Financialization and the moral hazard of central banking and fiat money

In the wide literature on the phenomena of financialization, ranging meanwhile from social sciences to economics and anthropology, a few aspects of the interplay between money, debt and power relations are highly underrepresented. These are especially the essential roles of states respectively governments and their dependence on central bank policies as well as the resulting moral hazards, which affect the whole process of financialization as we understand it. But before we go into depth, we need to understand what is meant by the abstract term financialization. Financialization, at least in social science literature, can be described as a “systemic transformation of capitalism“ or a “shift from industrial to finance capitalism”, with side effects like the globalization of production, the shift of corporate behaviour to shareholder value, the integration of non-financial actors in financial markets and the increasing indebtedness of households.¹ Most literature on financialization is based on (neo-)Marxist or post- and neo-Keynesian views on capitalism, neoliberalism and globalization, resulting in a mainly negative connotated, unilateral theorization, neglecting other important heterodox economical approaches and understandings, like the Austrian School of Economics, which in turn was a forerunner of the political philosophy of Libertarianism. Both, the Austrian School and Libertarianism, focus their attention on the state, the central bank and their impacts on the monetary system, when it comes to financialization and the effects of structural changes in economies and societies.²

So the aim of this short paper is to illuminate the underrepresented role of central banks as well as the dominant and globally used fiat-money-system in the process of financialization, to explain why these factors cause financial crises, indebtedness, moral hazard³ and unbalanced power relations among individuals, with a special focus on the situation in the United States, the Federal Reserve Bank (Fed) and the financial crisis of 2008.

**Financial crises and indebtedness: Products of not so free markets**

The current narrative regarding the 2008 financial crisis, also described as a systemic financial system collapse⁴, is that unregulated or at least underregulated markets created

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² Marxist views may attribute a role to the state in this process, but they focus primary on class relations and the struggles between them, not able to address causes of unbalanced power relations and the moral hazard of modern monetary policies to the real causers. Moreover Marxism sees the state as a tool, whereas Libertarians view him as a coercive power. Ultimately Marx and Engels themselves called for centrally controlled credit lending and interest rate politics. However, the Austrian School and libertarian scholars did not pay that much attention on the specific issue of financialization lately. Financialization is mainly theorized in essays over the causes and effects of financial crises, and not as an independent field of science.

³ In economics, moral hazard occurs when one person or institution takes more risks because someone else bears the burden of those risks.

uncontrolled and highly risky investment patterns in the financial sector, driven by greed, leading to debt driven bubbles that affected the global economy, causing mass indebtedness and bankruptcies mostly among middle and low income households and small enterprises. Authors in the Marxian tradition saw the crisis of 2008 as a product of neoliberal financialization and considered it as “the latest stage of capitalism”. But if we risk an Austrian look at the causes of the financial crisis of 2008, we cannot get around the fact, that monetary policies and especially the control over interest rates via the Federal Reserve Bank prepared the soil for volatile and unbalanced market activities not only in the U.S. but in the whole world via the Dollar-hegemony, forcing a flow of cheap and valueless fiat money into the economy and so encouraging mass-indebtedness of households as well as states via credit-based financing. So it may not be the “end stage of capitalism” or even the fault of “free markets”, but the massive impact of central-bank-planning, leading to state interventions in markets, that would generally correct themselves before crises become systemic. That the market isn’t as free as most academic writings in social sciences assume, proves the role and the abilities of the Fed and in particular its monetary policies in the years before the financial crisis of 2008.

The moral hazard of central banks

The Fed, and nearly every central bank around the world in their monetary area, has a monopoly on money creation and the control over interest rates for credits, to be specific the key interest rate which directly affects the costs and circulating amounts of loans and credits. Money supply and the determination of interest rates are mighty tools to manage and control economic developments, e.g. inflation or deflation. So the Fed is a primary driver of (in this case) the U.S. economy and thus has a direct impact on social relations, as we assume that economic developments affect human behaviour and vice versa, creating existential questions and ethical dimensions that need to be considered. So at this point we can no longer ignore this factor in the whole process of financialization. In this context and referring to the role of the Fed in the U.S. economy, libertarian scholar Jeff Deist came up in the year 2016 with the term “financial engineering”, throwing it into the debate on financialization. And I think it is

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6 The term “dollar hegemony” describes the fact that the world economy operates under the artifice of US hegemony, fortified by the US dollar as an international reserve and vehicle currency, given out only by the Federal Reserve Bank, see: Arrighi, Giovanni (1999): The global market. In: Journal of World Systems Research, 5 (2), pp. 217–51.
7 Self regulating markets are, inter alia, based on the principle of creative destruction, more under: Schumpeter, Joseph A. (2005): Kapitalismus, Sozialismus und Demokratie. UTB, Stuttgart.
8 Due to the desired brevity of the text, I will only focus on impacts on the macro-level and keep numbers, term-definitions and other economic excursions at short. After the 2001 recession, the FED began aggressively expanding the U.S. money supply, accompanied by repeatedly lowering interest rates, starting from 6.25 percent to 1 percent in 2003. This led to negative real Fed funds – “meaning that nominal rates were lower than the contemporary rate of inflation”. During that time a borrower was not paying but rather gaining in proportion to what he borrowed, which led to the temptation to finance nearly everything in the daily life via loans from banks. Also, as even the IMF stated, the easy-credit policy fuelled the housing bubble in the U.S. by creating huge demand bubbles which went into the real estate market, under: White, Lawrence H. (2008): How did we get into this financial mess?. In: Cato Institute Briefing Papers. Cato Institute, Washington D.C. p.3.
a great start point for a deeper elaboration. Financial engineering is here meant as a reference to social engineering, meaning manipulating individuals in order to develop desired behaviour. And it applies in the same way to the role which the Fed plays in the market. Put simply, the monopolistic control of the level of interest rates by lowering or increasing them and the systemic distortions caused by that prevent market participants from understanding the real price of anything, even their own conduct – a key factor in Austrian economic thoughts, as prices in a free market society reflect subjective preferences and utilities of individuals. But not only that. Central banks like the Fed act as lenders of last resort, which means that they offer an extension of credit to financial institutions experiencing financial difficulty which are unable to obtain necessary funds elsewhere. That in turn leads to excessive risk-taking by both financial institutions, like banks, and investors, which would be dampened if illiquid financial institutions were allowed to fail. Therefore, the lender of last resort may alleviate current crisis phenomena in exchange for increasing the likelihood of future crisis phenomena by risk-taking induced by moral hazard. This leads to market distortions, veiling bad loans, high-risk investments and potential bubbles, thus enabling households to get into debt via fiat money backed credit-financing, although they aren’t able to pay back mortgages and interest rates. Subsequently, this leads to massive dependencies of many citizens on a distorted and manipulated market, closing a missing link in the sphere of financialization on the issue on why non-financial actors get involved in the financial market. They were simply seduced to do so.

So as we saw, the Fed engineers financial behaviour of market participants, like individuals, banks, hedge funds or even states, and also creates a moral hazard in many areas, which gets us closer to the title of this paper. As we especially saw in the financial crisis of 2008, the concept of the lender of last resort worked, as some big financial actors were considered or labeled as “too big to fail” after they got into financial instabilities, leading the Fed to rescue them with newly printed money or to intervene as creditor. The narrative “too big to fail” was mainly created by state departments and the Fed themselves. In the view of Austrians, banks and financial institutions become “too big to fail” because they were encouraged to become so by central bank policies and at long last rely on state interventions, thus creating irresponsible and damaging investment mentalities without direct responsibility for taken actions and the chance for a creative destruction, in short moral hazard again. As Friedrich August von Hayek stated in his book “Monetary Nationalism and International Stability”:

“In the absence of any central bank, the strongest restraint on individual banks against extending excessive credit in the rising phase of economic activity is the need to maintain sufficient liquidity to face the demands of a period of tight money from their own resources.”

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10 This whole process also creates massive dependencies for citizens on the state, which I cannot go into more detail due to the scope of the text (e.g. a higher dependency on welfare programs, etc.).


The Feds “super power”: Turning money into debt

This leads us to the second and most important moral hazard area: The case of converting money into debt via fiat money and its creation out of nothing. First of all central banks have a monopoly on creating and giving out money (paper and coins), which alone is more than questionable and can at least be assumed as a massive intervention by imposing a legal tender, thus suppressing monetary competition and forcing market participants to use a certain means of payment. Secondly, central banks like the Fed also passed the right of money creation to commercial banks via fractional reserve banking\(^\text{13}\), creating the phenomena of fiat money. Fiat money is virtual money with no real use value behind it. As anthropologist David Graeber would say, it is the perfect example of the link between money and debt, as he showed a historical and sociological relation between the implementation of money systems and debt-based trade, both used as tools for ruling and coercive power.\(^\text{14}\) Fiat money is debt-based money in electronic book-entry form, created in the process of credit-lending. The fractional reserve banking system with its low reserve requirements actually enables banks to create trillions of dollars of credit out of thin air.\(^\text{15}\) This creates moral hazard for the banks because they have the possibility of creating virtually any amount of money and to buy virtually any amount of goods and services for sale, whereas the debtors have to pay fees and interest rates. In the end we have a never ending cycle of money creation and simultaneously increasing debt-levels. The only limits to this capacity are the hyperinflation that invariably results in the case of a great inflation of the money supply and very low liquidity standards on the fiat money creators (banks) through the Fed.

So the ultimate moral hazard arises, when the Fed imposes a legal tender and at the same time allows banks to use this currency virtually for an infinite credit-driven money-creation-process that in the end creates mass indebtedness via a steady increasing money flow into the economy. This never ending money flow is in fact just a central-bank backed bubble on which states base their fiscal policies, financial institutions their business strategies and households their budgeting. Because financial institutions and states are always the first receivers of the

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\(^{13}\) To keep it short and understandable: Fractional reserve banking is a banking system in which banks only need to hold a fraction of the money they give out as loans and which customers deposited there before as reserves, mostly just around 10 percent. This allows banks to create massive credit demands because they give out more money than they actually have. That in turn increases a debt-based money supply. Moreover, since the amount of deposits always exceeds the amount of reserves, it is obvious that fractional reserve banks cannot possibly pay all of their depositors on demand as they promise – thus making these banks functionally insolvent. Also the need for reserves is relaxed as banks can either sell financial assets to the central bank in open market operations, or the central bank can grant loans to banks at relatively low interest rates. In both cases, central banks remove the limits of credit expansion by determining the total reserves in the banking system.


\(^{15}\) It even goes further. Commercial and private banks are able to create money out of nothing via credit lending by intern accounting transactions (double-entry bookkeeping), creating a moral hazard by imposing interest rates on debtors for money that the bank actually does not have and at the same time creating wealth out of this debt by redistributing property. This is still considered a myth under orthodox economists. Nevertheless Prof. Richard Werner was the first to prove that empirically, under: Werner, Richard A. (2014): Can banks individually create money out of nothing? — The theories and the empirical evidence. In: International Review of Financial Analysis. Vol. 36. pp. 1-19.
newly created money by central banks like the Fed, they further gain massive benefits over those who dependent on this money-supplied institutions, mainly individuals or households, because the cash balances of the so called “early receivers” increase.\footnote{Rouanet, Louis (2017): How central banking increased inequality, under: https://mises.org/library/how-central-banking-increased-inequality, retrieved on 14.10.2018}

As we saw now, central banks and their diverse moral hazards play an essential role in the process of financialization. As Jeff Deist stated in his paper “The Undeserving Rich”:

\[...\] But surely central banking and morality cannot be neatly divorced. As Jörg Guido Hülsmann explains, central bank actions influence human behaviour in ways that necessarily involve questions of right and wrong. If we accept the Fed’s role as the primary driver in the US economy, how can we deny its role in picking economic winners and losers? And how can we deny that human actors respond to incentives, for good or ill? [\ldots]\footnote{Deist, Jeff (2016): The Undeserving Rich, under: https://mises.org/wire/undeserving-rich, retrieved on 14.10.2018.}

Human actors respond to incentives. So when we ask ourselves, why the financial sector and profit shares rise at an unhealthy level, why the focus in corporate behaviour shifts from long-term growth objectives to short-term shareholder interests, why non-financial actors are getting more involved in financial activities, why indebtedness and debt-levels rise dramatically in every sector of human action and why all of that leads to raising inequalities and unbalanced power relations in society, we can say clearly because of the institution of the central bank and its role in economy, which affects directly human behaviour, as we have seen for example with the Fed and its monetary policy before and after the 2008 financial crisis.

From a political science perspective, central banking creates unbalanced power relations in society and economy and at least questionable dependencies for citizens, governments and states on a virtual, debt-based money system and its administrators. From a sociological perspective it creates inequality as monetary policies and credit expansion lead to negative redistributive effects in the process of money creation and are the source of rising wealth for a few and income inequality in general. From an economic perspective the here shown moral hazards question the orthodox beliefs about the role of central banks as alleged useful actors in a (free) market society, as we saw in the case of potential financial engineering.

In the end, all we have to do is ask these simple questions to understand the moral hazard of central banking and fiat money:

What other business or institution is allowed to loan that which they have not earned - that which is not in their possession - that which doesn't even exist?

For any other company or institution, the moral hazard would be striking and at least a starting point for a broad social debate on the legitimacy of it.