



Financialization and the Global Economy

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The chapter will first discuss ‘financialization’, i.e. changes in the role of the financial sector. This will highlight (1) changes in household behavior, in particular with regards to household debt, (2) changes in the behaviour of non-financial businesses, such as shareholder value orientation and increased financial activity and (3) changes in the financial sector, in particular the emergence of the (hardly regulated) shadow banking sector, a shift towards household credit (rather than business credit) and a shift to investment banking/fee generating business.

Second the chapter will discuss the international dimension of financialization. Here the liberalization of capital flows and its consequences, the determination of exchange rates by capital flows (rather than by current account disequilibria), will be discussed. International financial liberalization has not fulfilled the neoliberal promise of generating investment-based growth, but rather has given rise to a series of financial crises that were typically driven by a swing of capital inflows (‘capital flow bonanza’) followed by capital flow reversals. Third, the chapter will offer an interpretation of the finance-dominated accumulation regime as having given rise to two distinct growth models (based on Stockhammer 2010): a credit-financed consumption-driven growth model (mostly in Anglo-Saxon countries) and a export-driven growth model (in Germany, Japan, and, possibly, China). Both growth models suffer from a structural demand deficiency, which is due to wage suppression, but each try to overcome this by different means (credit-financed consumption or export orientation). The chapter will thus highlight how financialization with its domestic and international effects have interacted with a polarization of income distribution to generate the structural imbalances that led to the crisis 2007-09.

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1. Introduction

One of the hallmarks of economic development since the early 1980s has been the increasing role of finance, often summarily referred to as financialization. The processes involved have had domestic as well as international dimensions. The task of this chapter is to summarize debates on both of them. In doing so we will ask what changes financialization has brought to the macroeconomic regime, in particular what its effects have been on the growth trajectory, on the stability of the system, in income distribution and, if countries have been affected, whether in the same way or in different ways.

2. Financialization

Financialization is the term used to summarize a broad set of changes in the relation between the ‘financial’ and ‘real’ sector which give greater weight than heretofore to financial actors or motives. The term has been used to encompass phenomena as diverse as shareholder value orientation, increasing household debt, changes in attitudes of individuals, increasing incomes from financial activities, increasing frequency of financial crises, and increasing international capital mobility (see Ertürk et al 2008 for a useful collection of seminal contributions).¹²

Most authors regard financialization as one of the key components of a broader societal shift in social and economic relations from a Fordist accumulation regime to a new ‘neoliberal’ regime (e.g. Glyn 2006, Harvey 2005).

The debate on financialization is fuelled by the popular perception that finance is increasingly dominating real activity. While the exact meaning of this statement is hard to pin down, there is ample evidence that financial activity has grown faster than real activity (as measured for example by GDP). To illustrate this Figures 1 to 3 present data for the USA. Figure 1 gives

¹ The debate on financialization is one where theories lag behind societal and economic changes. It draws on different theoretical and methodological approaches. Cultural economists have highlighted the incompleteness and contradictions of the discursive strategies of financialization (Froud et al. 2006), while macroeconomists have tried to identify the conditions for viable growth regimes; economic sociologists have argued that (financial) markets have to be constructed by specific actors with specific interest (MacKenzie and Millo 2003), while post-Keynesian economists have highlighted the fragile nature of finance-led growth.

² One of the first prominent works to use the term financialization was Arrighi (1994) who identified long waves of economic development in global capitalism that involve hegemonic and geographic shifts. While the upswings of these long waves are characterized by increased manufacturing and trade activity, in the downturns a process of financialization occurs: the leading power had initially established a competitive advantage in terms of production, but it shifts towards financial activities as its growth model gets exhausted and other players catch up. In contrast to Arrighi most of the recent debate uses the term more narrowly to refer to the period since the 1970s.

the stock market capitalization and stock market turnover. From 1997 stock market capitalization exceeds GDP, rising from 58% of GDP in 1988 to 163% in 1999 (and flattening out thereafter). The rise of stock market turn over is even more spectacular in the period from 33% in 1988 to 383% in 2008. Figure 2 gives the share of financial profits and profits from abroad to total corporate profits. This share has risen from just above 12% in 1948 to a peak at 53% in 2001. Finally, financialization has come with a dramatic increase in debt levels across different sectors. Figure 3 shows the debt of households, businesses and the financial sector (as a ratio to GDP). While the business sector has increased its debt from 52% of GDP (in 1976) to 77% (2009), household debt has increased from 45% (1976) to 96% (2009), with a clear acceleration in the early 2000s. Most spectacularly, the debt of the financial sector has increased from 16% to 111% (2009).³ The popular perception of the increasing role of finance is clearly substantiated by economic data: activity on financial markets has increased faster than real activity; financial profits make up an increasing share of total profits; and households as well as the financial sector are taking on a lot more debt. The following shall explore some of the changes financialization has brought to these economic sectors.

Insert Figure 1

Insert Figure 2

Insert Figure 3

Financialization was made possible by a series of measures to deregulate the financial sector and to liberalize international capital flows. Many of these measures were themselves reactions to increasing activities on the part of private agents to circumvent financial regulation. These measures include the phasing out of controls on international capital flows, a deregulation of the type of transactions that banks are allowed to engage in, and the lifting of interest rates ceiling (on deposits as well as on credit). The new financial landscape that arose was populated by new financial institutions ranging from money market funds to private equity and hedge funds and by a seemingly untiring wave of financial innovation that led to ever new financial instruments.

A first important area of debate has been the financialization of non-financial businesses. A re-assertion of the shareholder in the form of activist institutional investors and a wave of

³ These figures refer to *gross* debt. Typically debt will be used to acquire assets. The difference between the value of the assets and gross debt is net debt. It is useful to look at gross debt as the valuation of assets that may at times change dramatically as happened in 2008/09, whereas the nominal value of debt is fixed.

mergers and acquisitions often in the form of hostile takeovers have led to what has become known as ‘shareholder value orientation’. Ideologically this was backed by theories of corporate governance that analyzed firms in terms of principle agent problems and advocated shareholder value orientation as the appropriate goal of the firm (e.g. Jensen and Meckling 1976). Firms’ goals now prominently feature the rate of return on equity. This is done by means of increasing payouts in the form of dividends and via share buy backs. Remarkably, these developments have come with lower rates of investment by firms and, at the same time, with higher debt ratios of firms. In other words, firms often have taken out loans to buy back shares to increase shareholder value.

Political Economy approaches highlight the social costs of such strategies that often involved downsizing of employment and pressure on wages. Lazonick and O’Sullivan (2000) argue that there has been a shift from what they call ‘retain and reinvest’ to ‘downsize and distribute’. Fligstein (1990) argues that financial control is a particular model of controlling an organization, thus locating the source of financialization of non-financial firms in management. In the meantime a growing empirical literature has aimed to demonstrate that increasing financial activity of non-financial firms has had a negative effect on (real) investment of these firms (Stockhammer 2004, Orhangazi 2008, Demir 2009). Shareholder value orientation seems to be most pronounced in Anglo-Saxon countries; with continental European countries moving in the same direction.

The effects of financialization on households have been as profound as those on businesses. Individuals and households have become used to relying on credit.⁴ This has involved changes in attitudes as well as changes in financial institutions and instruments, among which the widespread use of credit cards is the most obvious. Household debt levels have increased sharply since the mid 1970s. In terms of volumes mortgage credit is the most important form of credit to households in all countries. Some authors have argued that consumption expenditures in the Anglo-Saxon countries seem to be determined by changes in asset prices or in credit rather than by income (Guttman and Plihon 2010). Faced with falling savings rates (in particular in the USA) mainstream economic institutions have investigated to what

⁴ A second important area where households have become financialized is with respect to the provision of old-age retirement. Many countries have shifted from a state-provided social security scheme to an increase prominence of private, market-based provision of pensions (Langley 2004, Blackburn 2007). More generally, financialization is part of a process by which various kinds of provisions against risks and the uncertainties of the future are organized via private capital market arrangements rather than through institutional arrangements. Prime examples include the shift from publicly provided pay-as-you-go pension systems to capital-based systems. Health insurance and the financing of education are other examples.

extent consumption expenditures react to asset prices. The falling saving rates were first explained by a wealth effect due to the rise in the value of financial assets because of the stock market boom.⁵ In the late 1990s a 5% marginal propensity to consume out of financial wealth was often quoted (with some more qualification for European countries; e.g. Boone et al. 1998). The stock market crash in 2000, however, did not result in a slowdown in consumption growth. The unabated consumption boom in the USA was then explained by booming house prices. Residential property was now identified as the key source of the wealth effect as it is more frequently accepted as collateral. Case et al (2001), Catte et al. (2004), and Girouard et al. (2006) find substantially higher marginal propensity to consume out of property wealth than out of financial assets.⁶

However, the more fundamental issue is whether the increase in household debt should be regarded as part of a rational decision process or as the outcome of broader social and cultural processes. Much of the mainstream literature assumes that households rationally increased their debt ratios as their wealth increased. From a Political Economy point of view increasing household debt is the result of increasing consumption norms in the face of stagnating mass incomes (Barba and Pivetti 2009, Cynamon and Fazzari 2009). A substantial part of the accumulated debt is due to households maintaining consumption levels that are unsustainable (and thus could be considered irrational). Or of a different strategy on the part of banks. From this perspective it is misleading to speak of a wealth effect, rather it should be called a *credit access effect*.

While household debt consists overwhelmingly of mortgages everywhere, the dynamics of consumption expenditures and household debt have differed substantially across countries. In the USA the consumption share in GDP had been increasing since about 1980. The trend is similar in the UK. Notably, in many countries the strong increases in household debt ratios coincided with property bubbles. However, in Germany and France debt ratios have increased much less and consumption ratios have declined since 1980. There has been a remarkable divergence between countries.

⁵ The distribution of household debt (and of its growth) is an important, if under-researched issue. Brenner (2003, 191) argues that most of the fall in the savings rate (in the late 1990s) occurred in the top income groups, who also benefited most from the increase in financial wealth. Evidence for the early 2000s, however, suggests that the debt burden has grown fastest for middle class households (Wolff 2009).

⁶ While there is substantial evidence for the USA (albeit based on a short period of observations!) to back up this story, the evidence on European economies was always much thinner. Typically the wealth effects estimated for continental European economies were not statistically significant and/or much smaller.

Financialization has had important ramifications for the financial sector itself. First with the emergence of a shadow banking system, a substantial and growing part of the financial sector does not take the form of (traditional) banking (or insurance), but of other, typically much less regulated, institutions such as investment funds, money market funds, hedge funds, private equity funds and special purpose vehicles. This shadow banking system has also served as a motor for financialization (for an early account see D'Arista and Schlesinger 1993). One important aspect of the emergence of the shadow banking sector is financial innovation, i.e. the development of new financial instruments that often helped to circumvent traditional banking regulation. Adrian and Shin (2010) estimate that in the USA the shadow banking system is now as large as the regular banking sector (measured in terms of assets). Second, within banking this development has led to a shift towards fee-generating business rather than traditional banking that generates income as a result of the interest differential between rates on deposits and on loans. Part of this has been the emergence of what has been called the originate-and-distribute model of banking (in particular in the USA), where mortgages were quickly sold in the form of asset backed securities. Thirdly, within banking there has been a shift to lending to households rather than to firms. In particular mortgages are now by far the largest loan positions (Ertürk and Solari 2006, Lapavitsas 2008).

Supporters of financial deregulation have argued that financialization will provide a superior way of dealing with risk; e.g. securitization was supposed slice risk into different parts (by means of different securities) and allocate it to those who were best equipped to hold it. The financial system would thus be more stable (e.g. IMF 2006, 51) and society better off. In contrast Keynesians have long argued that financial markets are intrinsically unstable and tend to generate endogenous boom-bust cycles (Minsky 1986). More recently, they have highlighted conflicts of interest and the dangers of the belief that risk could easily be sliced by means of looking at past correlations (Aglietta and Rebérioux 2005, Crotty 2009). The crisis of 2008/09 has shaken the optimistic liberal outlook somewhat, but its impact on economic debates is not yet clear.

3. Financial globalization

Financialization has also had important effects along the international dimension. The liberalization of international capital flows has led to increased volatility of exchange rates, often culminating in violent exchange rate crisis. This has led to a rich debate on the effects

of capital flows liberalization or, more broadly, of financial globalization.

The argument in favor of financial globalization is based on standard neoclassical economics and argues that financial globalization would allow capital to be allocated to its most efficient use. In particular it would benefit developing countries. Two important implications of this argument are that one would expect capital flows from rich to poor countries and that there be a positive correlation between indicators of financial globalization and growth. This approach had been advocated by McKinnon and Shaw and recently by Mishkin (2006). It has informed economic policy around the globe, in particular in the form of IMF programs imposed on developing countries. However, financial globalization has clearly not lived up to expectations. On average capital has been flowing ‘uphill’, i.e. from poor to rich countries. And even within the mainstream it is now accepted that “the majority of studies are unable to find robust evidence in support of the growth benefits of capital account liberalization” (Kose et al 2006). While true believers still defend financial globalization on the grounds that the benefits do materialize indirectly (Kose et al 2006) and would show up in the future (Mishkin 2009) or if only more sophisticated methods were used (Henry 2008), the empirical evidence for lack of positive growth effects is rather solid (Rodrik and Suramanian, 2009; earlier: Stiglitz 2000).

In contrast to the liberal vision, financial globalization and liberalization seems to have led, firstly, to frequent exchange rate crises driven by volatile capital flows and, secondly, to long-lasting international imbalances. First, as a consequence of financial globalization exchange rate movements are increasingly determined by capital flows rather than by economic fundamentals such as current account positions. Indeed episodes of massive capital inflows followed by sudden and sharp capital flow reversals resulting in exchange rate crises have been a common feature in particular for emerging and developing countries (Epstein 2005, Reinhart and Reinhart 2008). The macroeconomic dangers of volatile capital flows have so far been felt most acutely in emerging economies. Mexico 1994, Turkey 1994 and 2001, several countries in the course of the South East Asian crisis 1997/98, and Argentina 2001 are all examples of such crises related to capital flows. All of them have led to severe recessions (at times with double digit declines in real GDP), some of them long-lasting, others more short-lived.⁷ However, the EMS crisis 1992/93 also shook developed economies.

⁷ The fact that some countries recover quickly after a deep recession, does not imply that everything returns to pro-crisis. Onaran (2009) argues that financial crises often lead to lasting changes in functional income distribution.

The reason why changes in the exchange rate have such a devastating effect is that in liberalized international markets it is usually profitable to engage in interest arbitrage, that is borrow in one currency and invest or lend in another (often called carry trade). If, say, interest rates in Turkish Lira are higher than those in Euros (with exchange rates expected to be stable), it is tempting to take out a euro credit and lend in Turkish lira. By implication, assets and liabilities will then be denominated in different currencies. Abrupt exchange rate realignments may then have disastrous effects on firms' or banks' balance sheets.

Second, the liberalization of capital flows has also allowed countries to sustain current account deficits (or surpluses) at higher levels and for a longer time than during the Bretton Woods system.⁸ The flip side of the current account is net capital flows: (abstracting from changes in Central Bank reserves) net exports have to equal (net) capital outflows. Financialization has thus allowed countries to run larger current account deficits, provided that they can attract the corresponding capital inflows. Financial liberalization and globalization have, ironically, increased the potential for different developments across countries – if only as long as international financial markets remain calm. Typically the revaluation on financial market has come abruptly with capital flow reversals and exchange rate crises.

In the run up to the financial crisis 2008/09 the USA, the UK, Ireland and Greece ran large current account deficits, whereas Germany, Japan and China had large surpluses. International imbalances have played a prominent role in the debate on the causes of the 2008/09 crisis, but they can be associated with quite different theoretical interpretations. Bernanke (2005) coined the term 'savings glut', which argued that forces outside the USA have been the main driving force behind the US current account deficit. Politically this has served to shift the blame on China.⁹ Indeed, there were massive capital inflows to the USA, mostly from (Asian and OPEC) developing countries. After the South East Asian financial crisis, several Asian countries (notably China) pursued a strategy of undervaluation, which has proven quite

⁸ Financialization is part of the globalization of production. International production networks require international financial transactions and, in a setting with market-determined exchange rates, have given rise to various instruments to hedge against exchange rate variations. Foreign direct investment and its associated income flows will show up at financial income (e.g. in the form of dividends paid by a foreign subsidiary (Milberg and Winkler 2009).

⁹ While the imbalances argument has politically supported pressure on China to change its *exchange rate policy*, there has been surprisingly little pressure on Germany, the other big surplus country, to alter its *wage policy*. Arguably, Germany wage suppression is one of the root of 2010 Euro crisis (Lapavitsas et al 2010).

effective from a development perspective (UNCTAD 2008). The question whether these inflows have been forced onto the USA or whether they have rather been sucked in by the US financial sector is difficult to establish. But the savings glut hypothesis certainly downplays the dominant role of US institutions in the world economy, in particular the massive financial engineering that had been going on.

4. A finance-dominated accumulation regime? – Financialization and economic performance: growth, distribution and stability

Financialization and financial globalization have changed economic actors, their goals and their constraints. There is an ongoing theoretical debate on the characteristics of a ‘finance-led’ or ‘finance-dominated’ accumulation regime (e.g. Boyer 2000, van Treeck 2009, Hein 2011). To conclude, we assess the impact of financialization on economic performance, income distribution and stability. Our assessment is that the finance-dominated accumulation regime has been characterized by a sluggish overall economic performance with increasing financial fragility due to rising debt levels. But due to persistent international imbalances the specific effects have been quite different across countries.

Stockhammer (2010) argues that financialization has given rise to two different growth models: a consumption-driven growth model (mostly in Anglo-Saxon countries) and an export-oriented growth regime in other countries (such as Germany and Japan), both of which are explained as the results of the interaction of trends in the polarization of income distribution and of financialization. In Anglo-Saxon countries the shortfall of disposable income has been compensated by credit and increasing debt levels. The property boom allowed households to take out loans that they could not afford given their income, but that seemed reasonable to banks which assumed that property prices would continue to increase. These countries developed a *credit-financed consumption boom* that came with current account deficits. The resulting capital inflows again fuelled the property bubble and bubbles in other financial markets. In the second group of countries median working-class households faced a similar stagnation in wages. In these countries private consumption expenditures remained weak. Here net exports played the key component of demand growth. Thus these countries developed an *export-led growth model*.

Financialization also has had profound effects on income distribution. At least three channels

have been discussed in the literature. First, there has been rise of what is often called ‘rentiers income’, i.e. interest and dividend income as well as capital gains, has been well documented (Powers et al. 2003, Duménil and Lévy 2001). Second, the rise of incomes in the financial sector, most notably in the form of bonuses, has widened income disparity. Third, financialization seems to have shifted the power balance between capital and labour in a variety of ways ranging from changes in corporate governance to the increased range of possibilities opened to firms by financial globalization (ILO 2008). Several studies have found econometric evidence that financial globalization has led to a decline in wage shares (Jayadev 2007, Stockhammer 2009).

The debate on the effects on financialization on economic (and financial) stability is characterized by a strange schizophrenia. On the one hand there has been a series of major crises since financialization began that have obviously been related to the financial sector: the debt crisis in 1982, the Savings & Loans crisis in the USA in the 1980s, the EMS crisis 1992/92, the Peso crisis 1994, the Asian Crisis, the Dot.com bubble and finally the crisis of 2008/09; on the other hand a mainstream literature has declared this period one of increased stability, often referred to as the Great Moderation, which has given rise to substantial and technically sophisticated literature. The Great Moderation hypothesis, of course, has been called into question by the 2008/09 crisis.

To illustrate how this literature has missed the elephant in the room: IMF (2007c) presents evidence that business cycles have become more *moderate* since the 1970s: “output volatility (...) has been significantly lower than during the 1960s” (IMF 2007c, 85). Naturally, one would assume that this means that crises have become milder and less frequent. However, according to IMF (2002, Table 3.1) recessions have become *deeper* in the Post-Bretton Woods era than in the Bretton Woods era. How is this possible? As output growth (and expansions) was much higher in the Fordist era than in the post-Fordist era, volatility has indeed decreased while crises become harsher.¹⁰ But this does not mean that recessions have become less severe! Indeed, financial crises have become more frequent and more severe (Eichengreen and Bordo 2003, Reinhart and Rogoff 2009).

¹⁰ In discussing the question of stability it is important to note that by historical standards all developed economies are still characterized by big government: automatic stabilizers are in place and government consumption forms a sizable part of value added. The resilience of a sizable government sector and (by historical standards) a functional welfare state combined with active monetary policy may be a reason, why financial crises have so far not had a devastating effect on (advanced) economies (Stockhammer 2008).

The crisis 2008/09 has been the deepest crisis of capitalist economies since the Great Depression. It should be obvious that its causes are deeply connected with the processes of financialization and financial globalization. Whether the brutal return of financial instability to the capitalist centers marks the beginning of the end of financialization or the return to an unstable financialized normality of liberal capitalism will be subject of political struggles.

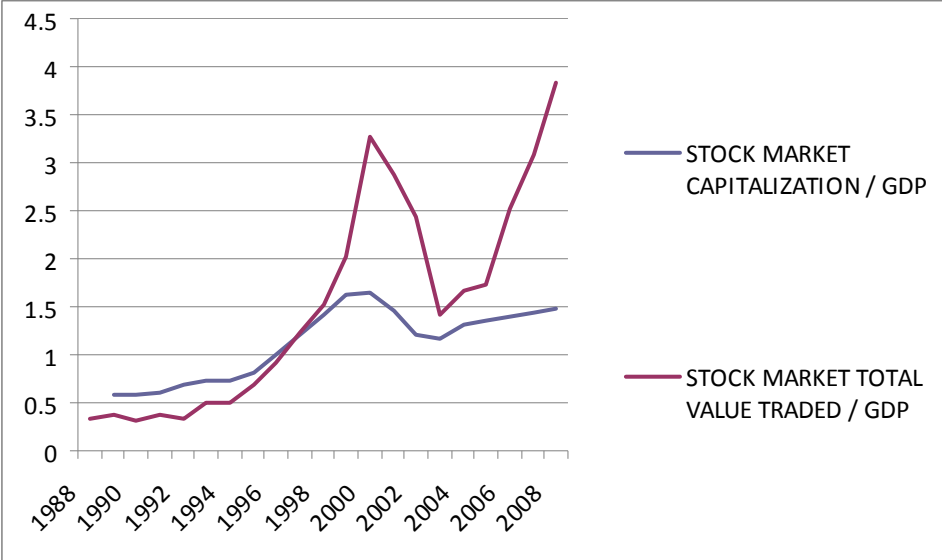
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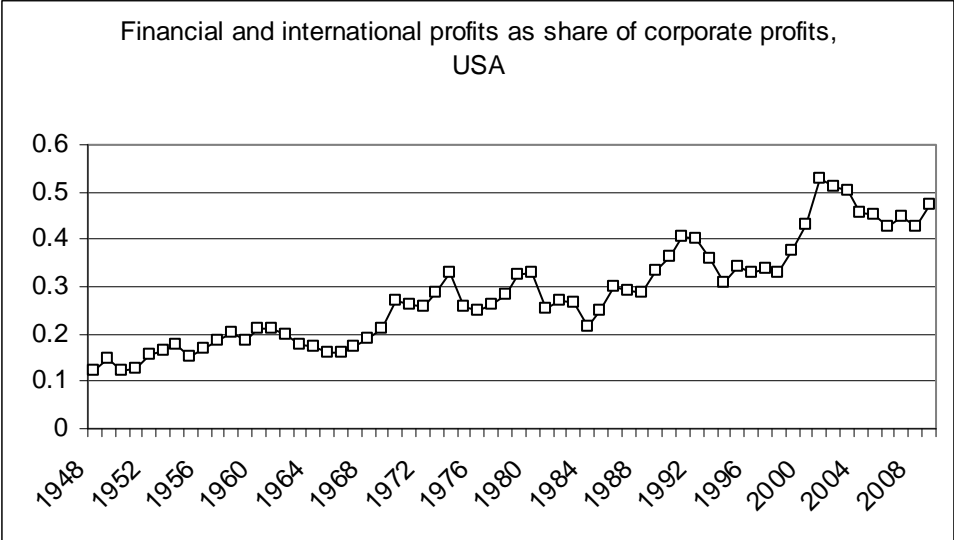
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Figure 1. Stock market capitalization and value traded as a ratio to GDP (USA)



Source: Worldbank Financial Structure data set

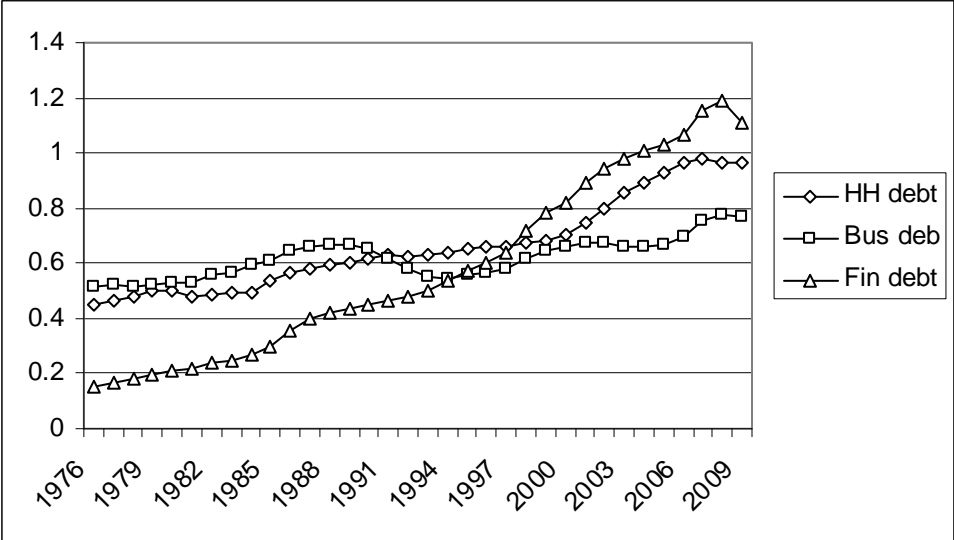
Figure 2. Financial and international profits as share of corporate profits



Source: BEA NIPA, Table 6.16B-D

Note: Financial and international profits includes domestic financial profits and (net) profits from abroad as share of corporate profits (with inventory valuation and capital consumption adjustments). There is a (minor) break in the series in 2001.

Figure 3. Debt of Households, businesses and financial sectors (as ratio to GDP), USA



Source: FED Flow of Funds, Table D.1