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Credit Guidance for a Desired Economy: An Original Institutionalist Critique of Financialization

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Abstract: Financialization describes the turn to speculative asset trading that has become increasingly central to economic life in recent decades. Critics argue this has occurred at the expense of the 'real economy', referring to production and trade. Critics further argue that finance's "normal" role is to serve the needs of the productive sector and real economic growth. Financialization is presented as a deviant form of capitalist development. Drawing on original institutionalist insights, this article argues that such a juxtaposition of the so-called 'real economy' versus deviant financialization is misleading. Financial speculation is a logical outcome of capitalism's actual real economy – capital accumulation. Firms within a capitalist economy must continually engage profit-seeking practices, which in turn produces psychological habituation in agents. The latter makes profit-seeking, not production-seeking, the psychological foundation of capitalist agency, such that all legal profit-making activity is an instance of capitalism's real economy. Prioritizing productive investment is a *desired* economy, an outcome that requires regulatory intervention. This paper proposes that credit guidance is a regulatory solution to financialization, one that can increase economic welfare.

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JEL classification: 038 – D91 – H11 – P10

1. Introduction

The financial sector has taken an increasingly central role in economic life over the past three decades, a process termed 'financialization' (Boyer, 2000; Bryan & Rafferty, 2006; Epstein, 2005; Krippner, 2011; Van der Zwan, 2014; Van Treeck, 2009). One important aspect of this shift has been the emergence of ‘a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production’ (Aalbers, 2008, p. 148). This occurs by trading asset ownership titles for houses, land, stocks, and financial instruments (Kelsey, 2015), creating speculation-driven accumulation patterns. A prime example of financialization in action is the trading of derivatives (Bryan & Rafferty, 2006). With derivatives the asset underlying the contract need never be owned by a derivatives trader, with the contract constituting ‘a bet: a promise to pay money determined by the occurrence or non-occurrence of some future event’ (Stout, 2011, p. 3). While derivatives can be used to hedge risk, they may also be used to speculate (gamble) for profit. Speculation in derivative contracts is especially illustrative of how financialization involves moving ever further away from the world of production of new goods and services in favour of trading already existing assets. Speculative financial activity significantly increases economic volatility (James K Galbraith, 2012; Minsky, 1982), with financial instruments central to the development of massive systemic risk that caused the 2008 Global Financial Crisis (Acharya & Richardson, 2009; Baker, 2008; Lewis, 2010). Thus, a key critique of financialization is the increased volatility that follows from increased speculation. Furthermore, this has the added effect of investment capital being diverted away from production towards speculative trading, negatively impacting employment and economic growth (Assa, 2012; Cecchetti & Kharroubi, 2015).

It is in this context that the concept of the ‘real economy’ has been operationalized analytically as a critique of financialization. As discussed in section two, highlighted studies tend to emphasize the view that ‘real economic growth’ under capitalism refers to ‘increased production and related growth in employment’ (Peetz & Genreith, 2011, p. 41) and that financialization is a deviation from the financial sector’s proper role supporting production. This presents a dichotomy between speculative finance and the so-called ‘real economy’. The dichotomy works by splitting the economy into two domains. The ‘real economy’ domain refers to the production of consumer goods and services, and is cast as the ‘natural’ or ‘normal’ sphere for capital investment, while the speculative ‘financialized economy’ is cast as deviant.

This article argues that presenting the economy this way is potentially misleading, implying that finance should be functionalist rather than capitalist in orientation, with ramifications for how we regulate the financial sector. What is typically referred to as the ‘real economy’ by analysts can more accurately be termed the ‘desired economy’, that is, the type of economy regulators, academics, policy-makers and citizens *may* desire when viewing

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the economy from a macro perspective. Assessing how we want the economy to behave in aggregate is a crucial first step towards devising effective regulations. On the other hand, how capitalist agents are incentivised to behave within capitalist relations on the micro-level is an altogether different matter. From the perspective of capitalist agencies the ‘real’ economy equates to whatever *legal* investment provides the best return. Thus, the majority of private investors do not typically (if ever) base their investment decisions according to the criteria of the best aggregate outcomes for society. As is now well-understood, it is the incentive for personal capital accumulation actualized within capitalist institutions that is the source of capitalist dynamism and productivity, but also the source of the system’s woes – from volatility to economic inequality.

This leads to the great difficulty of harnessing the system’s historically unmatched productivity, while at the same time ameliorating the less desirable aspects to produce an acceptable net social benefit. Such a goal has been a core objective within the tradition of the original American institutional economics[1] (Commons, 1924; John K Galbraith, 1971; Heilbroner, 1970; Mitchell, 1941; Whalen, 2020). The problem of regulating capitalism from the original institutionalist viewpoint is one of not throwing out the baby with the bath water. For example, only the state has the political mandate, power and resources to regulate what are also very politically powerful capitalist corporations, as laid out in the seminal work of American institutionalist John R. Commons (Commons, 1924). The difficulty for the state is found in the fact that too little regulation will result in the ‘robber baron’ capitalism of the late 19th century (or the global financial crisis of 2008), while too much regulation will stifle the pecuniary incentives that drive capital accumulation and productivity. Thus the goal for the original institutionalists was to find a socially acceptable balance between both extremes, as illustrated in Parsons description of Commons’ work as seeking ‘ways that could support the humanization and stabilization of [the capitalist] economy, without . . . impairing the productivity of the system’ (Parsons, 1985, p. 757). This goal has relevance for the debate on financialization.

Post-2008 debate over the sector’s proper role and how should it be regulated has grown. As argued here, this question has two different but equally valid answers, depending on who is asking. For capitalist agents the role of finance is to support investment at a

[1] The term ‘original’ is to distinguish this tradition from the ‘new’ institutional economics of Oliver Williamson and Douglas North, which broadly sits within the neoclassical tradition, and at risk of simplification tends to view institutions narrowly through the lens of reducing transaction costs. The original American institutionalist tradition takes a broader, more sociological view of economic institutions, as well as a more realistic view of the dysfunctions of capitalism.

profitable rate of return in *any legal activity*; for non-capitalists the function of an economy is to support material life, ranging from basic needs through to pleasure-seeking consumption. Put another way, the *capitalist* economic system has to be legitimate for both workers and capitalists. Just as mass unemployment and extreme working conditions will not be tolerated long by labour, constraints on financial sector activity will be resisted by businesses, and if viewed as excessive may lead to a capital strike, i.e. a refusal to invest. Thus, assuming we are still talking about a capitalist economy, financial regulation logically needs to be approached with regard to its effect on economic incentives *and* its ability to constrain the excesses of such incentives without undermining system productivity.

Original American institutional thought is well-equipped for this task. Thorstein Veblen's (1904) seminal analysis of pecuniary behaviour flowing from capitalist institutions highlights the mechanism through which pure speculation is an expected and inseparable outcome of the same institutionalized incentives that drive explosive productivity gains. The work of John R. Commons (Commons, 1924, 1950) will then be drawn upon to discuss original institutional approaches to regulatory intervention that sought to give reign to capitalist incentives while ensuring speculative excesses were contained. Following in this latter 'middle way' tradition (Whalen, 2020), the article then presents a regulatory solution of 'credit guidance' for bank lending (Werner, 2002a, 2002b).

The paper proceeds through five further sections. Section two outlines the 'real economy' critique of financialized capitalism. Section three draws on original institutional thought to outline an account of how institutional life generates habituated psychological dispositions that unconsciously motivate conscious decision-making. In section four I turn to the pecuniary habits of agents living under capitalist institutions. Section five discusses the vices and virtues of pecuniary habits, with insights for regulatory approached drawn from the legal institutionalism of John R. Commons. Section six discusses credit guidance as a solution to financialization that can harness pecuniary habits within a legal framework that increases welfare. The final section concludes.

2. The 'Real Economy' and Financial Deviance

Engelen's (2003) critique of financialization highlights the structural transformation of global pension funds from being primarily state-backed with defined benefits, to private pension plans, with defined contributions. In the former the payer gets a state-guaranteed return at retirement; in the latter the market value of the invested fund decides what return, if any, is forthcoming. Private pension funds are legally mandated to provide maximum returns, and bonus fees are related to performance, thus incentivising a pro-risk approach compared with public-backed funds. Upon maturity funds must begin meeting liabilities, selling assets to acquire liquidity. However, if market performance at the time of maturity is poor, fund managers must reinvest in more risky ventures to meet the shortfall, thereby acquiring a speculative orientation that leans towards buying and selling assets for high returns over the short-term, which in turn increases market volatility. Through this process the massive sums of pension fund money become financialized.

In addition, basic flat fee charges irrespective of performance mean a significant rentier cost is now an institutionalised subtraction from private pension funds. Engelen's analysis of the structural transformation of pension management provides valuable insight into the dangers of this type of financial innovation for economic stability, as well as related structural increases in rentier profit (2003, p. 1357). A further conclusion which Engelen draws from this analysis is that financialization 'has transformed the finance industry from a facilitator of other firms' economic growth into a growth industry in its own right' (Engelen, 2003, p. 1367). In stating it this way Engelen presents finance as a sector existing primarily to provide credit to facilitate productive investment (capitalism's claimed 'real economy'), and that activity aimed at maximizing profitable financial trading as a deviation from this role. A number of studies criticizing finance post-2008 reflect this potentially misleading view, some examples of which now follow.

Greenwood and Scharfstein argue that '[T]he financial sector exists to serve the needs of U.S. households and firms' (2012, p. 104). They further state that the sector's 'key functions…are to facilitate household and corporate saving, to allocate those funds to their most productive use, to manage and distribute risk, and to facilitate payments' (ibid: 104). In a study critiquing the increasing exploitation of homeowners through financialization of mortgage markets, Aalbers states capital accumulation becomes 'focused on the growth of finance not to benefit the real economy but to benefit actors within financial markets such as investors' (Aalbers, 2008, p. 148). Aalbers goes on to argue that 'financialization can be characterized as the capitalist economy taken to extremes: it is not a producer or consumer market, but a market designed only to make money' (Aalbers, 2008: 150). Van Arnum and Naples argue the shift of capital investment out of the 'real economy' and into the financial sector 'marked the beginning of financialization in the United States' (Van Arnum & Naples, 2013, p. 1161). Streeck argues that the growth cycle in the U.S. that led to the 2008 crisis as 'more fake than real' (Streeck, 2016a, p. 164) because it was a boom in (speculative) financial wealth that failed to generate a symmetrically large boom in aggregate demand of physical goods, the latter understood by Streeck as the 'real' economy of capitalism. Similarly, Durand argues that '[t]he stimulus provoked by the creation of fictitious [finance] capital is nothing more than illusion and waste, for it implies that part of the capital committed to production is instead diverted into other less efficient uses' (Durand, 2017, p. 48).

To sum up, the above studies provide important insights into how financialization has proceeded, as well as the deleterious effects of speculative trading on other economic sectors. However, at the same time these studies contain a prominent theme highlighting a potentially misleading view of capitalism's 'real economy', which is presented as only investment in production, while speculation is cast as deviant, a form of extreme capitalism or 'fake' growth. Engelen's statement that when operating "normally" finance is a facilitator of growth and not a growth industry in its own right captures the general position. However, from the perspective of financial sector CEOs and firm shareholders this logic has the line of causality in reverse. Rather, it is the case that in seeking to grow their profits private banks engage financial activities, which in turn may or may not facilitate increased production. If this were not the case how else would we explain the birth of modern finance from around the 13th century in the Italian city states (Arrighi, 2010), long before capitalist production emerged. Similarly problematic is when Aalbers argues that financialization is "capitalism taken to extremes". Normatively one might agree, but objectively it should be acknowledged that financialization is not extreme but rather the logical developmental outcome of the system's incentive structure, wherein survival depends upon increasing one's capital.

Or again, Durand's position begs questions such as who exactly has committed their capital to production? By what criteria is financial trading less efficient, and for whom? Clearly, for investment banks, stockbrokers, bond traders and private-equity firms financialization is a booming business. The 'real economy' analysis contains a tendency towards a functionalist account of finance that can lead to misplaced regulatory policy if it were to become dominant within regulatory thinking for reasons elaborated in section five below. The central issue is that the above critics of financialization present their version of a 'desired economy', referring to an economy wherein private financial firms focus only on productive activities, as the defacto 'real economy' of capitalism. However, at any given moment capitalism's real economy is the aggregate outcome of economic agents acting under incumbent capitalist institutions, and their institutionally habituated goals do not necessarily align with the goals of proponents who want more production and less speculation. Before discussing pecuniary habits and their consequences, it is important to understand that habituation in this paper refers to deep-seated unconscious mechanisms resulting from institutional socialization that prompt conscious action.

3. Institutionalized Habit-Formation

Over the past century institutional economists have built on the pioneering work of William James (1890a, 1890b) in arguing that institutional rules, formal and informal, are internalized by agents through a process of psychological habituation (Camic, 1986; Hodgson, 1997, 2004a, 2004b, 2010; Veblen, 1898, 1909, 1914). Once internalized these habits become integral aspects of an agent's subjective disposition, and operate causally through both conscious and unconscious mechanisms. James developed an original account of habituation as referring to actions that when repeated enough times 'may grow so automatic by dint of habit as to be apparently unconsciously performed' (James, 1890: 5). He gives examples such as 'buttoning and unbuttoning, piano-playing, talking, even saying one's prayers, may be done when the mind is absorbed in other things' (James, 1890: 5). James further argued that psychological habits of thought have a biological basis.

In a remarkable early figuration of brain plasticity[2] he argued that cognitive association of sequences of thought become habitual by changing the structure of neural pathways within the brain through repetition of a given experience (James, 1890a, p. 105). On the psychological level repetition generates chains of mental association correlated with relatively fixed neural configurations. Once neural pathways are set, relevant stimuli trigger habitual responses and actions that require little or no conscious attention. As James put it, through habituation 'we find ourselves automatically prompted to think, feel, or do what we have been accustomed to think, feel, or do, under like circumstances, without any consciously formed purpose, or anticipation of results' (James, 1890: 112). His point is that once established by conscious engagement with an activity, a habitual activity comes to be neurologically established as a set of unconscious associations that are triggered by relevant stimuli, and which thereby prompt typical responses with reduced need for conscious direction. Thus he argued that habit '*diminishes the conscious attention with which our acts are performed*' (James, 1890a, p. 114). Habits of thought and action become unconscious

[2] In a review of the academic conceptualisation of brain plasticity Kolb and Whishaw (1998) traced the concept to a paper by Tanzi in 1893. However, James (1890) *Principles of psychology* precedes this work by three years.

reflexive responses in situations where the relevant stimuli trigger the habitual action, and where no overt reasons or counter-stimuli exist to break the pattern.

Building on James' insights later institutional theorists have elaborated the concept of habituation as referring to a learned propensity 'that is moulded by environmental circumstances' (Hodgson, 2004a, p. 164). Camic defines habit as 'a more or less self-actuating disposition or tendency to engage in a previously adopted or acquired form of action' (Camic, 1986, p. 1044; see also Hodgson, 2015, p. 388). Similarly, Hodgson argues that: 'The mechanisms of habit are largely unconscious, but they may press on our awareness. Habits are submerged repertoires of potential behaviour; they can be triggered or reinforced by an appropriate stimulus or context' (Hodgson, 2004b, p. 652). This self-actuation is due to their establishment within 'subliminal areas of our nervous system' (Hodgson, 1997, p. 664). Thus, the crucial point is that habits have an automatic quality and remain latent potentialities when not in use (see also Kahneman, 2012; Kilpinen, 2000; Wood & Neal, 2007)[3].

Habituation effects can result from any kind of repeated activity, including piano playing, deference to authority within a hierarchy or ideological views about society. Furthermore, habitual activities typically become justified by systems of norms, values and ideologies. As Veblen pointed out, 'the accustomed ways of doing and thinking not only become an habitual matter of course, easy and obvious, but they come likewise to be sanctioned by social convention, and so become right and proper and give rise to principles of conduct' (Veblen, 1914, p. 7). Consequently, when an institutional order is argued by Veblen and others to generate habitual principles of conduct that are understood normatively by agents, what is being referred to is the generation of 'endogenous preferences' (Hodgson, 2003a).

Hodgson elaborates that by learning the rules and conventions through which an institutionalized relationship unfolds we are in effect *reconstituted* psychologically, which in turn is underpinned biologically by neural rewiring. Thus one the have learned the proper responses the typical solider does not pause to think 'salute now' when an officer appears, nor pause to think 'feel pride now' when the national flag is raised, both responses will engage automatically. Rather, it is the case that conscious effort would be required to break the learned habitual response. Army life is an extreme form of institutional socialization in the Goffmanian sense of 'total institutionalization', representing the effects of living within a

[3] Kahneman's (2012) landmark text applying insights from evolutionary psychology to economic decision-making in particular vindicates James' prescient foundational work in the field. Kahneman's work distils his own lifetime of study on the effects of unconscious priming (akin to James' view of habituation) on conscious decision-making.

fully administered social relation. However, habitual dispositions and learned responses of social agents to all the institutional relations of everyday life in specific times and places are not fundamentally different, even if more varied and of lesser intensity. These become our 'endogenous preferences', which refutes the standard neoclassical position that argues for the opposite, that preferences are exogenous, and that all human agents share the same rational, utility-maximizing preferences irrespective of historical time and place (Etzioni, 1988; Hodgson, 1988).

This deep-seated habituation effect is termed 'reconstitutive downward causation' (Hodgson, 2000, p. 318; 2001, p. 295; 2007, p. 95) which Hodgson (2011) later revised to 'reconstitutive downward *effects*', which retains the same overall meaning, but more clearly distinguishes between effects and a causality during socialization and to reinforce the view that agents are not slaves of social structure[4]. By generating endogenous preferences economic institutions are more than a convenient means to co-ordinate economic life and reduce transaction (e.g. Coase, 1937, 1992; Williamson, 1985). Rather they mold and confine the 'individual aspirations' of agents (Hodgson, 2001, p. 295), and through that process create *historical* subjects with a practice and philosophy that is highly congruent with the institutions within which they live. As Veblen noted, every society is pervaded by a 'certain characteristic logic and perspective, a certain line of habitual conceptions having a degree of congruity among themselves, a "philosophy," as it would once have been called' (Veblen, 1915, p. 267). Capitalism is no different to any other society in this regard, and for capitalists the profit habit dominates. Consequently, in relation to financialization, what is claimed by critics of finance to be an extreme form of capitalism, may not be extreme when understood at the level of the agent being impacted by 'reconstitutive downward causation'. The next section will elaborate this point.

[4] Hodgson's revision sought to ensure that the concept does not insinuate that agents (lower level) are social automatons enslaved mechanistically by institutions (higher level). The direct cause of agent actions are their evolutionarily endowed physical and mental capacities, psychological drives and dispositions as living entities. Institutions have constitutive effects that powerfully impact the development of these embodied capacities. But the individual as a living entity must mediate these effects, and the individual is the direct cause of actions at the lower level. Mediation occurs through both conscious mechanisms (reflection) and unconscious mechanisms (habits), and much socialization is internalized from birth prior to developing an ability to engage critical reflection. By replacing 'cause' with 'effect' Hodgson avoids positing an inaccurate 'mysterious' causal force from society to agent, while maintaining the conceptual explanation of powerful socializing effects on agency.

4. Pecuniary Habits and the Capitalist Order

Like all institutional orders, capitalism constitutes historical individuals for whom a given institutionalized life becomes second nature and normatively legitimate (Veblen, 1904, 1909, [1899] 1970). Veblen argued that it is ‘on individuals that the system of institutions imposes those conventional standards, ideals, and canons of conduct that make up the community’s scheme of life’ (Veblen, 1909, p. 629). In a study of the business enterprise he outlined the nature of those standards, ideals and canons of conduct peculiar to a pecuniary economy (Veblen, 1904). ‘Industry’ he noted, ‘is carried on for the sake of business, and not conversely’ (1904, p. 26). Veblen stressed that while ‘it may seem simply tedious to recite’ that business agents are motivated by profit in the first and last instance, it is nevertheless ‘necessary to keep the nature of this connection between business and industry in mind’ due to the far-reaching consequences in behavior it entails (Veblen, 1904, p. 27). While this is paradoxical in historical view, it is nonetheless the nature of the capitalist incentive structure.

As Veblen argued, once capitalism emerges as a fully-fledged institutional order there arises a class of business agents whose sole purpose is to manage investments with a view to a return on profit. The results are that, ‘the motives of the business man are pecuniary motives, inducements in the way of pecuniary gain to him or to the business enterprise with which he is identified’ (1904, p. 36) and ‘[t]he ulterior end sought is an increase of ownership, *not industrial serviceability*’ (1904, p. 37 emphasis added). Veblen continues stating that, ‘The base line of every enterprise is a line of capitalization in money values’ (1904, p. 85). Veblen’s key point is that under the duress of capitalist competition and the possibility of economic annihilation, every business decision is ultimately regulated by its impact upon capitalization. Thus ‘the ultimate conditioning force in the conduct and aims of business is coming to be the prospective profit-yielding capacity of any given business move, rather than the aggregate holdings or the recorded output of product’ (1904, p. 90). This approach by agents is not by choice in the first place, but due to an implacable structural necessity of capitalist economics.

Owners of finance capital do not operate as if industrial productivity, or what critics of finance call the ‘real economy’, is the goal in and of itself from the perspective of their private enterprise. Instead, their habitual economic orientation is determined by the fact that within a pecuniary economy ‘the defense of capital cannot be mounted like that of a citadel…[c]apital is powerful only insofar as it continuously runs the gauntlet of circulation’ (Heilbroner, 1986, pp. 58, 56). Heilbroner, whose work followed the original institutionalist

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paradigm, points to the central vulnerability inherent to the capital investment process as follows. To purchase the labor, capital goods and inputs required to produce goods and services, or indeed to purchase an existing asset for financialized trading, a firm must disperse its capital into the market place. This may be to pay suppliers and workers to produce things, or, it may be for speculative purposes. Having dispersed their capital economic agents must face the risk of never re-accumulating their initial investment, let alone a profit. This is because once in circulation other firms may accumulate those funds by having superior products, services, or investment strategies. Heilbroner notes that '[*t*]*his continual dissolution and recapture is the essence of the process of competition*, which can now be seen as an element in the working of the system that directly stems from the nature of capital itself' (Heilbroner, 1986, p. 57, emphasis original).

Even if competition has in some ways been 'watered down and hedged about' in a modern economy[5], it nevertheless continues to impart a structural injunction determining the 'basic rules of behavior that no participant in a market system can afford to disregard' (Heilbroner, 2000, p. 59). In returning to Veblen's anthropology of capitalism, business agents cannot avoid being socialized *as* capitalists if they continually live *as* capitalists. Through daily interaction with the rigors of capitalist life, economic agents become habituated with the pecuniary mode of life, that is, a life where the relevant stimuli trigger deeply established chains of association leading to a psychology and goal-orientation marked by a desire to make an unlimited amount of profit. Thus, what is true for a soldier who has been habituated to military life is no less true for the capitalist, who by repeated action within an institutional relation becomes reconstituted with the habit of money-making. Placed in the relevant institutional environment the typical business person's money-making disposition will be actualized, acted out, and thereby further reinforced.[6] In that sense, Goldman Sachs is arguably no less a 'total institution' than the U.S. marine core.

Veblen provides us with a psychological explanation for why private interests can depart significantly from public interests under capitalism, since in becoming an end unto itself the profit-habit can easily lead to profitable activities for owners of capital that have

[5] Competition may be reduced by sectoral concentration resulting in anti-competitive agreements between firms in an oligopoly, or in situations of monopoly or monopsony. It is because of such developments that all advanced economies today have competition authorities and antitrust legislation.

[6] An example of habituation at work is a recent discussion of corporate social responsibility (CSR) in the business media. The *Financial Time* discussed the possibilities and limits of CSR (Edgecliffe-Johnson, 2019; Wolf, 2018). One article discussing the limits provided this assessment by a corporate CEO: "Almost all of our customers are interested in what we can do to clean the environment and other [CSR] stuff. You can tell it's one of their core values…until you get to price" (Edgecliffe-Johnson, 2019).

deleterious consequences for others. Examples from early industrialization in Britain can illustrate the point. The 1833 Factory Act shows how bad employment conditions were, given that the following stipulations were deemed an improvement: 'no child workers under nine years of age', 'children of 9-13 to work no more than nine hours a day, children of 13-18 years to work no more than 12 hours a day' (United Kingdom National Archive, 2020). Extreme food adulteration, as sellers exploited a lack of regulation, was another example from industrial Britain of the dangers of the profit motive left to develop unchecked (Collins, 1993). Examples include coffee that was 30-50% adulterated with chicory, roasted corn or 'even burnt rags', while beer was often adulterated with a 'dangerous poison containing picrotoxin, to increase its bitterness and intoxicating effect' (Collins, 1993, p. 97). Adulteration occurred across the food chain contributed to the poor health of workers in 19th century towns until government regulation of the industry all but wiped out adulteration by the turn of the 20th century[7].

Such socially destructive outcomes were one reason as to why the state was required to take a growing role in the legal regulation of the modern capitalist economic system. The next section will discuss the seminal analysis of John R. Commons in detailing the relationship between the market and law, as well as discussing modern examples of both the virtues and the vices of capitalist habits as played out in the financial sector.

5. Vices and virtues of pecuniary habits: the middle path of John R. Commons

It is clear that the original American institutionalists were far from blind to the vices of capitalism, even while acknowledging its immense productivity, dynamism and innovation. It was the desire to manage this paradox for social benefit that underscored original institutionalist analysis of capitalism, particularly the work of John R. Commons (Fusfeld, 1977; Whalen, 2020). Commons viewed judicial sovereignty and a vibrant democracy as crucial to managing the tensions emerging from the economic system. In taking this view he developed a form of legal institutionalism (Commons, 1924, 1931, 1950)[8] with the goal of 'developing [a] compromise that included judicial limitation of unchecked individualism and

[7] Today the central food issue for public health is fast food high in salt and saturated fat. Dunn (2011) applies a Galbraithian analysis of corporate power to highlight the ability of fast-food corporations to drive demand for a product with significant health drawbacks, while also resisting calls to regulate the sector through lobbying. Galbraith followed the original institutional tradition of analytically outlining how diverges between public and private interests was a central component of capitalist development that required ongoing civic and regulatory engagement.

[8] It is beyond the scope of this article to provide assessment of the overall strengths and weaknesses of Commons work, but see Hodgson (2003b, 2004a).

government management of a variety of economic activities' (Fusfeld, 1977, p. 755). For Commons, understanding the role of law in stabilizing capitalist economic relations, and for legislating the outcomes of conflicts between social groups, was a central element of institutional economics.

Commons defined an institution as 'collective action in control, liberation and expansion of individual action' and which comprised of 'unorganized custom' and 'organized going concerns' (Commons, 1931, p. 649). The latter referred to entities such as the family, the corporation, the trade union or the state. Commons sought to analyze and explain the role of custom and the emergence of codified legal structure through the concept of 'transaction', referring to the basic unit of observable social interaction between two or more individuals, or between groups of individuals (Commons, 1924, pp. 4-5; 1931, p. 652). Transactions are forms of bargaining governed by both informal and formal rules of interaction, and may occur between equals, or between members embedded in hierarchical relations (e.g. employee-manager), and between groups acting in mutual dependency or in conflict. In economic life, transactions refer to those processes by which 'out of conflict of interests, a workable mutuality and orderly expectation of property and liberty [emerges]' (Commons, 1931, p. 656). Within the common-law tradition of Anglo-American jurisprudence much codified law emerges out of conflict over customary practices, whereby the ruling authority would 'reduce the custom to precision by adding an organized sanction' (Commons, 1931, p. 651). By foregrounding conflict during the formulation of common law Commons provides valuable legal-institutional concepts for understanding the evolution of finance, whereby economic practice (agency) interacts with custom during conflict and resolves into law (social structure) over time in ways that can inform the current debate over financialization and possible regulatory solutions.

In turning to financial innovation, Commons discussion of the Anglo-Saxon evolution of creditor-debtor relationship from a personal contract valid between the original participants to a saleable commodity highlights both virtue and vice during financial development (Commons, 1924, pp. 246-253). Commons begins by favorably quoting McLeod's claim that the discovery of debt as a saleable commodity has 'done more a thousand times to enrich nations than all the mines of all the world' (ibid, p. 246). Particularly important for this discovery to emerge with full effect was overcoming the common-law view of credit-debt contracts as personal and therefore non-transferable to third parties. The innovation 'consisted in inventing the transferability and survivorship of promises freed from the personality of the parties to the promises' (ibid, p. 250). Instead of a personal promise between individuals, the law is changed to allow full negotiability of a debt instrument such as a promissory note, turning it into an impersonal promise to pay X sum of money at Y time and place without condition. This allowed re-constitution of the relation 'into the property relation of assets and liabilities' through the properties of assignability and negotiability (ibid, p. 250).

However, as late as 1704 in Britain Commons points out that such promissory notes in the hands of third parties could be refused enforcement by the courts, and required an Act of Parliament in 1705 to provide legal certainty of their status as sellable securities, thereby allowing a market in commercial paper (bills of exchange/promissory notes) to emerge. The two crucial advantages of this financial innovation, notes Commons, is that it allows for a lower rate of interest, since liquidity is vastly improved, and a far more rapid turnover of capital (ibid, p. 253). On the latter point, he notes that the same amount of capital can be multiplied in terms of productive work done. For these and reasons beyond the scope of this article it has been widely acknowledged that the development of private finance and related financial innovations driven by profit-seeking agents over the past three centuries have been essential to the expansion and growth of capitalism's productivity (Bryan & Rafferty, 2006; Ferguson, 2008; Hodgson, 2015; Schumpeter, 1934). In particular, novel and increasingly complex systems for creating credit and managing debt, including double-entry bookkeeping, public and private bond issuance, bills of exchange and securitization, have been central to the development of national market economies (Hodgson, 2015, p. 158). This is the necessary and virtuous aspect of financial development.

However, the profit habit can and does turn such virtue into vice, and in the financial sphere this has frequently led to socially disastrous consequences. The Great Depression brought on by a decade of financialization that culminated in the stock market crash of 1929 is the most well-known historical example of the incentive to buy in order to sell gripping an entire nation. The social devastation of the following depression undermined classical liberal orthodoxy on regulation and minimal state intervention in the economy, allowing space for proponents of Keynesian to shift the public debate towards their position (Weir & Skocpol, 1985). Commons concept of 'transaction' refers to the bargaining that ensued between workers, capitalists and the state under conditions of social and political backlash against unrestrained financial speculation. The new political coalitions that emerged, alongside shifts in public understanding of the role of the state in the economy, provided the foundation for significant new laws to curtail the financial profit habit within bounds that still allowed capitalism's incentive structure to operate productively for decades after the crisis.

One of the most significant pieces of legislation was the 1933 Glass-Steagall Act that separated retail and investment banking, preventing banks from using deposits for high-risk speculative investments. This required the Act placing a constraint on capitalist agency, and from the conflict perspective provided by Commons we might reasonable expect investment banks and agents ideologically committed and materially dependent on free markets to oppose Glass-Steagall. In fact, the financial community began lobbying for repeal of the Act almost immediately after its enactment (Crawford, 2011), although without initial success. The rise of neoliberalism to policy prominence from the 1970s (Larner, 2000; Peck, 2012), alongside the development of the neoclassical ‘efficient market hypothesis’ (Fama, 1970) provided the political and intellectual firepower to overturn legislation that interfered with the fullest expression of the profit habit in the financial sector. Glass-Steagall was repealed in 1999, after decades of onslaught by its opponents.

There is debate as to the extent to which repeal of Glass-Steagall directly contributed to the Great Recession nine years later, however there is no doubt that other financial innovations such as derivatives played a central role (Funk & Hirschman, 2014), in a financial crisis which had devastating socio-economic consequences (Reeves, McKee, & Stuckler, 2014; Sherman, 2013). Financial instruments were at the heart of catastrophic systemic risk (Acharya & Richardson, 2009; Baker, 2008; Eichengreen, Mody, Nedeljkovic, & Sarno, 2012). Collateralized debt obligations (CDOs) were used to securitize subprime mortgages in the U.S. during the 2000s (Aalbers, 2008), turning them into tradable securities bought by institutions globally, who perceived the mortgage-backed securities to be literally as “safe as houses”. However, there was a perverse risk-management problem with subprime CDOs. The originating banks were making profits by selling the securities on to others. Profit incentives demanded the banks increase production of CDO-based securities, while the fact that the sellers were not holding any of the risk meant there was little incentive to ensure subprime lending was at prudent levels (Baker, 2008).

As the CDO secondary market boomed, so too did subprime lending thereby further boosting an already booming housing market. This in turn incentivized further speculative buying, increasing prices further, generating more demand for mortgages, allowing more securitization and so on, in a classic self-driving cycle. Eventually the level of subprime loans held within each CDO grew excessive, leading to growing defaults in 2007. Simultaneously, some investors realized the growing risks in the CDO market and used credit default swaps to make massive bets against these CDOs prior to their crash in value (Lewis, 2010). This massive shorting of the securities market significantly compounded the subprime losses for financial institutions globally and destroyed confidence in the system, resulting in a global breakdown of financial flows (Swedberg, 2010). While 2008 was novel in its scale, it was not novel in nature, given that financial crises driven by speculation are ubiquitous throughout capitalist history (Aliber & Kindleberger, 2015; McDonagh, 2020).

The above section highlights both the virtue and the vice of capitalist habits. Veblen's habit psychology explains the psychological impact of socialization within capitalist institutions, and provides a compelling and logical explanation for why financial speculation repeatedly reaches such fever pitch as has occurred throughout capitalist history. Compare a Veblenian explanation with one 'real economy' critic who claims that 'financialization can be characterized as the capitalist economy taken to extremes: it is not a producer or consumer market, but a market designed only to make money' (Aalbers, 2008, p. 150). Such a claim generate a fundamentally misleading account of the institutional and behavioral facts of capitalist life. A market designed only to make money is the purest real expression of the abstract demand on all capitalists to increase their capital or perish. The 'real economy' critique fails to grasp the reconstitutive effect of capitalist institutions on agent's subjective orientation, and the feedback loop this reconstituted agent behavior has on macro-economic outcomes. For agents and business firms whose economic livelihood depends in the first and last instance on how much profit they make, a market dealing purely in speculative asset trading is as rational as a market dealing in the production and sale of refrigerators or soya beans. Furthermore, what comes to be described as 'irrational' or 'speculative' after a crisis is typically considered as 'perfectly appropriate to the state of affairs before the outbreak of the crisis' (Schumpeter, 1934, p. 219).

The result is that pecuniary habits and the demands of economic structure continually reinforce one another in the business world, just as patriotism and military structure continually reinforce one another in the barracks. For the same reason that unquestioned authority is rational in the one, financial speculation is rational in the other. Consequently, critics of finance who claim capitalism's 'real economy' is production, or that the normal or natural role of the financial sector is to facilitate other firm's growth paradoxically present a picture of the economic system that hews closer to classical and neoliberal arguments that they may wish to acknowledge. They present finance as a servant to production rather than a slave to profitability, as Veblen argued.

While Veblen provided great insights into market socialization, Commons work outlined the crucial role of law in capitalist evolution. Only state-backed law could codify financial innovations such as full assignability and negotiability of contracts in ways that transformed them into saleable market commodities between third parties, as well as ensure enforceability of such contracts. Likewise, Commons recognized the crucial role of the state for mediating and regulating the outcomes of conflicts between affected social groups, political and economic, particularly after a crisis such as the Great Depression. The question then, as now, is what to do about financialization? On the one hand, speculative finance must be tamed; on the other hand, the financial sector is a for-profit sector within a capitalist system. The very same incentives that drive socially valuable innovations when managed prudently are also the source of volatility. The next section offers a proposal that follows in Commons' 'middle way' approach for making finance serve the needs of the productive economy while allowing profit incentives to play a lesser but still extant role, thereby preserving some of the risk-taking dynamism that drives capitalist productivity.

6. 'Window Guidance' as a Real Solution for the Desired Economy

The policy of 'window guidance' for private bank lending (Werner, 2002b) can achieve a regulated financial sector that facilitates productive and dynamic lending to private firms while repressing speculative lending. Werner's (2002a, 2002b, 2003, 2005, 2012) macroeconomic analysis provides compelling evidence for the effectiveness of 'window guidance' for private bank lending. Werner highlights in detail how the policy has been a central pillar of the East Asian economic miracle. Studies by the World Bank (1993) and others (Wade, 2004) have also concluded that window guidance played a central role in the historically unparalleled growth of economies such as Japan, South Korea, China, Malaysia and Indonesia. Here I focus on Werner's extensive analysis of this policy in Japan's economic development. 'Window guidance', also known as 'credit guidance' refers to 'a process of guiding domestic credit towards productive use and suppressing unproductive and unsustainable (hence systemically risky) use of credit' (Werner, 2012, p. 9).

Credit guidance policy has its modern origins in a macroeconomic approach developed by Germany's Reichsbank during the 1920s. The Reichsbank's approach was based upon the theoretical conviction that to maximize productive economic growth 'a system of state "guidance" of market economies' was crucial (Werner, 2002b, p. 15), which Werner points out was to later serve as the rationale for window guidance policy in post-war Japan. The key economic innovation pioneered by the German state during the 1920s and 30s was to design a bank-centered, rather than capital-market-centered, financing structure as the institutional environment under which credit guidance could be operated effectively (Werner, 2002b). The Japanese state was to implement a similar strategy post-1945. In arguing for the policy's success, Werner rejects arguments that Japan and the East Asian miracles occurred despite, rather than because of state intervention in the flow of credit. He does so by showing that credit guidance policy in Japan achieved its target of fast and high-quality industrial development in a manner predicted by theory prior to implementation.

Japan utilized credit guidance in two ways, with each approach designed to meet quantitative and qualitative goals respectively. First, guidance can be used to implement monetary policy in relation to the quantity of available credit, and second, to impact the qualitative allocation of credit in relation to a defined policy goal, which in Japan's case was targeted industrial development (Werner, 2002b, p. 7). Organizationally, this was achieved through regular meetings between the central bank and the private sector banks, whereby instructions on lending quantities per quarter were relayed. Sanctions to ensure the private banks complied with central guidance included the threat of potential sanctions or penalties for non-compliance, for example restrictions on a bank's loan growth quota, or unfavorable terms for individual banks when using the central bank's overnight discount window. Werner notes that these sanctions proved effective, and compliance was high (2002b, p. 8). More specific details of credit guidance included breaking lending down into sectors, subsectors, firm size and fund usage, allowing the policy to target 'preferred industries that had been indicated as "priority" or could be expected to yield a high value added with respect to the overall policy goals' (2002b, p. 8).

During the immediate postwar developmental phase Japan's central bank generated a list of preferred industries and priority categories for credit guidance. Category A (designated the most important) included textiles, shipbuilding and steel production, later followed by a focus on automobiles and electronics; category B included manufacturing not in A, along with retail, agriculture and infrastructure construction; while domestic consumption sectors such as department stores, real estate, entertainment and restaurants were placed in the final category C (Werner, 2002b, p. 25). The aim was to avoid unproductive or speculative credit allocation, and for three decades immediately after WW2 the policy underpinned high-quality development that transformed Japan into a global-leading industrial powerhouse. The country did experience a major real estate asset bubble the late 1980s. Werner (2012) argues that this outcome was due to a shift in the policy's usage for domestic politic reasons, whereby during the 1980s the central bank began allowing large credit expansion into real estate, resulting in asset inflation that eventually led to a speculative bust[9].

Credit guidance has a record of successful application across East Asia, supporting some of the most dramatic and effective cases of national development in recent economic history. It allows for selective macro-level direction of credit across the economy according to development needs. At the same time, the policy does not attempt to directly plan micro-level lending; rather, micro-level lending is left to private banks serving private firms in the specified sectors according to market incentives, thereby combining industrial policy with market discipline. The policy makes for a good choice in light of insights from the original institutionalists regarding the consequences of capitalist institutions on agent behavior. It can repress the worst outcomes of the profit habit in the financial sector, while allowing enough scope for the profit habit to drive productivity and innovation, in what is essentially an imperfect but beneficial trade-off – one that follows in the ethos of John R. Commons' middle way approach to regulation. When used correctly window guidance has shown it can support a macroeconomic policy for developing what is termed here a 'desired economy', referring to an economy that can achieve ongoing productivity gains, high employment and in which financial speculation is repressed.

One critical response to the call for using credit guidance policy in more market orientated Western economies is to argue that the policy was used in countries with strong centralized states, conceptualized as 'developmental states' (Johnson, 1982), that were institutionally and ideologically amenable to state-led industrial policy. In comparison, a decentralized liberal economy such as the United States does not have the requisite institutional or ideological conditions for successful implementation. Before responding to that critique a brief outline of the Asian 'development state' will be useful. Johnson (1982) outlined the key components of the East Asian development state. Such a state was capitalist by way of its commitment to private property and markets, but developmental by way of its activities in driving targeted sectoral growth based on explicit national economic objectives. An autonomous elite bureaucracy (MITI in Japan) is tasked with implementing intervention to meet these objectives, while close institutionalized links allow corporatist-style cooperation and consultation between politicians, the bureaucracy and the private sector. While this corporatist element could be compared to European coordinated market economies

[9] The reasons for this pronounced shift in Japan's approach are beyond the scope of this article (but see Werner, 2003).

as outlined by Hall and Soskice (2003), the developmental state 'involves an unusual concentration of public and private power which would be extremely hard to justify by the standards of pluralistic democracy' (Öniş, 1991, p. 119). Taking the United States as example, it has neither a history of state-led coordination nor anything like the degree of power concentration typical of a developmental state, therefore credit guidance could not be utilized. Two responses to that critique are as follows. First, the policy should not be simply grafted from an Asian context to liberal-democratic institutional context, but rather must be adapted to specific U.S. conditions. Second, the U.S. has a far more extensive record of industrial policy than is often recognized (Mazzucato, 2015; Wade, 2014), including existing institutional capacities that could be used for implementing credit guidance policy.

To elaborate each point in turn, all economic development is context dependent, and determined by path dependent processes, which is one reason why there is significant and ongoing variation across capitalist economies (Boyer, 2005). When Asian states made the decision to develop in a capitalist direction they did not attempt to directly emulate American or European capitalism, but rather adapted capitalist institutions and their existing institutional arrangements to create an Asian version of developmental capitalism. Likewise, any attempt to apply Japan's version of credit guidance in another political economy without adaptation to local conditions will fail. In the case of the United States the strong separation of powers between the executive, legislature and judiciary, alongside high degrees of autonomy between federal and state levels, would appear to militate against deploying industrial policy tools. This is true as far as it goes, namely that a highly centralize model of credit guidance is unlikely to be possible. However, the United States has a history of developing a successful decentralized 'network developmental state' that has largely operated out of public sight for ideological reasons (Mazzucato, 2015, p. 84; Wade, 2014, p. 388).

The origins of the network developmental state lie in the creation of the Defense Advanced Research Projects Agency (DARPA) in 1958[10] as part of America's Sputnik moment. Since its beginning DARPA has done far more than fund basic research that venture capital won't due to unknown commercial potential. Developmental guidance, facilitation of public-private consultation and engagement and supporting commercialization are all been elements of its remit (Mazzucato, 2015). SEMATECH, a not-for-profit consortium for accelerating chip manufacturing R&D is one of DARPA's many successes. The Small Business Innovation Research (SBIR) programme, ironically started under Reagan in 1982,

[10] 'Defense' was only added later, the original 1958 organization was ARPA.

further built on DARPA's decentralized industrial policy model by setting up a consortium between select government agencies with large research budgets and the Small Business Administration. The programme then used a funding model that required the agencies to designate small fractions of their research budgets as grants to small, for-profit firms. An assessment of SBIR after two decades of operation showed the awardees grew at a faster rate than comparable unfunded firms (Lerner, 2000). There are many more examples of policy success beyond the scope of discussion here.

The key point is that multiple American governments developed over time a decentralized network-based industrial policy that emerged in its concrete form as a consequence of the historical and ideological constraints of American political economy. That activity has resulted in a large infrastructure of public-private networks, consortia and related institutional arrangements that can be utilized for application of credit guidance policy in the United States, and/or as examples for creating new developmental networks to facilitate credit guidance that target federal and state policy goals. These goals could include development that incorporates progressive policy goals such as better labor standards and rates of pay, a green 'New Deal', and gender equality to name but a few. However, given that the state is not a neutral actor (Hall, 1993), the ability to ensure credit guidance that supports progressive economic goals is dependent on a number of factors. These include whether the existing balance of forces influencing state policy favor such goals, whether the goals of the incumbent administration favor progressive goals, and lastly the degree of relative autonomy the state has to be influenced by non-state forces.

Circumstances in the United States as of early 2021 are favorable for progressive policies. The glaring failure of neoliberal economics, the rise of China as the world's second largest economy using industrial policy, and the failure of the Washington Consensus to achieve sustained development in the global South are some of the factors transforming thinking on the role of the state in liberal democracies and developing countries (Aiginger & Rodrik, 2020). In the United States, the Biden administration 2021 has indicated a far more interventionist role for the Federal government to achieve desired economic outcomes, ranging from a Green New Deal to a plan for rebuilding domestic supply chains for critical goods. The latter requires increasing domestic manufacturing capability, and holds the promise of jobs that serve the middle and working classes. The political landscape in the Washington of 2021 therefore offers perhaps the greatest opportunity since the 1970s to invoke industrial policy on a large scale. Credit guidance is a proven policy tool that can support these stated goals, and achieve the Biden administration's desired economy, one that serves workers more and finance capital less.

7. Conclusion

This paper argues that the term 'real economy' should be replace by the term 'desired economy'. This shift in terminology is more than semantics. Rather, it refers to a central ontological fact about capitalism, namely that its dynamism is driven by the need of agents to turn capital into more capital, and that this institutional demand results in pecuniary habituation of economic agents. The profit habit ensures that private benefit will often come with public cost externalization, ensuring other community members foot the bill for extreme labor exploitation, food adulteration and financial depressions that increase profits in the given sectors. Nevertheless, the source of the vice is the source of the virtue, thus *effective* capitalist regulation must straddle a fine line. Variation in global regulatory environments impact wealth distribution, costs distribution, and the degree of asset speculation (finacialization) vs investment in new production and services. The extensive 'comparative capitalism' literature is testament to this fact (e.g. Boyer, 2005; Hall, 2007; Hodgson, 1995; Mastroeni, 2012; Streeck, 2016b; Witt et al., 2017). In the theoretical discussion of capitalism given here, each of these varieties is a product of profit-seeking agency embedded within a wider set of social institutions that vary across states, and vary in effectiveness for achieving broad social welfare.

Through a process of reconstitutive downward causation market institutions generate a profit-seeking habitual psychology that will on average view return on investment as the key criteria driving investment choices. From a macro perspective the structural effects of the aggregation of these pecuniary choices are capitalism's 'real economy', where expected profit, not social serviceability, guides action. Historically the regulation impulse has therefore been an attempt to create a desired capitalist economy in response to the regular failings of capitalism's real economy. Industrial policy has been the other policy avenue by which a suitably motivated state may turn capitalism's real economy into a desired economy, one that serves the community's economic welfare as far as possible within the logic of the system.

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