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Schumpeterian innovations, financial innovations and instability: An institutional perspective

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Abstract This paper seeks to assess the nature of financial innovations as regards the economic stability throughout an institutional framework within the Schumpeterian tradition. While in the Schumpeterian evolutionary process entrepreneurial innovations are assumed to lead the entire economy towards economic development, financial innovations do not obviously generate the same positive outcome for economic evolution. To point to the ambiguous nature of financial innovations the paper suggests a monetary interpretation of Schumpeterian capitalist dynamics and sheds light on the role of the institutional environment to ensure viable economic development. It then argues that in highly liberalized environment, unconstrained financial dynamics may lead to system-wide crises and make public regulatory schemes necessary for the sake of systemic stability.

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Innovaciones de Schumpeter, innovaciones e inestabilidad financieras: una perspectiva institutional

Resumen Este documento trata de evaluar la naturaleza de las innovaciones financieras, en lo que concierne a la estabilidad económica a través de un marco institucional dentro de la tradición de Schumpeter. Mientras en el proceso evolucionario de Schumpeter se supone que las innovaciones emprendedoras conducen a toda la economía hacia el desarrollo económico, las innovaciones financieras no generan obviamente el mismo resultado positivo para la evolución económica. Apuntando a la naturaleza ambigua de las innovaciones financieras, el documento sugiere una interpretación monetaria de la dinámica capitalista de Schumpeter, arrojando luz

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sobre el papel del entorno institucional, para garantizar el desarrollo económico viable. A continuación argumenta que en un entorno altamente liberalizado, la dinámica financiera sin limitaciones puede originar crisis a nivel sistémico, haciendo de los programas regulatorios públicos una necesidad en aras de la estabilidad sistémica.

1. Introduction

Schumpeter maintains that capitalist development rests on entrepreneurial innovation-led real sectors' changes. However, he also states that the financing of productive activities is at the core of the process of development. Financial institutions and markets (rules, regulation, banks, financial intermediaries) and their evolution in time should then be studied as crucial concerns in the analysis of economic evolution.

From this perspective, this paper presents an institutional framework within the Schumpeterian theoretical tradition through an examination of the role of innovations and competition in banking and finance and their consequences on systemic stability. Unlike the static neoclassical competition model, the Schumpeterian theory of economic evolution is related to a dynamic competition where rivalry through innovations shapes the foundations and the existence of economic agents. But contrary to the effects of Schumpeterian entrepreneurial innovations (assumed to feed an incessant creative destruction process), financial innovations may generate a destructive creation process and hamper economic development.

The first section shows that the Schumpeterian analysis of economic development is framed from an institutionalist perspective of endogenous change where financing conditions of productive activities play a crucial role. Creative destruction comes into the picture through entrepreneurial innovations whose impulsion stems from the rivalry between the existing structure (the ''old'' things) and the novelty (the ''new'' things). Thus the concept of competition is a dynamic and active process contrary to the textbooks' perfectly competitive markets adjustment model. In such a setting, the monetary character of capitalist economy is underlined and the crucial role of bank credit in the financing of new combinations is emphasized. The second section maintains that the evolution of money markets, though not detailed by Schumpeter, seems to respond to specific competitive and regulatory dynamics, closely related to institutional changes in financial markets. However, specific characteristics of capitalist financial dynamics make that unlike the positive consequences of Schumpeterian entrepreneurial innovations on economic growth, liberalized financial markets and subsequent innovations may generate some destabilizing dynamics. We then argue that the creative destruction process may turn out to be a destructive creation when financial innovations are not regulated in a suitable way. The last section presents some concluding remarks.

2. Discontinuous economic change: from entrepreneurial dynamics to monetary economy

In the Schumpeterian theory (Schumpeter, 1927, 1928, 1934), economic evolution is a process of discontinuous endogenous change since it comes from within – from entrepreneurs' decisions and actions – without any competitive market adjustment process. Schumpeter states that economic dynamics lie in how capitalism creates and destroys the existing structures through entrepreneurs' innovations. In this picture, there is a strong relationship between innovation and competition. But unlike the models of perfectly competitive equilibrium, the Schumpeterian competition is not a self-adjustment mechanism. This is a dynamic of rivalry in an incessant economic change without any central direction leading the economy to a general equilibrium. Such an evolutionary process is related to a specific institutional structure of money and financial markets since the behaviour of banks (bank-credit) and then the financing conditions of entrepreneurial innovations are assumed to be major determinants of economic development.

2.1. Institutional dynamics: process of competition and innovation

An institutional approach frames the Schumpeterian analytical thought. In *History of Economic Analysis* (especially in the second chapter), Schumpeter adopts an institutional vision and defines the relevant analysis as ''the study of questions how people behave at any time and what the economic effects are they produce by so behaving'' (1961:21). He stresses that the human behaviour includes: ''not only actions and motives and propensities but also the social institutions that are relevant to economic behaviour such as government, property inheritance, contract, and so on...'' (1961:21).

The analysis of economic change is therefore related to the analysis of institutional change (Festré and Nasica, 2009) as the economic structure as well as innovations are constantly framed through the change of institutional structure. Schumpeter maintains that capitalist evolution changes not only the existing economic structure but also and more fundamentally the institutional structure of society: ''The capitalist process not only destroys its own institutional framework but it also creates the conditions for another'' (Schumpeter, 1947:162, 1970:114). This change is a social and historical process as it ''does not emerge