Virtual economy must not infect real economy

I previously analyzed the current financial crisis on the basis of a theory of two economies: the first being real (products and services) and the second virtual (speculative, financial).

BY MILAN ZELENÝ

I said in the March 31, 2008 issue of *CBW*: "The second economy is not necessarily based on real flows of goods and services; its main product is money. It produces money directly, mainly through speculation, betting and gambling, without the interference of real products or services. Clearly, there is always something wrong with this second economy."

As a result of globalization, the Internet and telecommunications, the virtual economy has isolated itself from real economy. Doings in virtual economy are increasingly autonomous and self-stimulating; its behavior is determined by rules of games of chance, reacting to speculative trends, disinformation, rumors, borrowed money, manipulation of risks and information. Real economy earns money by creating added value while the virtual economy reallocates the money thus earned through stock exchange bets and speculations, mere shifting from one pocket to another, without creating added value. The more bets succeed, the more the players borrow and the higher is indebtedness (or leverage) of banks and investment houses, and companies that could not resist the songs of the sirens of greed—carmaker **General Motors**, conglomerate **General Electric Company**, aluminum maker **Alcoa**, insurer **American International Group** (AIG)—and transferred a great part of their real business to virtual business.

Natural human greed leads to increasingly risky bets and debts, often at the expense of healthy economic thinking and rationality. They seek new opportunities to play, invent new financial instruments and mechanisms for distribution of risks; that is, transferring risks to other players, even on the global scale, as well as innocent taxpayers and sound companies in real economy. As all speculative bubbles before, this bubble will burst in the end, speculative structures will collapse, winners and losers will be found—the only thing that will remain is real economy of products and services.

This is why it is necessary to understand the claim that the real economy is in order, the "fundamentals" are strong, the crisis is mainly taking place in the financial and political sphere. The aim is to prevent panic spreading to real economy. What are the sound foundations that politicians and financiers do not want to understand? The real economy is based on real products and services, productivity of workers, efficient technologies, innovation and creativity of creators of added value—all this is good in a global economy. The virtual economy mainly depends on speculation and playing with other people's money.

Separation of these two economies represents a "fatal dichotomy" in the new economy of the global world. The current crisis is an attempt to resolve this dichotomy by balancing two incompatible parts. Governments fight this and try to save with their interventions what is old and sick at the expense of what is new and healthy. This cannot succeed: The real economy is essentially stronger than the virtual economy. The new economy will have its way but, owing to government interventions, it will take longer and be more painful than free markets would wish.

The real economy is healthy; virtual economy is sick. It is like this in nature: A healthy organism cannot cure a sick organism, but a sick organism poses a great risk to a healthy organism. This gives rise to our strategic options: First, strengthen the healthy organism of the real economy to make it more immune to financial virosis; second, cure the financial sector with radical "antibiotics" and surgical operation, not by the application of "wet rags"; third, create a new organism able to integrate both parts successfully so that the financial sector again starts to "signal the state of the organism"; fourth, isolate the sick by separating the speculation sector as a "stock casino" and scaling down relations with real economy, which can function with its own financial resources; and fifth, change from publicly owned joint-stock companies to privately owned companies supported by privatization trends.

Although virtual economy is decreasingly controlled by the flows of the real economy, the contrary does not unfortunately apply: The real economy is only autonomous to an extent. Whereas the virtual economy does not need the real economy and makes do with money—the way racetrack betting is in fact a game between betters and horses are a mere pretext—and it could be done without them—real economy needs ➤

money to function. It earns a substantial sum by selling products and services and can transact business independently, see the **Bata Shoes** business without bank debts. Because of fluctuations in supply and demand, company's own reserves are often insufficient, and bank loans are needed. If banks and other financial institutions have lost their funds in speculation, however, commercial credit can slow down very much, become more expensive and, in an extreme case, "freeze." Then, of course, a sick virtual economy begins to affect adversely the real economy.

This adverse effect is not necessarily undesirable because it first strikes sick enterprises: heavily indebted, unable to satisfy customers, entangled in stock exchange machinations. According to the principle of economist Joseph Schumpeter's "creative destruction," it is often useful to let such companies go to the wall and make room for new enterprises, ones with new products and services, better organized to satisfy customers and not only to satisfy the company bosses.

When the virtual economy collapses, selective destruction of sick enterprises takes place (such as GM, GE, Alcoa, AIG). This is preceded by bankruptcies of sick enterprises in virtual economy, for instance financial houses **Bear Stearns Companies**, **Lehman Brothers Holdings**, and **Merrill Lynch & Co**. Government bailouts for such institutions run counter to the principles of "creative destruction," allowing survival of bad, outdated public companies whose assets have been stripped by the executives, with the threat of state socialism and further degradation of the space for new, modern, viable enterprises.


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A state rescue (bailout) does not guarantee a change in the behavior, values, priorities and organization of such enterprises. On the contrary, if such enterprises are taken over by the state, this conserves them, their conduct is rewarded and puts off necessary changes, cleansing and restructuring. A case in point is AIG, whose management went on as usual after receiving a $100 billion (Kč 1.8 trillion) injection of state money and organized extravagant luxury "weekends" for its agents and managers for half a billion state dollars.

In a global era, stock markets cease to reflect the real situation in real economy. Big fluctuations in the Dow Jones Industrial Average, both upward and downward, mainly reflect the situation in stock markets: reactions to trends, herd instinct, fear, uncertainty, waiting for "Godot." Just a few months ago the Dow Jones was over 14,000; recently, it fell below 8,000—this is certainly out of line with similar movements in the real economy. Let's take the price of oil: Only a month ago it was almost $150 a barrel, today it is below $80 a barrel—this surely has nothing to do with demand, supply or hurricanes, as the "analysts" claimed. Everything is mere speculation, up and down, supported by panic, fear and ignorance of economy. Now look at China: the highest growth in gross domestic product (GDP) in combination with the worst stock market.

The U.S. stock market offers investors the best opportunities at prices they won't see again for decades. Great companies can be had for a song. The economy is awash with cash, capital and state injections. Despite this, famous investors—with the exception of Warren Buffet—don't invest, and stock exchanges fall. Why? They are afraid—afraid of themselves, of their herd without a leader. To this day they foretell the future based on extrapolation of the past; they still bet on growth or decline but are helpless in transitions and inflections.

The state and politicians are seized by panic. Somebody appears on television every hour or so to calm people down, promising further measures, from nationalization to throwing overboard. Investors no longer think of investing but wait for the government to act, wait to see what it comes up with, how it will get nervous markets going. How much money will it make available, and will there be any for me? And what if I get none? It's best to wait. This is why stock exchanges collapse since the connection between speculators and politicians is extremely tight.

This psychosis is moreover stimulated in the U.S. by the unhappy presidential campaign. Nobody tells the truth any longer, the candidates spend millions of dollars to persuade undecided voters. Investors fear socialism and high taxes if the left wins. The right fears everything. Stock exchanges collapse. We see symptoms of illegal registrations of voters—see the scandal around the Association of Community Organizations for Reform Now (ACORN)—and a political crisis is in the offing. No wonder stock markets fall.

In the U.S. we need fewer financial engineers (see financial engineering) and more real engineers with real skills, able to propose and produce useful things. The financial architecture calls to mind Potemkin villages—they serve their politico-financial purpose, but no one can live in them. ■

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