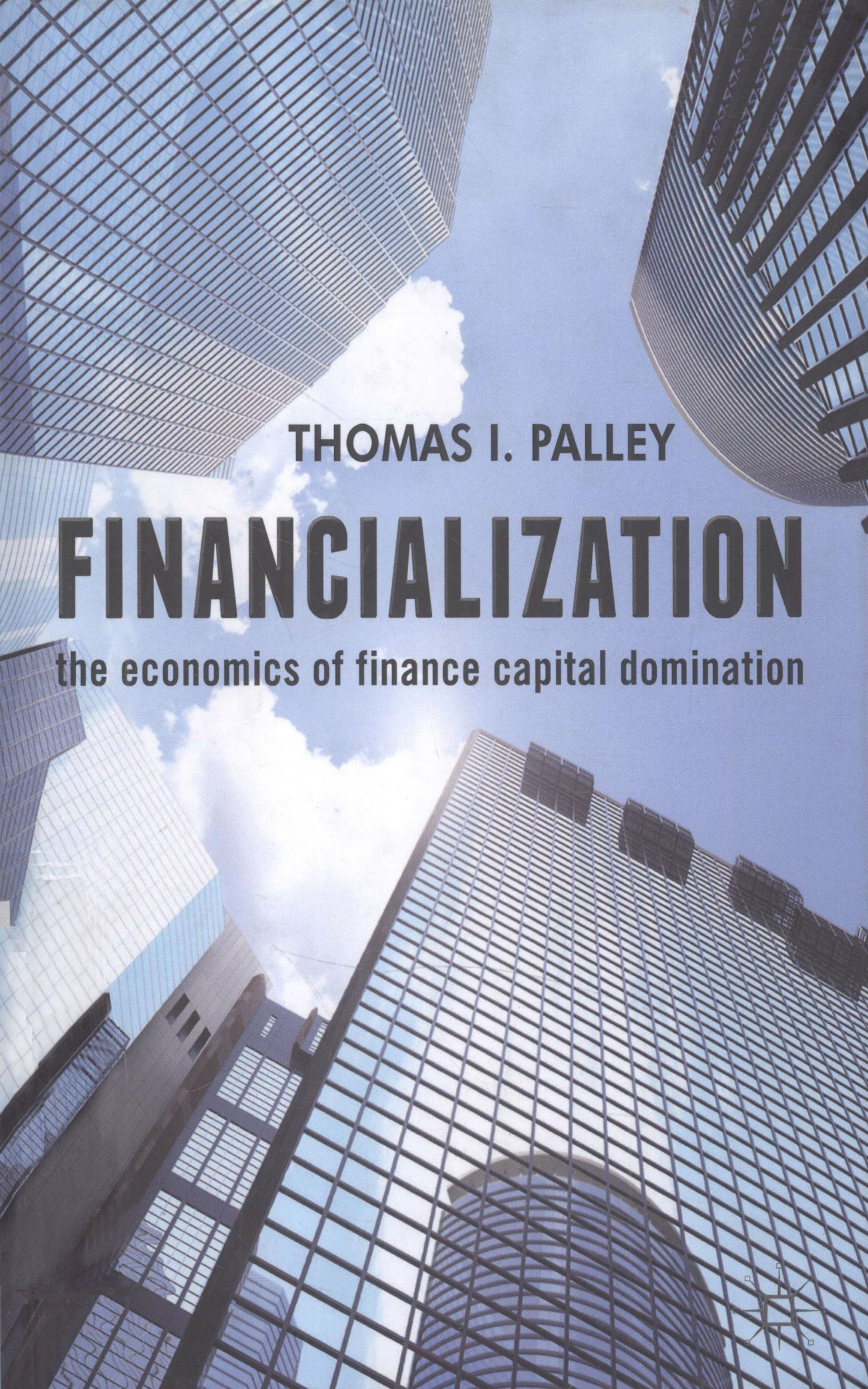

THOMAS I. PALLEY

FINANCIALIZATION

the economics of finance capital domination

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Overview: Financialization as Financial Neoliberalism

This book is about financialization, a term that has become popular to describe developments over the past 30 years within the global economy, and particularly within developed industrialized economies. Seen in that light, financialization represents the most recent stage of capitalist economic development.

Krippner (2004) provides a history of the term "financialization," and describes one definition as the dominance of the shareholder value model of corporate governance. Krippner (2005, p.174) also offers her own definition as "a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production." Epstein (2004, p.3) defines it as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies."

A simple alternative definition is that financialization corresponds to financial neoliberalism which is characterized by domination of the macro economy and economic policy by financial sector interests. According to this definition, financialization is a particular form of neoliberalism. That means neoliberalism is the driving force behind financialization and the latter cannot be understood without an understanding of the former.

1.1 Neoliberalism

Neoliberalism is both a political and economic philosophy (Palley, 2012; Chapter 2). As a political philosophy, it maintains that a *laissez-faire* deregulated market economy is the best way to promote individual freedom; as an economic philosophy, it maintains that a *laissez-faire* deregulated market economy is the best way to promote economic efficiency and economic well-being.

In the language of economists, such market arrangements promote Pareto optimal outcomes in which it is impossible to make someone better off without making someone else worse off. The claim is that resources are used in a productively efficient way (that is, production takes place at minimum cost so that it is impossible to produce the existing output at existing prices using less input), and that all opportunities for mutually beneficial exchange are used so that no gains from trade are missed. Consequently, it is impossible to either reorganize production or change the pattern of exchange so as to make people better off. Note, this does not mean outcomes are fair. The actual outcome will depend on the initial distribution of resources, and if the initial distribution is unfair the final outcome will be unfair. The important point is that the final outcome cannot be improved upon without making someone worse off.

1.2 The special standing of financial markets in modern neoliberal economics

Neoliberalism elevates the standing of markets which are argued to coordinate economic activity in an optimal fashion. Moreover, market behavior is deemed applicable to almost all walks of life. Where markets exist, the presumption is they should be deregulated, and where markets do not exist they should be created if possible. The market is viewed as the pre-eminent institution of social organization and coordination.

Financialization (financial neoliberalism) singles out financial markets and gives them special elevated standing. First, financial markets are held up as the ideal market. The claim is financial markets clear continuously via rapid price adjustment and are stable, and financial prices embody all economically relevant available information.

Second, financial markets are given a special economic role regarding the allocation of saving; the promotion of capital accumulation; the reallocation and spreading of risk; and as an instrument of corporate control. With regard to the allocation of saving, financial markets transfer saving from surplus economic units (savers) to deficit units (borrowers). This is the traditional microeconomic interpretation of financial intermediation. In neoclassical macroeconomics this role is played by the loanable funds market. The transfer of savings to deficit spending units supposedly counters the Keynesian problem of deficient aggregate demand. Financial intermediation, performed by banks and the loanable funds market, therefore ensures full employment. It also increases growth by allocating saving to those who will use the resources most productively and generate the highest returns. Furthermore, financial intermediation increases saving and investment as the higher returns earned from lending make saving more attractive.

Another way in which financial markets increase capital accumulation and income is through creation of liquid asset markets in which assets are readily traded and efficiently priced. The existence of liquid asset markets means that instead of holding unproductive money, economic agents can direct their income to the accumulation of productive assets that raise income and growth. They are more willing to accumulate capital in place of money because they know capital assets can, if needed, be readily sold and realized at reasonable values.

The existence of liquid asset markets in which assets can be readily transferred and sold at reasonable values also means that assets can more easily serve as collateral. Moreover, entrepreneurs are more willing to pledge assets as collateral because they are more confident that they will get a fair price should the collateral need to be realized. In this fashion, liquid asset markets effectively increase the supply of entrepreneurship, which also increases investment and growth.

Another function of financial markets is the reallocation and spreading of risk. One way of doing this is via insurance. Traditionally, insurance has focused on catastrophe insurance, but modern financial markets expand the scope of insurance through arrangements such as futures markets that enable producers to hedge income streams and input costs. The resulting ability to manage risk in turn makes producers more willing to undertake risky productive activity as they can purchase protection against the additional risk.

Catastrophe, income, and cost insurance have been the traditional risk management function of financial markets. However, taking the lead from Markowitz (1959) and Tobin (1958), modern neoclassical economics emphasizes wealth and income risk reduction via portfolio management. Liquid financial markets enable economic agents to buy financial assets with different risk–return properties. By appropriately combining assets (following the principle of "not putting all one's eggs in one basket") agents can form diversified portfolios that reduce risk. Such portfolio formation makes agents better off by reducing risk while holding expected returns constant. That in turn allows them to finance more productive risky assets relative to what they would be willing to do in a world without financial portfolios.

Adding new financial assets with different risk–return characteristics increases the opportunities for efficient portfolio formation. In terms of the Arrow–Debreu (1954) state contingent general equilibrium model, adding new financial assets effectively plugs missing markets by making available income streams for state outcomes in which income could not previously be purchased. That expands the set of possible trades, and enables more risk diversification, again making agents better off. Such reasoning provides a rationalization for financial innovations that introduce new financial assets, and this rationalization has been invoked to justify the creation of financial assets such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Such financial innovations also increase the liquidity (tradeability) of financial assets, increase the ability to collateralize assets, improve risk spreading, and increase the elasticity of finance for investment.

Lastly, financial markets provide an instrument of corporate control. Modern corporations are run by managers rather than shareholders, which creates a principal–agent problem. The core problem is that the managers (the agent) may not run the corporation in the best interests of the shareholders (the principal), by failing to maximize the net present value of the firm. Financial markets can provide a managerial discipline device by providing a market for control (Jensen and Meckling, 1976). Thus, where managers are falling short, activist investors can buy stock, acquire control of the firm, and replace the existing managers with other managers who run the firm in the best interests of shareholders. This is the basis of the shareholder value maximization model that Krippner (2004) defines as financialization.

1.3 The impact of financialization

The era of financialization has been marked by an enormous increase in the size of the financial sector. The economic justification for this expansion rests on the types of arguments presented above. The expansion of the financial sector has also been accompanied by significantly changed income distribution, and Figure 1.1 illustrates the pattern of change. Gross domestic product (GDP) can be decomposed into capital's and labor's share, and financialization has seen an increase (+) in capital's share and a decrease (−) in labor's share. Labor's share can in turn be decomposed into managers' share (salaries and other forms of compensation) and non-managers' share, and financialization has seen an increase (+) in managers' share and a decrease (−) in non-managers' share. Capital's share can be broken down into profits and interest income, and profits can be decomposed into financial sector and non-financial sector profits. In addition to seeing an increase in capital's

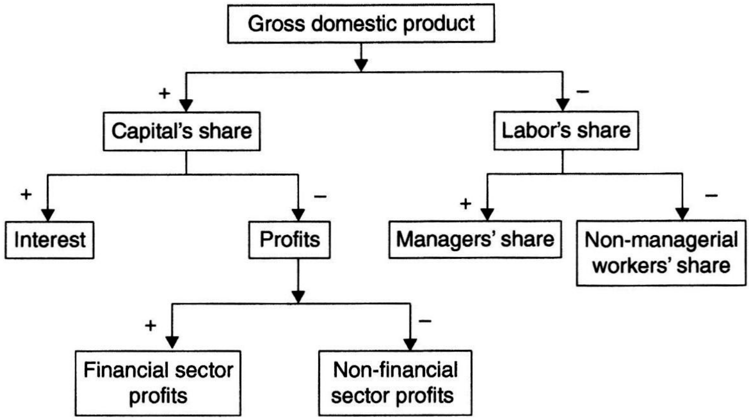

Figure 1.1 Financialization and the distribution of income

share and a decrease in labor's share, the era of financialization has also seen significant change in the composition of capital's share, with the profit share falling and the interest share rising. Furthermore, there has also been an increase in the financial sector's share of total profits and a decrease in the non-financial sector's share.

Neoliberalism is an ideology of elite interests, and it serves to shift economic power and income from labor to capital. Financialization reinforces this shift and further changes the distribution of income at a more disaggregated level by increasing the managers' share of the wage bill, increasing the share of interest income, and increasing the financial sector's share of profit income. These outcomes are the result of profound changes in the structure of the macro economy, and it is those changes which are the focus of this book.

The 30 years after World War II can be viewed as the era of Keynes. In the late 1970s economic policy turned in a neoliberal direction, and the triumph of neoliberalism is symbolized by the election victories of Mrs. Thatcher in the UK in 1979 and Ronald Reagan in the USA in 1980. The Keynesian era economic growth model can be characterized as a virtuous circle in which wage growth drove aggregate demand growth. The key features of the model were full employment combined with a wage system that tied wage growth to productivity growth. The logic was as follows. Productivity growth drove wage growth, which fuelled demand growth and created full employment. That provided an incentive for investment, which drove further productivity growth. This

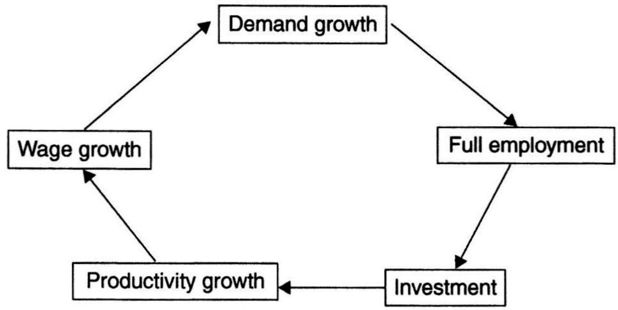

Figure 1.2 The Keynesian era virtuous circle growth model

model is illustrated in Figure 1.2, and it held in one form or another throughout much of the global economy – the USA, Europe, Canada, Japan, Australia, Mexico, Brazil, and Argentina.

After 1980 the virtuous circle Keynesian growth model was replaced by the neoliberal growth model. The key changes were (1) abandonment of the commitment to full employment, which was replaced by a focus on low inflation, and (2) severing of the link between wages and productivity growth. The new growth model made credit and asset price inflation the engines of demand growth, replacing wage growth as the engine of demand growth.

The neoliberal economic model weakened the position of workers and strengthened the position of corporations. It also uncuffed financial markets to serve the interests of financial and business elites. Reliance on debt and asset price inflation put financial markets at the center of the economic process, and hence the notion of financialization or financial neoliberalism.

Within the new model, finance plays three critical roles. First, it is critical to the aggregate demand generating process. Second, it is part of the mechanism for redistributing income between profits and wages. Third, financial sector interests guide economic policy, shaping regulatory policy, macroeconomic policy and international economic policy.

The neoliberal model undermined the income and demand generation process by shifting income from wages to profits and by widening wage inequality. That created a growing structural aggregate demand (AD) gap, and the role of finance was to fill that gap. Financial deregulation, financial innovation, speculation, and fraud enabled finance to fill the demand gap by lending to consumers and by inflating asset prices. However, three things should be emphasized. First, this role of finance was not part of a grand plan, but was instead an unintended consequence; neoliberal economists and policymakers did not realize they were a creating a demand gap, but their *laissez-faire* financial ideology let loose financial sector developments that accidentally filled the demand gap. Second, the process was inevitably unstable and always destined to stall. There are limits to borrowing and limits to asset price inflation, and every Ponzi scheme comes apart eventually. The problem is that it is impossible to predict when: all we know is that it will end. Third, the process went on far longer than anyone expected. As a result, the collapse was far deeper when it eventually happened in 2008.

When the financial crisis hit in 2008, after considerable delay policymakers were successful in stabilizing the system and preventing a second Great Depression. The 2008 and 2009 bailout of banks and provision of emergency liquidity put a floor underneath the financial system and stopped the run (that is, the flight from financial assets) that threatened to bankrupt the system. Simultaneously, the fiscal stimulus packages of 2009 shored up AD and put a floor underneath the real economy.

These measures stabilized the system but they did not reform the structure of the economy. The financial crisis of 2008 symbolized the exhaustion and implosion of the neoliberal model. In the wake of the crisis, financial markets are no longer willing to finance the credit and asset price excesses that filled the demand gap and drove the system for so long. Moreover, the economic system is burdened by three major structural problems. First, there is a debt hangover from past borrowing that negatively impacts AD. Second, there are the scars of the financial crisis and recession in the form of destroyed creditworthiness, reduced collateral values, and diminished animal spirits. Third, the economy is still afflicted by the structural demand gap caused by deteriorated income distribution. Consequently, the prognosis is one of prolonged economic stagnation.

1.4 The paradox of explaining financialization

Economic policy has been critical for the implementation of financial neoliberalism, and economic theory has provided the justification for economic policy. The expansion of financial markets was approved and facilitated by policymakers, and their policy actions were justified by appeal to the types of arguments about the benefits of financial markets made in Section 1.2.

This introduces a paradoxical twist. Orthodox neoclassical economic theory provides the justification for financialization, yet the actual real