“Economics for Everyone:
How to Cut Through the Jargon

Later Life Learning, Innis College
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Session 8

**Finance:
The Real Economy and the Paper Economy**

Chapters 17-19

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Key Concepts

- Money and prices
- Inflation, its causes, and its consequences
- The private banking industry
- Central banks and monetary policy
- Corporate finance and stock markets
- Financial instability and fragility
- Pensions and how to fund them

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Terms in Glossary

Money; currency; deposits; credit; means of payment; unit of account; store of value; barter; credit squeeze; banking cycle; central bank; fractional reserve; capital adequacy; inflation; monetary policy; relative prices; price level; deflation; real wage; nominal wage; consumer price index; GDP deflator; hyper-inflation; Milton Friedman; monetarism; quasi-monetarism; monetary targeting; corporate finance; bonds; shares; stock market; speculation; financialization; financial fragility; derivatives; pensions; pre-funded pension; pay-as-you-go pension; defined contribution; defined benefit

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What is Money?

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What is Money?

- Widely accepted purchasing power:
  - Something that allows its holder to exchange for other goods & services.
- Many things have been used as money. (Examples?)
- Today, most money is 'fiat money':
  - The money itself has no inherent value other than social acceptance, backed by the state.
  - Government ensures its usefulness by demanding taxes be paid that way.

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Money is *NOT* Currency…

(and it is mostly NOT created by government!)

- Printed currency today (produced only by the Bank of Canada) accounts for under 2% of total money in Canada.
- Most money consists of electronic deposits, and is transacted electronically.
- Most new money is created by banks when they issue a new loan.

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Out of Thin Air

"Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money."

Bank of England Quarterly Bulletin, 2014.

"The process by which banks create money is so simple that the mind is repelled."

John Kenneth Galbraith, Canadian-American economist (1975).

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What is it Good For?

- Three primary purposes:

1. Means of exchange.
2. Store of value.
3. Unit of account.

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Bitcoin

- Non-reproducible digital asset.
- Uses blockchain programming technology.
- 'Miners' run thousands of computers pointlessly to create the complex code for each new bitcoin.
- Price rises and falls with the mood swings of speculators.

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Bitcoin

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Honest Question: Is Bitcoin Money??

- Remember the three purposes of money:
  1. Means of exchange.
  2. Store of value.
  3. Unit of account.
- Is Bitcoin money?
- Put your answer in the Q&A…

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Capitalism:
A Monetary Production Economy

- Money has a long history.
- But took on new importance under capitalism:

1. Accumulating money (via profit) is now the ***goal*** of production.
2. Companies ***create*** new money in the act of initiating production.
3. Private for-profit businesses (banks & other financial firms) manage the monetary system, with odd effects.

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Money and Production

- A business wants to invest to start production and make profit.
- In a credit money system, it doesn't need to have already saved that money: it can borrow it.
- That loan creates new money.
- The money is spent to start production, employment, income, consumption.
- Hopefully it ends up making a profit (also measured in money).

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Real Capital & Paper Capital

- Real capital: tools, equipment, structures, machinery, infrastructure.
  - Any produced output that is then used to produce something else (rather than being consumed).
- Financial ('paper') capital: money that is used to facilitate investment and production.

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Forms of Finance

- Bank loans
  - Simplest, depend on ongoing relationship
- Bonds
  - Cut out bank as middleman
  - Introduce a new middleman (broker)
  - Securitized (bought and sold for profit)
- Shares / Equity
  - Highly securitized
- Complex, exotic forms of lending

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Implications of Finance

- Investment no longer constrained by savings
  - Just need a credible business plan
- Real capitalist & financier have shared interest in boosting the rate of profit
- But they may argue over the division of the flow of profits
- Overdeveloped financial industry may distract, destabilize real investment

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A Different Flow
(p.233)

- Given the stagnation of real investment, resulting weak growth, and limited profit opportunities, banks have looked to other outlets for credit creation.
  - Rather than productive businesses.
- Now lending direct to households is a bigger source of their profit.
  - Indebtedness finances consumption in face of stagnant wages.
  - Link between credit creation and the housing bubble.

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Inflation

- Real GDP = production of goods & services.
- Nominal GDP = its monetary value.
- Increase in average price level is inflation.
- A bit of inflation is good.
  - ‘Lubricates’ relative price changes.
- Too little or too much can damage.
- Bank of Canada target: 2%. Uses interest rates to hit it.
- Bank maintains certain unemployment necessary to hit the target.

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Financialization

- Since early 1980s, policy emphasized financial activity over real production
- Employment and real production were kept under tight control
  - The “danger” of inflation
- But finance was given total freedom:
  - Deregulation
  - Globalization
  - Speculation
  - Tax Subsidies
- Political/cultural effects
  - “Stock-marketization” of society

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The “Real” Economy and the “Paper” Economy


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The Real Economy and the Paper Economy

- Real Economy: the work we all do to meet our material needs & wants
- Paper Economy: financial sector; plays a different, unique role
  - Not directly productive
  - Trades in paper assets
- Theory: Paper economy facilitates, lubricates real investment & production
- Practice: For every $1 of productive lending & finance, the paper economy spends $100 on speculation (buying/selling existing assets)

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Profit Motive in Finance

- Private banks have a license to "print money" (ie. create credit)
  - Credit is essential to our economy
  - We've "outsourced" the job to banks

- They create credit in order to maximize their own profit
  - Too much some times
  - Too little some times (bankers' cycle)
- Must hold banking system to account to meet society's need for steady credit
  - And if need be, step in to do it ourselves
  - We can "print money," too!

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Productive and Speculative Motivations

- **Productive Profit:**
  - Invest, hire workers, organize production, sell product for more than it cost, keep profit
  - Results in production and employment
- **Speculative Profit:**
  - Buy an asset, sell it for more than you paid for it ("buy low, sell high")
  - Assets include shares, bonds, derivatives
  - Results in no production
  - Irrelevant to production at best, diverts attention and disrupts production at worst

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Sources of Financial Instability

- Leveraged credit creation (there's no 'real' money backing up the loans).
- Bank participation in investment banking and speculative finance (former separation eliminated in the 1990s).
- Credit creation to finance overpriced asset bubbles (now including housing).
- Mass participation in speculation (Reddit clubs) usually is a sign the end is near.

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Causes of Financial Crises

- Profit motive in credit creation
  - Creates an inherent cycle in banking
- Speculative impulse
  - Creates economic "attention deficit disorder"
- Deregulation, innovation, leveraging, globalization make it all worse
- Slowing real growth & investment
  - Greater financial overhang vs. smaller real base
- Dynamics of financial crisis are "hard-wired" into the DNA of this system
  - **It *WILL* happen again, unless we change the rules**

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STEP 1
Select an asset with a rising price
An asset is anything that can be bought and re-sold. Real estate. Dot-com internet stocks. Derivatives.
Even flowers. In the 1620s, the Dutch economy was ruined by a speculative episode focused on buying and selling rare tulip bulbs. Driven by speculation, tulips became astronomically expensive — until the crash.
Every speculative episode starts with an asset — any asset — whose price is initially rising, for whatever the reason.

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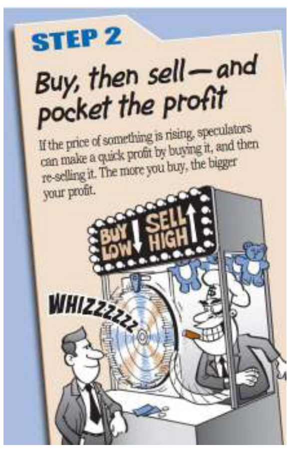
STEP 2
Buy, then sell—and pocket the profit
If the price of something is rising, speculators can make a quick profit by buying it, and then re-selling it. The more you buy, the bigger your profit.
BUY LOW
SELL HIGH
WHIZZZZZZ

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STEP 3
Hope the idea catches on
Driven by greed, envy, and competition, more and more investors pile into the market, all hoping to profit from the upswing. This "herd mentality" becomes self-fulfilling. If enough investors believe the asset's price will rise, and buy accordingly, then the price does rise. But it's fueled by mass psychology, not real economics.
STOCK BROKER
I'LL BUY SOME
I WANT SOME
ME TOO
IT'S THE LATEST THING
ME TOO
CAN I BUY SOME?
IT'S A SURE BET

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STEP 4
Add a big dose of cheap credit
Speculative bubbles could not expand far without the power of borrowed money. Investors borrow heavily to place ever-larger speculative bets. If those bets pay off, then the speculator's profits are amplified. It's very risky to gamble with borrowed money. But if financial regulations are weak, banks will offer the credit anyway. They are also entranced by the lure of quick speculative profits. The more they lend, the higher the price goes.
ASSET BUBBLE
SSSS
CHEAP CREDIT

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STEP 5
Don't look down
There's one big problem with this recipe: The collective faith of investors is the only thing holding up the price of the asset. If investors doubt this faith, and are no longer confident asset prices will keep rising forever, then prices fall back to earth — and quickly. Every financial bubble is thus followed by an inevitable financial crash.
It's like Wile E. Coyote after he runs off the edge of the cliff: it's only when he looks down, realizing nothing is beneath him, that he falls.
Investors' Stairway to Heaven

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STEP 6
Everyone sells
Once the first nervous investors sell off, fearing the inevitable crash, the herd starts running the other way. Everyone sells out as quickly as possible, trying to avoid losses — but their panic is also self-fulfilling, and causes the losses to be even bigger.
Original speculator
Bank A (lent to speculator)
Bank B (lent to Bank A)
Bank C
Bankers whose loans fueled the expansion are suddenly in jeopardy, because those loans cannot be repaid.

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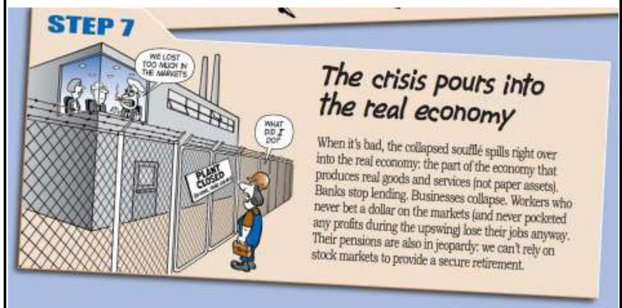

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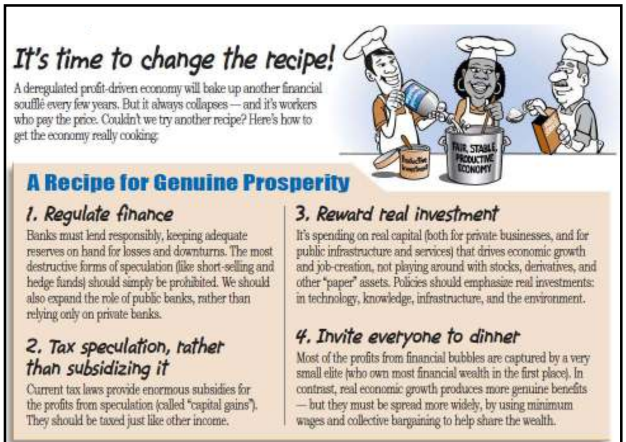

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Thank You!

Let's take 5 minutes…

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