its counterpart. And such an exorbitant advantage has rendered money, since its birth, the supreme umpire of market exchanges. Therefore, he who holds money has no difficulty in asking for a tribute, a reward for his unavoidable services. The premium that is claimed in exchange for the medium of payment – the *conditio sine qua non* for the survival of trade – is indeed interest: 'basic interest', as Gesell calls it.

Basic interest is exacted during the exchange process: the holder of money, whom Gesell identifies as 'the merchant', is able to collect from the producer an augmented sum for the fact that he has agreed to abstain from deferring, if not interrupting altogether, the purchase of the goods. The tribute, according to Gesell, has hovered, for several thousands of years, around 5% of total business capital.

Gesell lays much emphasis on the transaction during which the tribute is exacted (the exchange), and thus accentuates the intermediary position of the *mercatores* who, juggling their tinkling coins, ultimately find themselves pulling the strings of economic activities. However, although basic interest appears during the exchange, the role of the merchant, indeed, reduces to that of a mere 'taxman-middleman', since basic interest, which has to be squeezed out of the margin earned, must be handed over, unfailingly, to the provider of money. And who provides the money? As we move back to the origin of the chain of promises, we again meet the banker.

Alternative forms of means of payment, by preventing money from pretending usurious rates, tend to exert a competitive pressure that ultimately determines and regulates the threshold level basic interest converges to. There are three forms of payment competing with money. These are (Gesell (1920): pp. 227–233): the bill of exchange, barter, and primitive production (inspired by the model of the autarchic, self-sufficient, farm). If the banker tries to change interest higher than the equilibrium level, agents would experiment with alternative channels to the circulation of money. In developed capitalistic economies, barter and primitive production are not plausible scenarios; the only workable option left is the bill of exchange which, in the opinion of Gesell, is indeed capable of 'wresting' merchandise from bank money. The immediate effect of the parallel circulation of bills of exchange would be that of pushing

up the price of goods, since the same stock of money would then be available for a reduced quantity of merchandise (part of it being won over by bills of exchange). Yet, a gradual upsurge of prices would entice money to come out of the vaults in anticipation of a further increase; this renewed circulation would thus be accompanied by a reduction of the tribute, which would finally settle down to its former equilibrium level (that is, compatible with current institutional and productive conditions). Conversely, were the tribute to fall below the threshold, production would be stimulated to a point that would make prices collapse, and when prices collapse, money recoils immediately to hide in the safes, lest it be unable to exact the normal tribute. This sequence of effects would drive up the tribute towards its threshold value. Of course, there are stratagems to get the bill out of the way: one only needs to burden it, through stamp taxes.

Gesell's proposition that money will not circulate if goods prices fall (relative to wages and interest) is of paramount importance. In fact, we can now state that *an investment is compatible with the price system when the expected price level is high enough to warrant in exchange at least the exaction of basic interest.*

Gesell contends that the division of labor is not systematically balanced by an adequate stock of money, and this discrepancy – many goods versus scarce money – acts only to further depress the price of commodities. It is precisely because prices fall, that money hides to be hoarded. The supply of money decreases, the demand for money increases; so does the supply of goods, which pile up in warehouses. At this point, expectations enter the picture and the process of contraction winds downward in a spiraling path with self-reinforcing effects: fearing that prices might further decrease, no merchant dares to purchase anything; goods are 'unsellable' because they are cheap and threaten to become even cheaper. The crisis begins. An increase in prices has symmetrical repercussions: the holder of money knows that what he bought today can be sold tomorrow at a higher price; thus he buys as much as he can, relying heavily on credit leverage. Banks will encourage speculation as long as they feel they are in a bull market. Even in this case, the dynamics is of a self-reinforcing kind, yet with an inflationary bias: 'prices rise because they have risen'.

Hypotheses concerning: the nature of a boom, a collapse of prices and the ensuing crisis, and the routines adopted by banks to face the seismic waves generated by industrial transformation, will be canvassed in the following sections. In concluding this brief overview of Gesell's monetary theory, it is important to underscore how powerful and incisive the analysis of certain phenomena may be when money is no longer considered an ordinary

commodity, but is viewed, instead, as capital: “it is offered in exchange as long as it can obtain interest, and no longer. No interest, no money!” (Gesell (1920): p. 126). How distant such a vision is from those conceptions that liken interest to “the price of the heartbeat,”⁵ “the natural difference in value between present and future goods,”⁶ or “the reward for abstinence” (or forbearance).⁷

(2) *Expected Profitability of a Project: Technological Innovation and the Schumpeterian Entrepreneur*

We now turn to the macrodynamics of Joseph Schumpeter, notably as presented in his 1911 *magnum opus*, *The Theory of Economic Development* (Schumpeter (1983)). Although perhaps under-recognized, both by Schumpeter and the economics profession in general, there are striking parallels between the views on money, interest, and cyclical fluctuations of Gesell and Schumpeter. Moreover, Schumpeter’s theories expressly link the microeconomics of bank lending (notably, its first precept, identified in Part I, above) to macrodynamics processes of expansion, crises, and contraction.

For both Gesell and Schumpeter, interest is a monetary phenomenon. Schumpeter distinguished between a system of static, general equilibrium and the dynamic processes of economic development. In the former, production and consumption are so ‘synchronized’ that values just equal costs (fundamentally resolved into wages and rent) and not only pure economic profits, but interest (on productive loans) as well, disappear. Commercial banks have the legal privilege and economic power to create money, which they do through bank lending, notably to entrepreneurs. The latter are both willing and able to pay a premium, in the form of interest, for credit, because of their optimistic profit expectations. The ensuing economic boom features not only expanding investment, but also rising prices.

Schumpeter’s theory of the entrepreneur is the symbol of capitalist creativity, the Prometheus who snatches inventions from the Olympus of speculation or practice, molds them into industrial projects, and finally offers them to the community. The entrepreneur is that individual who, in the name of a new idea, a new ‘combination’, decides to subvert the productive *status quo* and reshape the organization of society, on the basis of sweeping technological (and other) transformations.⁸ He is the destroyer of antiquated procedures, the triumphant purveyor of new routines. He craves a microcosm shaken by significant productivity increases, growing per capita energy flows, myriads of goods and services: he dreams of an indomitable simplification of the mechanisms of economic symbiosis. To reach his goal, he needs machinery, brains and brawn; and to subtract these from their previous forms of employment, he will have to ‘tear’ them away from the captains of that same system he wants to sabotage

with his intuition. That is when banks – “manufacturing centers for the means of payment,” as Schumpeter defines them – enter the process: the entrepreneur is then bound to become their favorite customer. For him, they create money and credit “out of nothing” ((1983): p. 73), so that he will be able, counting on the new purchasing power, to lure workmen with higher wages and involve them in his enterprise. Thus, for Schumpeter, as for Keynes, increased purchasing power precedes increased production, and a rise in demand tends to create its own supply. For Keynes, the starting point of the argument is a position of unemployment, and rising demand stimulates higher output by pulling into employment formerly unemployed resources. In Schumpeter’s scenario, by contrast, the initial position is one of full employment. Larger overall production is rooted in innovation and economic development associated with dramatic shifts in employed resources from stagnant or declining sectors of the economy to expanding ones.

The peculiarity of the ‘banker-entrepreneur’ relationship lies in that ‘concession’ of the medium of exchange against goods that still have to be produced. In fact, before he can wear the insignia of entrepreneurship, the prospective entrepreneur will first have to become a debtor: the perplexing wedding of innovation and money is thus ratified. In Schumpeter’s words ((1983): p. 102), “the entrepreneur is the typical debtor in capitalist society.”

The injection of means of payment *ad hoc* tends to bid up prices. In this ‘reshuffle’ of purchasing power, the entrepreneur appropriates the resources he needs to develop his project.⁹ Once he carries out his design, “if everything has gone according to expectations, [he has] enriched the social stream with goods whose total price is greater than the credit received and than the total price of the goods directly and indirectly used by him” ((1983): p. 110).

Thus, Schumpeter supposes, that, under conditions of economic development, the total value of the new goods exceeds their overall cost of production, *and it is precisely this difference – namely, the entrepreneurial profit – that breeds basic interest*. Interest is that premium that must be handed over to the banker for having provided the means of payment, and that finds its ultimate justification in the disequilibrium caused by incessant human creativity.

In his words: “Interest is the price paid by borrowers for a social permit to acquire commodities and services without having previously fulfilled the condition which in the institutional pattern of capitalism is normally set on the issue of such a social permit, i.e. without having previously contributed other commodities and services to the social stream” (Schumpeter (1989): p. 98). Interest, indeed, “must flow from entrepreneurial profit” (Schumpeter (1983): p. 175). If profits were zero, as in long run, perfectly competitive equilibrium, then interest would also be zero. If entrepreneurs “were in a position to

commandeer the producers' goods that they need to carry their new plans into effect, there would still be entrepreneurs' profit, *but no part of it would have to be paid out as interest* . . . It is only because other people have command of the necessary producers' goods that entrepreneurs must call in the capitalists to help them remove the obstacle which private property . . . puts in their way." Entrepreneurs must therefore share profits with bankers, whose power to create money permits entrepreneurs to obtain resources in advance of any productive contribution on their part. Interest thus acts as a "brake" or "tax upon profit" (Schumpeter (1983): pp. 175, 177). Supposing that entrepreneurs are able to satisfy creditors with a recompense smaller than total pure economic profits, they, no less than bankers, are willing to strike such a bargain.

In such ways, Schumpeter blended astutely entrepreneurial profit and bank interest into one concoction posited as the ideal fuel for industrial transformation.¹⁰

Bank premium and entrepreneurial profit are comparable to two states of the same monetary phenomenon: that is, basic interest. The former is the 'neutral' state in the phase that precedes innovation, the latter is the 'excited' state that corresponds to the climax of expansion – both real and monetary – fired off by the technological or other discontinuity.

Now one may ask what guarantees that an innovation, on a purely monetary level, will yield, at least for a certain amount of time, profit margins wide enough to recoup at least basic interest. Indeed, why should the total value of the merchandise produced with more sophisticated machinery be higher than the sum of costs and credit?

One of the important teachings of the immense and captivating literature on the history of innovations is that great transitions have always witnessed the clash of two paradigms: in general, compared to the obsolete and defeated technique, the winning paradigm warrants a net saving of energy (both human and material) in the transformation process. On a more abstract plan, the *demarche* of a technology may be summarized in what is defined as a 'learning-curve': this is a relationship that expresses average costs of production of a certain good or service as a decreasing function of time and quantity (an L-shaped unit cost curve). In other words, as time goes by, the quantity churned out with the new technology or organization increases, this increment allows engineers to refine and perfect the basic processes, and such a gradual learning pattern, which is triggered by the productive phase proper, reduces in turn the average cost of production. This simple, yet powerful, model allows one to portray technological strife as a confrontation between the learning curves of the two rival paradigms. The question of how these two curves are positioned with respect to each other, in the 'unit cost-time' plane, is a secondary issue, the

main point being that, from a certain point onwards – along the time axis – the curve of the new paradigm will be below that of the rival: this means that the costs of the entrepreneur decline very rapidly, much more rapidly than those associated with the contending technology. This efficiency differential will keep on widening until the old standard is definitely beaten and supplanted by the new combination of the innovator.

The efficiency differential, that is, the difference in cost between the old and the new ‘way of doing the thing’ is indeed the spark that kindles the multiplication of credit. From the moment the competition begins to gain momentum, and opportunities to profit at the detriment of the obsolete standard become consistent, the banker and the entrepreneur ‘sneak in’ the widening efficiency gap and try to take advantage of it as long as they can – that is, before the entire productive apparatus is converted to the new mode.

Here we observe a ‘micro-macro’ transition phase: the interactions between the ‘micro’ and the ‘macro’ sphere set the pace of the comprehensive process of technological conversion. The first impulse is of a ‘macro’ nature: the intention, professed by the entrepreneur, to bring to life his intuition is the first symptom of a further step that the social transformation process is about to take. Here is the ‘micro’ response: the possibility of exploiting a cost differential unleashes lending: *ad hoc* means of payment are thus created. The entrepreneur recruits the necessary resources. Second, the ‘macro’ signal: prices begin to soar. ‘Micro’ again: the banker takes heart and expands credit.

The fresh increase in prices and the first effects of learning retroact on credit, which keeps on feeding, relentlessly, the inflationary cycle. Production is expanded. The economy whirls in the boom. Bank lending routines are simple; as the efficiency gap widens, new customers swarm the waiting room of the banker. Meanwhile, prices, production and technological expertise rise. As for technological competition, the selling price of the goods produced with the new modes has to be set at a level slightly lower than that of the goods produced with standard machinery: if the latter selling price – net of inflation – does not vary sensibly in the course of the competition (generally, an old technology, when facing a new one, is very near the exhaustion of its learning economies), the partisans of the new paradigm will earn large profits. These will reach a maximum when the returns of ‘learning-by-doing’ are highest, that is, when the cost difference between the two technologies is greatest.

So much for the success story. There finally comes a time when the efficiency gap narrows and then disappears, simply because the old technique does not exist anymore: the market has adopted, in bulk, the ‘new combination’, which it happily hails as the new standard. Two important, interrelated, phenomena contribute to the reversal of the business flow. On the

one hand, the profits earned during the technological struggle have been obtained at the expense of that center of interests that revolved around the old standard: the total volume of debt owed to the banking sector, especially that of the 'late-comers' in the process of conversion – at a time when the gap was rapidly narrowing - is substantial. On the other hand, the payment of debt irrevocably translates into an equivalent subtraction of purchasing power from the community, which will obviously have pernicious effects on the demand for goods.

Thus, once the technological margin has vanished, the system, being greatly burdened by a growing debt and threatened by its own instability, is irremediably thrown at the mercy of the famished pangs of effective demand. The system is overwhelmed by saturation. If the productive machine happens to churn out redundant quantities of goods at a decreasing cost, prices necessarily decline: the exaction of basic interest is set at hazard. This 'macro' warning is heeded by the set of 'micro' routines designed to drain money out of the system, with a simple 'stoke of pen'. . . . There follows a description of the downturn somewhat reminiscent of that sketched by Gesell. The crisis begins.

This coarse discussion of the swinging motion that paces the convulsions of the business cycle, corroborates the principle whereby money is the umpire of market exchanges. As Veblen observes ((1978): pp. 209–210), “the disturbances of the mechanical process of industry, which are a conspicuous feature of any period of crisis, follow from the disturbances set up in the pecuniary traffic instead of leading up to the latter.” The nature of money – the innate tendency of capital to exact a tribute as a 'reward for scarcity' – is indeed the approximate source of the instability.¹¹

Within the narrower perspective of the 'banker-entrepreneur' bond, the 'micro-macro' transition phase may be regarded as a thick web of stimuli and responses, actions and reactions, between the collection of short-range routines (bank lending decisions, expansion and contraction of credit and production) enacted by the agents (bankers and entrepreneurs) and the high potential macroeconomic dynamics (discontinuities and technological adoptions, the battle of paradigms, consumption trends). Such dynamics are in turn the joint outcome of all the other groups of routines - of any kind – prevailing in the system in a certain period. More precisely, *'macro' phenomena are the dynamic aggregate result of all 'micro' procedures*: economic agents, each one of them treading one, well specified, path – once they are aggregated – become subject to the jolts of collective motion, which is governed by laws of its own.

Thus, the special lending routine devised to detect profitable opportunities must take into account the name and reputation of the loan applicant, and the

means that would enable him to honor his 'promise', that is, to repay the money loaned to him, plus interest. Yet, the risk associated with a given project is divided into two components: a personal and a macroeconomic one. And the foregoing discussion gives a hint of which one is more disquieting.

The awareness: (1) of 'betting' on margins of profitability that are, more often than not, purely virtual (major organizational and technological revolutions are rather infrequent); (2) of being subject to the saturation of demand; (3) of the constrained ways of money which, besides causing the unflinching destruction of much purchasing power, sacrifices the weak links of the system – be they banks or firms, brings the entire productive apparatus under the custody of financial power. Thus, financiers get, at last, the chance to calibrate economic development and steer the monetary flows in such a way as to avoid – within a manageable range – excruciating fluctuations.

Big Business develops as a follow-up to the refinements of mass production: it culminates in the advent of imposing financial and industrial agglomerates that belong to the newborn colony of shareholders, but that are actually governed by unidentifiable wards of public trust. This is the jubilee of the real Invisible Hand: this is the regime of *absentee ownership*, and thus the transition from Schumpeter to Veblen.

(3) *The Relationship between Banks and Firms: Veblen on Trusts and Absentee Ownership*

The wave of industrial concentrations that took capitalism by storm in the early twentieth century was the reaction of the banking system to the instability generated by the competitive pressure on the costs of production, and consequently on the price level. Firms, and especially their creditors, came to the conclusion that cutthroat competition was ultimately unsustainable; price wars constrict credit flows and profit margins that ultimately depend upon those flows.

The solution to this state of affairs was the stipulation of veritable collusive pacts, designed to monitor the produced output and thus shield prices from the impact of technological and other innovations.

The economic engine then functions as a cartel whose members are assigned shares in exchange for a 'line of credit', allocated by the central financial board. Such a board, consisting of a consortium of large banks, distributes the lines of credit on the basis of a detailed scheme contrived to prop up the capitalization of the group.¹²

In his *Theory of Business Enterprise*, Thorstein Veblen ((1978): Chapter V) reduces the fundamental mechanism of the great capitalist enterprise to the combined work of two gears: namely, capitalization and earning-capacity. The

former is the overall market rating of the profitability of a firm, reckoned on the basis of expectations that reflect prevailing demand conditions. The latter, by indicating competitive pressure, can be thought of as a sort of financial barometer that measures the profit margin on sales, in step with the technological evolution of contenders.

Every time the two gears get out of step with one another because of learning economies, some firms are doomed to collapse. In other words, every time market capitalization exceeds earning-capacity, the entrepreneur finds himself with watered down capital: were the efficiency gap to thrust the total amount of debt beyond a certain threshold, he would be left with no other option than to liquidate his swollen property.

The remedy to such a 'pathological' tendency of innovation in a monetary profit-driven regime is a business coalition, whose task is to bring profits to a 'reasonable' level – that is, compatible with the market capitalization (Veblen (1964)). In order to work out an industrial structure that is 'balanced' and fairly self-sufficient, Interests will agree on the reduction of output, promotional sales, and strategic investments. This kind of coalition is known as a *trust*. Under the aegis of such a potent amalgamation of machinery, accounting and coercion, technological innovation is progressively bridled.¹³

It is when the large banks finally get to preside over the trusts that the regime of *absentee ownership* is solemnly inaugurated. Veblen coined this expression for his insightful book of 1923 (Veblen (1964)), published twenty years after his first analysis of American oligopoly (Veblen (1978)).

The absentee owner is the symbol of that industrial transformation that has given rise to the emergence of trusts. The dimension of the holding company has distorted the nature of ownership and has progressively pushed the generic owner out of the arena of business interests. Like innovation, participation in industrial affairs also becomes a routine. The shareholder thus stands as an absentee owner, one among many other absentees, who, all together, represent the trusts. The impersonal nature of ownership, by reason of its marked routinization, allows in reality an effectual transfer of all incisive decision-making into the hands of a restricted brethren of absentee owners. All those who have contributed to the fusion of industrial and financial interests, and who, by virtue of this hazy aura of impersonality, remain indistinguishable and hardly controllable.

This particular institutional configuration, according to Veblen, does not truly represent the systematic accomplishment of some design contrived by a group eager to defend their vested interests; it can rather be viewed as a temporary state of equilibrium (an unstable one), which has been reached after a series of trials and errors. Such attempts and corrections form indeed the

trajectory of an evolutionary process triggered by the need to protect the price system from the 'onslaughts' of technological innovation.

The first step that led to the regime of absentee ownership, towards the end of the last century, was the rescue operation bankers organized to salvage ailing industrial complexes, that is, firms that failed to align their market capitalization with earning-capacity, the former being much larger than the latter. Such concerns generally found themselves burdened by significant overhead charges when, for the reasons mentioned in the previous section, the market, after a promising start, gradually tended to 'close down', to become saturated. This forced price levels down and thus depressed earning-capacity, especially that of those captains of industry that had been advocating fusty strategies. The rescue culminated in the creation of a number of innovative institutional solutions. These were: the 'holding company' - the 'mother' of the group -, the coalescing power of mergers, and the establishment of a highly coordinated network of contacts among the directing boards of all the involved concerns. Moreover, the additional credit entrepreneurs insistently asked for in order to alleviate the pain caused by the gashes of overhead charges (given by the difference between capitalization and earning-capacity) enticed bankers to interfere in industrial matters ever more pressingly.

Therefore, the huge credit flows – in both directions – that could not have taken place without the reformulation of the industrial structure, was the driving force behind the entire reorganization process.

It is at this time that the institution of the *investment banker* emerged,¹⁴ as a convergence point between the industrial apparatus and absentee ownership, of which he is the custodian and the highest representative.

The way bankers took over the productive system, as an institutional phenomenon, had nothing to do with a 'coup': the control of management gradually took place, in line with the recurrent recapitalization that followed the first major mergers of insolvent enterprises. The investment banker was conceived when, at the time the first trusts were constituted, the banker who had been in charge of the rescue was rewarded with a voluminous block of securities issued through the new recapitalization of the group. On the one hand, the investment banker found himself managing directly the interests of the firm; on the other, the 'bonus' he was granted gave him a further incentive to protect the new market rating, which was the true source of his income.

Recapitalization was customarily brought at a level significantly higher than the sum of the capitalizations of the firms involved by the merger and, as a rule, much greater than the market value of all assets owned by the group. This is how *capital value inflation* came about: an operation analogous to the creation of means of payment *ad hoc* for the sake of the Schumpeterian entrepreneur.

It is similar in the sense that the inflationary process acts like a sort of smoke screen, which allows for the propagation of a 'margin of reshuffle'. Within this margin, purchasing power is actually redistributed. The entrepreneur, with the freshly created money, withdraws resources from their previous use; the banker, through the new recapitalization, is allowed to attract within his sphere of influence growing chunks of absentee ownership. The manipulation of the value of industrial intangibles turns out to be the new procedure for the redistribution of purchasing power: this gives an idea of how monetary dynamics is capable of propagating itself and expanding through accounting manifolds ever more distant from the *real* enterprise. Money represents the *first* level of such accounting geometries that can momentarily be phased out from their real economic counterpart; the market capitalization – indeed, an offshoot of money itself – acts at a *second* remove from the basic activities.

The target values of the new recapitalization are set by investment bankers in accordance with their expectations. Once they hold the reins of the productive machine, phasing capitalization with earning-capacity becomes possible. For this reason, new mergers, right after they are sanctioned, function satisfactorily: the absentee owners have indeed at their disposal all the necessary elements (collusion, regimented technological innovation, credit management) for calibrating the basic routines and oil, at least in the initial phase, the main business gears, compatibly with the price level. Thus, 'sponsored' firms (by investment bankers) may rely on a greatly increased purchasing power that gives them room for maneuver on the market. Yet, within the boundaries of a fully coordinated collusive agreement, there is no reason to grant any particular privilege – for a given level of efficiency – to one firm rather than to another. The implication of such an arrangement is that anyone, if possible, will ask for credit, or else be driven out of the market. The combined outcome of these converging conducts on the part of agents is that credit does not give any relative advantage to the firms of the consortium; the party that benefits is again the 'manufacturing center for the means of payment': the expansion of credit has bestowed upon it larger overhead charges and, as a consequence, a more pervasive control of industrial activity.

Even in this scenario, prices have risen after the steady injections of means of payment; and in the businessman's 'apperception', this is indeed a good sign. When prices are going up, merchants perceive that they are earning more and thus that they are in a better position to face their debt charges. The entrepreneur – who, like all his microeconomic fellows, lives on routines ("if prices go up, I'm better off") – insists on 'considering the dollar *sub specie aeternitate*', and, of course, he deludes himself – as Veblen believed: prices might go up, but so do overhead charges. Furthermore, purchasing power has

been distributed in a fashion that cannot set the stage for a bright season of profits (we shall return to this issue momentarily).

The 'contract' that binds banks and firms together within the absentee configuration truly works as a buffer of credits and debits of all participants. As was said earlier, the equilibrium is reached by dosing carefully the output rate so as not to perturb the price level that buttresses the entire capitalization of the cartel. We have also acknowledged the *monetary* gap that has arisen between the capitalization and the market value of the group's assets: from that gap, banks draw their premium, namely overhead charges.

The essential point here is that the entire structure is ever more dependent on **money**; not metallic money, but *fiduciary* currency. The peculiarity of a complex interlacing of economic 'promises' lies in fact the *trust* that keeps the chain links together; the more intricate is the fabric of deferred exchanges, the more articulated the division of labor becomes, the more a monetary economy is bound to become a *credit economy*. Transactions are concluded mostly through book-keeping compensations on bank accounts, while the percentage of business exchanges regulated in currency is small. As experience indicates, the monetary flows animating Big Business run into the virtual accounting universe of the 'custodians of solvency', as Veblen suggestively named the ruling absentee elite. Absentee ownership emanates precisely from this power of creating and expanding accounting units. The monetary gap from which basic interest is extracted is the most conspicuous fruit of such a power. Furthermore, granted that trust acts as the psychological cohesive factor of the mass of agents, the means of payment – which measures the earning-capacity – must be guaranteed and carefully monitored by a central coordinating agency of the several credit institutions. The agency Veblen identified was the Federal Reserve Board: it is no coincidence that such an agency was established in the heyday of absentee ownership, 1913.

If the psychology of the group adhered thoroughly to the precepts of the banking community, agents would expect prices to soar indefinitely, with the blessings of the 'custodians of solvency'. Yet, as we have said above, the cartel is only *apparently* stable: Veblen stressed the fact that, within this great group of interests, cohesiveness and cooperation prevail prevalently in the financial component of the organization, whereas in the industrial arena, competitive pressure is still palpable. The partial achievement of absentee ownership is basically that of bringing together the various productive lobbies to stipulate a *pax commercii*.

Competition thus subsists, but it is condensed within 'reasonable margins', i.e. margins set by that price level that warrants the exaction of basic interest and all its overhead derivatives.

The scenario envisaged by Veblen differs from the Orwellian world populated by omnipotent trusts, since a marginal residue of rivalry is still allowed for in the engineering of absentee owners – possibly, also, as an unuttered tribute to the indestructible myth of the self-made man. Within the tacit regulations of the collusive agreement, firms make use of this residue of competition to struggle over a relatively larger share of that monetary gap banks have created. The constraint on output ‘closes’ the model: an increase in sales – and in profits – for one line of production is obtained at the expense of another line. Business tools such as marketing and promotional sales then become the suited strategic weapons firms have recourse to on a regular basis to dispute a greater sliver of the differential between the overall market capitalization of the trust and the effectual monetary cost of the productive apparatus.

Because of the ‘business fury’ bewitching entrepreneurs raised in the corporate era – whose only goal is to ‘realize’ on the selling price – the cartel cannot be stable. In the regime of absentee ownership, money and the ‘fabric of credit’ are deemed trustworthy by operators, but the ‘desire of gain’ – the cumbersome legacy of a recent past – which fails to arouse a comparable optimistic disposition, still struggles to find its proper place within the new framework.

Veblen died in 1929, the year of the Great Crash. Evidently, what seemed a perfect device broke down at the peak of the most severe crisis modern capitalism ever experienced. Between 1921 and 1933, 13500 banks failed (Scherman (1938)); and during those same years, one of the most spectacular technological transformations was taking place: the transition from steam to electric power.¹⁵ The repercussions of such a transformation on the manufacturing system were momentous, and the effect was further amplified by another kind of revolution – managerial and organizational – which disrupted the industrial routines of the time: mass production.¹⁶

Veblen predicted that the ‘great union of Interest’ he investigated would have been murdered by the *auri sacra fames*. One may surmise that such a devastating coupling of circumstances (electricity + mass production), and the bountiful future it inspired, unleashed in American entrepreneurs their most anarchic business spirit, and thus shattered the cartel.

Moreover, the numerous bank failures of the Great Depression proved that, besides the threat of mutiny by the industrial crew, financial commanders had to fix serious malfunction of the credit engineering of the system. Countries hit hard by the depression adopted similar legislative remedies to these leaks: the main objective was to prevent commercial banks, which attracted short-term savings, from conveying their deposits into loans with long-term maturities.

The idea was that of disconnecting – within the same credit unit – these two basic phases, so as to avoid savings and short-term liquidity being bound to industrial and real estate assets whose dynamics are tightly linked to oscillations in market capitalization.¹⁷

According to this extreme simplification of the problem, the ‘desire of gain’ of the business mentality on one side, and long term financing with short-term deposits on the other, may be identified as two of the major causes which, by striking a first, damaging, blow to absentee ownership, thrust the economy into depression. At any rate, Veblen’s intuition was very powerful, and the system, as he viewed it, does not differ substantially from the one we live in today.

In fact, the question of ‘regimented’ technological innovation remains of topical interest, as does the phenomenon of investment, which is addressed in the discussion of the third and final lending routine examined in the present article.

(4) Socially and Technically Productive Investment, Overhead Charges and Purchasing Power; Douglas and Malthus

The foregoing discussion has focused on the ‘perturbative’ impact innovation – notably, scale and learning economies – may have on the cost of production, and thus on prices. A sharp decline in the price level, as was noted, depresses *ceteris paribus* the entrepreneurial rate of profit. The capitalization of invested stock does not warrant the repayment of basic interest: money is drained out of the system.

But this is not the end of the story: investments designed to boost the productive potential of industry are a source of additional mind-boggling snags for the financial system. To probe deeper into the essence of the problem, searching for clues to the concatenation of banking and industrial dynamics, Gesell’s theory of interest is, once again, of great help.

The thick fog that has always shrouded the notion of ‘interest’ is caused by two phenomena. The first is the characterization of interest as a **natural** element (the epithet has been used and abused, since the very early formulations of the Enlightenment) of the inexorable laws of economics.¹⁸ The second is the confusion between interest on money – that is, basic interest – and *interest on capital*. These two variables, argues Gesell, must be clearly distinguished.

Basic interest is a monetary phenomenon: it is the price for the use of the medium of exchange. Owing to the power of exacting a tribute, money may properly be regarded as a kind of capital.¹⁹ Interest on capital is a by-product of basic interest.

Houses, machinery, and plants are capital. However, unlike money, these goods do not exact interest during the exchange, so that it may be handed over to the ‘manufacturing center for the means of payment’. Instead, interest upon capital arises in the course of the production process and is collected by owners of capital goods. “This power does not, however, lie in the characteristics of such things, but in the fact that money here, precisely as with the [perishable] wares, prepares the market conditions necessary for the collection of interest” (Gesell (1920): p. 240). Houses, machinery and factories are real goods, but owing to the fact that money, at the origin, claims a reward for the services it provides, industrial capital – which has to be financed with money – will have to be allocated in such a way as to exact a similar tribute.

Usury, a purely monetary phenomenon, propagates its iron logic to the means of production. Since the foundation of usury is, according to Gesell, the capacity to ‘embarrass’ the counterpart – that is, to enmesh the will of the transacting party – in the economic realm, this condition translates into *an artificially limited supply with respect to demand*. In other words, in order to collect interest, it is necessary to limit the goods and services that cater to basic popular needs. *Money, machinery, factories, houses, and so on, yield interest because they are scarce.*

This proposition subverts the dogmas of neoclassicism, whereby the economic problem is “the problem of allocating scarce resources.” In the light of Gesell’s theory, which builds on the intuitions of Proudhon (1929), the economic problem becomes ‘the problem of freeing resources that are made artificially scarce’.

Thus, the factors of production are burdened with interest since the whole system is geared to a monetary standard, set by basic interest. This is what Gesell means when he asserts that interest upon capital is a by-product of basic interest. More specifically, basic interest is the equilibrium value²⁰ interest upon capital converges to.²¹

Saying that the factors of production are burdened with interest implies a clear vision of the essential capitalistic mechanisms. According to Gesell, ‘The employer does not buy work, or working hours, or power of work, for he does not sell the power of work. What he buys and sells is the product of labor, and the price he pays is determined, not by the cost of breeding, training and feeding a worker and his offspring (the physical appearance of the workers is only too good a proof that the employer cares little for all this), but simply by the price the consumer pays for the product. From this price the employer deducts the interest on his factory, the cost of raw material, including interest, and wages for his own work. The interest always corresponds to basic interest: the employer’s wage, like all wages, follows the laws of competition: and the

employer treats the raw material he intends his workmen to manufacture as every shop-keeper treats his merchandise. The employer lends the workmen machinery and raw material and deducts from the workers' produce the interest with which the raw material and machinery are burdened. The remainder, so-called wages, is in reality the price of the product delivered by the workmen. Factories are simply, therefore, pawn-shops' (Gesell (1920): pp. 258–259).

In this picture, the factory itself is capable of generating interest, insofar as the total number of factories is scarce (and wage-labor is abundant). Machinery is scarce and so are raw materials. And moving backward along the chain of production, we are bound to reencounter money and its inseparable basic interest.

The importance of the nexus between basic interest and interest upon capital for the nature of productive investment resides in the monetary bond that ties firms to banks.

As we saw in the previous section, all provisions taken by absentee ownership aim at managing judiciously the capitalization of the financed industrial groups. Veblen made clear ((1978): chapters V & VI) that a firm's capitalization no longer represented – as it usually did in the nineteenth century – the total cost of productive equipment; the latter rather corresponds to its lower bound.

The goal of modern business enterprise is that of evaluating as accurately as possible the potential earning-capacity of competing concerns. The estimate of such a capacity is what is known as *good will*; it is the crucial component of capitalization. Good will, in turn, is a proxy for the comparative advantage (trademarks, secret formulas, franchising, every form of 'quasi-rent' . . .) a given firm has over another. Therefore, the whole category of industrial intangibles and capitalized costs is apt to play a predominant part in the evaluation of firm activities. This institutional arrangement leads the involved consortia to swell their monetary values, and thus to create that gap firms will struggle over – within the allowed margins. Those groups that will be able to align their earning-capacity with capitalization will be the victors.

Within the 'restricted competition' that takes place among the different firms belonging to a cartel, these will resort to every possible chicanery, ruse, artifice and sharp practice in order to appropriate a portion of the monetary gap as great as possible. The margin on which firms can operate is given by the difference between the selling price and the cost of production. Of course, they will try to reduce costs.

At this point, the producer faces the opportunity to reduce, among the various expenses, those in capital goods, yet, he doesn't even think about it. Why? "The earnings of invested capital are of the nature of overhead charges,

for the sake of which the business is carried on, and any curtailment of which will therefore foot up to so much of a defeat of the purpose for which business is carried on” (Veblen (1964): p. 393).

When Veblen writes that the returns from invested capital *are in the nature* of overhead charges, he is in fact reaffirming the derivation of interest upon capital from basic interest. Overhead charges are the cost of credit, of banks’ support. They are themselves basic interest. And money transfers interest to goods, rendering them capital: the same happens here with the factors of production. Everything that is ‘capitalizable’, and can, therefore, bolster earning-capacity, warrants an extension of credit. Any expedient, be it productive or simply promotional, which may be expressed in monetary units, will be encapsulated in capitalization, in view of the looming battle for the monetary surplus. Businessmen won’t begrudge outlays for this type of item. “Which comes to saying that the curtailment, if any, must take effect in those expenditures which go to the man-power and the outlaying farm population; these factors of the industrial system being not capitalized and, for the time being, not capitalizable, and so being not carried on the books as assets to which the business is bound over in the way of fixed charge” (Veblen (1964): p. 393). The non-capitalizable factor *par excellence* is unskilled labor. This explains why Gesell likened firms to pawnshops and the Krupps to pawnbrokers.

The process of substitution of machinery for men illustrates how a distribution of income favorable to absentee owners comes about. Let us consider the following simple example. We first assume that the selling price (we are in a one commodity world) is fixed – a necessary condition for the survival of the cartel – at a level of, say, 15. This amount is apportioned to the three protagonists of this simplified economy: banks earn 5 as basic interest, producers earn 5 as profit, and workers earn 5 as wages. If the employer-entrepreneur believes that, by replacing workers with machines, he could bring wages down to 3, he would then share with the bank a markup of 12. If this line of thought prevails, credit is immediately granted and, most probably, the banker would want (and expect) to make a greater profit out of the investment: so he charges a higher interest rate. Basic interest increases and – following the theory of Gesell – the increase is transferred to capital: interest upon machinery loaned to workers rises accordingly. This shift in monetary flows may lead to an equal division of the margin: the banker and the entrepreneur get 6 each. For the firm, the ratio of fixed costs (overhead charges) to variable costs (wages) was, before the substitution, 5:5; after the substitution, it becomes 6:3. The technological transition in a monetary regime leads to an increase of what C.

H. Douglas defined as *machine charges* (Douglas (1979): p. 42), yet another name for basic interest.

Indeed, the new composition of costs does not entail any irregularity for the firm: capitalization has increased, and of the 5 units that were paid over to laborers, one is saved and one is transferred to the bank.

However, the shortcoming of this development is that, *on purely monetary terms*, the substitution of machines for men, that is, the conversion of wages into machine charges, translates into an immediate destruction of **purchasing power** (defined as the demand for goods, backed up by a sufficient quantity of money). Investments that aim at a pervasive automation of the basic processes of industrial transformation invigorate market capitalization, yet they simultaneously create a growing gap between the current price level and the workers' purchasing power.

Such cumulated monetary dynamics further exacerbate the instability of a system unable to buy its own production: evidently, money concentrates in the hands of those who sell goods at a price higher than that at which they bought them (Douglas (1979): p. 28).

Post-war finance in the United Kingdom offered Douglas the opportunity to illustrate the mechanisms that allow central banking to exercise its pecuniary monopoly at the expense of the propertyless strata of the economy. He wrote in 1930: "The great spending departments obtain the money with which to make their monthly payments by means of drafts upon what is called the 'Ways and Means Account', which is in fact merely an overdraft kept with the Bank of England. The Bank of England treats this overdraft of the government as cash which, since it rests upon the credit of the country, it is clearly entitled to do. The sums received in taxation go to the reduction of the government debit on the Ways and Means Account, so that we have the position that the money which the government spends is created by the Bank of England, is loaned to the government, and is repaid by taxation of wages, salaries and dividends, which were originally derived from this and other bank loans, which, in turn, have to be repaid. . . . The only surplus purchasing power at the disposal of the individuals comprising the nation would be the excess of bank loans over bank repayments, i.e. debt, together with money received for exports over money payments for imports, which is, of course, the explanation of the statement commonly made that Great Britain lives upon its exports . . ." (Douglas (1979): pp. 57–58).

The ways to bridge this gap (Douglas (1979): p. 49) can be: the export of goods on credit, the sale of merchandise below costs, the forced bankruptcy of the weakest links, and the creation of money for public works through government deficits. This last antidote, in particular, is of special interest for it

has worked, since the dawn of economics, as the lubricant of the price system. Deficit spending is an old expedient: the advocacy of government spending shines forth in the writings of British author Thomas Robert Malthus.

Malthus believed, like the classical economists generally, that the ‘progress of wealth’ depended on such underlying determinants of potential supply as an expanding population and labor force, saving and capital accumulation, fertility of the soil, and inventions (Malthus (1986): pp. 309-360). But he conceived the economy as a giant **consuming**, as well as producing, machine. To maintain and extend prosperity, there also must be “an effectual and unchecked demand for all that is produced.” This *may* occur, and is more likely to do so when savings are channeled into investment, “are furnished from increasing gains, and by no means involve a diminished expenditure on objects of luxury and enjoyment” (Malthus (1986): pp. 361, 367). But the ‘balanced’ or ‘proportioned’ adaptation of supply to demand, and thereby to “the actual tastes and wants of the consumers” and to the creation of “new tastes and wants” is “no easy task” (Malthus (1986): p. 371).

Malthus argued that “if, instead of saving from increased profits, we save from diminished expenditure; if, at the very time that the supply of commodities compared with the demand for them, clearly admonishes us that the proportion of capital revenue is already too great, we go on saving from our revenue to add still further to our capital, . . . we must be aggravating instead of alleviating our distress,” with resulting low profits, stagnation, and unemployment (Malthus (1986): p. 425).²²

Thus, Malthus’s basic model of inadequate aggregate demand is characterized by over-investment and under-consumption, and the absence of an excess of saving relative to investment (or hoarding). But once consumption demand (and thereby profits) fall, additional contractionary forces ensue, derivative from the initiating reduction in demand. Inadequate demand for goods causes gluts for commodities and thereby labor. Profit rates fall and low returns to investment elicit hoarding (“owners of floating capital vainly seeking outlets”) and excess supply of capital. In at least a secondary part of his analysis, Malthus “was clearly not a believer in the typical classical doctrine that all savings are automatically spent (invested).” Hoarding is “a distinct possibility” (Paglin, Introduction to Malthus (1986): p. viii). Moreover, an initial decrease in consumption tends to generate deflation in wages and prices. In Malthus’s viewpoint (and contra Ricardo), a rise in money wages and a decrease in prices of consumers’ goods, despite their apparent similarity, are ‘most essentially different’. Higher money wages typically occur in the context of a cluster of circumstances, including a distribution of wealth that gives it an ‘increasing value’, ensures full employment, and creates a demand for “further

produce” and “the capital which is to obtain it,” all “infallible sign[s] of health and prosperity.” By contrast, a “general fall in the money price of necessaries often arises from so defective a distribution” that “its value cannot be kept up.” Even “under the most favourable circumstances,” “temporary unemployment” is ‘unavoidable’. In many instances, unemployment and ‘abject poverty’ is ‘permanent’ (Malthus (1986): pp. 393–94).

A “glut of commodities in general,” caused by an insufficiency of aggregate effective demand relative to potential supply (under full employment conditions) is at least a ‘possibility’, Malthus contended. And given “the actual habits of mankind, it is a probable occurrence.” Workers, “if they possessed the will, they have not the power [to consume].” And “capitalists, though they have the power, have not the will to consume . . . to the necessary extent” (Malthus (1986): pp. 315, 404). Under these conditions “the consumption and demand occasioned by the workmen employed in productive labour can never *alone* furnish a motive to the accumulation and employment of capital; and with regard to the capitalists themselves, together with the landlord and other rich persons, they have, by the supposition, agreed to be parsimonious, and by depriving themselves of the usual convenience and luxuries to save from their revenue and add to their capital. Under these circumstances, it is impossible that the increased quantity of commodities, obtained by the increased number of productive laborers, should find purchasers, without such a fall in price as would probably sink their value below that of the outlay, or, at least, reduce profits as very greatly to diminish both the power and the will to save” (Malthus (1986): p. 315).

When a capitalist, by saving and then investing his surplus, forces interest upon capital below basic interest, industrial development, being deprived of money, comes to a halt. ‘Too many’ houses have been built, ‘too many’ goods have been produced, ‘too many’ machines have been assembled. The capitalist will refuse to turn the power on until his workers will be able to “produce an excess of value above what they consume, which he either wants himself in kind, or which he can advantageously exchange for something which he desires, either for present or future use” (Malthus (1986): p. 404).

A robust expansion of savings on the part of capitalists, which translates into an equivalent expansion of the productive apparatus, has adverse repercussions on the price level: the exuberance of modern manufacturing centers seems to be at odds with the geometry of basic interest. Because the accumulation of capital sows the seeds of its own destruction, the secret is to find that ‘certain proportion’ between production and between consumption and productive classes which would, by supplying the missing portion of purchasing power, close the cycle, and thus prop up demand, profits, production, prices and

interest.²³ The right proportion, according to Malthus, is determined by a number of factors, of which ‘the progress of invention in machinery’ is the most important. This contention would lead one to deduce that the more advanced the state of the technological arts, the lower is the proportion of labor devoted to manufacturing.

Malthus proposed “three paramount means to establish a ‘union’ between the will to demand, notably to consume, and the powers of production,” and thereby an “adequate stimulus to the continued increase in wealth:” the “division of landed property, the extension of domestic and foreign trade, and the maintenance of such a proportion of unproductive consumers as is best adapted to the powers of production” (Malthus (1986): p. 425).

First, Malthus advocated a division of landed property that was sufficiently “easy” to create a “greater number of demanders in the middle ranks of life who were able and willing to purchase the results of productive labour.” A “very large class of effective demanders” had been created, according to Malthus, by the early nineteenth century, in the middle ranks of society, who had the potential to acquire tastes more conducive to raising levels of effective demand than either owners of “immense land properties” or “owners of small properties” (Malthus (1986): pp. 374–79).²⁴

Second, Malthus argued that a “deficiency of effectual demand” had often caused “stagnation,” early in a nation’s economic development, long before growth in the supply of output is constrained by a Ricardian stationary state. Conversely, an increase in demand through expansion of domestic and foreign trade, as distinguished from an increase in potential supply, can stimulate growth in wealth and capital. For example, an “opening of a communication” between two markets, formerly separated by an “impassable river or mountain,” causes an extension of the market. As in Adam Smith’s classical exposition, this fosters greater division of labor and thereby larger potential supply of goods. But it also causes greater demand for goods, and thereby labor, through closer adaptation of supplies to the structure of domestic and foreign demand, and creation of new demands and wants (Malthus (1986): pp. 383, 388).

A third solution envisaged by Malthus to correct for insufficient aggregate demand called for a class of consumers who “are not themselves [directly] engaged in production . . . of material objects.” Landlords and other men of property stand “preeminent” in this respect, through their purchases of luxury goods and wasteful expenditures, and employment of menial and intellectual servants. All “personal services paid voluntarily,” according to Malthus, “whether of a menial or intellectual kind, are essentially distinct from the [productive] labour necessary to production. They are paid from revenue, not

from capital. They have no tendency to increase or lower profit” (Malthus (1986): pp. 398, 400, 408).²⁵

Malthus’s third admonition also acknowledges the social utility of government spending, employment of state employees in particular, and provision of a nascent service economy within the monetary architecture of capitalism. National wealth, Malthus believed, has been “decidedly stimulated by the consumption of those who have been supported by taxes.”²⁶ For instance, Malthus propounded the employment of workers in “those kinds of labour, the results of which do not come into the market, such as roads and public works,” and which do not compete with wares manufactured by productive labor (Malthus (1986): pp. 410, 429).

Although Malthus rails against the “evils of a great national debt,” the social costs of the debt may well be ‘more than counterbalanced’ by its benefits, notably a wider division of landed estates and property, a larger middle class, and a closer approximation to full employment. At least, any reduction in the national debt (as in transition from war to peace) should be gradual, to minimize dislocation (Malthus (1986): pp. 411, 426).

In any event, it is not plausible that, in order to prop up the price level, capitalists will surrender profit and interest, and hand them over, in full, to the unproductive class through taxation, so that the entire output may be sold.²⁷ A part of their revenue will be taxed, but the remaining fraction, which is necessary to solve the macroeconomic equation, *will have to be borrowed*: the price of the loan being, again, interest. The State will run into debt. And the interest paid to creditors, interest on public debt, is a further outgrowth of basic interest.

Part III

SUMMARY AND CONCLUSIONS

Summing up, there have been several expedients that Business has systematically adopted to allay monetary disturbance and economic stagnation: exports (as indicated by C. H. Douglas), the Malthusian palliatives (wider diffusion of property, increase in trade, unproductive consumption, and public debt) and the collusive strategy – which blossomed into the fully coordinated absentee ownership – designed to monitor and ration industrial output.²⁸ Of the Malthusian palliatives, Veblen believed that private wasteful expenditures, albeit efficacious in the short term, were totally unable to match the extraordinary abundance of industrial output. This is something which the State, instead, seems, up to a certain extent, more qualified to do: “Armaments,

public edifices, courtly and diplomatic edifices and the like are almost altogether wasteful . . . They have the additional advantage that the public securities which represent this waste serve as attractive investment securities for private savings, at the same time, that, taken in the aggregate, the savings so invested are purely fictitious savings and therefore do not act to lower profits or prices” (Veblen (1978): pp. 255–256).

Productive investment is the sap of industry which, in the broader meaning of the word, Friedrich List ((1983): p. 71) celebrated as “the mother and father of science, literature, the arts, enlightenment, freedom, useful institutions, and national power and independence.” The establishment of a vast and expanding manufacturing sector represented, for nineteenth century nationalist economists like List, the foundation of a technologically advanced, virtuous and affluent society, and the strongest bulwark against the commercial imperialism of England.

However, even the great bourgeois aspirations to industrialism had to reckon with money and basic interest. Thus, productive investment, one among the most “moral” of all economic activities, sees its realization constantly threatened (1) by its own capacity to abate costs of production and (2) by the artificial scarcity of capital, which immediately raises the issues of exploitation and under-consumption. The gray eminence lurking behind both cases is still basic interest: it has succeeded in immunizing itself from these two diseases, first, by imposing the restriction of output and, second, by forcing purchasing power to follow the patterns outlined above.

As the foregoing discussion hinges on authorship stretching from Malthus to Veblen, it would seem that the points elaborated in the paper would be mostly applicable to the factual record of the late nineteen twenties – the historical culmination of this long sequence of economic speculation. And that is indeed the case. This is an essay in the history of economic thought, whose core ideas draw substance from a particular chronological backdrop, namely the turbulent phase *preceding* the financial ‘re-engineering’ of the corporative era, and subsequent post-WWII globalization and international cooperation. The issue of interest and lending and the associated dynamics of instability, considered in the light of those dramatic epochal and institutional changes and spoken in words not inimical to those chosen herein, calls for an additional and no less important research effort, which would figure as the proper complement to this brief exposition. Nonetheless, it must be readily conceded that current re-evaluations of past scholarship owe their propriety and usefulness to their direct bearing upon current, unsolved, problems.

Interest and unbridled financial subterfuge, such as that practiced by bank affiliates (investment divisions of banking consortia that were licensed to deal

in securities with the capital of the holding companies) throughout the industrialized West, contributed to the collapse of the late twenties and the succeeding depression of the thirties; they formed one integral component of the problem. The excesses of speculative subreption conducted by institutes of public interest, such as banks, were reined and fenced in by means of remedial legislation, notably in the United States. As was said earlier, underwriting corporate securities became the focus of specialized investment groups, whereas traditional commercial banking, because of its depository function, was confined to short term credit (industrial, consumer, etc.). In the United States, this provision was enacted with the Glass-Steagall Act (1933); the law is allegedly still enforced to this day, and has been ever since its implementation the source of a lively debate in the banking world as to expediency of such a strict separation of lending facilities. Granted that American commercial banks can no longer melt their depositors' money into the capital structure of the affiliated industrial concerns,^b the argument sustained in this article (especially in the section devoted to Veblen's *Absentee Ownership*), if transposed to a modern key, is not bound to suffer much thereby, for the institutional prohibition drafted in Section 16 of the Glass-Steagall Act has merely re-arranged the monetary provisioning of firms. Banks, commonly defined, still provide short-term supplies of credit, whereas capital subscription is managed by mutual funds, insurance corporations and other financial intermediaries, which, by way of a hushed and impatient casuistic *tourneur*, have come to be known in the literature as 'non-bank banks' (the 'bank-banks' being institutes that (1) accept deposits legally withdrawable on demand, and (2) make commercial loans). Thus, industry still has to face a *lender*, be it a bank or a 'non-bank bank': with respect to the pre-WWII scenario, the institutional framework has been significantly altered and the physiology of monetary volatility has hitherto reflected the shift, yet the crux of interest exaction remains, and so does the concomitant scaffolding of overhead inflation.

Of course, similar banking systems in different countries may fare at a certain point in time in ways strikingly dissimilar. This leads one to reiterate that money and monetary appurtenances are but *one*, albeit fundamental, component of a critical situation; a financial crisis is the creature of the fulsome

^b Incidentally it is of some interest to notice how interlocking directorates presided by Federal Reserve high officials spreading to the most capillary venues of corporate business, as evidenced by charts drawn up by the staff of the Committee on Banking, Currency and Housing of the House of Representative (August 1976), seem to hint at a much closer bank-industry relationship than what transpires from the mainstream debate on the supposed rigidity of the Glass-Steagall Act.

encroachment of imperishable money on the unfolding of the physical economy. The malady may take on a wide variety of pathological manifestations, as much as convalescence or recovery may assume several healthy guises; case studies and comparative analyses of the impact of specific banking policies on the macro-dynamics of single countries, or clusters of tightly interconnected countries, should result in sensible diagnoses and much needed documented phenomenology. The sole aim of the present work has been to offer a generalized description, as an exercise in the history of economic thought, of the seed and chief vectors of pecuniary contagion inside the body economic.

As to the possible contours of future research inspired by the approach(es) examined in this work, a few hints may be provided. The cases of France, Japan and Germany may be usefully brought into focus. Unlike the United States, these three countries allow banks broadly defined to steer the course of long-term industrial endeavor by contributing substantial funds to the capital structure of the concerns involved.

Financial deregulation, exacerbated banking competition and narrowing margins of profit are important factors behind the recent recession and the high failure rate of small and medium-sized firms in France. Non performing loans in 1994 were approximately 10% of the total – that is 7% of GDP.^c The banking law of 1984 has redefined the role of universal banking and thereby kindled shortly thereafter a vigorous dealing of financial derivatives and industrial shares among French monetary intermediaries. The percentage of total shares in circulation held by banks in France has been, and still is, smaller than that subscribed by their counterparts in Japan and Germany,^d nonetheless, the *Credit Foncier de France* in 1995, and, most important, the *Credit Lyonnais* in 1993 – up to then, the foremost banking consortium of Europe – could not avert disarray. Analysts have attributed the great losses (1.8, 6.9 and 12.1 billion FF between 1992 and 1994) suffered by the *Credit Lyonnais* to four main causes: (1) misguided activities of the European branches; (2) unscrupulous, and often unorthodox, financing of the film industry; (3) the uncouth relationship between the bank and industrial corporations; (4) real estate speculation. As to point (3), The *Credit Lyonnais* had invested during the late eighties in a wide and diversified range of industrial enterprises (e.g. chemical, food processing, agricultural, construction, computers, steel, etc.); 4 out of 24 billion francs of equity ownership were, at the end of the ‘business cycle’, written off as losses.

^c OECD [Economic Surveys, France, (1997)].

^d Financial sectors controlled 8% of the equity market at the end of 1995 in France, whereas in Germany and Japan, the figures were 30.3 and 35.8, respectively [Deutsche Bundesbank (1997)].

Coupling fruitless immobilized capital with real estate speculative inflation proved to be the decisive mix that toppled the confident agenda of the bank. Scenarios such as those depicted in the earlier sections of this chapter (Schumpeterian competition and Veblenian equity inflation) seem applicable to this instance.

Japanese banking as a whole has endured a similar strain since the ‘bursting of the bubble’ in the early nineties. Asset price inflation and sky-high land values, halted by a brusque hike in the rate of interest, struck a smarting blow at the much lauded Japanese ‘main bank system’.^e Total uncovered losses in all deposit-taking institutions for end-March 1998 reached Y20 trillion (approximately 4% of GDP), whereas disclosed non performing loans as of the same date amounted to Y35 trillion. Despite the experts’ decoys planted in official reports that beckon to *productive insufficiency* in the face of an aging population, as the nondescript element lurking behind the crisis, financial turmoil in Japan is likely to better claim its position as an instance of the abuse of absentee ownership. The difficulty in palliating the disease, rather, seems to stem from a deficient internal consumption (here Douglas applies) and, at the remote removes of causation, from a not so suspicious lack of cooperation on the part of Japan’s chief G-7 partners.^f

There now remains to answer briefly why, among those countries characterized by the pervasive presence and action of universal banking, Germany has met her financial challenges in the past decade with relative success.^g As the principal safeguard, one may infer from contemporary statistics that Germany seems to have sacrificed (in truth, within restricted bounds) employment to the stability of her monetary structure. Second, the intrinsic fickleness of the stock market has always been the object of muted advertence and governance on the part of German capitalist interests. Although it ranks as the fourth exchange of the world, Germany’s financial market is far

^e ‘The firm borrows or has equity owned by many banks, but the main financier is delegated responsibility for monitoring the firm. The bank and its main client firm reciprocally own equities, although there is a limit imposed on the bank’s ownership, and proxy voting by the bank is not permitted’. [Aoki (1994): p. 41].

^f Given the relatively high correlation value (0.862 between 1980 and 1990) of Japan’s nominal long-term rate of interest with the corresponding average figure computed for the G-7, it would not be too bold to advance the supposition that the nefarious – from the Japanese viewpoint - jolt in the trajectory of the interest rate of the early nineties may have unmasked the Main Bank System’s fundamental disequilibrium *at that point in time*, at the behest of foreign preoccupied interests. (The estimate of the coefficient of correlation is taken from the econometrics appendix by A. [Levy and Panetta to Ciocca and Nardozzi (1993): p. 121].

^g We refrain at this juncture from assessing the potentially serious implications of the looming \$30 billion exposure of German banks to Russian debts.

from wielding any incisive and direct influence upon the productive dynamics of the country, compared to the exchanges of New York, London or Tokyo. The highly protected banking structure, shaped after the centralized precepts of the *Hausbank* (the mother bank holding the equity of the industrial groups) system, manages current industrial and monetary policies through a 'co-determined' arrangement that attracts interlocked firms – whose exposure to banks covers about 60% of total liabilities – and shielded unions bent upon insulating the smooth functioning of these complex socio-economic conglomerates that form the kernel of the so-called 'German way' to capitalism. Most important, banking is firmly rooted in the territory through its *fiscal* service within the community; issues of municipal and regional bonds (*Kommunalobligationen*) are the banks' monopolistic privilege (about half of all bonds issued by German banks in the early nineties). The close link to public administration – which, at the 'macro' level is predicated upon a careful calibration of credit (and above all the rate of interest) in view of the expected tax yields from the *Lander* and the municipalities – is a legacy of the corporative era. Indeed, the ever subtler harnessing of public finance to monetary management *and* mismanagement is yet another protective device of modern pecuniary systems (Douglas, again, is pertinent on this count). All salvaging operations in the industrialized West since the Great Crash have featured as their leading theme the transference of bad debts from ailing firms to *ad hoc* entities established by government authority, with a view to disburdening the overheated banks, overhauling the industrial ventures, and honoring the lending parties (whose shares had been transferred to the newly created bodies) over long stretches of time, by resorting to sweeping *taxing* schemes (there is the *public* nature of the operation) molded in accordance with the surging obligations. The credit institutes directly implicated in the collapse continue to receive interest payments as a counterpart to the cession of the temporarily barren assets, which bears testimony to banking's usufructuary power over the manufacturing of the means of payment. To return to the French example, it is the task of the *Societe de Participation Banque Industrie*, which has been established by the State and Thomson CSF (a French conglomerate corporation) to arrange the disembodiment and eventual privatization of the relinquished assets of the *Credit Lyonnais*. Again, pouring public finds into the 'holes' of the Japanese banking industry is seen as a remedial 'must' in the current framework of financial reform.

Germany has always benefited from her strong position on the trade balance; something which, though, was of no avail to Japan in the midst of her financial throes (yet another cure expressly envisaged by Douglas); but what seems to have 'saved' Germany from the brink of monetary confusion throughout the

last decade, and was unique to her station in history, was indeed the reunification. Customarily regarded in the mainstream literature as a thorny deal for the dynamic West Germans, this reunion appears instead to have bestowed upon the Fatherland something of an unexpected boon. For one, much of the enormous surplus and capital gains derived from the outstanding throughput of West German industry has been healthily decanted into the pauperized East. Thus, capital, perhaps unintentionally, has not been ‘petrified’ into land values, as has happened in France, and especially in Japan, but instead has flowed into the ex-DDR, partly in the form of a gift.

In a short story by Pessoa, an anarchist recalls how, in the early days of his militancy, he came to the conclusion that people cannot travel on the road to absolute freedom as an organized group. A hierarchy would very soon emerge, unintentionally; therefore, the anarchist argued, each must traverse the road to freedom alone. Each had to emancipate himself from bourgeois figments independently from everybody else; and since money was the most constraining of all social figments, the anarchist chose to be a banker and thus became the freest of all men.²⁹

NOTES

1. All quotations from works in Italian have been translated by Guido G. Preparata.
2. “Through banking, he who possesses wealth difficult to exchange can create a circulating medium. He has only to give to a bank his bank note – for which, of course, his property is liable to get in return the right to draw, and lo! His comparatively unexchangeable wealth becomes liquid currency. To put crudely, banking is a device for coining into dollars land, stoves, and other wealth not generally exchangeable” (Fisher (1963)).
3. See for example (Schumpeter (1989)) and (Ciocca (1991)).
4. Survey on international banking, April 1993.
5. “Finally, we may rest assured that amongst men only pleasure is given a price, nay, it is convenience that is bought and sold; and, since one cannot feel pleasure without causing distress and mischief to some other, the money disbursed goes to mitigate the deprivation of pleasure caused to others. To make someone’s heart palpitate is hurtful: thus we ought to pay him. What is known as the *fruit of money*, when it is legitimate, is nothing but the price of the heartbeat; and he who mistakes it for something else, deceives himself” (Galvani (1963): p. 292).
6. “Capital goods or production goods derive their value from the value of their prospective products; nevertheless, their value never reaches the full value of these prospective products, but as a rule remains somehow below it. The margin by which the value of the capital goods falls short of that of their expected products constitutes interest” (Von Mises (1989)).
7. “Of the gains, however, which the possession of a capital enables a person to make, a part only is properly an equivalent for the use of capital itself; namely, as much as a solvent person would be willing to pay for the loan of it. This, which as everybody

knows is called interest, is all that a person is enabled to get by merely abstaining from the immediate consumption of his capital, and allowing it to be used for productive purposes only” (J. S. Mill (1987): pp. 406–407).

8. In *The Theory of Economic Development* ((1983); p. 66), Schumpeter identifies five forms of innovation, including technological change: (1) the introduction of a new good – that is, one with which consumers are not yet familiar – or of a new quality of a good; (2) the introduction of a new method of production, that is one not yet tested by experience in the branch of manufacture concerned, which needs by no means be founded upon a discovery scientifically new, and can also exist in a new way of handling a new commodity commercially; (3) the opening of a new market, that is a market into which the particular branch of manufacture of the country in question has not entered, whether or not this market has existed before; (4) the conquest of a new source of supply of raw materials or half-manufactured goods, again irrespective of whether this source already exists or whether it has first to be created; (5) the carrying out of the new organization of any industry, like the creation of a new monopoly position (for example, through trustification) or the breaking up of a monopoly position. Although the focus, within the text of this section of this paper, is on technological change, most of what is said pertains generally to the Gestalt of what Schumpeter characterizes as ‘innovation’.

9. The process of credit inflation had already been discussed, essentially in the same terms – and with a richer description of the monetary instruments involved in the operation – a decade earlier (1904) by Veblen in *The Theory of Business Enterprise* (Chapter V): ‘Funds obtained on credit are applied to extend the business; competing business men bid up the material items of industrial equipment by the use of funds so obtained; the value of the material items employed in industry advances; the aggregate of values employed in a given undertaking increases, with or without a physical increase of the industrial material engaged; but since an advance of credit rests on collateral as expressed in terms of value, an enhanced value of property affords a basis for a further extension of credit’ (Veblen (1904): p. 205). The next section will be devoted to the contribution of Veblen; we now follow the exposition of Schumpeter by reason of the strong technological bent of his argument and the construction of his argument largely in competitive terms.

10. Ideologically, the allegedly ‘creative’, technological and ‘irresistibly human’ foundation of interest, contrived by Schumpeter, is much more seducing and less embarrassing than the genteel perambulations of Benthamism, which, indeed, rest firmly on a highly concentrated distribution of wealth.

11. For a mathematical examination of Veblen’s portrayal of financial instability, see Ronnie J. Phillips, ‘Veblen and Simons on Credit and Monetary Reforms’. *Southern Economic Journal*, vol. 55, no. 1, (July 1988), pp. 171–181.

12. In the United States, the connections between banks and industry intensified at the time of the wild speculations in railway stock (the legendary fortunes accumulated by characters such as Hetty Green and J. P. Morgan epitomized that period) and soon spread to all the other vital sectors of the industry. In this respect, “There seems to have been a greater incidence of outside financial control in railroads, but the influence of investment banking houses like Drexel Morgan, Kidder Peabody, and Kuhn Loeb was strong in life insurance, steel, copper, electric traction, and electrical equipment [. . .]. In most industries in which Morgan had interests, railroads or insurance or commercial banking, his representatives would sit on the boards of two or more competing firms, in

which case 'order' would be imposed and competition would be minimized. Such interlocking directorates were common in the age of financial capital" (Duboff (1989): pp. 62–63).

13. Even Schumpeter is forced to give up the romantic epic of the Entrepreneur – the protagonist of *The Theory of Economic Development* – and rethink the economic system, by depicting it – in *Capitalism, Socialism, and Democracy* – as a gloomy world ruled by gigantic trusts, where the triumph of man is in every respect replaced by the ubiquitous power of holding companies. These are giant firms capable of annihilating any individualistic ferment, by digesting and assimilating it as functions of their own metabolism. Organisms of this sort do not wait to be disrupted by *external* forces, such as technological revolutions: innovation, for immunological reasons (to protect themselves from price wars) are directed *inside* the trusts, and the various learning phases are cautiously regulated by appointed engineers, compatibly with market conditions. With the advent of trusts, research and development become themselves standard firm routines.

14. Even this institution may be tagged as a Schumpeterian innovation, although a financial one. J. P. Morgan was the pioneer, and his innovation, like all successful innovations, was soon imitated until it became a current economic procedure, i.e. a routine.

15. One of the most exhaustive studies on the transition can be found in (Schurr et al. (1990)).

16. (Piore, Sabel (1984)).

17. In the United States, during the nineteen twenties, short-term money, i.e. ordinary deposits, were actively tied into long-term ventures through the often unbridled lending policy of the so-called 'affiliates' – financial intermediaries depending on mother banks for financial capital, yet endowed, up to the Great Crash, with remarkable investing freedom. Banking collapse in the early nineteen thirties was greatly accelerated by the uncouth tampering of the affiliates with the maturity of the funds entrusted to them. The banking legislation of 1933 set out to redress the financial abuses of the 'roaring twenties' and separate, within the institutional arena of banking, short-term long-term lending – the precinct of merchant banking proper. For a detailed account of the lending patterns followed by affiliates, see W. Nelson Peach, *The Securities Affiliates of National Banks*. Baltimore: Johns Hopkins University Press, 1941.

18. Three examples of contrivances which described interest as an essential factor of the economic realm, have been given at the end of the section dealing with Gesell's theory of basic interest (see above end notes 5, 6 and 7).

19. Gesell's definition of capitalism (Gesell (1920)): 'An economic condition in which the demand for loan-money and real capital exceeds the supply and therefore gives rise to interest'.

20. For instance, if many houses were to be built so as to force interest (that is, rent) below basic interest, money will cease to be loaned until, for a series of circumstances (such as a great population increase), a house-rationing level that will warrant the exaction of basic interest is reestablished. Conversely, if the demand for housing far exceeds the available supply, interest upon capital (rent) would gradually rise above basic interest. The opportunity to exploit the return differential would prompt money to forage real estate investments. The financing will continue until the two rates are brought into equality.

21. It is worth stressing that the theory of Gesell represents a complete subversion of Wicksell's dichotomous juxtaposition of a real – or 'natural' – and a monetary interest rate. The real (or natural) rate is the rate that would prevail even in an ideal barter economy, and which typifies the essence of the phenomenon: that is, the net permanent return from the physical means of production. The monetary rate instead, is nothing but the 'pecuniary reflection' of the former. The objection critics raise is that the natural rate, as thus defined, has little to do with the concept of 'interest': how can interest, which has the nature of a tribute, be associated with 'the net permanent return of the physical means of production?' These are two different things. How can 'interest' be given in a barter economy? According to the heterodox tradition in monetary-macroeconomics, Wicksell's elaboration is yet another mystification and the neoclassical distinction between a 'real' and a 'monetary' plane is a source of misapprehension and confusion, both in the teaching and the study of economic theory.

22. Malthus ((1986): p. 421) cites the example of large reductions in government spending in England after the Napoleonic wars, coupled with tax decreases for the wealthy, resulting in upward shifts in the propensity to save, but large and sustained reductions in consumption.

23. "We may conclude, therefore, with little danger of error, that such a body of persons as I have described it is not only necessary to the government, protection, health, and instruction of a country, but it is also necessary to call forth those exertions that are required to give full play to its physical resources" (p. 408).

24. In addition to medium-size land-owners and farmers, Malthus's "middle class" included those who derived their income from commerce and trade, manufacturing, the professions and "salaries of different kinds" and from "interest of public and private debts" (Malthus (1986): p. 379).

25. "Every society must have a body of persons engaged in personal services of various kinds; as every society, besides the menial servants required, must have statesmen to govern it, soldiers to defend it, judges and lawyers to administer justice and protect the rights of individuals, physicians and surgeons to cure diseases and heal wounds and a body of clergy to instruct the ignorant, and administer the consolation of religion. No civilized state has ever been known to exist without a certain portion of all these classes of society in addition to those who are directly employed in production. To a certain extent therefore they appear to be absolutely necessary" (Malthus (1986): pp. 406–407).

26. Malthus presumes that taxation is "judicious" and not too "heavy," that is, so heavy as to "clog all the channels of foreign and domestic trade, and almost prevent the possibility of accumulation" (Malthus (1986): p. 401).

27. Let us slightly modify the previous numerical example and assume that the banking system loans the capitalists 5 to pay the workers in exchange for an interest equal to 1 (rate of 20%). The total value of output is 15; workers spend 5 (and, therefore, do not manage to save anything (this is a simplifying assumption); capitalists spend 4 and state employees buy the remaining 6. The whole output is sold. Thus, on the demand side, $15 = AD = 5 + 4 + 6$. On the income side, banks have earned 1 as basic interest, workers have been paid 5, and the productive system has pocketed the rest, that is, 9; $15 = Y = 1 + 5 + 9$. The working class saves 0, whereas industry saves $5 = 9 - 4$ (earnings less expenditures); now, the savings of banks and firms (1 as interest + 5) corresponds precisely to the sum the State needs to buy its share of output and, thus,

support the price system. Yet, this amount will not be entirely taxed to cover the expenses of the Treasury; instead, the missing portion will typically be borrowed from the capitalists: this is how the dynamics of public debt is triggered.

28. Actually there is another remedy – a corollary of public expenditures in weapons and military initiatives – still very fashionable, which calls for the opening of foreign debouches, by the use of force.

29. Fernando Pessoa, *O Banqueiro Anarquista*.

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