

Venture Money

Schumpeter's theory and practice

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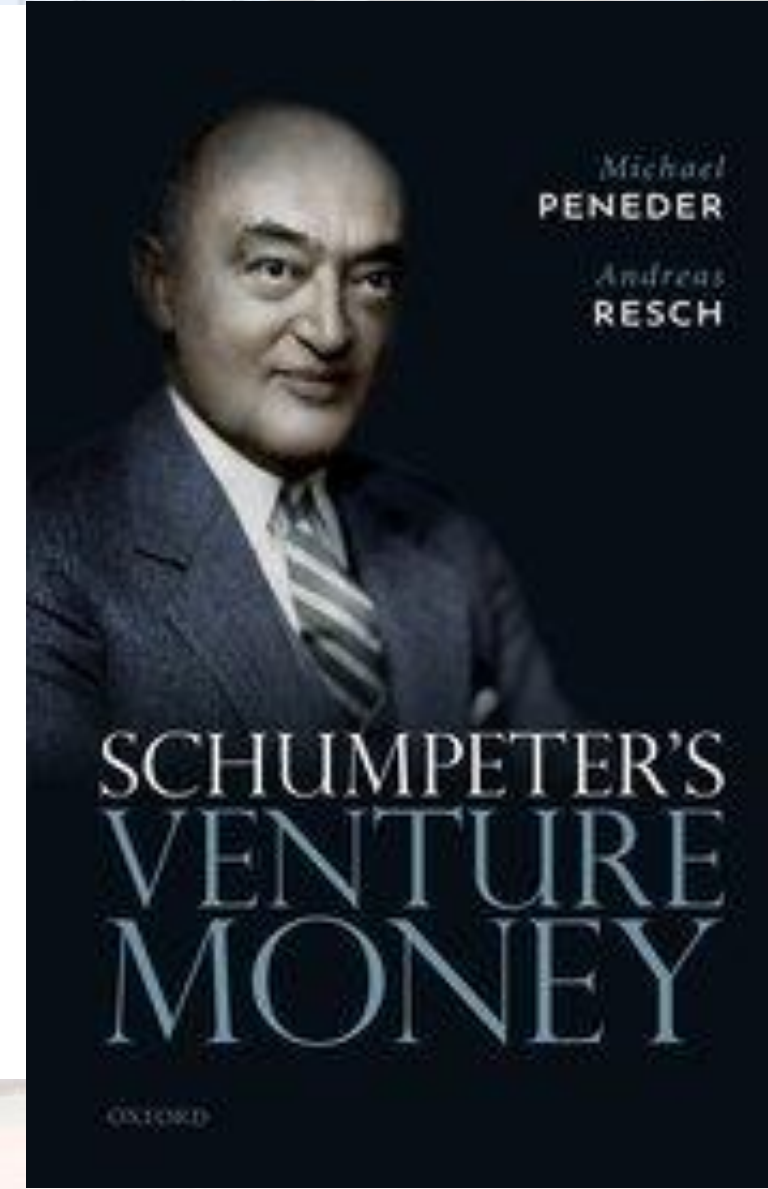
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- Introduction
- Schumpeter's **theory** of venture money
 - Claim theory
 - Endogeneity
 - Non-neutrality (“Schumpeter hypothesis”)
- Schumpeter's **practice** as
 - Banker
 - Proto-venture capitalist
- Concluding remark

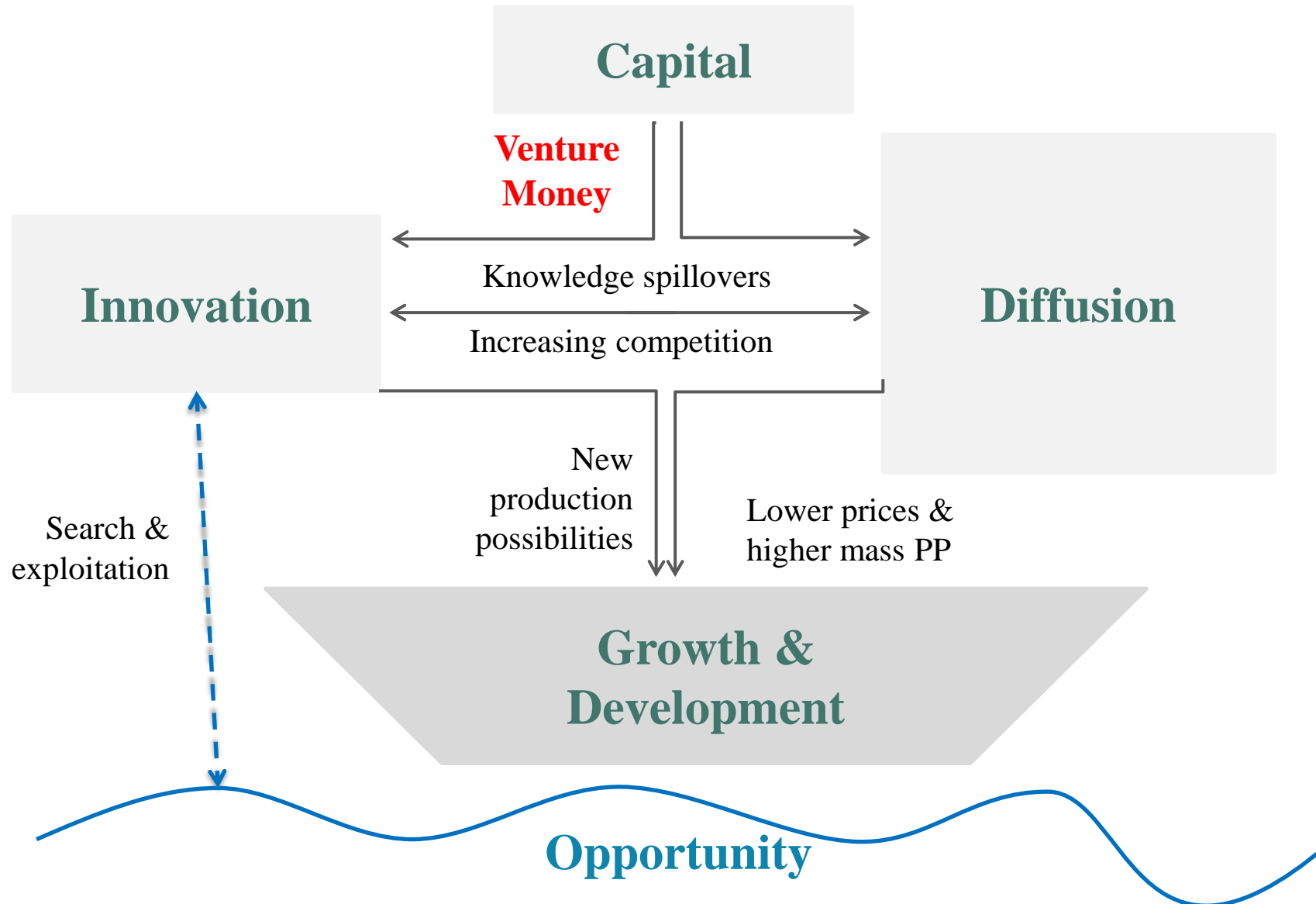
- **Four chronological parts, interwoven**
 - I. Financial **History** and (heterodox) monetary thought
 - II. Schumpeter's Monetary **Theory** of Development
 - III. Schumpeter's failed financial **ventures**
 - IV. Current **legacy**

- **Several special threads, e.g.**
 - Schumpeter and the early **origin of venture capital** (*ICC* 2015)
 - **Digitization** and the evolution of money (*JEEC* 2021)
 - Schumpeter's **theory and practice** of venture money (*ISS* 2024)



Theory of economic development, in a nutshell

Theory (1/7)



- **Heterodox sources**
 - William *Potter* ca. 1650: cash-in-advance problem
 - John *Law* 1705: issuing paper to mobilize idle resources >> capital gains
 - Henry **Thornton** 1802: “credit theory of money”; forced savings, cumulative causation, prudent central banking
 - [J.S. *Mill* 1806-73, Friedrich *Bendixen* 1864-1920: claim analogy]
 - Knut *Wicksell* 1898: money rate of interest; credit economy, forced savings
 - Friedrich **Wieser** 1851-1926: income theory of money; money as a social institution
 - Rudolf **Hilferding** 1910/1981: promoter’s profit as a business model *sui generis*
- Extensive but **scattered**, in parts unfinished works on money, e.g.
 - *Wesen und Hauptinhalt der Nationalökonomie* 1908; *Theory of Economic Development* 1911/1934, **Money and the Social Product** 1917-18/1956, *Steuerstaat* 1918, *History of Economic Analysis* 1954, *Das Wesen des Geldes* 1920(30)s/1970
- Sorting out partly uncommen or confusing **terminology**

- Money is neither a commodity nor mere legal fiat, but essentially a **claim ticket** to the social product
 - Economic explanation against (i) theoretical metallism and (ii) Knapp's state theory
- Primary function is that of a common **unit of account** (*standard of value*)
 - (Logical) **origin** of money in credit (rather than as medium of exchange)
- Foremost a **social technology for clearing accounts**
 - Digital payment systems
 - **Distributed (general) ledger**, “i.e. the idea that everyone's economic acts are recorded on a real or imaginary current account ... one could call it the *basic concept of monetary theory*” (WDG, 1970, p. 127).

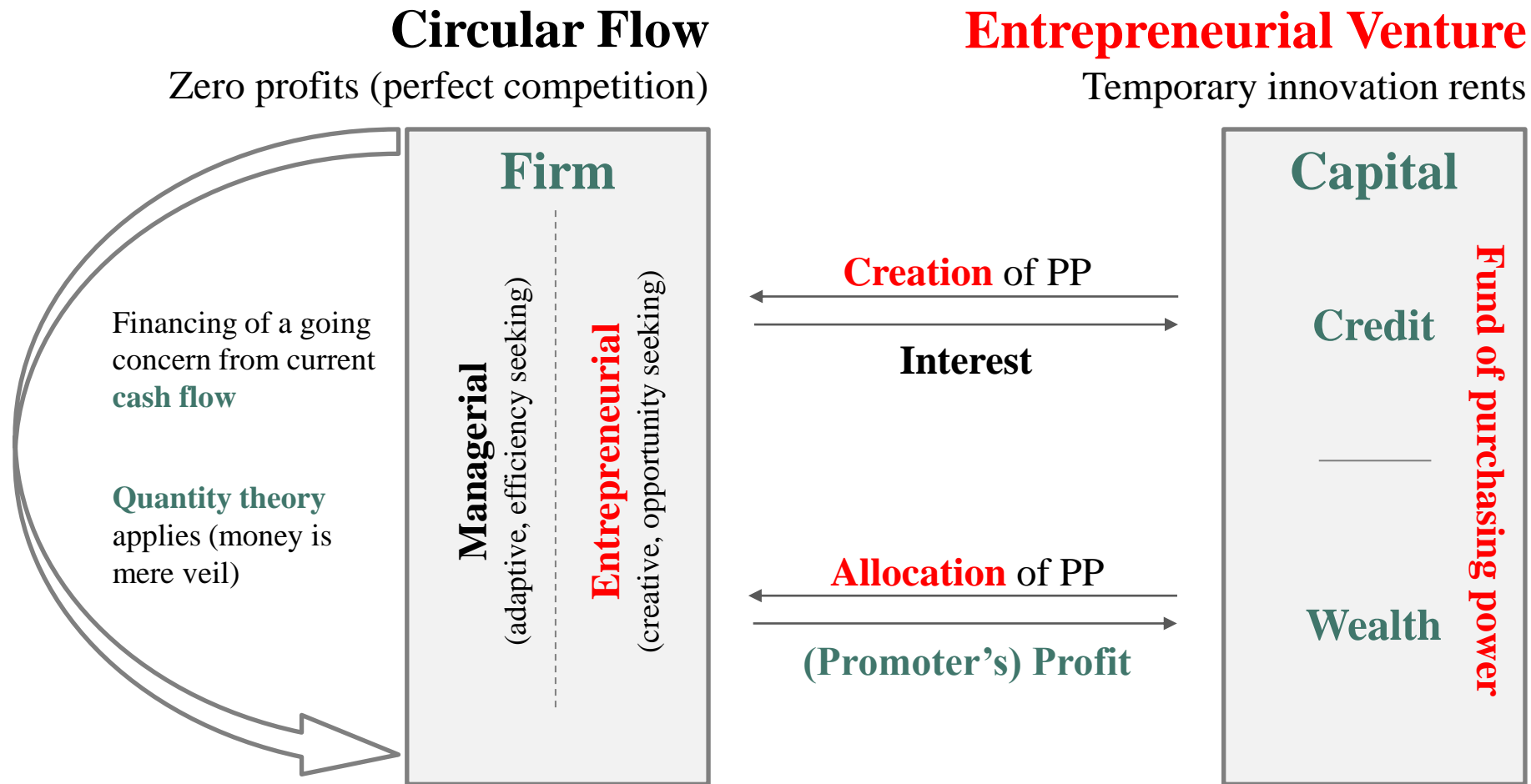
- **Income approach**: what affects prices is not the *stock* of money, but the *flow* of actual expenditures
- **“Ligament”**: money supply responds to demand for credit through the *de-novo* creation of bank balances
 - In anatomy the ligament is a band of tissue which connects the bones. It must be **firm**, but also **elastic** and capable to expand and contract
- But the system is not self-correcting (as in Smith, Banking School)
 - *Cumulative causation*: inflated expectations >> overexpansion of credit >> under stress, banks can temporarily refinance their losses among themselves
 - *Laissez-faire* leads to financial cycles with excessive expansion of credit
- Regulation and prudent central banking to **contain financial crises**

- Money is **exogenous**, in equilibrium with full employment
 - Changes in money supply affect only the **price level** but not relative prices
 - If relevant, then only by causing financial disruptions and economic **disorder**
 - QT consistent with claim theory
- Money is a mere **veil**, that is neutral to real production
- Born in the **golden age** of QT, Schumpeter is critical of, e.g.
 - Velocity (better “efficiency”) of circulation is not constant
 - Ratio of credit to “money” is not constant (as in Fisher’s equation), also not in the long-run (>> history of financial innovations)
- **Price effects** of monetary expansion **are uneven**

- While many **price effects** are transitory, some irreversibly set the economy on different paths
- Credit for **productive investment**
 - **Increases** money supply, purchasing power of entrepreneurs, demand and **prices** for means of production (labour, machinery, etc.)
 - **Forced saving** due to lower purchasing power of other firms
 - **Creative destruction** as firms at the margin drop out of the market
 - Interest + **(promoter's) profit** remain in circulation after redemption
 - Prices decline, if social product increases faster than claim tickets

Entrepreneurial finance

Theory (7/7)



Basic positions

1. **Venture Money:** non-neutrality
2. **Banks:** enable entrepreneurs to gain control over resources through the creation of credit – Scope for money creation – Ephors
3. **Promoters' Profit:** conflict between bankers/financiers and entrepreneurs
4. Entrepreneurship – Schumpeter **Mark 1:** admiration for ingenious, energetic, vigorous individuals vs disdain for inventors and professional staff in the 'static', 'hedonic' sphere
5. **Mark 2:** perfect, financially strong organizations led by professional managers
 - for the first time in „Sozialistische Möglichkeiten von heute“ 1920/21

Time- and situation-specific positions

- Specific role of **Viennese banks** after WWI
 1. Banks attract **foreign capital**
 2. Maintain **central position** in CEE
 3. Financing of **SME** in Austria

- **Industrial development** in Austria
 4. Internal market **too small** for large industries -> medium-sized industries

Economic situation after World War One in Austria

Practice (3/12)

- **Dissolution** of the Habsburg Empire → small national markets
- **Depressed** economy, industries worn out due to war economy
- **Hyperinflation**, october 1922 stabilization through internationally guaranteed bond, austerity policy, and tight money

Macro Data Austria 1920-1927

Year	Inflation (%)	GDP growth	GDP level (1913=100)	Bank rate	Lombard credit	No. of Joint Stock Banks	No. of Private Banks
1919	149		69,9	/	/	34	146
1920	99	-5,7	66,4	/	/		
1921	205	10,7	73,5	/	/		
1922	2877	9,0	80,1	/	/		
1923	133	-1,1	79,3	9,0	65,8	76	282
1924	18	11,7	88,5	11,6	25,5		
1925	9	6,8	94,5	10,9	12,6	51	230
1926	-1	1,6	96,1	7,5	8,4		
1927	3	3,1	99	6,3	7,2	40	152

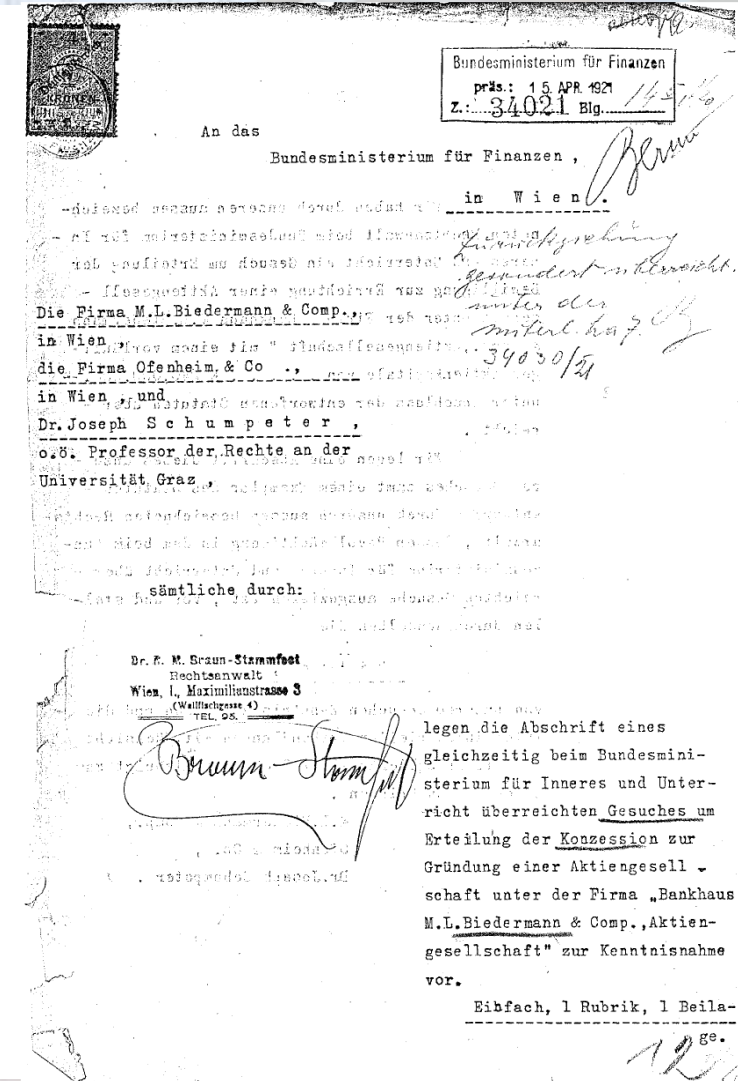
- **Overall thesis:** Schumpeter tries to put his **theoretical positions into practice**
 - A clear indication: he uses **text modules** from his earlier publications for professional communication, e.g. in the application for a banking license, articles of association of the stock corporations, etc.
 - Obviously, his plans are strongly influenced by the ‘heroic’ **Mark 1** entrepreneurial concept

Biedermannbank - application

Practice (5/12)

Arguments in the application for a banking license

- New bank attracts foreign capital to Austria
- Strengthens the role of Vienna as a financial center in CEE
- Aims to finance medium-sized industries in particular



Biedermannbank – how it failed

Practice (6/12)

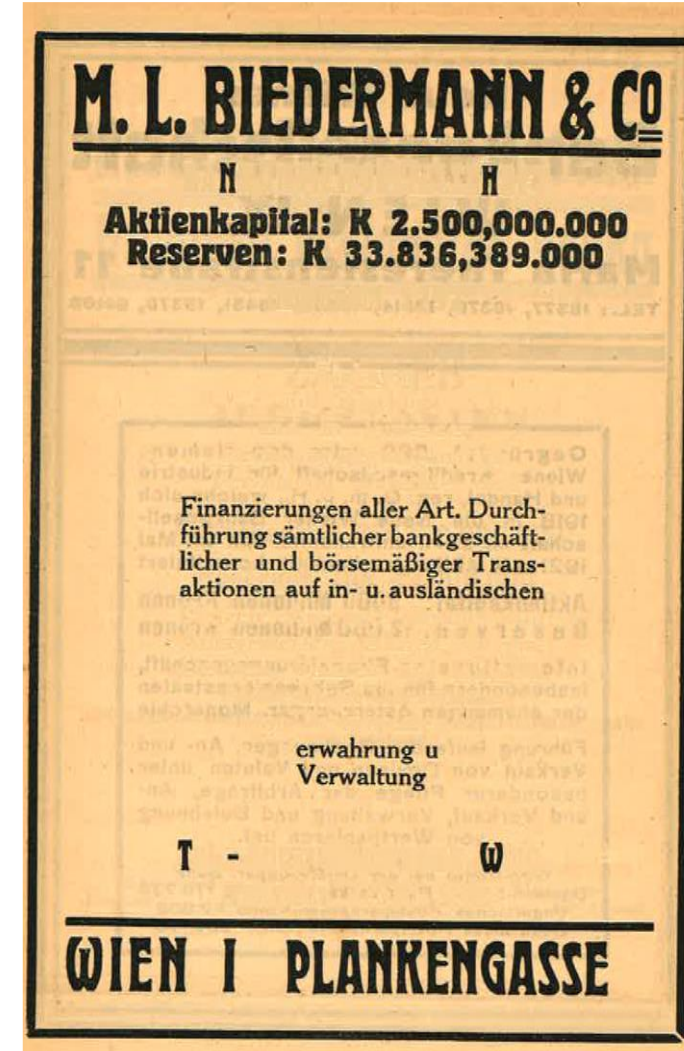
Strategic **flaws** in a difficult economic **environment**

Conflicting shareholders

Schumpeter + friends *vs* Anglo Austrian Bank/BoE/M. Norman
Schumpeterian Banking *vs* English Banking

→

- 1921/1922 Bank misses speculative deals during inflation era
- 1923 Shifts towards industrial relations during „bull market“ after hyperinflation
- 1924 Bank + customers: Losses from stock market crisis, failed speculation against French franc and banking crisis
→ de facto insolvent



Rudolf Maria Braun-Stammfest – a peculiar personality

- Schoolmate of Schumpeter at the Theresianum elite school in Vienna
- Inherits a certain fortune and is a successful business lawyer before WWI
- Loses money that he invests in dubious inventors
- Wants to fanatically build up industries after WWI
- Peculiar hypochondria: only leaves the house with a neurologist
- Start-ups with informal closed funds – not illegal, but on the edge of legality

Schumpeter is **fascinated**

1. “that he invests all his energy in the industries”,
2. considers the companies to be “designed correctly in economic respects”,
3. appreciates the start-up method with informal closed-end investment funds

while *Gustav Stolper* regards Braun-Stammfest as an **imposter**

Four **industrial firms**, founded from 1920 onwards

1. Technical porcelain
2. Electro-technical components
3. Glass
4. Metallurgy and paints

Arguments in the **applications** for the formation of the stock corporations

- Fast growing markets and innovative technologies
- Import substitution
- Medium industries fitting to small Austrian market



Braun-Stammfest Group

Practice (9/12)

Firm	Founding fund	Purchase of site	Constitution of JSC	Start of Production
Porcelain (Wels, Upper Austria)	Autumn 1920	March 1921	18 Feb. 1922	Nov. 1921, Summer '22
Glass (Wels, Upper Austria)	February 1922	Mai 1922	22 Feb. 1923	/
Electro technical Factory (Wels, Upper Austria)	March 1922	Mai 1922	28 Dec. 1922	Dec. 1923
Metallurgical Comp. (Hainfeld, Lower Austr.)	Late Spring 1921	June 1921	15 March 1922	Cont./ Dec. 1923

The course of corporate development

- **1920-1922** Pre-financing of companies through informal closed-end investment funds on the edge of legality – Value losses of funds due to inflation
- **1922/23** First companies start production, but with heavy losses
- **1923** Fresh equity and ever higher usurious loans, imposter partner, managerial deficiencies
- **1924** Banking and stock market crisis: fresh capital no longer available – financial collapse



Reasons for failure associated with Schumpeter's theoretical positions

- His theories led him to be **overly optimistic** about the bank's potential – he was soon no longer taken seriously in the bank for day-to-day business
 - Because of Mark 1 he pays too **little attention** to the carefully professional development of the business
 - Because of Mark 1 he is **prone to imposters**
 - Because of his theory on the conflict over promoters' profits, he favored Braun-Stammfest's investment financing **on the edge of legality**
- **Neglecting importance of professional organization and management** as stressed in Mark 2

- End of 1924 jobless banker and academic
- Personal debt of almost 3 million euros (2024) to Biedermannbank, other banks and private lenders for loans, failed speculations, tax debts + a large assumption of liability for the industrial group
- Until the end of the 1920s, his work was overshadowed by money worries and the danger of being accused of fraudulent bankruptcy
- Help from some friends and very clever negotiations to overcome the debt
- Impairment of his scientific work in Bonn, in particular on the money book

- **Theoretical** developments
 - Attention to **financial frictions** in the *economics of information* (e.g., Akerlof 1970, Stiglitz-Weiss 1981, Myers-Majluf 1984, Bernanke 1996, Stiglitz-Greenwald 2003)
 - Schumpeterian **growth models** (e.g., Segerstrom et al 1990, Aghion-Howitt 1992/98 with variants of finance-growth nexus)
 - Agent-based models (**ABMs**, e.g., “Keynes meets Schumpeter” Dosi et al. 2010, 2020)
- ... and mounting **empirical evidence**
 - **Positive** finance & growth nexus (e.g. King and Levine 1993, Rajan-Zingales 1998, Allen et al 2018, Rossi-Scalise 2019)
 - Concerns about **financialization**, i.e., speculation, inflated returns of financial assets, crowding-out skilled labour or productive investments, undermining financial stability
- ... in support of **Schumpeter’s non-neutrality of money!**

Thank you for the attention!

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