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## Encyclical Letter "Caritas in Veritate" : An Economist's Reading

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# Encyclical Letter “*Caritas in Veritate*”: An Economist’s Reading

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On the 29 of June 2009, the Pope Benedict XVIth published *Caritas in Veritate*, his third encyclical letter. It was addressed to the clergy but also to “lay faithful and all people of good will”. In the two papers assembled here under one single title, the author enters in dialogue with the Papal encyclical from the perspective of an economist interested in ethical issues related specially to finance.

First paper “Incompleteness of Economy and Business: A Forceful Reminder” is to be published in the Journal of Business Ethics. It underlines the logical incompleteness of both economic theory and business practice. Although *Caritas in Veritate* does not address this question explicitly, the reminder of incompleteness seems to be the main lessons the “dismal” discipline should draw from the encyclical.

Second paper “Fecundity vs. Efficiency: Rediscovering Relations” will appear in the forthcoming book “Human Development in Business” (D. Mele & C. Dierksmeier, ed.). The paper analyses the ethical underpinnings of the present systemic crisis. It builds on the “category of relation” – as suggested by *Caritas in Veritate* - in the context of financial activities and contrasts it with the “category of transaction”. In conclusion, the paper suggests that transactions may breed efficiency but only relations will breed fecundity – economic, social and spiritual.

*Caritas in Veritate*, as every encyclical, is a letter, an invitation to exchange. The comments and thoughts expressed here are not only a respectful answer to the Pope’s message but also a set of questions and possible suggestions on how to make the main message of the Church easier to understand be it by “lay faithful and all people of good will” who are either practitioners of business and finance, or teachers of management, finance or economics in universities or business schools.

# Incompleteness of Economy and Business:

## A Forceful Reminder<sup>1</sup>

*Paul Dembinski*

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**ABSTRACT.** Only seldom mentioned explicitly in *Caritas in Veritate*, economic and business life seems to be at the centre of papal concerns. Indeed, many different but related arguments developed in the encyclical converge on one central, yet not clearly stated, conclusion or thesis: economic and business activities are “incomplete”. The present paper will explore the above-mentioned “incompleteness” thesis or argument from three different perspectives: the role, the practice and the purpose of economic and business activities in contemporary societies. In doing so, the paper will heavily draw on questions and, still not fully learned, lessons derived from the present financial and economic crisis. *Caritas in Veritate* provides an appealing moral framework in which many of these lessons take a deeper sense and a more comprehensive meaning. The notion of “incompleteness” is applied here to economic and business theory and practice in the sense derived from well-known Gödel’s theorems. They state in terms of logical and mathematical demonstrations that no system of axiomatic statements can provide a proof of its own consistency. Such a proof requires the use of statements belonging to another (higher) level system. In the case of economics or business theory and practice these “higher level” statements are value judgments. By stressing the importance of ethics and moral philosophy for daily life, *Caritas in Veritate* strongly reminds us that neither economy nor business are self-sufficient either in organisational and social, practical or moral terms.

**KEYWORDS:** *Caritas in Veritate*, ethics, exchange, financial crisis, Gödel’s Theorems, incompleteness in economics, purpose of business, relation, System of National Accounts (SNA), transaction

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<sup>1</sup> To be published in a special issue of *Journal of Business Ethics*.

## Introduction

According to the too often quoted phrase attributed to Milton Friedman, the “purpose of business is business”.<sup>2</sup> However, by saying this, Friedman and his disciples suppose a shared understanding of what “business” means in the two senses used in the aphorism: *business as practice and business as purpose*. If at one point there was an agreement in these questions, this is no longer the case since the present crisis has shaken many certitudes that went unquestioned for decades. In consequence, in the present context the Friedmanite saying could well be nothing more than an elegant but void or even fallacious statement, or even a sophism.<sup>3</sup>

The ongoing financial and economic crisis proves to be a very peculiar moment: unexpected, fearful, potentially lethal to our way of life, but paradoxically, until recently at least, it did not shake the way financial and economic activities are conducted or regulated. When the financial order was shaken to its roots, a number of wrongdoings were publicly confessed and promises were made both by private and public actors as to their future conduct. Looking back to the first pages of major daily newspapers during these months of fear, one has the impression that modern capitalism, tantalized by the crude colours in which the lightning of the crisis has put its functioning and whereabouts, was examining its own practices without complacency while simultaneously reviewing its foundational values. In these moments of lucidity, practices were examined against values and judged in moral terms. As the storm calmed down, the existential fears disappeared. Consequently, “real life” and self-preserving arguments of “business as usual” resurfaced and regained progressively all the ground previously lost to idealistic ones. Today, little trace of these ambitious declarations and commitments is left either in public debate or in private practices. The gravity of the crisis and the seriousness of the flaws in dominant practices that appeared so clearly in the lightning of the storm are being forgotten or even denied, as if it was just a collective nightmare.

*Caritas in Veritate* (CV) was published in summer 2009, a few days before the Aquilla (Italy) G20 meeting. Speaking up when crisis fears were driving the level of systemic self-insurance to its lowest level, gave the Pope a larger than usual audience and drew a lot of attention to the document. The encyclical did not address technical issues related to the financial crisis, but to the surprise of many, it put the crisis in a larger perspective by proposing a theological and eschatological reading of it. By doing so *Caritas in Veritate*—in line with the tradition of the social teaching of the Church—was leaving to the addressees, people of good will, the task of choosing the

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<sup>2</sup>“Widely attributed to Friedman, and sometimes cited as being in his work *Capitalism and Freedom* (1962) this is also attributed to Alfred P. Sloan, with citation of a statement of 1964, but sometimes with attestations to his use of it as a motto as early as 1923.” Available at [http://en.wikiquote.org/wiki/Milton\\_Friedman](http://en.wikiquote.org/wiki/Milton_Friedman). Accessed 16 September 2011. See, among others, Davis: 2005, ‘What is the business of business?’ *McKinsey Quarterly*, August 2005, 105-113.

<sup>3</sup> Khurana, R. and Gintis, H : 2008, ‘What is the Purpose of Business?’, *BizEd*, Jan/Feb, 55-56.

most appropriate ways to bring their personal and social daily deeds and practices in harmony with the theological and eschatological requirements.

While only seldom mentioned explicitly in the document, economic and business life is at the centre of papal concerns. Indeed, many different but related arguments developed in the encyclical converge on one central, yet not clearly stated, conclusion: contemporary economic and business practice and the related dominant theories are “incomplete” at least from the Christian perspective. Consequently they should neither be seen as autonomous nor self-sufficient. They need to be framed and supported on one side by the cultural and political concern for the common good and on the other by personal concern for fraternity, ethics and morality.

The present paper will explore the above-mentioned “incompleteness” argument from three different perspectives: the role, the practice and the purpose of economic and business activities in contemporary societies. In doing so, it will draw heavily from questions and (still not fully learned) lessons derived from the present financial and economic crisis. *Caritas in Veritate* provides an appealing moral framework in which many of these lessons take a deeper sense and a more comprehensive meaning.

The notion of “incompleteness” is used here in the sense derived from well-known Gödel’s second theorem. This seminal theorem demonstrates in formal logical terms that a system of axioms can be proved as logically consistent only if it is incomplete. In other words, a proof of consistency of an axiomatic system requires the use of statements external to the system itself. When applied to economic and business practice or theory, the Gödel’s theorem reminds us that those systems which pretend to provide an internal self-justification cannot but fail to do so and are, in fact, simply recursive. A final justification can only be derived from higher order statements that are external to the economic and business realm, namely moral philosophy or even theology.<sup>4</sup> Keeping in mind Gödel’s seminal contribution, the paper uses it to explore the logical underpinnings of the ways economic activity is justified, measured, assessed and practiced in the contemporary world.

## **The role of the economy and business in society**

According to the well-known statement by Lionel Robbins, economics as knowledge, and, more broadly, economic activity, is about increasing the level of efficiency in the use of scarce resources to satisfy the unlimited needs of humanity.<sup>5</sup> The achievement of the permanent increase in

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<sup>4</sup> Gödel, K.: 1931. ‘Über Formal Unentscheidbare Sätze der Principia Mathematica und Verwandter Systeme’, *Monatshefte für Mathematik und Physik* **38**, 173-198; see also Weisstein, E. W. ‘Gödel’s Second Incompleteness Theorem’, available at <http://mathworld.wolfram.com/GoedelsSecondIncompletenessTheorem.html>. Accessed 16 September 2011.

<sup>5</sup> Robbins, L.: 1932, *An Essay on the Nature and Significance of Economic Science*. (Macmillan London). “Economics is the science which studies human behavior as a relationship between given ends and scarce means which have alternative uses” (p. 16).

efficiency is guaranteed by the combination of two institutions with one rule of behaviour: namely the enterprise, the market and the so-called “profit motive” or economic rationality.

In theory, when the system of perfectly interconnected markets is “complete” (that is, when a market for every possible good or service exists), the inventiveness of business people eager to pocket profits drives society to the highest possible level of efficiency, but at the same time perfect competition prevents profits from growing beyond a median level achieved in all activities. This self-correcting mechanism keeps the idealized economy on the efficiency path. However, the abyss between theory and reality should not be neglected. In the real world markets are not complete, competition is not perfect and profits are far from negligible. Consequently, extreme caution should prevail in extrapolating to the real world any theory-based conclusion. Indeed, the temptation is enormous to take the promises of theory at their face value and transpose to the real world conclusions stemming from the idealized world of models.

Only if markets are complete in the above-mentioned sense, is limited profit an indication of efficiency in the use of resources. Indeed, the complete market hypothesis means that the market mechanism runs all dimensions, spheres, and issues of social life, leaving nothing, outside of its scope and reach. Only under this extremely restrictive hypothesis can the economic calculation be said to take into account all the costs and benefits (which are by definition expressed in monetary terms) without leaving anything of importance outside. In all other cases, one cannot exclude that in real world the economic activity generates, outside of the accounting perimeter, costs—and possibly benefits—usually called externalities, which are not taken into account in the calculation. In consequence, as long as the system of markets is incomplete, the result of any calculation in terms of monetary costs and benefits is undermined by the existence of externalities—which by definition have no price and no value tag. Thus, as long as the completeness hypothesis is not satisfied, every accounting profit or loss takes into account only costs and benefits which relate to the part of social life that is governed by market mechanism. Consequently, the pretension of economic calculus to lead society to enhanced efficiency has to be taken with great caution.

The financial crisis drew the public’s attention to the enormous amounts of profits generated by banks and other financial institutions. In 2007, the US financial institutions were generating about 40% of corporate profits while contributing only 15% to the US GDP.<sup>6</sup> If limited profits, according to the model, would indicate that efficiency is at its highest, extravagant profits say just the opposite. Other indications point in the same direction as they suggest that the level of strategic and financial interdependence in the global economy is growing and the level of

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<sup>6</sup> *The Economist*, 19 of March 2008. Available at <http://www.economist.com/node/10881318>. Accessed 16 September 2011.

competition remains low. Accordingly, the world economy could well be far from its optimal level of efficiency advocated by theory.<sup>7</sup>

Persistence of imperfect competition and of incomplete markets can lead to two opposite lines of action. According to the first—free market view—one should aim at extending the scope of markets to every dimension of social life, while for the other, meta-economic and political forces should limit the role of markets only to certain domains of social life. In the first case, as promised by theory, economic logic aspires to be the dominant principle governing society, and efficiency will remain its ultimate goal. In the latter case, market mechanism and economic logic are bound to be only one among other allocating mechanisms at work in society.

The discussion about the adequate extension and role of markets is not new. The question has also been, directly or indirectly, addressed in previous social encyclicals from *Rerum Novarum* to *Centesimus Annus* and also by many social thinkers and economists interested in Christian social thought or doctrine.<sup>8</sup> *Caritas in Veritate* clearly states the incompleteness of purely economic mechanisms by saying that “...the conviction that the economy must be autonomous, that it must be shielded from ‘influences’ of a moral character, has led man to abuse the economic process in a thoroughly destructive way. In the long term, these convictions have led to economic, social and political systems that trample upon personal and social freedom, and are therefore unable to deliver the justice that they promise” (CV 34). The Pope goes on to say that “[e]conomic activity cannot solve all social problems through the simple application of commercial logic. This needs to be directed towards the pursuit of the common good, for which the political community in particular must also take responsibility” (CV 36).

Sceptical about the capacity of market logic to run the whole of society, the encyclical acknowledges the importance of markets, provided the mechanism is not left alone. “The Church has always held that economic action is not to be regarded as something opposed to society. ... Society does not have to protect itself from the market. ... (...) the market is the economic institution that permits encounter between persons” (CV 34). But later on, the encyclical qualifies as follows this statement: “Without internal forms of solidarity and mutual trust, the market cannot completely fulfil its proper economic function.”(CV 36)

## **The doubtful relevance of SNA related indicators**

Many interpretations and discussions took place to capture the precise meaning of the acknowledgment by the encyclical of the doctrinal incompleteness of the economic and business logic. This does not require

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<sup>7</sup> Dembinski, P. and B. Fryzel, eds.: 2010, *The Role of Large Enterprises in Democracy and Society* (Palgrave, London).

<sup>8</sup> Novak, M.: 1991, *The Spirit of Democratic Capitalism* (IEA Health Welfare Unit, London) p. 112; Zieba, M. : 2000, *Les Papes et le Capitalisme* (Saint Augustin, Saint Maurice); Laurent, B. : 2007, *Eseignement Social de l’Eglise et l’économie de marché* (Parole et Silence, Paris), and many others.

further elaboration here. However, this doctrinal position—not new in Vatican documents—has important technical implications for the importance given to different measurements of economic activities in the overall assessment of the achievements of societies. This is especially the case with the set of concepts and measures rooted in the more than half a century old methodological framework of the System of National Accounts (SNA). Aggregates such as GNP and GDP, and the growth rates derived therefrom, are the most classical, best known and widely used set of economic measures and success indicators. Yet these tools carry with them a set of built-in assumptions and methodological limitations that are worth spelling out here when discussing the “incompleteness thesis” of economics and business logic.

The relevance of SNA-related indicators for assessing the overall performance of societies has been criticized from five main angles, closely related to its “incompleteness”: the human development perspective, the happiness gap, the grey-economy, the ecological perspective, and the uneven value perspective.

In early 1990s, economists working with United Nations Development Programme started to devise ways to shift the development agenda away from SNA accounts to a more people-centred approach. In this framework a Human Development Index (HDI) has been established. It combines GNP per capita with other indicators such as access of children to education and life expectancy. Despite the fact that HDI levels present a rather high correlation with levels of GNP per capita, HDI has achieved its own legitimacy over the 20 years of its existence.<sup>9</sup>

The second line of critique of SNA is related to its empirically demonstrated inability to provide even an approximate indication of the level of happiness or well being of societies concerned.<sup>10</sup>

The third line of critique is summed up very clearly in the recent report authored by A. Sen and J. Stiglitz on flaws and limitations in the prevailing SNA.<sup>11</sup> The issues raised by the group of eminent authors refer to limitations that prevent the SNA from covering all the fields it should. Consequently, the experts’ effort aims at granting the possible maximal extension of the SNA framework so as to make it capture as much of social life as technically possible. Beyond technicalities, the authors do not see any other fundamental reason why the SNA coverage should not be complete and thus far extended beyond the scope presently governed by market mechanism.

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<sup>9</sup> ul Haq, M.: 1995, *Reflections on Human Development* (Oxford University Press, New York) and UNDP, *Human Development Report*, annual publication. Available at [www.hdr.undp.org](http://www.hdr.undp.org). Accessed 15 July 2011.

<sup>10</sup> Frey, B. and A. Stutzer: 2002, ‘What can economists learn from happiness research?’ *Journal of Economic Literature*, **40**(2), 402-43 and works by Lord Richard Layard such as Lionel Robbins Memorial Lectures 2002/3, delivered at the London School of Economics “Happiness: has social sciences a clue?” <http://cep.lse.ac.uk/events/lectures/layard/RL030303.pdf>

<sup>11</sup> Presidency of the French Republic: 2009, *Report by the Commission on the Measurement of Economic Performance and Social Progress*, p. 300.



The three mainly technical limitations of SNA on which the report focuses have been conceptually identified for a long time but are still present: (a) for administrative reasons, the SNA is unable to capture adequately all the ongoing economic activity such as grey or black economy; (b) the SNA does not encompass—mostly for technical reasons—quasi-economic activities performed outside of the market, such as household work; (c) the SNA does not properly capture all the costs related to the economic activity, especially the damage made to the environment which is, in accounting terms, a free good. On the basis of such a diagnosis, which in essence is far from new, most of the ongoing intellectual and technical efforts aim to make the SNA ever more all encompassing or more complete.

The fourth line of critique touches on the fundamental problem of how to know whether the accounting notion of “value added” that stands at the centre of the SNA methodological framework also has a normative meaning, as the use of the word “value” might suggest. In other terms, the question would be: “Is any accounting value added positive or good?” In a strictly economic view, every sound activity from the business perspective is “adding value” in the SNA sense. However, some of these activities may seem less valuable than others. An often-quoted example is a car repair after an accident. It adds value in the SNA sense, but usually results in a loss of the car’s value for the owner. Gasoline spent in traffic jams by no means has either a positive effect on the economy, on the ecology or on society but, in accounting terms, it contributes to the increase of SNA based aggregates.

The point which this critique makes forcefully is to stress the fact that the accounting framework is unable by construction to distinguish between “useful” value added, “neutral” value added and “not useful” or even deceptive value added.<sup>12</sup> By taking the SNA figures at their face value, without any screening, one takes for granted that every accounting value added effectively adds value to society. In doing so, one implicitly, and erroneously, supports the claim of SNA framework to be “complete” and more broadly to the view that the corresponding figures give a true and complete image of societal valuations and realities. In its ultimate conclusion, this argument converges with the one derived from the “happiness paradox” discussed earlier.

Protagonists of debates around the financial crisis have, sometimes forcefully, asked what is the meaning or counterpart of the accounting value added (between 5 and 15% of GDP in OECD countries) by the financial sector?<sup>13</sup> Every time an attempt is made to distinguish between “valuable” and “not so valuable” value added, the use of a value judgment is required. Such a judgment has, by definition, to come from the outside of the SNA framework. This fact further underlines its incompleteness. At its inception, in late 1930s, the SNA framework was not designed to be complete, its

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<sup>12</sup> For an excellent discussion of this problem, see Cobb, C., T. Halstead and J. Rowe: 1995, ‘If the GDP is Up, Why is America Down?’, *Atlantic Monthly*, October, 59-68.

<sup>13</sup> Krippner, G.:2005 “The financialization of the American economy”, *Socio-economic Review* 3(2), 173-208; Dembinski, P.: 2009, *Servant or Deceiver? Financialization at the Crossroads* (Palgrave, London), p. 200.

limits and limitations were widely recognized. Since then however, the SNA successes have been breeding the “completeness” ambition, which is still prevalent today.

Finally, the fifth critique of the SNA derived figures is probably the least researched for the time being but potentially the most devastating. The point to be made here is the following: as long as the SNA will not provide a “complete” cover of all social and economic activities, its figures will remain not only incomplete, but also misleading, ideologically loaded and thus simply wrong. An example will help to capture the argument: a meal taken by a group of five at home contributes to the GNP/GDP only for the amount of cost of its ingredients. The same meal taken at a restaurant would have a much greater contribution to GNP/GDP. Consequently, switching from home-based meals to restaurant meals will translate as economic growth both in terms of GDP and in terms of jobs. But is it really growth with its positive connotation? Or is it only expansion of the domain regulated by the business or market logic at the expense of another domain controlled by the logic of sharing?<sup>14</sup>

The example used here is not anecdotal. It explains one of the less studied aspects of the expansion of service activities. The growth of services in terms of jobs and value added, and the corresponding structural transformation, was the main engine of the economic growth that took place in OECD countries during the last decades.<sup>15</sup> The argument presented here suggests that SNA figures are largely misleading. What they present as *ex nihilo* creation of value added, is—to a large extent—just a transfer of activities from non-market logic to the market logic. And here, an implicit value judgement carried along with the SNA framework comes into play because this transfer has been called “growth” with its highly positive connotation. In other words, the hypothesis of a “growth fallacy” has to be carefully investigated both from the quantitative and conceptual perspective.

Today, the dominant trend wants the SNA framework to be as complete as possible but, despite all the efforts, this goal has not yet been achieved. Most of the present SNA limitations would disappear if all social activity was conducted according to the market and business logic, and if humans were perfect *homines oeconomici*. But this is fortunately not the case. The critiques and limitations discussed here acknowledge in fact a double “incompleteness” of SNA: on one side in terms of coverage, on the other in terms of incapacity to provide grounds for the ultimate value judgment. The discussion above allows us to derive three sets of not totally compatible positions in the debate. For the *fatalists*, the still prevalent

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<sup>14</sup> Arthur Pigou, in his seminal work “Economics of Welfare” identified the following paradox as a serious but not a destructive shortcoming of the notion of “national dividend”: “... if a man marries his housekeeper or his cook, the national dividend is diminished”. Pigou, A.: 1932, *Economics of Welfare*, (first published in 1920) (Macmillan, London). Available at <http://www.econlib.org/library/NPDBooks/Pigou/pgEW.html>. Accessed May 2011

<sup>15</sup> Maroto Sanchez, A.: 2010, ‘Growth and productivity in the service sector: The state of the art’. IAES Working Paper Series 7/2010. Instituto de Análisis Económico y Social, Alcalá de Henares. Available at [http://www.iaes.es/publicaciones/DT\\_07\\_10\\_ing.pdf](http://www.iaes.es/publicaciones/DT_07_10_ing.pdf). Accessed 16 September 2011.

hegemony of GDP/GNP figures has to be challenged by the use of other synthetic measures and indicators so as to provide an adequate assessment of social well-being. For the *optimists*, the SNA framework should be continuously expanded in order to make its measures and outputs more meaningful every day. And finally, for the *realists*, the scope, meaning and ambitions of the SNA should be explicitly contained so as to capture only the effective and valuable growth, i.e. all situations when only ex nihilo value creation takes place. This would leave aside “apparent” growth (growth or activities derived from transfer of activities from one logic to another) outside of the SNA’s scope and mandate.

This lengthy discussion of the SNA pretension to completeness has made more apparent the agenda hidden beyond accounting technicalities. In fact, this framework provides an implicit and partial intellectual justification for the continuous expansion of the role business and economic activities in contemporary societies. The arguments in favour of greater “completeness” have proved in recent decades to be politically very seductive in most OECD countries despite sharp altermondialist critiques against the looming “marchandisation” of the world. *Caritas in Veritate* insists that despite its seductive capacity, neither the “completeness thesis” of economic life nor the claim of economic logic to be self-sufficient can be accepted on anthropological as well as on purely theological grounds. While acknowledging the power and efficiency of the economic logic, the encyclical stresses also that they have to be oriented and guided from outside. “This requires further and deeper reflection on the meaning of the economy and its goals, as well as a profound and far-sighted revision of the current model of development, so as to correct its dysfunctions and deviations” (CV 32). “Development must include not just material growth but also spiritual growth” (CV 69). Or “(y)et it must be acknowledged that this same economic growth has been and continues to be weighed down by malfunctions and dramatic problems” (CV 21).

## **The practice of business: from efficiency to fecundity**

After having shown how far reaching the implications of the incompleteness thesis are for the role that economic activities ought to play in society, the time has come to address its implications for the practice of business. The way business and economic activities are conducted stands at the centre of the Pope’s concern. Indeed, the most striking paragraphs in *Caritas in Veritate*, deal with gratuitousness, and are of direct relevance to the actual practice of business.

“There is no free lunch”—this often repeated statement summarises the core principle of much of contemporary business thinking and practice. It is also the main principle of every “serious” economics or management textbook. It means that there is no place left, and there should be no place left, for free gift and gratuity either in the business practice, in economic activity and even in economic thought.

Both economic practice and theory are based on the same premise: nothing is free; everything has to be paid or compensated for by an

equivalent. From a business perspective a truly “free lunch”, with no expected future counter parties or advantages, means forgone income, while in macro-economic terms, it means loss of efficiency. From this follows an important recommendation: if pockets of gifts and gratuity still exist, they should be eradicated in the name of increased income and macro-economic gains in efficiency. As a consequence, gratuity is either business opportunity or waste and for both reasons it should be substituted with a commercial transaction. By eradicating gratuity, humanity is supposed to head towards greater efficiency and closer to the ideal of “complete markets” referred to in the previous paragraph.

In such a context, economic efficiency would be at its peak as the individual—perfectly selfish and, therefore, perfectly isolated—communicates with the rest of the world exclusively by means of prices and quantities. Thus, the intellectual building up of a society, not to say of a market civilisation, rests on a strong anthropological vision known by the name *homo oeconomicus*. In a world of *homo oeconomicus*, a free lunch is an absurdity. The anthropological cornerstone of contemporary economicist ideology has been laid down by Vilfredo Pareto in Lausanne, on the shores of Lake Geneva, where he lived at the beginning of the 20th century. However, under Pareto’s pen, *homo oeconomicus* was only an exercise in style. Over the last twenty years or so, the fundamentally selfish rationality of *homo oeconomicus*, totally devoid of any ethical concern, has become a not only a general reference used in economic modelling but also the anthropological underlying present in business teaching and practice, especially in marketing.<sup>16</sup> Although largely dominant, this paradigm is not totally hegemonic among economists. Some authors, such as Herbert Simon and Stefano Zamagni, to mention only two names out of a much longer list, argue that not only egoism but also altruism is compatible with economic thinking and theorizing.<sup>17</sup>

The practical relevance of this intellectual construct of economics as theory has been seriously brought into question by the current crisis. A world of complete markets, together with *homo oeconomicus*, suffices to establish an entirely and exclusively economic ideal of civilisation. In such a world, the clash of selfish individuals, put into competition by the market, is sufficient to solve all problems and all conflicts through exchange transactions (see below). Such a state of affairs corresponds to the ideal of what may be called “economic fundamentalism” which could—if it has not happened already—degenerate into an ideology.

*Caritas in Veritate* refutes point by point both the economicist ideology and the resulting business practice. “There ought to be (some) free

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<sup>16</sup> Demeulenaere, P.: 1996, *Homo oeconomicus* (Presses universitaires de France, Paris). See also ‘From Homo oeconomicus to homo ethicus’, *Finance & the Common Good* **22** (2), 3-7.

<sup>17</sup> When discussing the current use made of utility theory, Herbert Simon reminds us that it is compatible with an altruistic anthropology but also acknowledges that its use has been distorted: “That economic actors desire only economic gain is a far stronger assumption that they maximize utility. It is also empirically false” (p. 158). Simon, H.: 1993, ‘Altruism and Economics’, *American Economic Review* **83** (2), 156-161. On this topic, see also Zamagni, S., ed.: 1995, *The Economics of Altruism* (Edward Elgar, London).

lunches,” the Pope seems to say. This is so because human nature blossoms and reaches its fulfilment in generosity and in generous relations with others. The Catholic Church offers a reading of human nature diametrically opposite to that of *homo oeconomicus*. Charity (*Caritas*) can’t have another foundation or justification than that of the truth (*Veritas*) of the human nature. The encyclical clearly spells out the link between the two, “(t)ruth opens and unites our minds in the *lógos* of love” (CV 4). Nowadays, business practice and economic thought tend rather to pose as centres of social and individual life. Taking the opposite view, Benedict XVI emphasises their incompleteness. Business and financial transactions are, at best, means, while what is truly at stake concerns the ends. Economic and business activities are there to serve human destiny rather than preside over it. The encyclical states “if the market is governed solely by the principle of the equivalence in value of exchanged goods, it cannot produce the social cohesion that it requires in order to function well. Without internal forms of solidarity and mutual trust, the market cannot completely fulfil its proper economic function” (CV 35).

Although the encyclical recognises explicitly the importance of the equivalent exchanges, of contracts, of profit and of the institutions that are governing them, i.e. the market and the enterprise, it calls to see them as means and to discover their proper meaning in the light of proper goals. These means are necessary, but not sufficient to allow each human being and all people to fulfil their vocation of integral development. It is not a question of legislating or of acting through macro-political regulations, which hardly succeed, as it is in guaranteeing a minimum of justice, but of reconfiguring in depth the practice and behaviour of economic agents. “The importance of this goal is such as to demand our openness to understand it in depth and to mobilize ourselves at the level of the ‘heart’, so as to ensure that current economic and social processes evolve towards fully human outcomes” (CV 20).

At the heart of the papal diagnosis lays the non- or ill-development of contemporary humanity, a situation that doesn’t come down to the material dimension only and that isn’t confined to the so-called developing countries. The current crisis, then, is “an opportunity for discernment, in which to shape a new vision for the future.” The encyclical insists on a necessary double renewal in order to come out of the crisis. It is necessary to start at the intellectual level where the need for a “new humanist synthesis” is striking, and follow with practical action, where new business models, practices and structures are to be experimented with and put into action.

This double renewal demands that human truth should never be lost from sight in such abstractions as structure, technique, progress, and growth. Profit and market can never overwhelm human beings in their individuality and their uniqueness. How are we to articulate the generous aspiration to this “new humanism” in day-to-day action? In the encyclical there are no recipes with a magic wand, there are no technical and impersonal “it’s just a question of ‘one should’ or ‘one must’”. The only practicable path suggested by Benedict XVI is that we are all to act or, more realistically, that each person starts acting without waiting for the others. By doing what?

And here comes the revolutionary recommendations: by putting some giving and generosity into the heart of business practice (not aside of it), which means by going beyond the strict (and in fact sterile) equivalent exchange in order to write a surplus into it, a dimension of giving. The encyclical says indeed that “(t)he great challenge before us, accentuated by the problems of development in this global era and made even more urgent by the economic and financial crisis, is to demonstrate, in thinking and behaviour ... that in commercial relationships the principle of gratuitousness and the logic of gift as an expression of fraternity can and must find their place within normal economic activity” (CV 36). These words resound like an invitation to business practitioners to acknowledge and by-pass the highly seductive but erroneous vision of equivalence and of completeness at the heart of the currently prevailing “no free lunch” paradigm. This is a call to part ways with the corresponding economic ideology.

The current prevalence of the equivalent transactions in the business world derives from their key technical features that make them easy to manage. The first characteristic of transactions is their *impersonality*. In transactions, what matters are the goods exchanged, not the persons or actors who exchange them. Consequently, the identity of actors does not and should not have any impact on the price paid or on the quality of the purchased unit of good. Each unit is supposed by the theory to be strictly identical to all the others. This may be true in depersonalised industrial production, but is more difficult to be achieved in services. That is the reason why sophisticated marketing trays used to “personalize” the transaction. This is, however, only a mere instrumental customisation dictated by yield management techniques, rather than true personalisation that would require taking into account the genuine person of the other.

A second important characteristic of transactions is their *instantaneity*. A transaction is equilibrated at the moment it takes place, there is no future to it, and there is no past, only the instant when the equivalence has been established by agreement of parties. A transaction is instantaneous and therefore *static* by design. A third characteristic is the *completeness* or equivalence of transactions in line with the “no free lunch” principle. Every dimension of the exchanged goods or services is taken account of in the price formation; nothing is left for free or unpaid for. A fourth characteristic, is the fact that an impersonal transaction will only take place in an environment in which the necessary level of *trust has been provided by means external* to the transaction itself. Auditors, solicitors, lawyers, experts, insurers, brokers, etc. embody the rule of law, which in the last analysis provides trust necessary to allow impersonal actors to exchange and trade on more or less organized markets.

Finally, the fifth and last characteristic of transaction is its *instrumental nature*. Impersonal buying or selling is a mean used by each of the parties to achieve a goal that lies, by definition, outside of the transaction itself. The transaction will provide cash to the seller that she will be able to use when buying goods and services, while the buyer will use the purchased goods to satisfy a more or less urgent need. Consequently, parties aspire only to an efficient closing of the transaction.

Because of all these characteristics, transactions may appear as self-contained and independent units easy to quantify, to assemble, sort or categorise. As such they are easy to manage by impersonal and highly technical procedures used in corporations and taught in modern business schools.<sup>18</sup> On a macro-economic level, the world made of transactions appears in the categories of economic analysis as efficient. All this being said, *Caritas in Veritate* is much less enthusiastic about the prevalence of transactions than economist view and business practice would expect. The main reason for this discomfort is the moral incompleteness of transactions, which are unable to provide “heart” to efficiency. They are unable by themselves to turn efficiency into fraternity, as they are unable to turn growth into integral development. The main reason for this is the inability of transactions to acknowledge the uniqueness of the other, to see the counter party to the transaction as a person. The encyclical says, “[e]conomic, social and political development, if it is to be authentically human, needs to make room for the principle of gratuitousness as an expression of fraternity” (CV 34). Previously the following distinction between neighbours and brothers has been made: “As society becomes ever more globalised, it makes us neighbours but does not make us brothers. Reason, by itself, is capable of grasping the equality between men and of giving stability to their civic coexistence, but it cannot establish fraternity” (CV 19).

It has been argued at length that the rapid growth of the number of financial transactions during the last quarter of century was one of the causes of the crisis. It has also been argued, that for a long time a shift was taking place in banking business models from relation-based business models to transactions based-ones.<sup>19</sup> Today the quantitative supremacy of transactions over relations is very clear in the financial arena. But in fact it also affected other industries and most of received business practices. During the last quarter of the 20th century western societies moved a long way from Tönnies’s *Gemeinschaft* to *Gesellschaft*. In this process, the fecundity of relations as a mode of interaction has been sacrificed to the promises of efficiency carried by a transaction-based society.

As the encyclical invites people of good will to rediscover the “category of relation”, it provides a unique opportunity to oppose the two notions, transaction and relation, and contrast their features along the lines proposed above. If a transaction is *anonymous and impersonal*, quite the opposite is true for relations. Only when parties know each other in their peculiarities, might they enter a relationship. This is for instance true in a debt relation which leaves room for the mutual adaptation and recognition of peculiarities and singularities of each of the parties. If transactions are instantaneous, relations have by definition a *duration*: some are everlasting, others are short, but all extend beyond the instant. A relation is therefore inscribed in time and as such has a history, and in most cases, a future. Consequently, relations have a built in dynamics, as opposed to the

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<sup>18</sup> Mintzberg, H.: 2004, *Managers not MBAs*. (Prentice Hall, London).

<sup>19</sup> Dembinski, P.: 2009, op cit. Meeerschwam, D.: 1987. ‘Breaking Relationships: the Advent of Price Banking in The US’, in S. Hayes (ed.) *Wall Street and Regulations* (Harvard Business School Press, Boston), pp. 63-97.

instantaneous and static nature of transactions. If transactions are, or at least pretend to be, technically complete because they are built on *equivalence* in an economic sense, relations, by definition, are a succession of unbalanced moments. Like walking, a relation is a succession of disequilibria that feed and counter-balance each other. This non-equivalence characteristic of relations provides room for gratuitousness and gift that can develop into reciprocity (which is not identical with equivalence). For instance, *trust* is one of the most important gifts that a party to a relation—any relation including a business one—can give to the other party. Once introduced into a relational framework, trust can grow (or disappear) as the seed of a fruit that will blossom and mature in the next stages of the relation. Unpredictable as to its future, a relation is potentially the *locus of fecundity* while transactions do not leave any room for it. Many business examples show that joint projects and cooperation often lead to totally unexpected fruits.

As said before, transactions require trust to be provided by the environment in which they take place. Indeed, the rule of law, the judiciary institutions, accounting rules, procedures and, in some cases, also rating agencies, are supposed to provide external trust necessary for smooth, impersonal and anonymous transactions. In the case of relations, the situation is different: trust—or distrust—develops internally. *Parties trust each other* because they know their respective individual peculiarities. Consequently, when developed into networks, relations can contribute to an increased level of trust in society. The famous saying of London bankers “my word is my bond” does not mean anything outside of a club or network of mutually trusting gentlemen. This, however, should not obscure the fact that mafia and other criminal networks are also built on mutual trust (and sometimes fear).

It has been shown that in transactions the other party is *instrumental*. This is only to some extent true in relations where the other has a face, an identity and a time-span. Even in a business environment where relations are tools for conducting operations, seldom are they only instrumental. If this is the case, they will fail because of not having achieved the minimal level of trust required for a more forceful development. More and more often smaller enterprises complain about the fact that their larger business partners have totally lost the sense of inter-personal relations and run business on a purely contractual basis.

By contrasting relations with transactions, their potentials clearly appear. Transactions by their commitment to *instantaneous efficiency*, deliver immediately everything that can be harvested at once. On the opposite side, relations *balance the fruits of past efforts with the seeds for future results*. Looking from a strictly business perspective, both transactions and relations are useful and complement each other to a large extent. The crisis has shown however, that the preference for transactions, one aspect of which is short-termism, has driven our economies into very dangerous waters. The best example in this context is the so-called “originate and distribute” strategy of financial institutions active in the sub-



prime.<sup>20</sup> This strategy attracted much attention after the crisis and may have been one of the triggering factors of the crisis. In this business model, the mortgage financial relationship was initiated only with the purpose to be sold on to another financial institution. In this example, the relation was instrumentalized for the needs of a subsequent transaction.<sup>21</sup>

The call of *Caritas in Veritate* to redesign business practice comes at a time when the business community is rediscovering the need for trusting relationships but for less theological reasons. The reason lies in security and proper risk management. The convergence of these two concerns provides a window of opportunity for a profound change in practice but also in the way future business people are trained. Thinking and acting more long term could open up the minds of decision makers to distil some graciousness in the hard world of business which may lead them to recognize the face of the other—using Levinas’s images—behind the cells of their Excel spreadsheets.

### **The purpose of business – serving the persons**

As mentioned above, according to the widely quoted, but fortunately not always accepted, Friedmanite saying, the practice of business is business’s only purpose. More precisely, and in line with today’s dominant “shareholder view” of the corporation, this means that return on capital should be the main purpose of business. The incompleteness thesis (or argument) challenges forcefully this extremely narrow view of the purpose of economic and business activities. The encyclical strongly qualifies the currently undisputed “profit motive”: “(p)rofit is useful if it serves as a means towards an end that provides a sense both of how to produce it and how to make good use of it. Once profit becomes the exclusive goal, ... it risks destroying wealth and creating poverty” (CV 21). These words stand in sharp contrast to the emblematic response of Gordon Gekko, the hero of the film *Wall Street* (1987). When asked about how much he wanted to earn, his answer was simply “more”.

Over the past years much has been written about the role of the “greed factor” in the making of the recent crisis.<sup>22</sup> Legal and mechanical checks and balances have been discussed and devised including limitations on top executive remunerations and bonuses. G-20 was supposed to propose a global measure on these issues—but progress has been more than limited. This being said, such measures did not address the issue of purpose in its essential meaning. According to the still prevailing dominant view, inherited from Mandeville, private vices—thanks to the mysterious and almost divine

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<sup>20</sup> Bank of International Settlements started warning about the dangers of this strategy as soon as 2006 and 2007 – see the corresponding BIS’s Annual Reports.

<sup>21</sup> See Frankel, T.: 2002, *Honour and Trust. American Business Culture at the Crossroads* (Oxford University Press, Oxford).

<sup>22</sup> Among many books and articles, Augar, P.: 2005, *Merchants of Greed, The Greed Merchants: How the Investment Banks Played the Free Market Game* (Penguin Books, New York); Partenoy, F.: 2003, *Infectious Greed* (Times Books, New York); and Anne T.: 2010, *Die Ger war Grenzlos* (Ullstien, Berlin).

work of the invisible hand—are transformed into public virtues.<sup>23</sup> The logical strength of this argument has seduced generations of social philosophers and business leaders as it makes senseless any discussion about the “true” purpose of business. On the contrary the encyclical, in line with previous papal teaching, even though it acknowledges the importance of profit as success indicator, stresses that it needs to be at the service of a higher purpose.

The main qualification here is that profit as such does not tell anything either about the conditions in which it has been generated or used. No moral judgment on profits can be formulated without clarity on these two points. Unlike the contemporary “new philanthropy,” which underlines the generosity of those that made fortunes when they distribute them, for the Christian, the ways in which profit has been generated is probably even more important than its use. Indeed, from a management perspective, profit may—in some cases—result from a lack of commutative justice in the relations between the enterprise and its main stakeholders. It may well happen that the enterprise takes advantage of its market power to enforce prices or wages that are unjust. This may happen without any violation of existing positive legislation, but only by violating the natural duty of justice and prudence.<sup>24</sup>

This discussion shows that if the purpose of business is limited to “profit”, it is set to remain incomplete. It misses the ultimate purpose of any human economic activity: “Man is the source, the focus and the aim of all economic and social life”<sup>25</sup>. This reminder has far reaching consequences for the business world; man is to be served, not to be taken advantage of. Thus the purpose of business is to help human development, and not to enslave him to services and products he does not really need. Neuro-marketing today is well advanced in the use of sub-conscious selling techniques, brand management and advertising campaigns that “target” (in the proper sense) segments of the market often made up of the most vulnerable, as in the case with the sub-prime mortgages.<sup>26</sup> All these techniques aim at generating profits, at building up the shareholder value of companies. But do they serve men and women?

The encyclical also reminds us that the “subsidiarity principle” is above all a moral, and not merely a management, principle (CV 57). Although subsidiarity is often referred to in matters of political, constitutional and social organisation, its moral underpinnings are seldom discussed in the context of economic and business activities where it is seen more as a management tool of decentralisation aiming at increasing the

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<sup>23</sup> Foley, D.: 2006, *Adam’s Fallacy. A Guide to Economic Theology* (Harvard University Press, Boston).

<sup>24</sup> When analysing the current financial crisis, the Bank of International Settlements states the following in its Annual Report 2009: “... these weaknesses allowed the entire financial industry to book profits too early, too easily and without proper risk adjustment” (p. 7)

<sup>25</sup> *Caritas in Veritate*, 27, quoting Second Vatican Ecumenical Council, Pastoral Constitution on the Church in the Modern World *Gaudium et Spes*, 63.

<sup>26</sup> Twitchell, J.: 1998, *Lead Us Into Temptation. The Triumph of American Materialism* (Columbia University Press, New York).

overall efficiency of the organisation. If taken earnestly and applied to economic life, the moral dimension of subsidiarity could well suggest that economic and business activities have to preserve and respect the autonomy of the clients with regard to goods and services that may put them into dependence. This reminds us once again that the conditions in which profit has been generated are at least as important as the amount of profit itself.

If businesses were careful at producing only goods and services that ennoble their clients and help them in their integral development, then only “good value added” would be produced in the economy. Consequently, one of the limitations of the SNA discussed earlier would disappear.

## Beyond incompleteness – towards a unique decision framework

Figure 1 below proposes a frame of reference that may be helpful for checking the meaning and sense of business decisions or actions. This framework is the cornerstone of an assessment methodology currently being developed by the Observatoire de la Finance, called “Mind the (ethical) gap”<sup>27</sup>. It suggests that every business or professional decision has at least four dimensions and that each of these dimensions stems from a specific paradigm and should be considered together with the other dimensions before a final decision is reached. When applied to specific situations or decisions, this analytical framework could assist in searching for options and alternatives, as it shows that more often than not, in real life, tension may occur between the legal deeds, the profit motive, the care of the intrinsic quality of action, and the external impact of any decision.

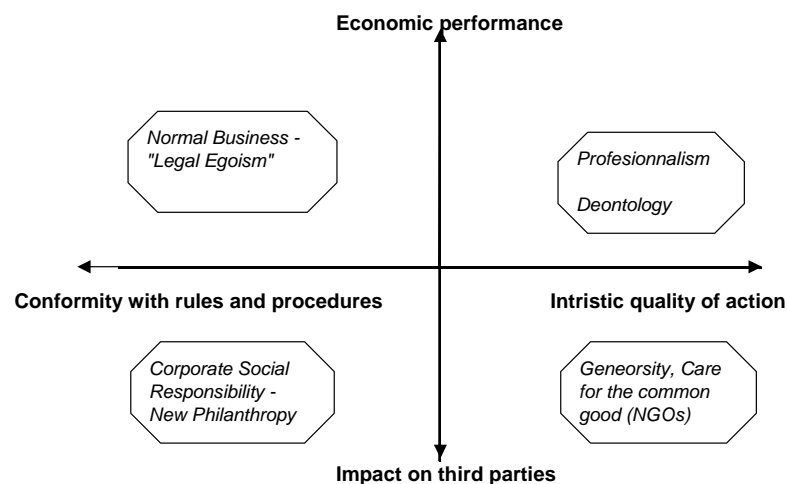


Figure 1. Ethics in Business: four dimensions that help give sense and meaning to any business and economic decision.

<sup>27</sup> Available at [www.obsfin.ch](http://www.obsfin.ch). Accessed 16 September 2011.

This framework has four dimensions, each of which contributes to give a moral compass to any business decision: (a) in the North: contribution to economic performance; (b) in the East: the intrinsic quality of the action, the professional “doing well”; (c) in the South: the quality of impact the decision has on third parties, on those that are not involved in the decision making process and will be confronted with its consequences; (d) in the West: the degree of conformity with legal rules and internal procedures of the enterprise.

In a “complete” business world, corresponding to the one depicted by the dominant economic theory, only the N-W part of the diagram matters, the other portions are irrelevant. On the opposite, in an environment where gratuitousness prevails, S-E portion plays a prominent role.

By reminding us that the four dimensions give meaning simultaneously to any decision, this assessment framework offers a possibility to escape the golden prison of the completeness dogma. Indeed, the only way for new humanism to progress in the business community is to remind us of the meta-economic meaning of any economic or business activity.

## **Conclusion**

The crisis has increased the interest for “ethics” in the business world, at least in some of its circles. In parallel, on the political level, in the aftermath of the crisis, a broader call to “moralise capitalism” has been issued by the French President Nicolas Sarkozy in January 2009.<sup>28</sup> Even if these words remain, for the time being, without clear content, their use shows that many share the feeling that the “profit motive” is an incomplete and even dangerously reductive description of the true purpose of business.

Ethics specialists also seem to be divided on the issue of purpose. Two main approaches can be distinguished: the dominant “Business Ethics” view closer to professional deontology (i.e. obligations agreed within a profession and related to its role in society) and the “Ethics in Business” which acknowledges that the source of ethics is transcendent to the realm of business and professional life. The two best-known traditions of “Ethics in Business” are virtue ethics and the Kantian categorical imperative approach.

For the currently dominant “Business Ethics” view, deontology seen as a set of accepted professional codes of conduct will guarantee and preserve the good functioning of the business community or of the market. This approach to ethics takes business activity and its logic as a given. For the “Ethics in Business” approach, business is a field in which more general ethical principles have to be applied. This allows for a constant questioning of business logic itself and requires consequently the identification of the underlying general ethical questions behind the peculiarities of every

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<sup>28</sup> “La crise du capitalisme financier n'appelle pas à la destruction du capitalisme, qui serait une catastrophe, mais à sa moralisation” said President Sarkozy on the 8th of January 2009. Available at <http://www.elysee.fr/president/les-actualites/discours/2009/colloque-nouveau-monde-nouveau-capitalisme.6846.html>. Accessed 16 September 2011.

business situation or action.<sup>29</sup> Only this approach, which refers to “higher level” statements, is compatible with the incompleteness view as it refers to values and virtues that have a universal meaning, not limited to the business sphere and not derived from it. For the “Ethics in Business” approach, the ethical obligations are exogenous and transcendent to the field of business while they are to a large extent endogenous to it for the “Business Ethics” view.<sup>30</sup>

This paper has showed that one of the ultimate points the last encyclical makes is to stress the unbridgeable incompleteness of business and economic activities. Such a conclusion may be destabilizing to many who might have thought or even taken for granted, as they follow the still dominant paradigm in business, that the economic and business life was morally autonomous. This paper has argued, using Gödel’s theorem, that the claim for moral autonomy is logically inconsistent as neither business practice nor economic activity can provide a self-justification without referring to “higher level” statements. This means that economic activity and business practice in any case rely on a moral judgment either made implicitly or explicitly. By making the “incompleteness” point clear, *Caritas in Veritate* encourages all of us to spell out and critically assess the content of the implicit “higher level” statements that we use to comfort our “business as usual” worldviews. To Catholics, and more broadly to Christians, the encyclical provides an in-depth moral and theological discussion of the “higher statements” relevant to their worldview. In doing so, the encyclical provides a powerful pedagogical instrument for Christians and contributes greatly to setting the ground for dialogue on these issues between Christians and non-Christians.

This being said, those who want to take the incompleteness argument seriously and want to act consequently, will have to change their way of thinking and acting in their professional life. It will require from all concerned, business and political decision makers as well as civil servants and middle management, to permanently question and assess the meaning of their activities in the perspective of the ultimate finality of every human deed: the fostering of the human fraternity.

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<sup>29</sup> Mele, D.: 2009, *Business ethics in action: Seeking Human Excellence in Organisations* (Macmillan, New York)

<sup>30</sup> Ossipow, W. : 2010, ‘Deux pistes pour penser les relations entre éthique et finance’, *Finance & Bien Commun*, **36**, 125- 135.

# FECUNDITY vs. EFFICIENCY :

## Rediscovering Relations<sup>1</sup>

*Paul Dembinski*

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**ABSTRACT.** This paper is a modest contribution, mainly from the economic perspective, to the endeavor of mapping this “new trajectory”. It aims at comparing and investigating two basic forms of social, financial and economic interaction: namely the category of “relation” on one side, and the one of “transaction”, on the other.

The long term trend of expanding volumes and values of financial transactions sheds light on the products and markets that stand behind the three decades long expansion of the financial sector. Clearly this expansion has been a transaction-driven one, leaving financial relations play an important but less visible role.

In every modern economy the financial sector carries out two allocation processes: the process of allocation of capital that is relation-based and process of allocation of risk that is transaction based. Since late 1970s, a profound transformation is taking place driven by the accelerating emancipation of the risk allocation activities. Progressively this function acquired independence by developing its own instruments (derivatives), its own techniques (asset management) and professional skills. This change, from classical relation-based finance to a much more transaction oriented one, fundamentally affected their mutual relationship.

The logic behind the development of the CDOs provides a good example of how the relationship between financial relations and transactions has changed. These synthetic products aim at presenting a risk/return profile attractive for a potential buyer, i.e. to a third party who is neither an one of the initial parties to a financing relation. The well-documented recent tragedy of the American sub-primes provides an illustration of the true motives and behaviors behind the CDO driven “originate and distribute” strategy.

As *Caritas in Veritate* invites to rediscover the “category of relation”, it provides an opportunity to compare it with transactions. If a transaction is anonymous and impersonal, quite the opposite is true for relations. Only when parties know each other in their peculiarities, they might enter a relationship. This means that most of relations have a built in dynamics, as opposed to the self-contained and static transactions. If transactions are complete because build on equivalent exchange, relations, by definition, are a successions of unbalances.

By contrasting relations with transactions, their potentials clearly appear. Transactions by their commitment to instantaneous efficiency, deliver immediately everything what can be harvested at once. On the opposite, relations are the locus of fecundity, they balance the fruits of past efforts with the seeds for future results.

The shifting of emphasis form transactions and efficiency to relations and fecundity requires the new types of incentives – not only material and monetary but also moral - to be developed which encourage long-term commitments in all areas of the economy and the financial sector. If horizons become longer, fewer long-term relationships will be sacrificed of exploited by untimely transactions geared to short-term gain. The real challenge for practitioners, public and private, that feel inspired be *Caritas in Veritate* is to clearly prefer relations – as opposed to transactions – in their everyday deeds. The world may change only because we change.

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... new trajectory of thinking is needed in order to arrive at a better understanding of the implications of our being one family; interaction among the peoples of the world calls us to embark upon this new trajectory, so that integration can signify solidarity rather than marginalization. Thinking of this kind requires a *deeper critical evaluation of the category of relation*. This is a task that cannot be undertaken by the social sciences alone, insofar as the contribution of disciplines such as metaphysics and theology is needed if man's transcendent dignity is to be properly understood. (CV 53)

In these words the encyclical *Caritas in Veritate* calls to give our thinking a “new trajectory”. This new trajectory is expected to bring us closer to the deep understanding of the bonds of solidarity, which is essential to think and live humanity as one single family. The prerequisite for a successful journey along the new trajectory, says the Pope, is the critical evaluation of the “category of relation” in the light of what is essential in the Christian message, namely “man's transcendent dignity” (CV 53). Although, the Pope expects that the contribution of social sciences to this task will be of importance, in his opinion they ought to be complemented by theology and metaphysics.

As to the contribution of social sciences, they will really contribute to the “new trajectory” only if they successfully supersede their disciplinary walls and boundaries so as to progressively build a trans-disciplinary understanding of the “category of relation”. Once developed, such a conceptual framework will usefully serve as an anchor for further analysis and action.

This paper is a modest contribution, mainly from the economic perspective, to the endeavour of mapping this “new trajectory”. It aims at comparing and investigating two basic forms of social, financial and economic interaction: namely the category of “relation” on one side, and the one of “transaction”, on the other. Although transaction is not mentioned in the Encyclical as a “category” worth studying, it is used here as a contrapuntal tool very helpful for a better understanding of relations. The starting point for this investigation is provided by mounting tide of financial transactions experienced in the last three decades whose impact on the landscape and functioning of the OECD economies (and societies) proves deep and lasting. In the second part of the paper, the categories of transaction and relations are investigated in broader, in more philosophical terms while the third and last part deals with the consequences of mounting tide of transactions that expands well beyond finance and has tangible social

and economic consequences. The last part provides a systemic diagnosis to the present crisis. By doing so, the last section draws on the “Manifesto for Finance in service of the Common Good” made public by the Observatoire de la Finance in 2009.

## **1. The Mounting Tide of Transactions in Finance**

According to the Bank of International Settlements (Annual Report 2010), between 1984 and 2009 the share of the financial sector in GDP almost doubled in United States and UK (from 5 to more than 8% of GDP) while in European Union it grew slightly from 5% to somewhat above 6%. Even if the macro-economic mode of accounting for the financial sector value added is still in discussion (Sen & Stiglitz 2009) the figures reported above clearly suggest that a structural change has taken place in the developed economies. Indeed, since late 1970’s, the financial sector has been one of the important drivers of macro-economic growth of the developed economies, especially those hosting a world-class financial centre.

This expansion is also visible through most of the statistical series describing financial activities. A closer examination of some of these series shows precisely that these were the main drivers behind the growth of financial services. Beyond their statistical and technical aspects, these changes have far-reaching ethical consequences for the working of the economic and social fabric, they will be discussed at length in the next section of this paper. In the three decades between 1975 and 2007:

- Capitalisation of markets expressed in terms of nominal GDP more than doubled in all developed countries, while it has been multiplied by nearly four in the US;
- The value of outstanding debt obligations (public and private) grew in the similar to the above proportions both on internal and international markets;
- In 2007, the notional value of trades in derivatives amounted to 8 times world GDP, while these instruments barely existed in late 1970s;
- The value of foreign exchange transactions in 2005 amounted to more than 15 times world GDP while there were insignificant in mid 1970’s.

The precise quantitative handling of statistics related to financial activities is difficult because of the lacking comprehensive methodology and homogeneity in the way data are collected and presented. One main conceptual difference has to be remembered: some of the series relate to financial transactions and measure flows of trades in financial assets during a period, while others refer to the balance sheet values and measure values of these assets at a certain date. According to a rough estimate: in 2005 the value of world financial assets (stock data) amounted to about 12 world GDP while the value of annual financial transactions (flow data) amounted to 70 times the same GDP. To make the point even stronger: in mid 1970s the turnover, i.e. the total value of transactions, in the so-called “real economy” was about 10 times larger than the turnover in financial assets while in 2005, financial transactions amounted to 30(!) times the turnover if the “real economy”. It appears that, in three decades, the ratio of financial



transactions compared to the transactions in “real economy” has been multiplied by 300!! (Farrell & Lund, 2007; Dembinski, 2009; McKinsey Global Institute, 2010, see also [www.beyondglobstat.org](http://www.beyondglobstat.org)) Because of the still lacking comprehensive and solid statistical methodology, these figures can pretend to provide, at best, orders of magnitude. However, despite their weaknesses, they allow to grasp in quantitative terms the scope and speed of change in the role and way finance works.

The long term trend of expanding volumes and values of financial transactions sheds light on the products and markets that stand behind the expansion of the financial sector referred to above. Clearly this expansion has been a transaction-driven one, leaving financial relations play an important but less visible role. Three underlying processes have driven this expansion:

- (a) Financial innovation which, since at least three decades, generates continuously new forms of assets and financial products which in turn breed ever new transactions;
- (b) Increased velocity of financial assets (i.e. steady acceleration in the speed of their circulation) which is tantamount to ever shorter average periods of holding a given assets. In this context, the so-called “nano-trading” pushes the holding periods to its technical limits;
- (c) Long-term continuous increase in demand for holding financial assets, such as shares, has been steady pushing up their valuations.

The mounting tide of financial transactions sketched above provides ground for labelling the three decades between mid 1970’s (collapse of the Bretton Woods systems and the first oil shock) and the beginning of the crisis in 2007, as the “Three Euphoric Decades of Finance”. These decades follow other three decades (end of WWII and oil crisis) which have been called by Jean Fourastié “The Glorious Decades” (Fourastié, 1979) because of high growth, low inflation and low unemployment.

According to the standard view, in every modern economy the financial sector fulfils a set of basic functions: (a) facilitation of payments (b) collection of savings (c) financing of investments (d) management of risk through its pricing and trading (Merton, 1995). This being said, the relative importance of these functions may vary in time and space, as do the technical tools, institutions and techniques. These four key-functions carry out two allocation processes vital to any developed economy: on one hand the process of allocation of capital (to which contribute the three first functions of the list), and, on the other hand, the process of allocation of risk which is carried out by the bouquet of activities associated with the fourth function. Although these processes are still today technically and institutionally interwoven, they are clearly distinct from the analytical point of view.

These two allocating processes are very different in nature. The process of allocation of capital is carried out through the establishment of medium and long term financing agreements or contracts between on one side a party that has excessive cash and wants to exchange it - temporarily or permanently - for a future stream of revenues and on the other side a

party that is willing to use this cash in a productive way (credit or investment) able to generate the expected stream of revenues. These financial contracts, if properly legally packed and priced may find their place on balance sheets of different institutions and become financial assets. Each of such contracts is associated with specific risks that relate to the conditions (micro – and macro-economic) of the successful completion of the project and the execution of agreed payments. As a result of the matching needs, medium and long-term financing relationships are established in the economy.

Things are different when it comes to the allocation of risks. The main reason of allocating risks is to provide to the various economic agents a financial protection (hedging) against future adverse events or misfortunes. As the spectrum of future adverse events or misfortunes and their possible or expected occurrences are permanently updated by new information, the allocation of risks is a never ending, permanent process that ideally would require a continuous reallocation of all financial assets existing in an economy. The reallocation proceeds through exchanges among interested parties of already existing financial assets. In consequence, the allocation of risk is a transaction related process where each party permanently adjusts the risk/return profile of his or her portfolio by changing its composition in relation to the newest relevant information. He or she does it by exchanging, or committing to exchange (like in derivatives) in the future, the already existing assets.

Until late 1970s, the two above mentioned allocating processes were narrowly connected because most of the existing financial contracts were not transferable. In consequence, once an economic actor has entered a financial agreement or relation, he remains exposed to the risks associated with it until the natural termination of the contract. When assets are non-transferable, each actor can only marginally adjust his or her portfolio's risk/return profile by carefully selecting the characteristics of each new contract he or she decides to enter. Such was the traditional way banks used to manage risks by adjusting the structure of their balance sheets - assets' as well as liabilities' sides – through the prudent selection of their new counter-parties and clients. As long as non-transferable assets prevailed, allocation of risk was just another, technically non-autonomous, aspect of the capital allocation process (Albert, 1991).

Since late 1970s, a profound transformation of the world finance is taking place. An accelerating emancipation and growing autonomy of the risk management and allocation activities drive it. Today, capital allocation and risk allocation are distinct processes, connected through the financial markets where assets are traded. Three factors have mainly contributed to this general trend by which the two processes became institutionally distinct:

- (a) The radical growth in the volume of transferable financial assets, i.e. contracts allowing for an almost costless substitution of parties during the duration of the financial relation. This long term trend led to the relative strengthening of financial markets where such assets are traded and the corresponding weakening of classical savings and credit banks;

- (b) The invention and expansion of a new class of financial assets: the derivatives. These contracts allow exchanging today future commitments related to an underlying financial assets or indexes. Options are the most widely known and used financial derivatives. An option is a contract whereby a party buys (or sells) today the possibility of buying or selling at a specified future moment, an underlying assets at a price agreed upon today;
- (c) The development of so called structured finance and its synthetic products. These very sophisticated products combine in one other existing assets or contracts with conditional commitments such as insurance contracts or options. They are designed either to cover an ad hoc risk or to take advantage of pricing inefficiencies. Much, although not all, of these products are tradable ones like the famous Collateralised Debt Obligations (CDOs) or Credit Default Swaps (CDSs).

The three evolutions just described contributed to making the transactions easier and less costly which in turn increased the traded volumes (depth and liquidity of markets), the number of transactions and the price volatility. Progressively the risk allocating function of financial sector acquired independence by developing its own instruments (derivatives), its own techniques (asset management) and professional skills. These grew in importance within the universe of finance in comparison to the more traditional activities related to the allocation of capital. It appears in consequence, that the expansion of transactions (see above, the statistical orders of magnitude) has been mainly driven by the needs of the risk allocating function, which, in this way, thoroughly contributed to the expansion of the financial sector and to the economic growth. This change has also been apparent in the revenue structures of main financial institutions: during the period under discussion, the share of fees and trading commissions increased steadily to represent today well above 50% of the operating income of major banks, not to speak of non-bank financial institutions. During the same period, the capital allocating activities increased in line, but not faster, than GDP.

The emphasis of financial activities, which during the Three Euphoric Decades moved from classical relation-based finance to a much more transaction oriented one, fundamentally affected their mutual relationship. Until quite recently, financial relations (either credits or investments) were created because parties to the contract were sensitive to project's promises of generating medium or long-term revenue streams.

Even if some of many of these contracts were technically transferable, it was above all a guarantee allowing – in case of necessity – the financing party to exit a relation before its natural termination (provided he or she was able to find a buyer willing to step in his or her place). In most cases, not the (transaction) selling price, but the initially expected revenue flows were the prime motives for initiating a financial relation. This suggests that, in these times, financial relations were mainly designed to meet the needs and requirements of the parties directly involved. Things have changed since.

The logic behind the development of the CDOs provides a good example of how the relationship between financial relations and transactions

has changed. CDOs are modern, synthetic (complex) products designed by financial engineers. They combine in one single asset combined characteristics using for this a great number of “primary” financial relations or contracts. The combination is aimed at presenting a risk/return profile attractive for a potential buyer, i.e. to a third party who is neither an one of the initial parties to any of the “primary” relations. In other words, CDOs are financial artefacts or packages that prove attractive to actors different from the original parties to the underlying “primary” financing relations. A fundamentally ethical question arises at this stage: pro qui bono are, in the last analysis, the “primary” relations initiated and by whom? Does this relation stem from matching of needs of the parties, or does the prospect of a profitable sale of a CDO trigger the intermediary to actively (not to say aggressively) propose to a potential financed party carrying characteristics that are of interest to the final buyer of the CDO product, an attractive “primary” relation? To what extent do such “primary” financial relations serve the medium and long-term needs of parties, and to what extent do they serve above all those that use them as “raw material” or “components” required for synthetic products? Do the initiators of financial relations, here specialised financial intermediaries, have in mind other interests than their own?

The well-documented recent tragedy of the American sub-primes provides an illustration of the true motives and behaviours behind the “originate and distribute” strategy. The O&D strategy has been applied for years, above all but not exclusively, by investment banks that made fortunes by using their financial engineering skills to produce and market the corresponding CDOs. The crisis has shown that in many cases (but not in all) the CDOs proved harmful to the two parties to the underlying financial relations: to the owners of homes unable to pay their debts, as well as to the ultimate holder of CDOs such as pension funds or households who understood only after the sub-prime collapse how risky their assets have been (BIS, 2007 & 2010).

What the O&D strategy clearly shows is that the hierarchy between the relations and transaction has been inverted for the sake of the latter. The prospect of transaction became a strong driver for generating and calibrating new relations. It looks like, in the case of CDOs, long-term relations (mortgages, credit-card or student credits) have become instrumental for the prospective transaction in which the intermediaries had a clear interest. The hierarchy between relations and transactions has been inverted when long-term constraints have been imposed on some for the sake of immediate gains by others. The following quotation of the Encyclical seems to find in the case of CDOs, but more broadly in the case of immoderate acceleration and multiplication of financial transactions, a very clear illustration. “Economy and finance, - says the Pope - as instruments, can be used badly when those at the helm are motivated by purely selfish ends. Instruments that are good in themselves can thereby be transformed into harmful ones.” (CV 36) Then the Pope continues, “Financiers must rediscover the genuinely ethical foundation of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interests of savers. Right intention, transparency, and the search for positive results are

mutually compatible and must never be detached from one another.” (CV 65)

## **2. Relation and Transaction**

The evolution of financial dealings shows that in real social and economic life, transactions and relations are not just abstract categories. They are two distinct but interrelated modes of social interactions that stay in complex and dynamic mutual relationship. The purpose of the present section is to investigate and compare these two categories so as to better understand their mutual influence and interaction.

Transactions are the key characteristic phenomena of a market economy. They are the locus where equivalence is assessed, where “equivalent exchange” takes place and where money operates and shows its power. According to Jacques Julliard, equivalent exchange allows the “reduction ad pecuniam” to take place which then he compares to a pagan form of transubstantiation. As real and potential transactions are overwhelmingly present in modern societies, the transacted goods tend to lose their (as well as exchange parties) specificity and their natural incommensurability. As the perspective of monetary transaction becomes overwhelming, the world turns every day flatter and more clearly one-dimensional (Julliard, 2008).

In fact, according to the still dominant “scientific” view, market economy is about equivalent transactions, they are the self-contained basic units of any purely economic society. Like quanta or atoms allow seeing the physical world as magma, transactions give the impression that they reach beyond the surface of social and economic realities: with help of transactions anything can be fragmented at will. Once fragmented by transactions, the world seems easy to organize, to manage and to govern. What matters in transactions are goods and services exchanged, and their value, not the persons who exchange. Thus, impersonality and anonymity is one of the main characteristics of transactions. In a perfect market transaction, price and qualities do not depend on the identity of parties involved. Thus, almost by nature, perfect transactions – not only financial ones - are price-sensitive and party-neutral.

The transaction-based world-view has also permeated the managerial literature under to main code names “nexus of contracts theory of the firm” and “principal-agent paradigm” Both of them are widely accepted and supported by a shared anthropological position of pure utilitarianism where money is the sole argument of any utility function. For the proponents of these theoretical approaches, homo-economicus is the truest expression of the human nature for which the only reality that matters is a transaction-related one (Jensen & Meckling, 1976, 1994). In consequence, these essentially anti-moral theories propose the only one instrument for influencing the behaviors of others – be it within or outside of an organisation - contractual payments as incentives (Posner 2010 and the following discussion).

A second important characteristic of transactions is their instantaneity. A transaction is equilibrated at the moment its conditions are agreed between parties. It is an instant, a quantum of economic time when, like in a flash illuminating darkness around for a fraction of a second, equivalence is brought into motion. Like in quantum physics, transaction time is discontinuous, made of separate and perfectly static and self-contained moments.

A third characteristic of perfect transactions is their economic completeness. By this is meant, that all the relevant peculiarities of the goods exchanged are taken account of in the valuation process, that no characteristic is left outside of the perspective in line with the “no free lunch” principle. Only seldom real world transactions are complete in this sense, but financial transactions are considered to be the closest to perfect completeness.

Another important characteristic of transaction is its instrumental nature. Transaction is a mean of exchanging something that has less subjective value to me for something that has more. Buying and selling are thus pure means serving each of the parties to reach their own goal, which, by definition, lay beyond the transaction itself. Transactions are like milestones on a road.

From a macro-economic perspective, perfect transactions are tantamount to perfectly functioning markets that, in turn, according to the prevailing knowledge, guarantee the most efficient use of available resources. Mainstream economic theory, as well as policy, highly prizes efficiency. This being said, macro-efficiency is a by-product of smoothly functioning markets that require and make happen perfect transaction. These markets, financial and others, are in charge of the continuous process of allocating goods, services and risks.

Because of all the above-mentioned characteristics, transactions appear as economic quanta, ephemeral units independent one of the other, easy to assemble, to sort or to categorise and also easy to quantify. In a transaction based worldview, everything seem easy to manage by impersonal and highly technical procedures today used in major corporations and taught in “best” business schools. (Mintzberg, 2004; de Gaulejac, 2005, Posner , 2010 and discussion).

Although *Caritas in Veritate* does not address directly transactions as a category, it does it indirectly, by emphasising the uniqueness of the other in human dealings and by reminding the “principle of gratuitousness as an expression of fraternity” (CV 34). In this crude light, transactions appear as deriving their strength, at least from a strictly economic point of view, from standing in open contradictions with papal recommendations: purely impersonal, they are unable to express fraternity, and self-sufficient and complete, they do not allow for gratuity

As *Caritas in Veritate* invites people of good will to rediscover the “category of relation”, it provides an excellent opportunity to compare it with the “category of transaction”. If a transaction is anonymous and impersonal, quite the opposite is true for relations. Only when parties know each other in their peculiarities, they might enter a relationship. This is for

instance true in a credit and debt relation in which room is left for the mutual adaptation and recognition of peculiarities and singularities of each of the parties. If transactions are instantaneous, relations have by definition a duration: some are everlasting, others are short, but all extend beyond the instant. This means that most of relations have a built in dynamics, as opposed to the self-contained and static transactions. If transactions are, or at least, aspire to be complete because build on equivalent exchange, relations, by definition, are a successions of unbalances. Like walking, a relation is a succession of disequilibria: the energy gathered in a step sets the ground and makes the next step possible. At any moment in time, a living relation is thus, by definition unbalanced.

Another way of looking at the non-equivalence, in which any relation is rooted, is to see it as a locus of gratuitousness and, possibly of gift. On these bases, reciprocity, not equivalence may develop. In a recent book, Cardinal Bertone says that unlike equivalent exchange, reciprocity takes into account the actual possibilities (i.e. possibly changing in time) of each of the parties (Bertone, 2008). In this sense reciprocity, rather than exchange, seems to be the true engine of any relations.

This being said, why do impersonal, self-contained, instantaneous transactions happen? What makes potential parties enter into transactions with unknown, faceless parties? In the last analysis, any exchange requires a certain, even if limited, level of trust among parties. Where does this trust come from when the party is anonymous and thus cannot be trusted as such? Impersonal transaction will only take place when the institutional environment provides the necessary level of trust. This means that trust is external to the transaction itself. Auditors, solicitors, lawyers, experts, insurers, brokers etc. embody the rule of law, which in last analysis provides the minimal necessary level of trust to allow faceless actors to engage in exchanges and trade on more or less organized markets. (Gambetta, 1988).

In July 2002, the then chairman of the US Federal Reserve, Alan Greenspan, has very convincingly stressed that the balance, which has to be maintained in a market economy between personal and institutional trust, between trust from within and trust from outside of transactions, is extremely vulnerable to a generalisation mounting wave of ethical misbehaviours and moral hazard type abuses. 'Well-functioning markets require accurate information to allocate capital and other resources, and market participants must have confidence that our predominately voluntary system of exchange is transparent and fair. Although laws and contracts govern business transactions, if even a modest fraction of those transactions had to be adjudicated, our courts would be swamped into immobility. Thus, our market system depends critically on trust - trust in the word of our colleagues and trust in the word of those with whom we do business. Falsification and fraud are highly destructive to free-market capitalism and, more broadly, to the underpinnings of our society.'

The case of relations is different; trust is a dynamic component of relation. In relations, trust is interpersonal, internal to the relations. As such, trust is one of the most important gifts, which a party to a relation – any relation including a business one - can give to the other party. Once introduced into a relational framework, trust can grow (or disappear) as a

seed of a fruit that will blossom and mature in the next stages of the relation. Unpredictable as to its future, a relation is the locus of fecundity. Many business examples show that joint projects and cooperation often lead totally unexpected fruits, which overtake even the highest expectations. These are the fruits, in the full sense of the word, of fecund relationships.

By contrasting relations with transactions, their potentials clearly appear. Transactions by their commitment to instantaneous efficiency, deliver immediately everything what can be harvested at once. On the opposite, relations balance the fruits of past efforts with the seeds for future results. H. Mintzberg uses a different vocabulary, he speaks of exploitation and explorations, and says the following: “Every economy needs both exploration and exploitation, one to create, the other to realize the benefits of creation... The danger lies in tilting too far in either direction. Economies and companies that favour calculating ... tilt too far in the direction of exploitation – of the efficiency at the expense of discovery. (Mintzberg 2004, p.121)

Implicitly Mintzberg poses the key question: the question of sane proportions between transactions and relations (exploration and exploitation in his terminology). These broad questions have been raised also by Tönnies’s famous distinction between *Gemeinschaft* (community) and *Gesellschaft* (society). The Popperian distinction between *Closed Society* made of sticky relation and the liberal *Open Society* where transactions prevail, provides an insight into the same problem. Indeed Popper writes in 1940s “We could conceive a society in which men practically never meet face to face – in which all business is conducted by individuals in isolation who communicate by typed letters or by telegrams, and go about in closed motor-cars. Such a fictitious society might be called a “completely abstract or depersonalised society” (Popper, 1991 edition, p 174). In age of mobile phones, of computer screens and of traffic congestions, these words clearly suggest that Popper does not describe a “fictitious” (or absurd) society, but our way of living. The question thus is, does our transaction- dependent way of life still deserve to be called “society”? According to *Caritas in Veritate* (CV, 19) gratuity is an essential component of fraternity which, in turn is foundational to any true (Christian and thus human ) society, whereas in a transaction based environment, gratuity is perceived rather as a weakness, as an imperfection and an inefficiency that is bound to be eliminated by the properly working market mechanism.

### **3. The Crisis: when Transactions Endanger Relations**

The current crisis is not just economic or financial – it is system-wide. The remedy therefore is not simply a matter of the financial sector coming back into line with the ‘real’ economy, and the risk allocation process loosing in importance in relation to the capital allocation process. The crisis is the outcome of years of unremitting pressure of the search for efficiency, which harvested more than it created. In consequence of the decades long transaction drive, material, social, intellectual and ethical relational foundations of societies based on political and economic freedom have been



dangerously weakened.

The pressure of transactions has been cascading from purely financial world to the rest of the economy. The doctrine of ‘shareholder value’ first put under pressure large listed transactional corporations by imposing a short-term horizon and sky-high return on investment requirements (Mintzberg, 2004). These then passed the pressure on in three interconnected directions: to their staff around the world, under increasingly fierce managerial pressure to keep improving their performance; to consumers, under growing pressure to innovate as a result of ever more sophisticated marketing techniques; and to smaller businesses, suppliers and distributors in both the North and the South, which also found themselves under often unbearable pressure to perform. This pressure – which at first only affected the financial sector – thus spread to the rest of the economy and from there to the whole of our society, our culture and our everyday lives. Today, short-term results prevail in all aspects of economic and social life: relations are being replaced by transactions, exploitation replaces exploration, creativity and fecundity are less and less cared for (Frankel, 2006). At the same time, the patience, loyalty, sustainability and trust on which relationships depend have been undermined, and distrust is becoming more widespread everyday. On financial markets, this trend was concealed for a long time by the abundance of liquidity which allowed transaction to run smoothly and to accelerate, but in mid-2007 the less organized markets suddenly ran out of liquidity – this showed how deep was in fact the level of distrust in these anonymous markets.

The trend towards more transactions has been greatly facilitated by the political appeal of deregulation and by the ‘laws’, ‘theorems’ and so forth that Nobel prizewinners have put forward in support of financial rationality. The steamroller of the ‘efficiency ethos’, validated by supposedly scientific truths, has steadily crushed moral and ethical resistance (Marglin, 2008). The transaction based efficiency ethos has gradually worn down moral resistance and become the ultimate criterion of judgement. The extreme focus on efficiency has resulted in internal organizational procedures in which tasks and responsibilities are assigned so specifically that staff loses sight of what their work actually involves. This has led to widespread ‘ethical alienation’: staff no longer wonder, or care, whether their work is meaningful or justified because only short-term results count.

When separated from moral considerations, the ‘efficiency ethos’ has led to increasingly crude manifestations of greed. This has created more scope for the selfishness that is inherent in human nature. Relationships and related trust are betrayed are all too often to one partner’s wish to get out and to cash out, leaving the other partner in the vague. Such barefaced acts of betrayal or disloyalty risk destroying what is the essential mechanism in any free society or market economy namely trust between people. The free market, based on players’ sense of responsibility, is making way for a ‘greed market’ which will in turn require escalating controls, rules and procedures in both the public and the private sector. This is not only very costly, but makes players even less willing to behave in a responsible

manner (Lewitt, 2002). The documentary film “Inside Job” (2009) provides a breath-taking illustration of this point for the financial industry at least.

This diagnosis suggests that the fundamental values of freedom of judgement, responsibility and solidarity – on which the common good depends, and without which a free and humane society cannot exist – are now under threat. The Euphoric Decades resulted in an over-development of transactions in proportion to relations to the point that the very fabric of our societies is in danger. The broken balance has to be restored and the richness of the category of relation rediscovered. From a Christian perspective, two interdependent and complementary instruments are proposed: Veritas and Caritas.

The search for truth implies a critical of the epistemic, anthropological and ethical foundations of assessment of the prevalent economic, financial and managerial worldview. This may end up challenging the dogmatic focus on economic and financial efficiency and justifying renewed ethical and political concerns about the common good. Where appropriate, the results should quickly be made an integral part of economic, managerial and financial training courses. At the same time, they should lead to a redistribution of research and educational resources that will encourage a fundamental reform of economic thinking.

#### **4. Conclusion**

The shifting of emphasis from efficiency to fecundity, from exploitation to explorations is a long term and multi-layer endeavour. If successfully initiated, it might be further supported by a self-accelerating process which will start once the strength of reciprocity and gratuity is first identified, and then acknowledge. The shift envisaged here is not a mere adjustment but a systemic change. Efficiency is still today the powerful organising principle overriding all its potential challengers. The crisis has opened a window of opportunity. As a consequence alternative modes of behaviour and thinking gain some visibility: *Economia di Communion*e is one but not the only example. Many initiatives under the umbrella of “solidarity-based-economy” try to extend their activity beyond the purely transactional model.

This implies the new types of incentives – not only material and monetary but also moral - to be developed which encourage long-term commitments in all areas of the economy and the financial sector. If horizons become longer, fewer long-term relationships will be sacrificed or exploited by untimely transactions geared to short-term gain. A new balance must be struck – in both qualitative and quantitative terms – between relationships and transactions, both of which are essential to society.

However, experiments are not enough, they will spread only when emphasis on relations is translated in legal terms. In OECD countries, legal frameworks changed so as to provide to all more flexibility tantamount to increased efficiency. This approach allows for permanent re-allocation (not only of risks) but endangers commitment, which is essential to creativity. The crisis shows that the pendulum has to swing back: legal frameworks (in

finance, labour markets, taxation, accounting) have to shift as to reward medium and long term commitment of parties to a common project or cooperation. Making transactions more ‘sticky’ (in terms of lesser flexibility) would encourage relationships and efficient production rather than efficient allocation. This could lead to a rediscovery of the benefits of ‘shortening transaction chains’.

Smooth systemic changes (transitions) require a shared political will, only revolutions come by surprise. Rehabilitating relations and restoring a sane proportion between them and transactions in a wide undertaking that would also require, and *Caritas in Veritate* is clear about it: “(t)he great challenge before us, ..., is to demonstrate, in thinking and behaviour, not only that traditional principles of social ethics like transparency, honesty and responsibility cannot be ignored or attenuated, but also that in commercial relationships the principle of gratuitousness and the logic of gift as an expression of fraternity can and must find their place within normal economic activity.” (CV, 36)

If successful, the systemic change advocated here will profoundly affect also the financial sector. It will be restructured so that to perform in a more balanced than today way its two main roles through which it should serve, and not drive, the economy and society, namely by allocating capital and by allocating risk. In this way also in the financial sector the balance between relations and transaction could be restored.

The “category of relation” proposed by the Pope has proved to be a powerful conceptual tool on which a framework for analysing the present state of civilisation should be developed further on. The power of this category is not only conceptual but also, and possibly above all, practical. The real challenge for practitioners, public and private, that feel inspired by *Caritas in Veritate* is to clearly prefer relations – as opposed to transactions – in their everyday deeds. The world may change only because we change.

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## Abstract

On the 29 of June 2009, the Pope Benedict XVIth published *Caritas in Veritate*, his third encyclical letter. It was addressed to the clergy but also to “lay faithful and all people of good will”. In the two papers assembled here under one single title, the author enters in dialogue with the Papal encyclical from the perspective of an economist interested in ethical issues related specially to finance.

> First paper “Incompleteness of Economy and Business: A Forceful Reminder” is to be published in the Journal of Business Ethics. It underlines the logical incompleteness of both economic theory and business practice. Although *Caritas in Veritate* does not address this question explicitly, the reminder of incompleteness seems to be the main lessons the “dismal” discipline should draw from the encyclical.

> Second paper “Fecundity vs. Efficiency: Rediscovering Relations” will appear in the forthcoming book “Human Development in Business” (D. Mele & C. Dierksmeier, ed). The paper analyses the ethical underpinnings of the present systemic crisis. It builds on the “category of relation” - as suggested by *Caritas in Veritate* - in the context of financial activities and contrasts it with the “category of transaction”. In conclusion, the paper suggests that transactions may breed efficiency but only relations will breed fecundity - economic, social and spiritual.

*Caritas in Veritate*, as every encyclical is a letter, an invitation to exchange. The comments and thoughts expressed here are not only respectful answer to the Pope’s message but also a set of questions and possible suggestions on how to make the main message of the Church easier to understand by “lay faithful and all people of good will” who are either practitioners of business and finance, or teachers of management, finance or economics in universities or business schools.

## Keywords

*Caritas in Veritate*, ethics, exchange, financial crisis, Gödel's Theorems, incompleteness in economics, purpose of business, relation, System of National Accounts (SNA), transaction

## JEL Classification

A11, A12, A13, A2, G01

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