

The Funding of Economic Misery

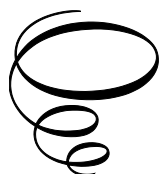
The Funding of Economic Misery:

*The Disconnect between
Financing and Wealth Creation*

By

Savvakis C. Savvides

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between Financing and Wealth Creation

By Savvakis C. Savvides

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FOREWORD

The book is about the “disconnect” of funding from wealth creation and the parting of entrepreneurship from productivity in the blind pursuit of the wealthy for a riskless return in an unregulated financialised world economy. The author discusses the systematic and methodical erosion of the real economy by organised special interests which drive and use political power to seek a riskless platform through which to maintain and increase their acquired wealth. Neo-liberal thinking has infiltrated all aspects of finance and banking and as a result the purpose of banks to lend productively as it was originally conceived has taken second place to the existence and capturing of the collaterals and other security assets available. Financialization facilitates the risk averse predisposition of the plutocrats regarding capital investment but at the heavy cost of suppressing the real economy and the general welfare of the people at large.

ACKNOWLEDGEMENTS

I wish to thank Marios Kourtellis and Dr George Georgiou for their very helpful edits and comments. Special thanks are due to Marios particularly for proofreading, correcting and tidying up the final manuscript. Many thanks also to my friend and good economist Les Manison with whom we have discussed over the years many of the issues raised in the book and published several papers together. All errors are, of course, mine.

PREFACE

Following the financial crisis of 2007/8, a number of economists began to question the functioning of the modern capitalist system which has become reliant on rentier revenues detached from productive investment. The driving force of rentier capitalism and the associated financialization of society, including the political system, has been neoliberalism or, what was referred to during in the late 1970s, free-market economics. The enrichment of rentier capitalists has been accompanied by growing income inequality and corruption as well as a “disconnect” between policy makers and the citizens whose welfare they supposedly represent.

In this important book, Savvakis Savvides brings these various strands together by looking at risk aversion, money and the real economy, debt, and wealth extraction. The book draws together several papers which Savvakis has published during the past 20 years or so. Most of the chapters contain useful charts which help to illustrate the arguments. Each chapter contains a bibliography and references thus enabling the interested reader to delve deeper. The book will be of interest to students and academics and can serve as textbook on advanced undergraduate courses. It is highly recommended.

Dr George M. Georgiou

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I

INTRODUCTION

How Crony Capitalism Operates to Transfer and Destroy Wealth

The book is a criticism of how a crony capitalism economic system operates to transfer and destroy wealth. It highlights the main economic distortions that lead to financialization of the economy and result in wealth extraction rather than wealth creation.

The reality is that the world economies are not as generally perceived ranging between two extreme economic models. A free and well-functioning real economy should have elements of both and moreover have in place “Chinese walls” that ensure that monopolies and oligopolistic cartels are contained and kept in check. Capitalism as defined and written on by classical economists was put forward by its proponents with a lot of caveats and conditions necessary which conveniently for some are put aside and are mostly ignored in the reigning *neo-liberal* thinking. Adam Smith probably wrote more about the threat of monopoly and political power intervening with a competitive market mechanism than he praised the undoubted benefits of a properly functioning laissez-faire system.

The book derives from a series of publications by the author in which he argues that *the corruption of the market economy stems from the monetisation and the de facto control of the money supply by special interest groups* as well as the exploitation of the market resulting from the distortions imposed upon it from special interests and unscrupulous bureaucrats and politicians as regard to the system’s ability to fund economic development for the welfare of the people at large.

The Deception of Money

Money is simply a promise to pay. It has no intrinsic value. It is however essential in facilitating exchange which is vital for the efficient operation of

a market economy. This however raises the question of who promises to pay and even more essentially what is promised to actually pay the bearer of the money. Initially, money was a promise by the Sovereign of a country (the King or Queen) to pay the bearer of a money note the *equivalent* amount that was for in Gold or Silver. Today however, it is a promise by essentially **no-one** to **replace the note with another one of the same nominal value!** In essence, it is like going through the motions of assuring the bearer of money that their notes have real value but without, in fact, backing that promise anything of value. Yet, the *illusion* of money being a means to wealth facilitates exchanges and keeps the world economies functioning. When all the world believes this, strangely enough, money is pursued by all, and it makes the world economy functional and efficient in exchange. But in a world where money possession and wealth disparity are at extreme levels and where global financial markets and banking are very unregulated it also opens the door and gives the opportunity to “predators” to use it to grab existing wealth rather than to create new wealth and prosperity for all.

This is essentially the subject analysed and discussed in this book. Money, instead of being employed productively in the real economy to create new wealth for all, is weaponised through this loose and largely unregulated financial system whose prime concern is to hedge investment risk and largely through a failing banking system results in seizing existing wealth.

From Democracy to Plutocracy

The term *Plutocracy* originates from the Greek “*ploutokratia*”, and it is composed of two words of “*ploutos*” for “*wealth*” and “*kratos*” meaning “*strength and authority*”. According to the *Oxford Advanced American Dictionary*, *plutocracy* is “*government by the richest people of a country*”. The *Oxford English Dictionary* defines *plutocracy* as “*the rule or control of society by the wealthy*”. It can also refer to “*a state or government characterized by the rule of the wealthy, or a class that exercises power by virtue of its wealth*”. The term describes a social order where executive and legislative authority is influenced and largely determined by the influence of the power elite and the organised special interests of the wealthy. This is what essentially corrupts and obscures a free-market mechanism and disrupts the efficiency and maximisation of welfare that may potentially provide. It is in this context that the term is used in this book which aims to show how wealth is transferred rather than created and leads to misallocation of capital and economic misery.

The term plutocracy is the main characteristic of crony capitalism. To this, one should add traits of behaviour that may be better described as *favouritism* or even nepotism. Moreover, nations may become plutocratic through *kleptocracy* or *rent-seeking*.

The distinctive pattern is that others such as relatives, friends, or colleagues as well as organised pressure groups are often granted special privileges thereby causing further distortions to the free working market mechanism. The wealthy however is the main contributing factor to the decay of the *laissez fair* market. The book will therefore focus on the plutocrats and how the extreme inequalities we live in the 21st century distort and erode the free market and change the system so as to be accommodating their main risk aversion needs which is basically the avoidance of business and capital investment risk. This is facilitated at the expense of general economic development and welfare for the public at large.

When special interests slowly but surely infiltrate a democracy and plutocracy becomes the dominant factor in a state minority interests prevail over those of the majority. Corruption and serving the few outweigh the democratic rights of the electorate. Nepotism and the negative predisposition of plutocrats to undertake a risk in the real economy eliminate individualism and suffocate entrepreneurship. Cronyism and favouritism reign supreme and “politics by the people for the people” is generally side-lined. Citizens’ duties and obligations take precedence over the rights of the people for prosperity and a decent living. The plutocrats’ generally only care about maintaining their acquired wealth and increasing it by any means available to them. The impetus to create is not the driving force and takes second place to maintaining and acquiring more wealth. Money and political influence is the instrument through which this is sought to be attained.

This eventually leads to deregulation and the formation of monopolistic cartels in a world financial system which funds the *transfer of existing wealth* from the many to the few instead of *creating new wealth* to boost economic development and one that serves the general well-being of the people at large.

Banks are Part of the Problem

Each of us, whether we realize it or not, has two sources of income. From his work and, directly or indirectly, from the net worth of his balance sheet

(mainly from rents and/or sale of property). However, the usual analysis refers almost exclusively to income through work and/or through social earnings. However, this, unfortunately, is only one side of the coin that does not at all give the whole picture and the magnitude of the enormous destruction that the myopic and egocentric tactics of politicians and other cunning people have brought to unsuspecting citizens whose only aim is to improve their personal and family welfare. The reality is however much more tragic if one takes into account that banks, with barely any supervision from the regulatory authority and with the blessings and encouragement of special interests and politicians who are in power load them with well collateralised but mostly unrepayable loans. But the crime in the economy is that most of these loans are often non-productive and many only for consumption purposes. No proper assessment of the ability to repay is carried out by the banks.

Banks have a specific and concrete role to play in a capitalist economy. This rests primarily on their role and duty to redirect savings into economically viable projects and lend productively. This crucial role and service by a healthy banking system is often by passed and ignored by those politicians who put forward the argument that banks are essential for an economically viable economy. If a bank is not lending productively but serves special interests of plutocrats not only is not conducive to economic development but rather an instrument for impoverishment and misery. Without sound foundations and with solvent borrowers, banks have no role. In practice, many of these politicians who urge us to support the banks “in order to save the economy”, such as in the Cyprus debacle of 2013, have only managed to save themselves by stepping on their victims to offer the banks that caused the problem in the first place not only a lifeline but a red carpet to walk away and escape justice. Unfortunately, neo-liberal thinking is taking over behind the scenes with the co-operation of politicians and Governments to facilitate the rentiers and serve the self-centred needs of the plutocrats at the expense of the general welfare of the people.

Impoverishment through Broken Balance Sheets

If one looks more broadly, the problem is much bigger than the income statistics might show. The middle class is being impoverished through irresponsible debt by “zombie banks” which dance to the appetites and rhythms of politicians, plutocrats and other intermediaries, such as lawyers and accountants, many of whom in the process become rich themselves. This has two catastrophic effects that have not yet been fully understood.

One is bankruptcy, through mortgages of bad loans of households and small and medium-sized enterprises. The sale of these loans to foreign funds further exacerbates the problem, especially because they do not offer the same to the borrower on the pretext that it would be immoral banking practice to do so. However, the long-term effects of the creation of balance sheets with reduced and/or negative net worth are expected to be even more severe on the economy and the well-being of the people in general. Many articles have been published on how private debt leads to the “Balance Sheet Recession” [1][2][3]. The result is the squeeze of the middle class and not only, through a failing banking system and practice. Sweeping the problem of gargantuan but well-secured private debt with mortgages under the carpet by selling it off to foreign “vulture funds” cannot solve the problem. On the contrary, it exacerbates it because it consolidates and makes more permanent the bankruptcy of most households and companies, even making the ability to take out new loans practically impossible. The worst, but more long-term problem, is that it eliminates the purchasing power on which new economically viable projects could be found and financed [4].

Wealth Concentration and Risk Aversion

The concentration of wealth and extreme inequality in an economy brings about a major distortion to an otherwise free economy which normally encourages individualism and entrepreneurship. As it is argued in the book the plutocrats aim primarily to preserve their acquired wealth and seek ways to increase it in a relatively riskless to them manner. This however brings about the creation of monopolistic power and oligopolistic cartels that rip apart many of the benefits to be derived from a free-market mechanism. Moreover, with an obliging Government and loose regulatory regimes plutocrats seek to “invest” their money where the return is more-or-less assured and the risk of losing is minimal to non-existent. The biggest culprit in all this is a dysfunctional and rather unregulated financial system in the world. This is the main reason we have witnessed the emergence of many collaborators to help them attain their objective, such as the hedge funds, wealth management divisions in major banks, private banking, and even financial advisors. The unfortunate thing in all this is that the market is actually responding to the needs of the effective demand, but which as it happens, is shaped by the risk aversion attitudes of the wealthy who are not willing or are often even competent to undertake the entrepreneurial risks in the real economy so as to create new wealth.

The only way to give the plutocrats what they require therefore, and in the process enrich the intermediaries, is to focus on the *transfer of existing wealth*. Unfortunately, a loose and unregulated banking system provides them means and facilitate wealth managers to attain their objective. The casualty however is the real economy and the economic welfare of the people at large. This is what the book argues and attempts to demonstrate.

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II

THE PURSUIT OF ECONOMIC DEVELOPMENT

(This chapter is based on a paper published following the Cyprus bail-in of 2013¹).

The question that is too obvious but only rarely answered what really economic development is and how it should be pursued. In the aftermath of the Cyprus bail-in and the blanket approach of the Government to attract foreign investment the author reminds that failed projects do not promote the cause of sustainable economic development. The point is also made that although cost benefit analysis and risk analysis can indicate viable capital investment projects (public and private), one should bear in mind that a developmental project should be both viable financially (from the Owner's and Bank's perspective) but also from the point of view of the Economy. Special concessions, subsidies, relaxations, and tax exemptions made by a government over-eager to attract foreign investment may indeed make a financially viable project non-viable from the Economy's perspective. To successfully accelerate the pace of economic development, three areas of focus are suggested to take measures for:

1. Institutionalise and enhance the credit risk assessment of commercial banks,
2. Set up a Development Bank to source and position new long term loan funds and lead the way in the financing of major projects in the economy,
3. Create the capability of Government to have independent expert advice on the structuring, evaluation and financing of public sector and Public-Private-Partnership (PPP) projects.

¹ Savvides, Savvakis C. (2014) "*The pursuit of economic development*", Journal of Finance and Investment Analysis, Scienpress, Vol. 3, No. 2.

Economic Development and Cost-Benefit Analysis

Economics is about using economic resources to maximise the utility of a society. To move an economy closer to that optimum point of economic welfare it is necessary to employ capital and labour and other factors of production such as land closer to their most efficient uses. However, to successfully accelerate the pace of economic development, in addition to increasing the levels of employment and attaining high efficiencies for the factors of economic production, it is also necessary to yield a good return on capital. This in effect means that a project scrutinised through a cost-benefit analysis test should have positive net present value (where the projected net cash flow discounted at the opportunity cost of capital is greater than 0). The methodology of cost benefit analysis for capital investment projects is well documented² and is applied worldwide successfully for over 50 years.

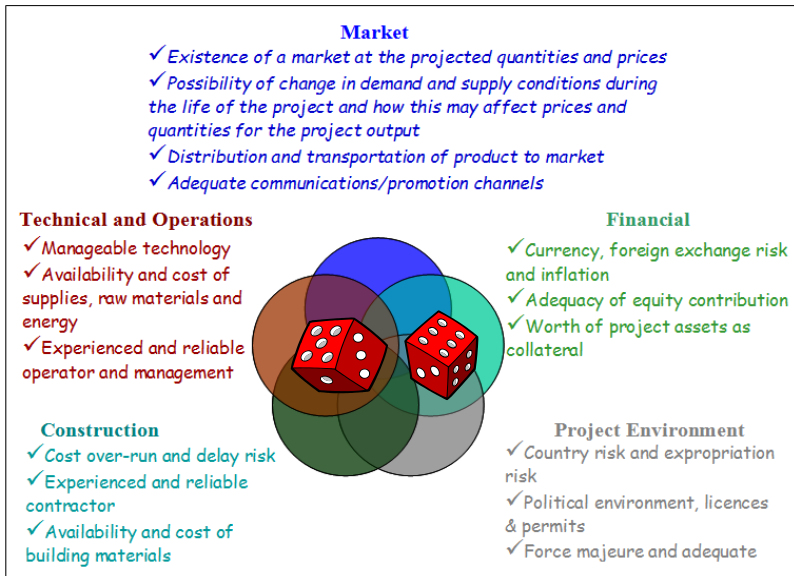
Risk Analysis and Project Financing

Moreover, because with any new project the outcome is by definition uncertain it is also desirable to evaluate the impact of alternative possible scenarios in light of the risks that are intrinsic to the project and ask whether there is the capability to overcome them. In other words, any new investment project should have a manageable risk profile and the decision whether to undertake (and finance it) should depend on the outcome of this risk analysis³. If the project risks are properly identified and measured it is often possible to seek and find suitable solutions to mitigate and manage it among the different stakeholders of the project. Figure 1 outlines the typical risks that a project is subject to, and which must be assessed before the capital investment and finance decision is taken⁴:

² Harberger, Arnold C., and Glenn P. Jenkins 2000, Jenkins, G.P., 1998.

³ For the methodology of Risk Analysis in Investment Appraisal see Savvides, Savvakis C. 1994.

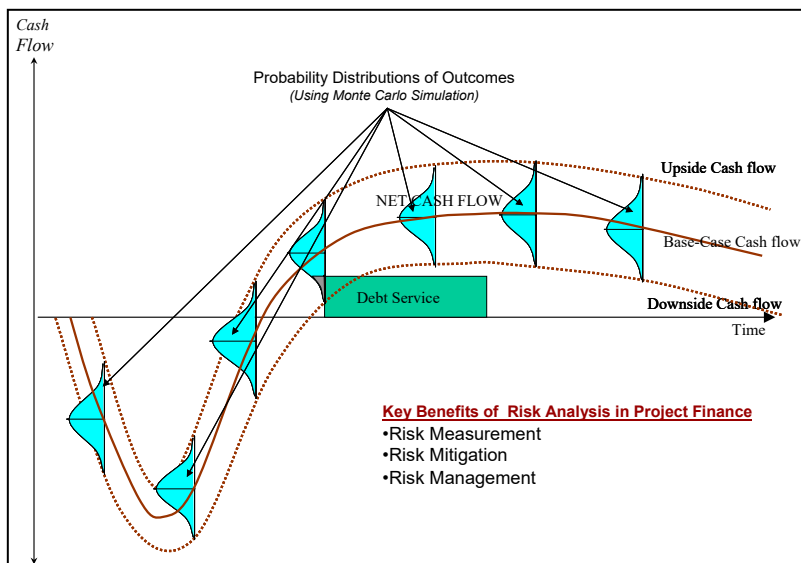
⁴ For an exposition on Analysing and providing for Market Risk in Project Evaluation see Savvides, Savvakis C. 2000.

Figure 1 - Sources of Project Risk

A proper and thoughtful appraisal of a proposed business plan seen through the prism of a sound financial model that accommodates for risk analysis will reveal and gauge a number of inherent risks which can be charted along the projected life of the project and most importantly from the point of view of the lending bank indicate how these may affect loan disbursements and loan service during the repayment period⁵ (Figure 2⁶).

⁵ For complete case-studies that include financial, economic and risk analysis see: *Andreas Andreou, Glenn Jenkins, Savvakis C. Savvides and 1990 and Andreas Andreou, Glenn Jenkins, Savvakis C. Savvides, 1991.*

⁶ Source: Savvides, Savvakis C. 2011.

Figure 2 - Risk Analysis on Projected Cash Flow

Sustainable economic development therefore can only be attained if capital investment and financing is directed towards funding the most viable and ergo competitive projects. Real economic development comes from building on solid grounds and from funding projects which add net customer value and are cost effective. Only viable and competitive projects promote the cause of economic development. This holds true for both foreign and local investment projects. An investment in a project which is likely to foreclose before its expected life span or that is likely to be unable to repay its loans only drags the economy even further into recession.

Project Stakeholder Analysis

The cash flow projections of any investment project should be looked at with respect to its different project stakeholders⁷; the “Owner” of the project which includes the loans and other inflows and outflows relating to the owners of the project, the “Banker” (or Total Investment view) where it is assumed that the project is all equity financed in order to show how good the project is in supporting the repayment of its obligations (including the

⁷ Jenkins, G.P., 1998.

loans it may wish to raise), and last but not least, the “Economy's View” where the basic cash flow is adapted and the prices adjusted to reflect the net benefits and costs arising to the Economy in general. Economic value (which is the building block of economic development) occurs when the net present value arising from the costs and benefits cash flow of a project from the Economy's perspective is positive.

Economic development therefore stems from investing and funding economically viable projects. It does not come about because a foreign or local investor is persuaded, or “bribed”, to invest in a project he would never have invested in without the special concessions, subsidies, relaxations and tax exemptions that may have been made by an uninformed and over-eager government to attract foreign investment. This happens time and again where a public sector concession authority does not understand the distinction between an economically viable vis-à-vis a financially plausible from the Owner's point of view investment project. Non-viable investment projects inevitably only drag the economy even further into recession.

Conclusion

The requirement to identify, appraise and finance developmentally strong projects is even greater when there is a crying need for restructuring to get the economy out of recession. In such circumstances, a government should be ready to make the necessary reforms and put in place those mechanisms necessary to facilitate this critical process for spearheading economic development. These may include the better regulation of banks to focus on their core savings and lending activities and the retraining/reorganisation necessary to enhance their capability to assess credit risk for restructuring existing loans⁸ and for granting new ones. It may also consider the creation of a Reconstruction and Development Bank to take steps so as to secure and position long term funds and lead the way in the financing of major projects in the economy in a new development initiative. Last but not least, the Government should create its own capability so as to have independent expert advice on the structuring, evaluation and financing of public sector and Public-Private-Partnership (PPP) projects and for managing the project development and procurement process. Without a competent and totally independent professional body (such as a National Advisory and Finance Agency) it is practically impossible to ensure that the public is receiving value for money from a privatisation or a PPP project. Indeed, a newly

⁸ Savvides, Savvakis C. 2011.

created Development Bank in the model of the German KfW Bank can serve both as a lender to industry and as advisor to the Government on Public Sector and PPP projects. In the final analysis the Government should understand that economic development is best served when capital investment, whether from the Public or Private sector, is directed towards projects which are economically viable for the country under free market competitive conditions.

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III

FINANCIAL MARKETS, BLOATED GOVERNMENTS, AND THE MISALLOCATION OF CAPITAL

This chapter is largely based on a published paper by the author in 2012⁹. The world seems to be at the mercy of the financial markets. How is it that the public sector of most of Europe and the United States have borrowed an amount which is almost as big, and in many cases bigger, than their annual Gross Domestic Product (GDP)? Historically, such huge amounts of borrowing by Governments were only justified to finance wars. One may indeed wonder for what purpose these massive amounts of Government borrowings were used for. Were they employed to build crucial infrastructure like roads, ports, dams, transport, communication networks and so on? With very few exceptions, the answer is most definitely not. The money was used primarily to expand Government through paying the constantly rising salaries and pensions of an ever-increasing public sector and to fund subsidies and social benefits of the welfare state and more recently of course to bail out Government owned companies and banks in times of financial crisis. In short, successive Governments used finance from foreign and local borrowing unproductively to fund the bloated Government machine, their own pet projects and to keep themselves in power.

Government Borrowing

Government borrowing is a form of indirect taxation because sooner or later the people are called upon to pay for it. This is done either through austerity measures in the form of tight control of expenditures and additional taxation for a long period of time but which however more often than not also stifle

⁹ Savvides, Savvakis C. (2012) “*Financial markets, bloated governments and the misallocation of capital*”, Journal of Finance and Investment Analysis, Vol. 1, No. 2: pp. 201-219.

real economic growth or through an increase in the money supply which is used to service the bonds and repay the loans but which also raises the prices of goods and services (inflation) and makes the local currency fall in value as compared to the value of other international currencies (devaluation).

There are opposing schools of thought as regards which is the best way to pursue salvation once the finances of a nation get so screwed up that one or other of the above measures must become the order of the day. For the increase in the money supply and inflation route to be an option at all however a nation should have control of its own currency or be part of a group of states that share a common currency but which, unlike today's Euro zone countries, do not have conflicting interests and objectives regarding the side effects of the alternative medicines to be administered to cure the patient. For Germany and some other European countries in the north inflation is anathema and as a result the only objective of the European Central Bank as was recently declared is to keep inflation under control. If inflation sets in, Euro zone countries like Germany will lose in many ways. Their products will become more expensive and less competitive but equally importantly, German investors holding European bonds will find that the value of their investments will decrease sharply. On the other side of the table, for southern countries who find themselves with Government debts which cannot possibly be repaid, inflation is not necessarily all bad. Inflation is perhaps the only cure in a highly leveraged world. The enormous Government debts of Greece, Italy, Spain, and many other European countries including France cannot possibly be eradicated by austerity measures. Not only is it very unlikely that such measures can be sustained for decades but even if it were possible to do so, their impact on reducing the debt would be very small.

The debate so far has been driven by a rather unchallenged assumption that what needs to be done for a country in trouble is to gradually improve its credit rating and get back to borrowing from the financial markets. I beg to differ. Why should a country be borrowing for anything other than to finance specific properly assessed viable projects which can stimulate and foster economic development? Most of these types of projects do not even need to be undertaken by the public sector and can be selected and financed on pure project finance criteria and possibly, some may argue preferably, under a Public-Private-Partnership model of development. Government borrowing which does not relate to specific development projects and is not entered into on the basis of proven economic return and repayment capability is a form of indirect taxation because sooner or later the people will be called upon to pay for it. Indeed, any repayment capability attributed

to a Government, by the Credit Rating Agencies primarily, has to do with the finances of the country (such as the level of Government debt compared to actual and expected GDP) but also on the ability of the Central Authorities to impose new taxes and/or apply spending cuts on its people. Why is it legal, therefore, for Governments to borrow and thereby impose an indirect tax on its people when clearly if they tried to justify and apply such new taxes directly, they would fail and possibly fall from power?

Classical economists clearly prescribed the cure for this for a long time now. What is needed is legislation which forbids Governments from entering into debt and renders unconstitutional any non-project related borrowing by the public sector. Thomas Jefferson and Milton Friedman have been advocating something like this as being the only way by which the people will ensure that their governments are kept under control and they do not thus condemn future generations to decades of poverty and subversive measures at the mercy of the “money masters” of the world. Thomas Jefferson wanted to enact legislation that would “simply forbid the general government from going into debt” while Milton Friedman actually went as far as to propose “an amendment to the Constitution” which will ensure that they never regain control¹⁰.

It is quite intriguing and rather scary that amid what is possibly the worst financial and economic crisis that the world has ever had to face no-one actually brings up the issue of why and when Governments should be going into debt. The problem is perceived as one of weathering the storm in order to get the Governments back to borrowing from the financial markets as soon as possible. It is astonishing that no-one really questions why indeed Governments are allowed to continue to go deeper and deeper into debt where the citizens are providing the collateral. It is indeed quite incredible why not even economists discuss the issue of uncontrolled Government borrowing and instead they are only concerned on how they can get them back to the disastrous road of debt which inevitably will lead to even more bloated Governments, for which, of course, future generations will have to eventually pick up the bill.

But what are the causes leading to the predicament that the world finds itself today. If we can understand what has created this dire economic situation,

¹⁰ Quoted from: *A Program for Monetary Stability*, by Dr. Milton Friedman, Fordham University Press (N.Y. 1960, 1992), pp. X, 66-76, 100-101; and *Free to Choose* by Dr. Milton & Rose Friedman, Harcourt Brace & Co. (San Diego 1980, 1990), pp. 307-308.

we may hope to give some guidelines as to the structural changes that must be in place to avoid something like this happening again in the future. But in order to do that we must first understand what is the link between money and the real economy.

Money and the Real Economy

Money is just a medium of exchange. Money is not a good. It does not add to the wealth of a nation any more than a distant vacuum in space does. This is because money cannot be consumed. The only way one can consume money bills is by burning them to produce heat. The total of goods and services in the World at any point in time is a finite number. When one consumes a product (i.e. eat a banana) the total World wealth is reduced by the value of the product that has just been consumed. When money is used in a transaction the stock of money in circulation remains exactly the same. The money just changes hands from one person to another. Money can be increased or decreased (through money issues or fractional banking – credit) but has no intrinsic value. Therefore, the real economy (which can in theory at least work just as well as a barter economy) is totally different from the money market economy. The theory of free market economy refers to the former, not the latter. Distortions in the money market do have an impact on the real economy however because decisions taken in financial markets inevitably affect the **allocation of capital** in the real economy and inevitably cause a **redistribution of wealth**.