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Financial socialism: The role of financial economics in economic disorganization ☆

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ABSTRACT

A growing body of research shows evidence that financial economics played a significant role in recent financial crises, such as the subprime mortgage crisis, Enron and Long-Term Capital Management. This track record is a wake-up call for managers and investors who employ financial economic models. This paper demonstrates how financial economics decouples market prices from the valuation by customers and resource owners in a systematic way. As an organization principle, financial economics replaces value-driven investment by a theory-driven ruling of anonymous financial markets – a scenario warranting the title "financial socialism". Implications for customer valuation, financial accounting, and a maxim for the sound application of financial economic models are presented.

1. Introduction

Financial economics aims to make investing more robust by employing economic theory and stochastic models for the valuation and trade of securities. A growing body of research shows evidence for systematic failures of financial economics in three recent crises: In the case of Long-Term Capital Management the Federal Reserve Bank needed to initiate a historical bail-out to cover the losses produced with financial economic models for speculation on treasury markets. In the case of Enron, managers used financial economic models to move losses off the balance sheet thereby stimulating a historic fall in stock-market prices. In the case of the subprime mortgage crisis, bankers and mortgage lenders used financial economic models to expand credit and take-on risks that almost broke the financial system (Anonymous, 2010; Chandra, 2003; Fox, 2003; Lowenstein, 2000; Reinhart & Rogoff, 2009). The failures of financial economics come as a wake-up call for business managers and entrepreneurs who employ financial economic models for spotting market opportunities, the design of business models or the estimation of future business risks.

This paper elucidates the systematic features of the failures of financial economics by employing market process theory of the Austrian school of economics. In the Austrian view, entrepreneurs establish businesses as a response to unserved customer needs or idle economic resources. Entrepreneurs employ market prices in order to identify business opportunities and manage projects for their exploitation (Foss, Foss, Klein, & Klein, 2007; Harper & Endres, 2010; Hayek, 1945; Koppl, 2008; Lachmann, 1977; Shane & Venkataraman, 2000; Von Mises, 2007). In contrast, financial economic theorists assume that the market is on a path towards equilibrium. If markets merely adapt to the equilibrium-price, an individual investor cannot beat the market. If speculators assume the market on the path towards equilibrium, their winning strategy is to bet on the emerging equilibrium price rather than valuing traded assets. Financial economic models employ market data and economic theory in order to inform investors on equilibrium-based investment strategies. By focusing on equilibrium, financial economic models deliberately ignore valuations of individual market participants and the potential impact of rare events. Consequently, financial economic models decouple prices from the valuations of resource owners and customers in a systematic manner. Decision makers delegate entrepreneurial responsibility and accountability to financial markets, as soon as they make unconsidered use of financial economic models. Such a situation shares characteristic features with socialist calculation elucidated by the scholars of the Austrian school of economics. In socialist calculation, a bureaucracy composed of economists and statisticians employs economic models and market data in order to allocate resources in a theory-efficient manner (Keizer, 1989; Koppl, 2008; Rothbard, 2004; Vaughn, 1980; Von Mises, 2007). At its extreme end, financial economics assumes a world where entrepreneurs are redundant and financial markets have superior knowledge of customer needs and the potential of resources – in other words a world of financial socialism.

This article shows how financial economic models systematically replace value-driven investment with theory-driven speculation. As an implication, managers should strive for value-in-use studies as practiced in business marketing for the evaluation of market opportunities

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and scrutinize the exposure of financial accounting to the interference of financial market speculation. Despite their limitations, financial economic models may play a useful heuristic role by representing the ignorance of the decision maker. Financial economic models are questionable tools for predicting market prices.

The following section introduces the core idea underlying financial economics and its salient features. Section 3 presents the investment decision in the perspective of Austrian market process theory. Section 4 compares the financial economic approach of market-driven speculation with the Austrian approach of value-driven investment. Section 5 presents three cases that demonstrate how financial economics systematically disrupts the performance of businesses and markets. The discussion section provides a summarizing account of the working of financial economics in the three cases, highlights the epistemological cause of the financial economic paradox, and discusses contributions of marketing, entrepreneurship and financial accounting to value-driven investment strategies. Not the least, the discussion proposes a maxim for the productive application of financial economic models. A final conclusion accounts for key lessons and implications for future research.

2. Market-driven speculation — the pillars of financial economics

Financial economics proposes that the individual investor cannot beat the market: If markets are rational, individual investors can at best hope to hit the equilibrium price that results from the competitive bidding of buyers and sellers. More specifically, financial economics assumes that the conventional value-driven approach to investment almost certainly fails. In the value-driven approach, investors estimate the present value of future income streams flowing from an investment. Because future income is uncertain, conventional investors employ their experience, information networks, and a portion of guts feeling to estimate the value of an investment. Under the assumption that prices for an investment title, like stock, bond or commodity move towards equilibrium, conventional investors will almost certainly fail, as even their best estimations will deviate from the equilibrium price. Therefore, financial economics holds that financial-market-driven speculation strategies will outperform value-driven investment strategies (Derman & Taleb, 2005; Fox, 2009; Taleb, 2007). Financial economics builds market-driven strategies on three pillars:

1. *Economic theory*: Neo-classical economics assumes that financial markets play a key role in removing imperfections of markets for goods and services (Arrow & Debreu, 1954; Fisher, 1919). The more speculators sell underpriced assets to overpaying buyers, the more likely will resulting market prices move towards equilibrium. The key theoretical contribution of financial economics is to substitute net-present value calculation of conventional investors with a system of investment models exclusively using prices of financial markets. On Modigliani and Miller's assumption that equity and debt are perfect substitutes, a company can use stock market prices to calculate its cost of capital as for example in the Capital Asset Pricing Model (Fama, 1970; Fox, 2009; Modigliani & Miller, 1958; Sharpe, 1963).
2. *Statistics*: Bachelier pioneers financial economics as he proofs that in equilibrium price variations will follow a normal distribution like events of games in a carefully designed casino (Bachelier, 1939, 2006; Fox, 2009; Taleb, 2007). Following Bachelier's proposition, financial economics applies means–variance analysis in order to calculate the expected price of an investment. Financial economic models assume that asset prices follow a normal distribution. If they trust a pure statistical approach, investors can construct investment portfolios that best match their individual appetite for return-maximization or risk-reduction (Fox, 2009; Markowitz, 1991).
3. *Securitization*: Securities are in use at least since the times of antique Greece. Back then, the philosopher Thales of Milet used to make a profit by providing owners of olive mills advance funding in spring in exchange for the right to rent them out to olive farmers in fall during the olive harvest. (e.g. Keys, Mukherjee, Seru, & Vig, 2010). An owner can employ a security to convert illiquid assets (e.g. olive mills) into liquid securities (e.g. advance funding from a speculator) (Keys et al., 2010; Loutskina & Strahan, 2009; Shin, 2009). As a key contribution of financial economics, Black, Scholes, and Merton propose a model for valuing securities. Black-Scholes-Merton approach employs the price of the underlying asset, the expected volatility, the going interest rate, the strike price of the option, and the time span for its expiration in order to calculate the option value (Black & Scholes, 1972, 1973, 1974; Merton, 1972). The Black–Scholes–Merton approach enables investors to calculate option prices with the almost exclusive use of financial market data. Financial economics provides the theoretical foundation for the exclusive use of financial data for investment valuation. If markets are rational, equilibrium prices are the superior navigation instruments for investors.

To conclude: Financial economics offers the investor an elegant system of models that make almost exclusive use of financial market data for estimating the future price of an asset. Financial economics claims to transform the craft of conventional value-based investing into a science guided by economic theory and statistic calculation. Financial economics holds that market-driven speculators will outperform value-driven investors and that financial markets will force an economy towards equilibrium.

3. Value-driven investment — Austrian market process theory

Financial economics offers a market-centric theory of speculation under equilibrium conditions. In contrast, the Austrian school of economics emphasizes the role of value-driven investments by entrepreneurs as the driving force of economic growth. Austrian scholars claim that economic action is vital under conditions of disequilibrium, where customers have unserved needs or economic resources lay idle (Hayek, 1945; Menger, 1981; O'Driscoll & Rizzo, 1996). Disequilibrium provides fertile ground for entrepreneurs who spot productive opportunities for higher valued use of resources and drive business projects for their exploitation (Kirzner, 1973, 1997; Shane & Venkataraman, 2000). Arbitrage is the simplest form of business opportunities, where agile entrepreneurs buy low from undervaluing sellers and sell dear to overvaluing customers. Higher hanging fruits call for the organization of business projects: Entrepreneurs employ projects like the introduction of new products, the implementation of more efficient processes of production, apply new approaches to organization, or the connection of distant markets for seizing more rewarding opportunities (Khalil, 1999; Kirzner, 1973; Schumpeter, 1951). Entrepreneurs employ business projects to recombine resources and monetize the results at a profit. Business projects take time from their inception to the monetization through the sale of products. Entrepreneurs need capital investment to buy out resource owners, implement their business idea, and monetize the results on product markets (Harper & Endres, 2010; Lachmann, 1977; Lewin, 1999; O'Driscoll & Rizzo, 1996). This process is inherently uncertain, as entrepreneurs can never be sure that prices reached on product markets will justify the costs of resources and capital needed to implement the business project (Casson, 2005; Knight, 1921; Langlois, 2007). At the inception, expectation of profit opportunities stimulates entrepreneurs to take action. However, entrepreneurs can only make viable claims on their performance once they have monetized their business project. Entrepreneurs use financial accounting to navigate their business projects towards profits. Profits indicate business success while losses imply failure or the need for complementary investments (Menger, 1981; Rothbard, 2004; Von Mises, 2007; Young, 1987).