University of Helsinki, 1 October 2010

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Macroeconomic aspects of “financialisation“

Till van Treeck,

Macroeconomic Policy Institute (IMK), Duesseldorf, Germany

Research Network Macroeconomics and Macroeconomic Policies (FMM)

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- **Yearly academic conference in Berlin during the last weekend of October (ca. 200 participants)**
- **Bi-annual Summer School on Keynesian Macroeconomics and European Economic Policies**
- **www.network-macroeconomics.org**

Structure of the presentation

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- Common views about “financialisation” in the political economy literature
- Some stylised facts: The “financialisation” of the US economy
- Theoretical rationale for financial deregulation
- Microeconomic and macroeconomic risks of “financialisation”: mainstream and Post Keynesian perspectives
- “Financialisation” and the world economic crisis

Structure of the presentation

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- **Common views about “financialisation” in the political economy literature**

Financialisation: “Profits without investment“ and decoupling of financial sphere from real economy?

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- „Among the manifestations of this lack of control over management [in the Fordist period, TvT] were the pursuit of market share and growth at the expense of profitability.“ (OECD, 1998, p. 17)
- ‘shareholder-oriented restructuring promotes profitability by slowing down growth’ (Höpner, 2005)
- „financialization (is) a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production (see Arrighi, 1994).“ (Krippner, 2005: 174)
- „Nonfinancial firms responded to falling returns on investment by withdrawing capital from production and diverting it to financial markets“. (Krippner, 2005: 182)

Financialisation as a “variety of capitalism”?

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- „Conversely, where firms are more dependent on dispersed equity markets, face the prospect of hostile takeovers, and confront regulations that give shareholders more power relative to stakeholders, the autonomy of the firm and its managers will be more dependent on current profitability. Here, labor markets allowing for high levels of labor turnover and competitive wage-setting will be more efficient, because they enable managers to reduce wages or staffing levels more quickly in response to fluctuations in current profitability, and allow the kind of labor relations that permit firms to exploit the high levels of capital mobility available in such economies. This combination of institutional practices corresponds to the case of a classic LME.“ (Hall and Gingerich, 2004: 23)

Business profits, investment & stock market, USA, since 1960

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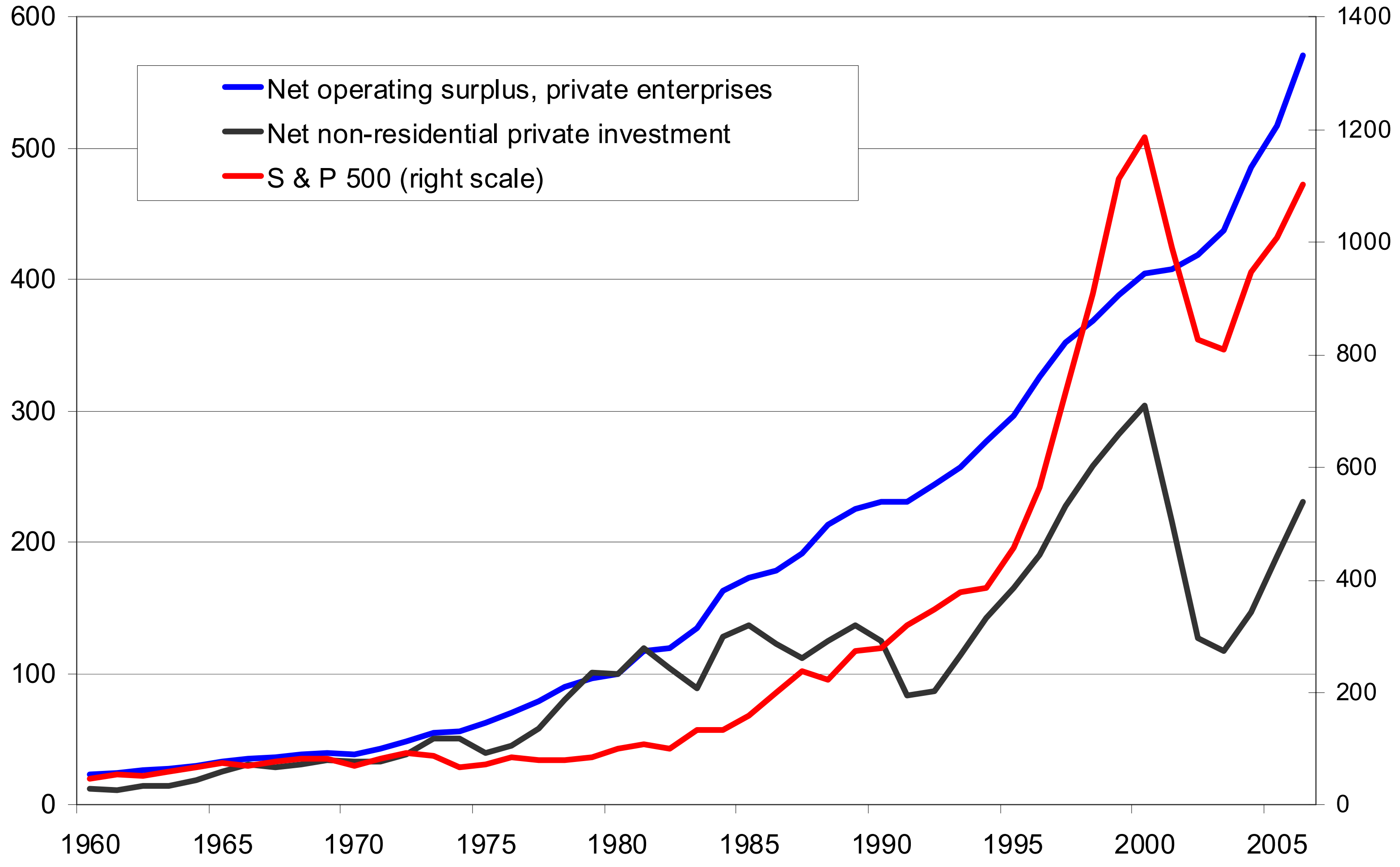
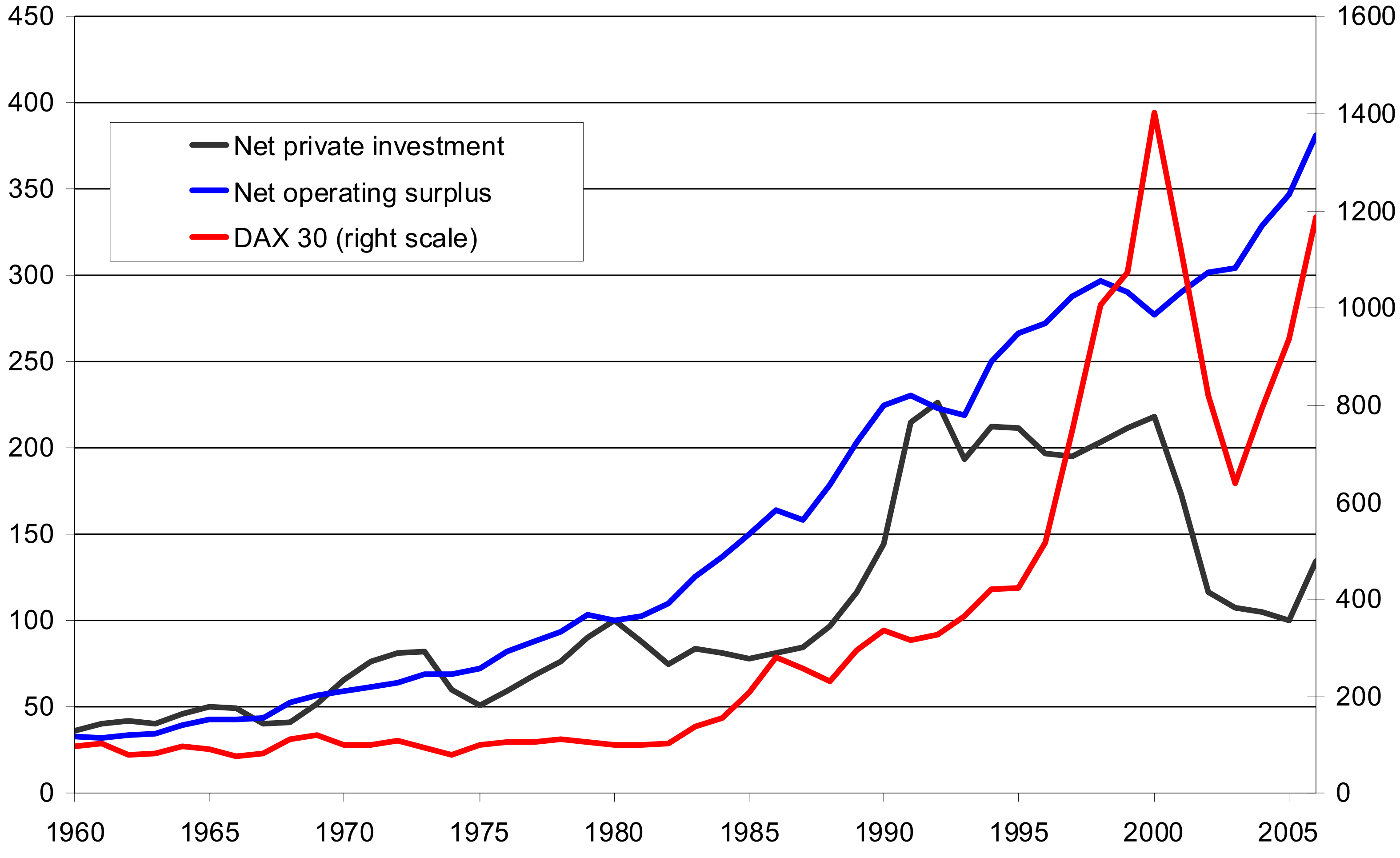


Business profits, investment & stock market, Germany, since 1960



Some macroeconomic constraints

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- At the firm level, there may be an inverse relationship between profitability and accumulation
- But at the macroeconomic level, we have:
  - Profits = Investment + Consumption out of profits – Savings out of wages + Government deficit + External surplus
- And why is it that most LMEs had current account deficits?
  - Private financial balance + Government financial balance + Foreign financial balance = 0

“Profits without investment“?

- **Income = Profits + Wages**
- **Production = Investment + Consumption**
- **Income = Production**
- **Profits = Investment + Consumption – Wages**
- **Profits = Investment + Consumption out of profits – Savings out of wages**
- (Open economy with state:
- Profits = Investment + Consumption out of profits – Savings out of wages + Government deficit + External surplus)

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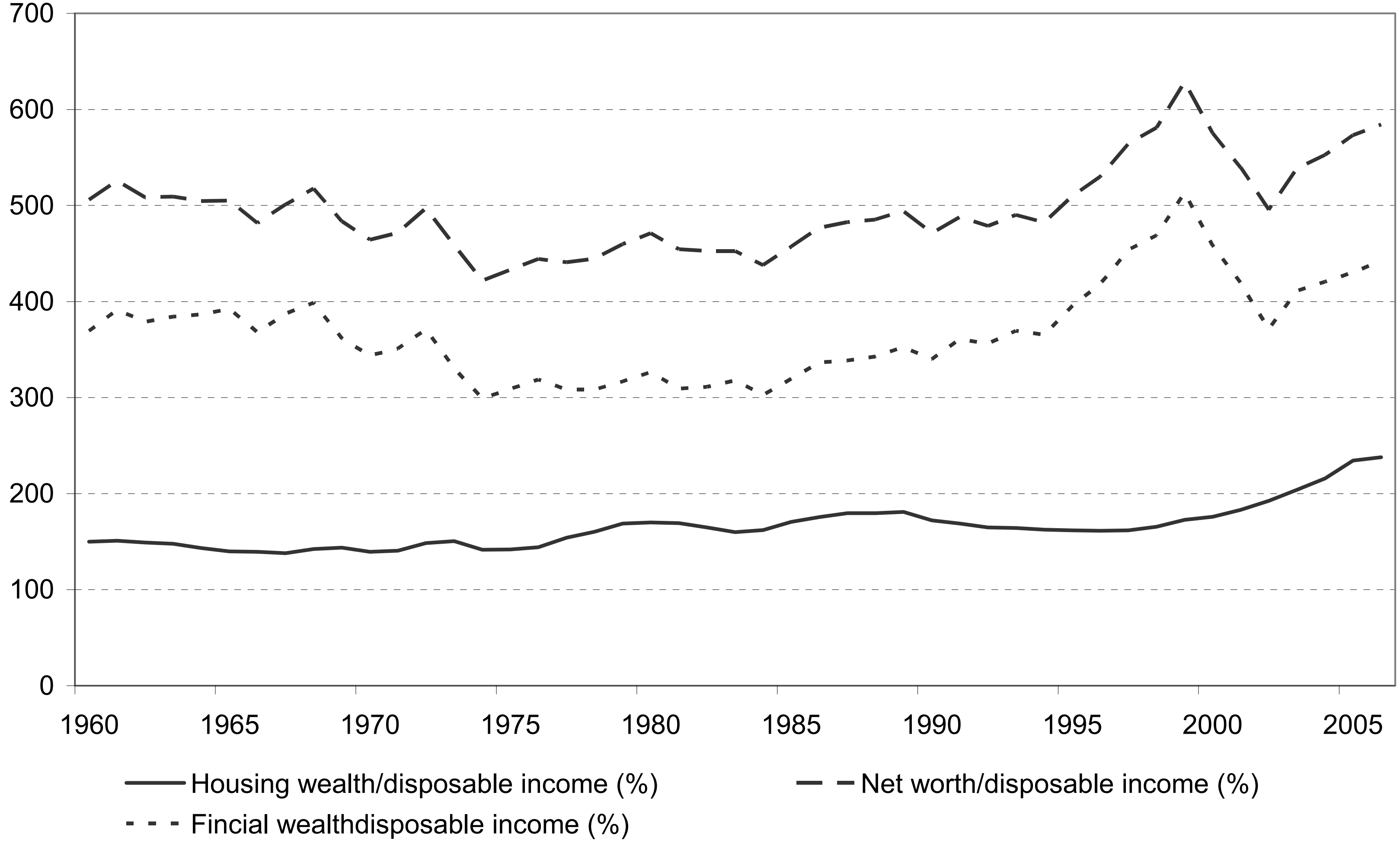
Wealth-to-income ratios, USA, since 1960



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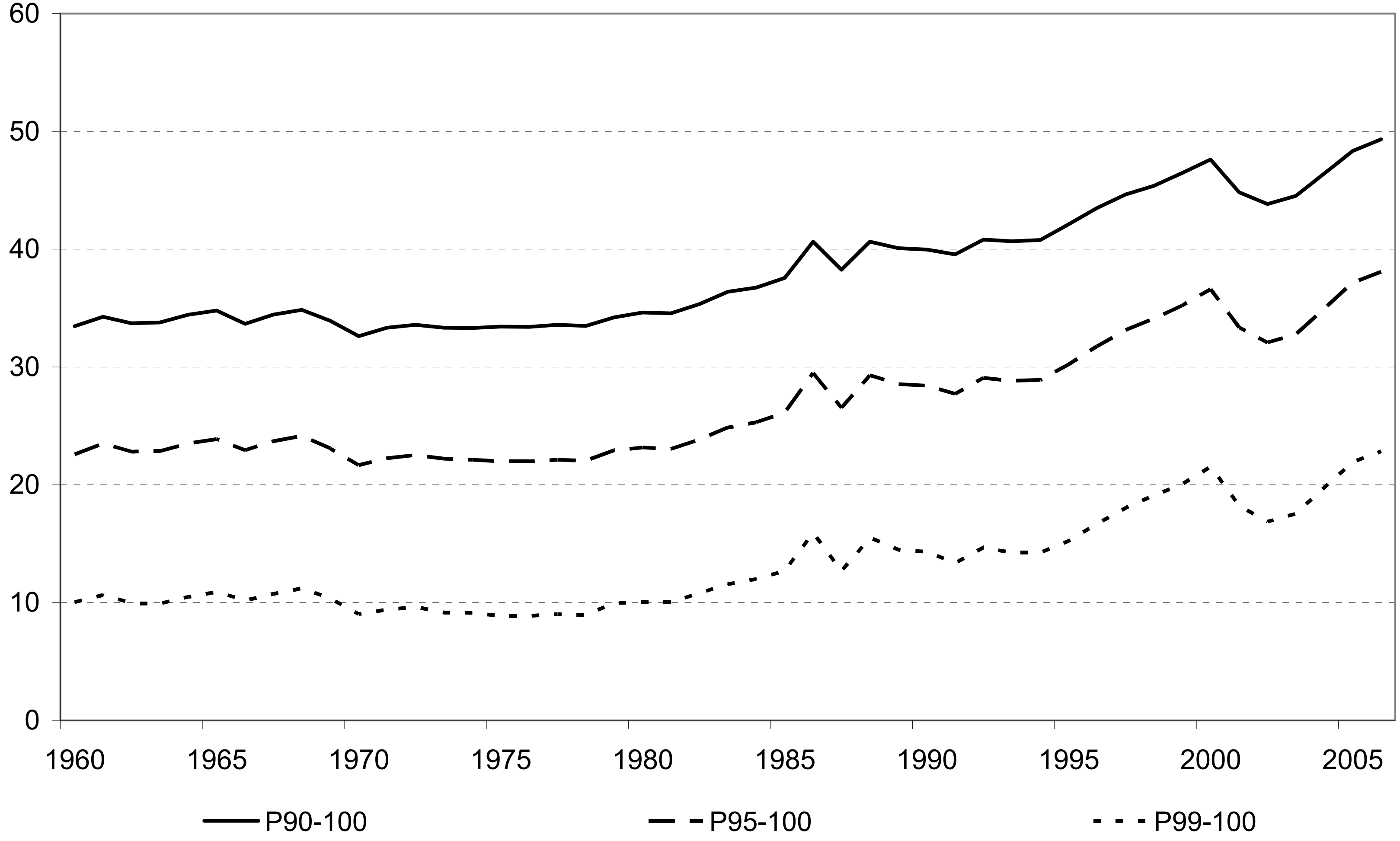
- **Some stylised facts: The “financialisation” of the US economy**

Highest income shares, USA, since 1960



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Saving rate & debt-to-income ratio, USA, since 1960

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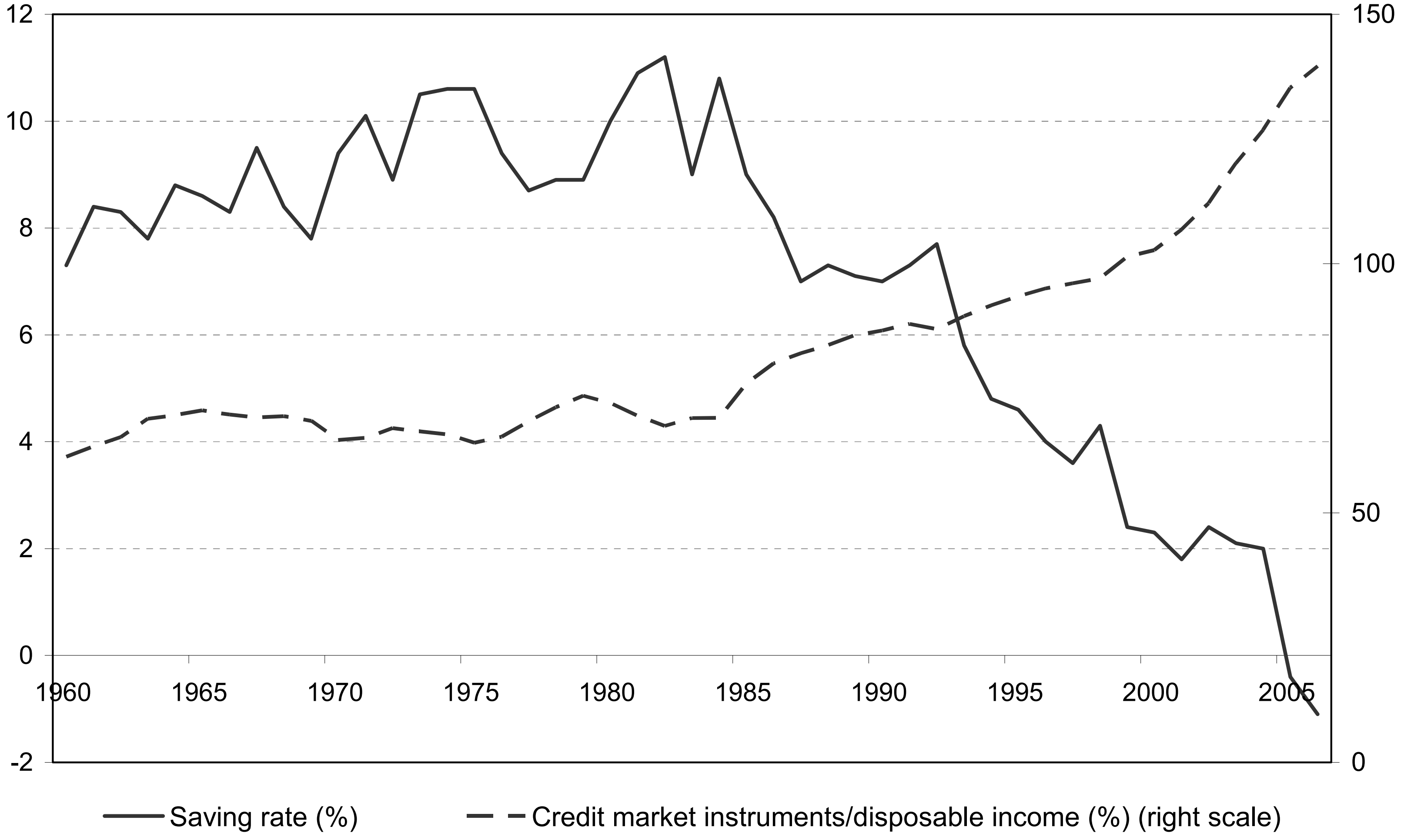
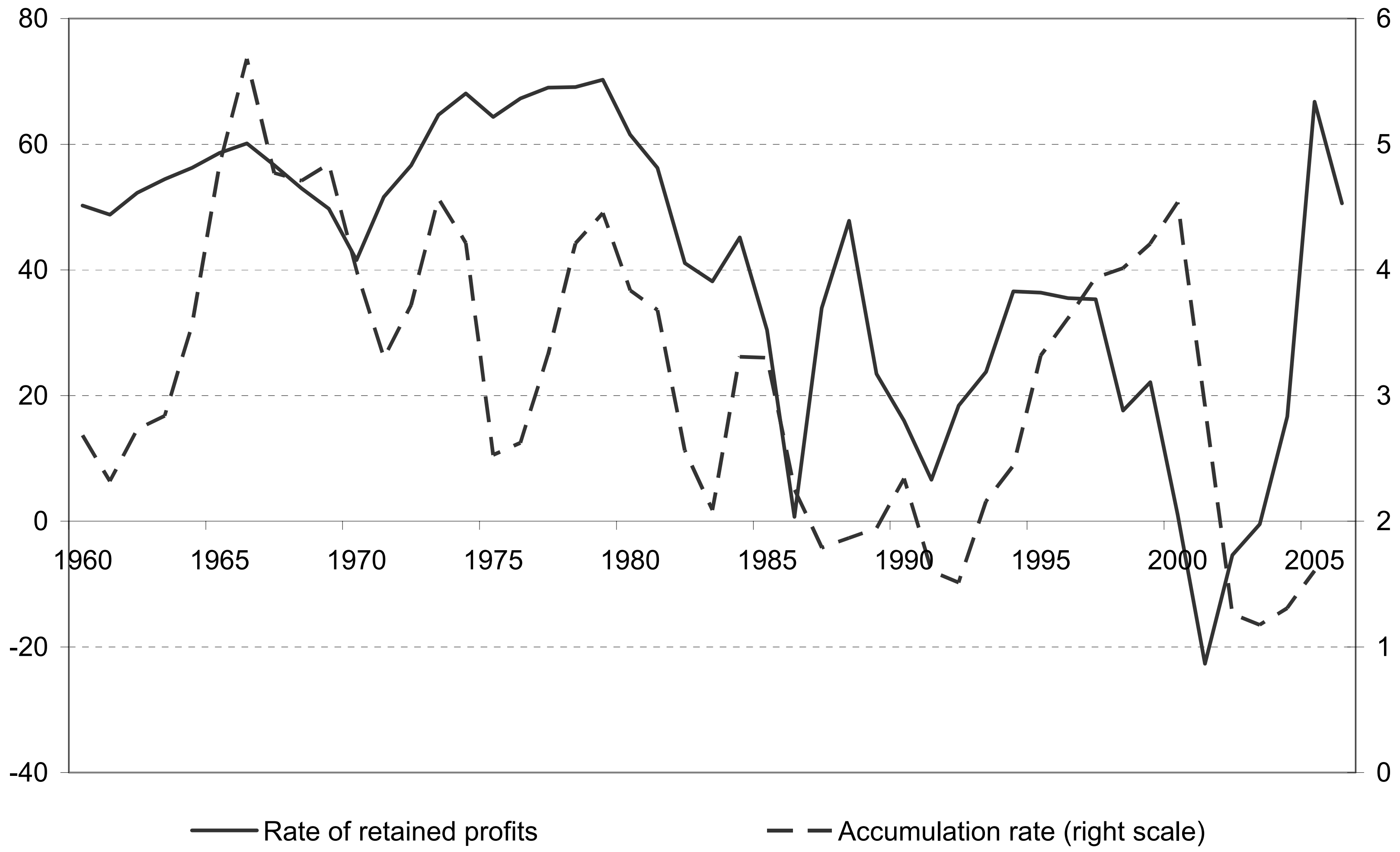


Growth rate of capital stock & rate of retained profits, USA, since 1960



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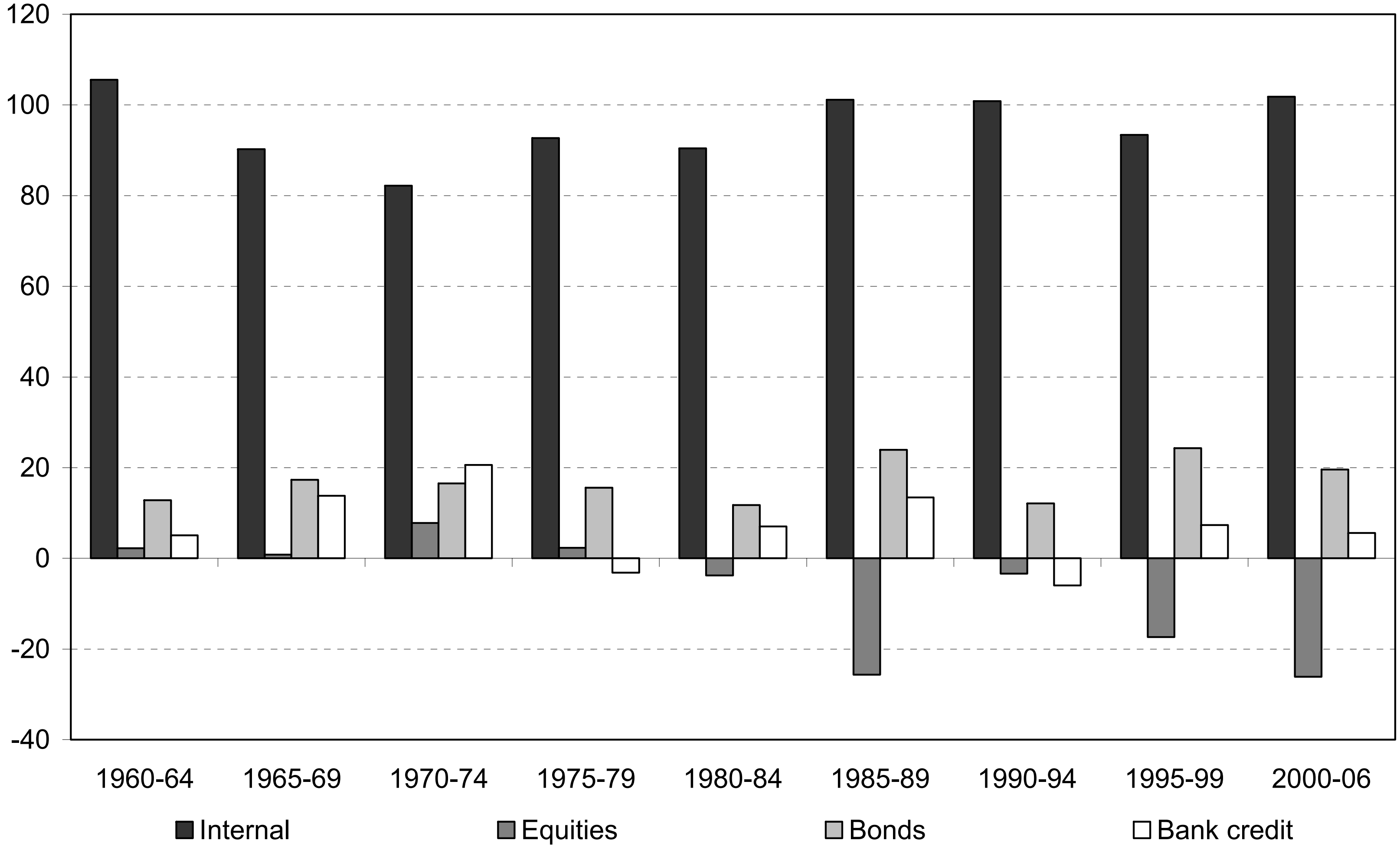
Sources of finance of gross investment, USA, since 1960



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Debt-to-capital ratio, NFCs, USA, since 1960

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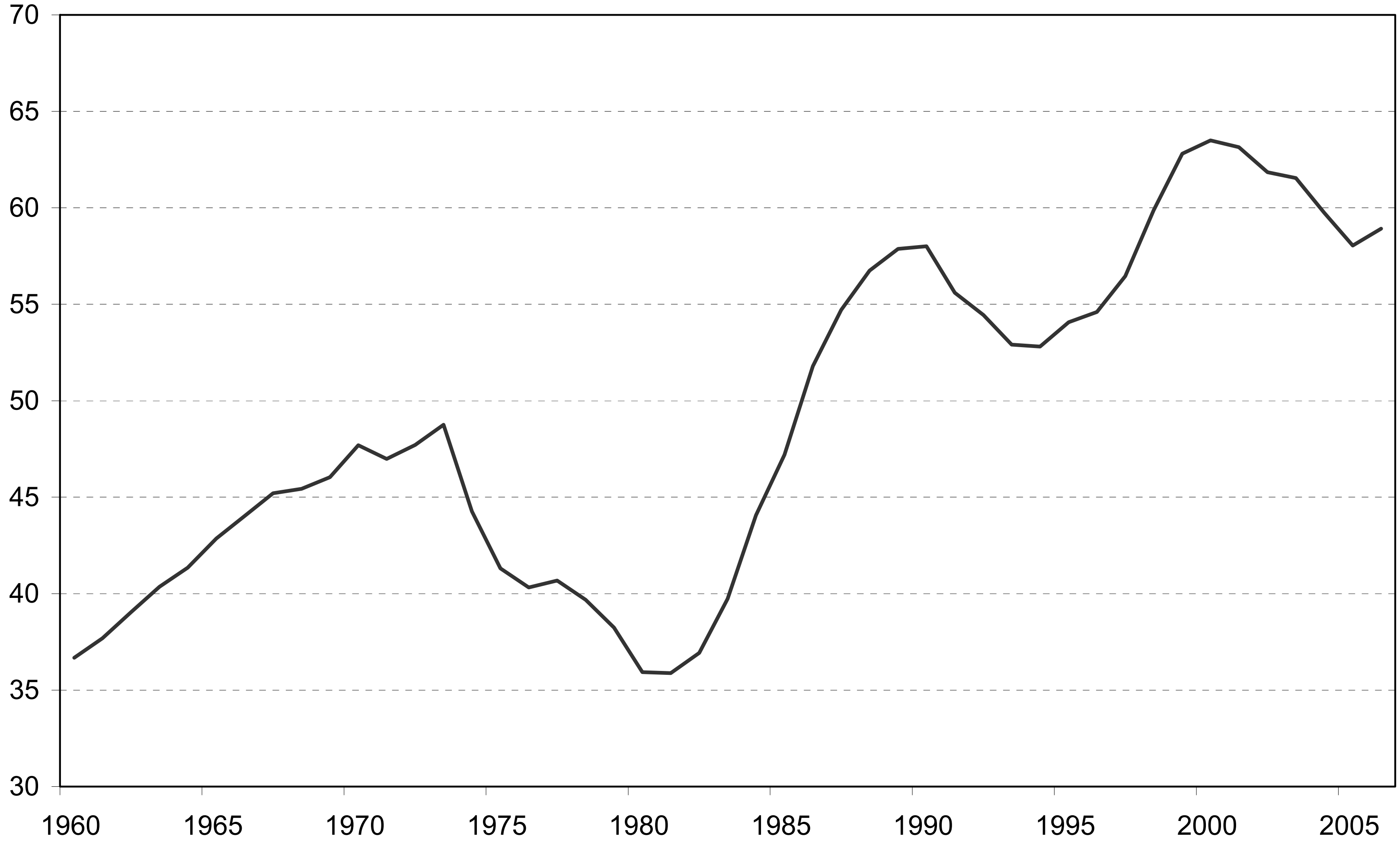

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- Theoretical rationale for financial deregulation

Theoretical rationale for financial deregulation – private household sector

- **Better allocation of savings**
  - Higher returns on savings through disintermediation
  - Investment/Pension/Hedge Funds allow savers to diversify risks
- **More flexible borrowing opportunities**
  - Smoothing consumption over time by borrowing against financial and housing wealth and against anticipated productivity gains
  - Theoretical foundation: Permanent Income Hypothesis (Friedman, Hall,…)

Theoretical rationale for financial deregulation – business sector

- **Stop “overinvestment” by Fordist “techno-structure” (Galbraith) and increase profitability**
  - “Among the manifestations of this lack of control over management were the pursuit of market share and growth at the expense of profitability […]” (OECD, 1998, p.17).
- **Better production/investments projects through disciplining management (“carrot-and-stick”)**
  - Stock market oriented remuneration as a solution to the principle-agent problem between shareholders and managers (Jensen and Meckling, 1976)
  - Market for hostile takeovers (Manne, 1965)

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- **Microeconomic and macroeconomic risks of “financialisation”: mainstream and Post Keynesian perspectives**

Microeconomic critique of shareholder value orientation

- **“Short-term performance obsession” may prohibit even profitable investment**
  - business managers fear a “severe stock market reaction to small EPS misses” (Graham et al., 2005). Result:
    - “the majority of managers would avoid initiating a positive NPV project if it meant falling short of the current quarter’s consensus earnings” (Graham et al., 2005; see also Jensen, 2005)
    - “an immediate boost to EPS rather than value creation dictates share buyback decisions” (Rappaport, 2006)

Microeconomic critique of shareholder value orientation

- **Dividend payouts and share buybacks reduce internal means of finance and may prevent “positive NPV” investment due to liquidity constraints**
  - Investment is overwhelmingly internally financed (Rajan/Zingales, 1995; Corbett/Jenkinson, 1997; van Treeck/Hein/Dünhaupt, 2007)
    - Firms are reluctant to issue new equities (Myers/Majluf, 1984);
    - Firms’ access to loans depends on their financial position (Kalecki, 1937; Stiglitz/Weiss, 1981; Chirinko, 1993);
    - Firms see retained earnings as an entitlement to invest (Akerlof, 2007)

Microeconomic critique of market-oriented consumer finance

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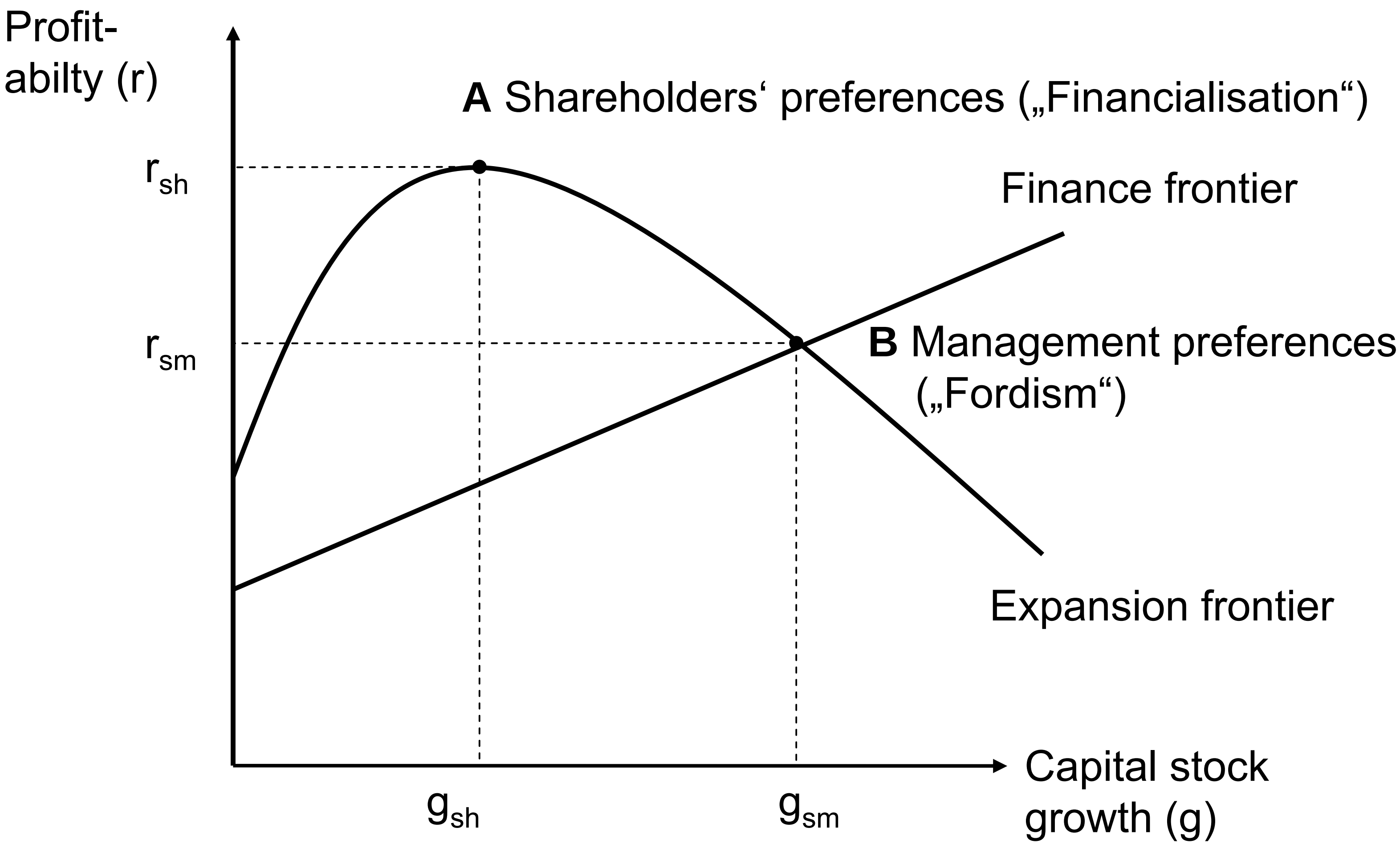
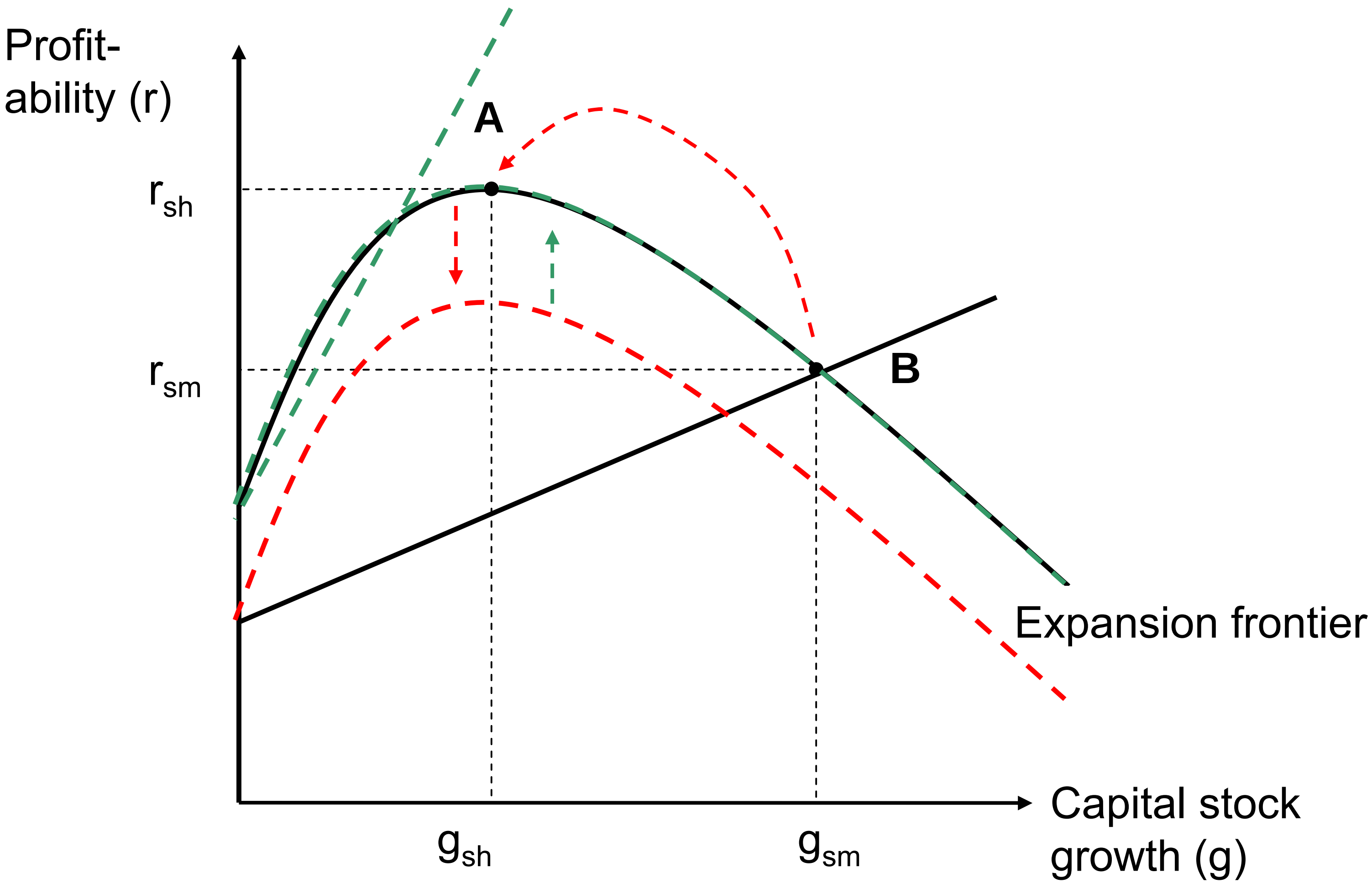
- **“(t)he flow of some of the most talented people in the United States today into law and financial services might then be one of the sources of our low productivity growth. When rent-seeking sectors offer the ablest people higher returns than productive sectors offer, income and growth can be much lower than possible.”** (Murphy et al., 1991, p. 506)

A re-interpretation of the Post Keynesian theory of the firm (e.g. Lavoie, 1992)



Microeconomic growth-profitability trade-off does not simply carry over to the macroeconomic level



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Macroeconomic risks of financialisation: higher profit payouts by firms

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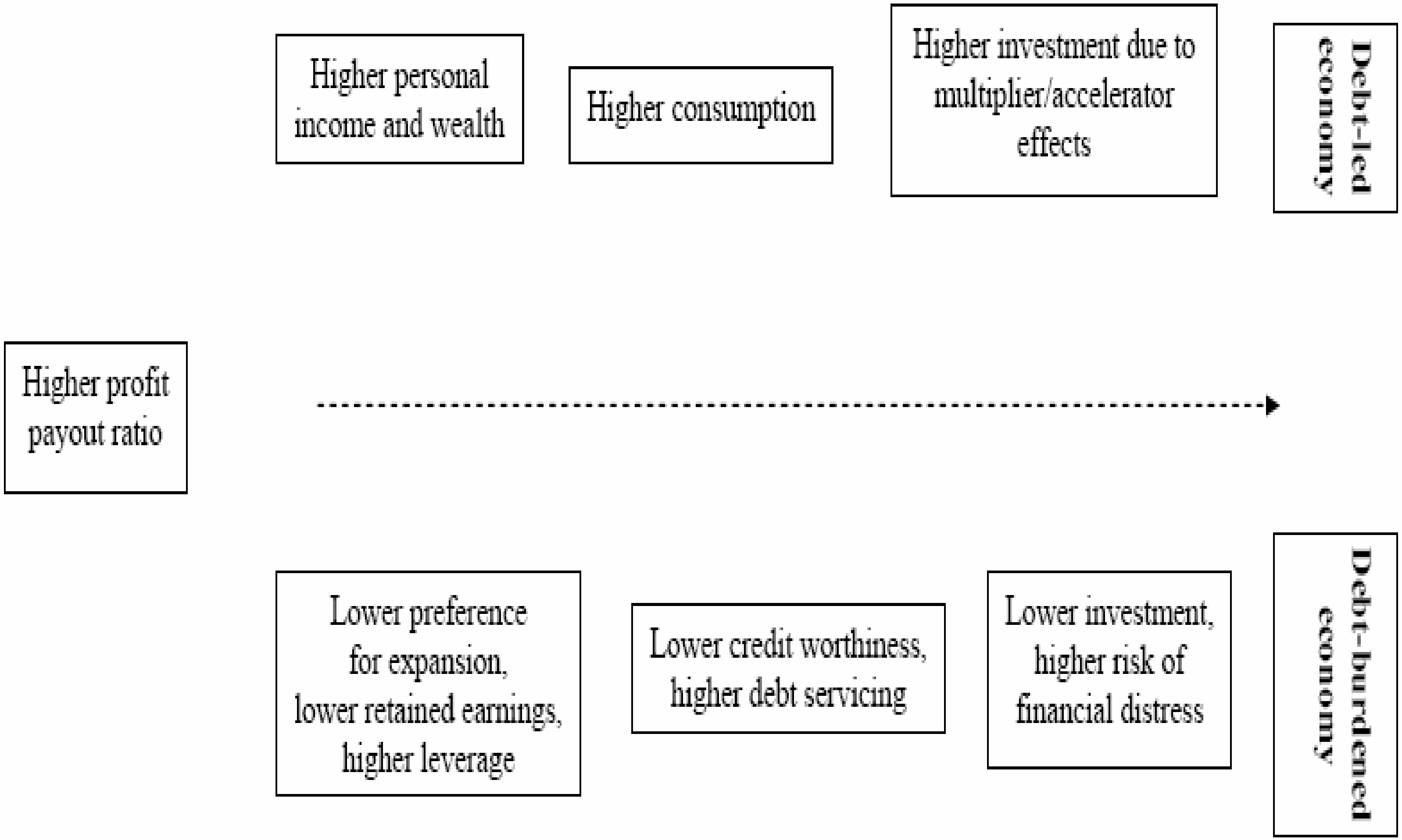
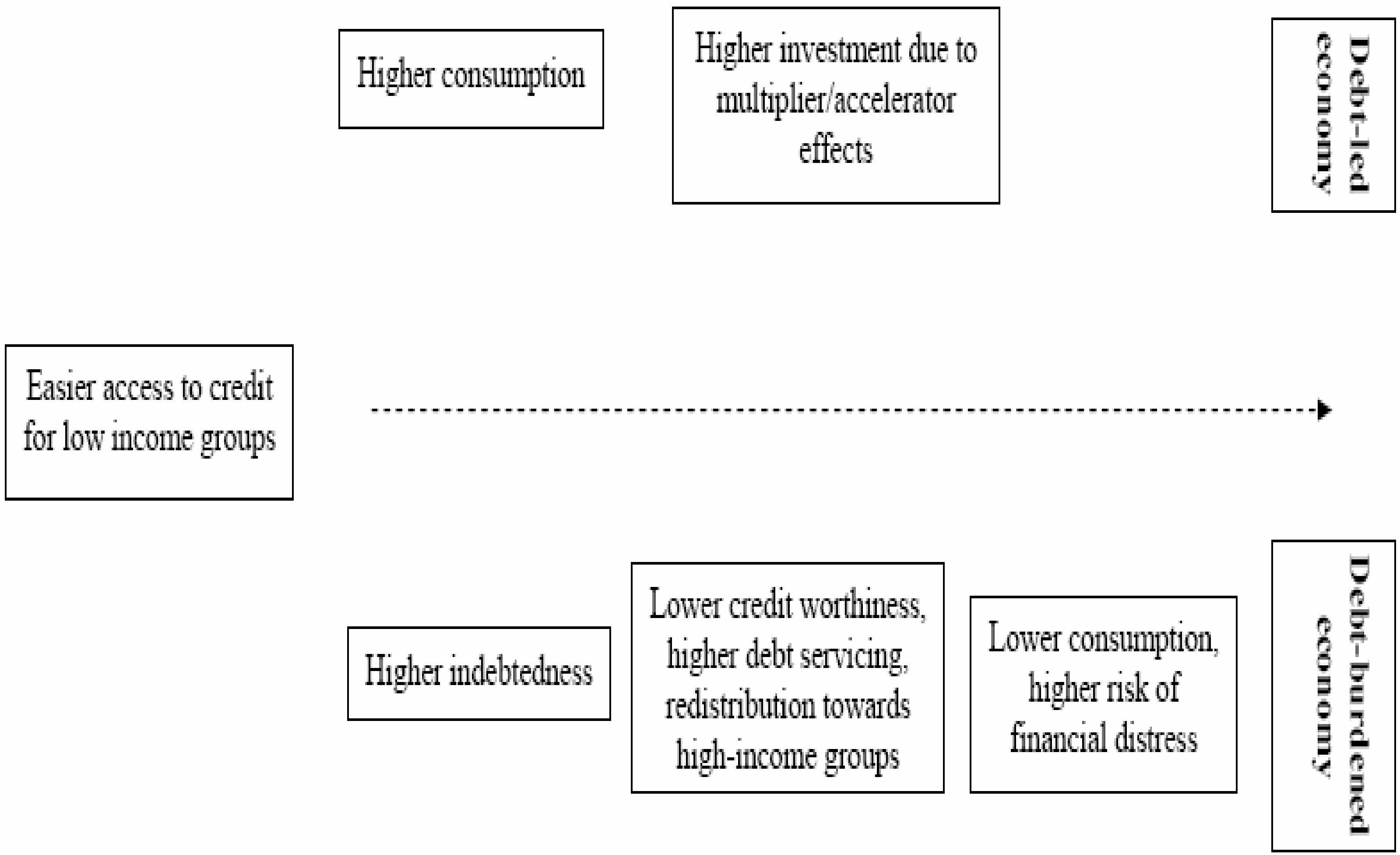


Macroeconomic risks of financialisation: easier access to credit for households



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Stock-flow consistent (SFC) modelling

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- Godley, W., Lavoie, M. (2007): Monetary Economics. An Integrated Approach to Credit, Money, Income, Production and Wealth.
- Based on two traditions
  - James Tobin
  - Wynne Godley
- „No black holes“: „Everything comes from somewhere and everything goes somewhere“
  - Balance sheet (stock) accounting identities
  - Transactions (flow) identities
  - Behavioural equations
- Numerical simulations, using e.g. Eviews

Balance sheet matrix and transactions matrix

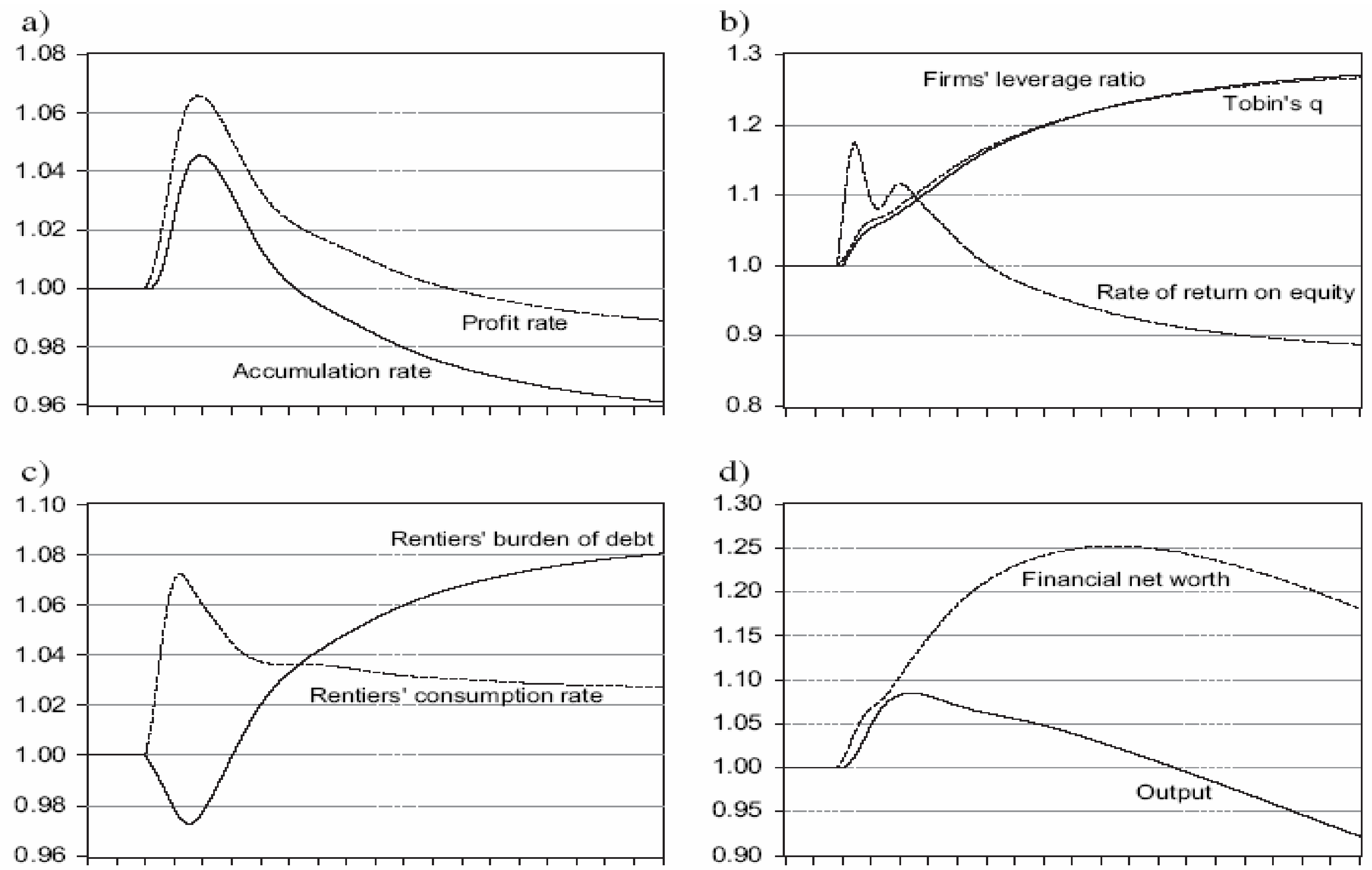
Table 1. *Balance sheet matrix*

	Households		Firms	Banks	Total
	Workers	Rentiers			
Money		$+M_r$		$-M_s$	0
Equities		$+e_r p_e$	$-e_s p_e$		0
Loans		$-L_r$	$-L_f$	$+L_s$	0
Capital			$+K$		K
Total	0	V	$K - e_s p_e - L_f$	0	K

Table 2. *Transactions matrix*

	Households		Firms		Banks		Total
	Workers	Rentiers	Current	Capital	Current	Capital	
Consumption	$-C_w$	$-C_r$	$+C_s$				0
Investment			$+I_s$	$-I_d$			0
Wages	$+W_s$		$-W_d$				0
Profits		$+FD$	$-(FD+FU)$	$+FU$			0
$\text{Interests}_{\text{loans}}$		$-i_l L_{r,-1}$	$-i_l L_{f,-1}$		$+i_l L_{-1}$		0
$\text{Interests}_{\text{deposits}}$		$+i_m M_{r,-1}$			$-i_m M_{s,-1}$		0
Bank profits		$+FB$			$-FB$		0
Δ loans		$+\Delta L_r$		$+\Delta L_f$		$-\Delta L_s$	0
Δ money		$-\Delta M_r$				$+\Delta M_s$	0
Equity issues		$-\Delta e_r p_e$		$+\Delta e_s p_e$			0
Total	0	0	0	0	0	0	0

Increased share buybacks lead to a debt-led economy that eventually turns debt-burdened



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Increased share buybacks lead to a higher profit rate but to a lower accumulation rate

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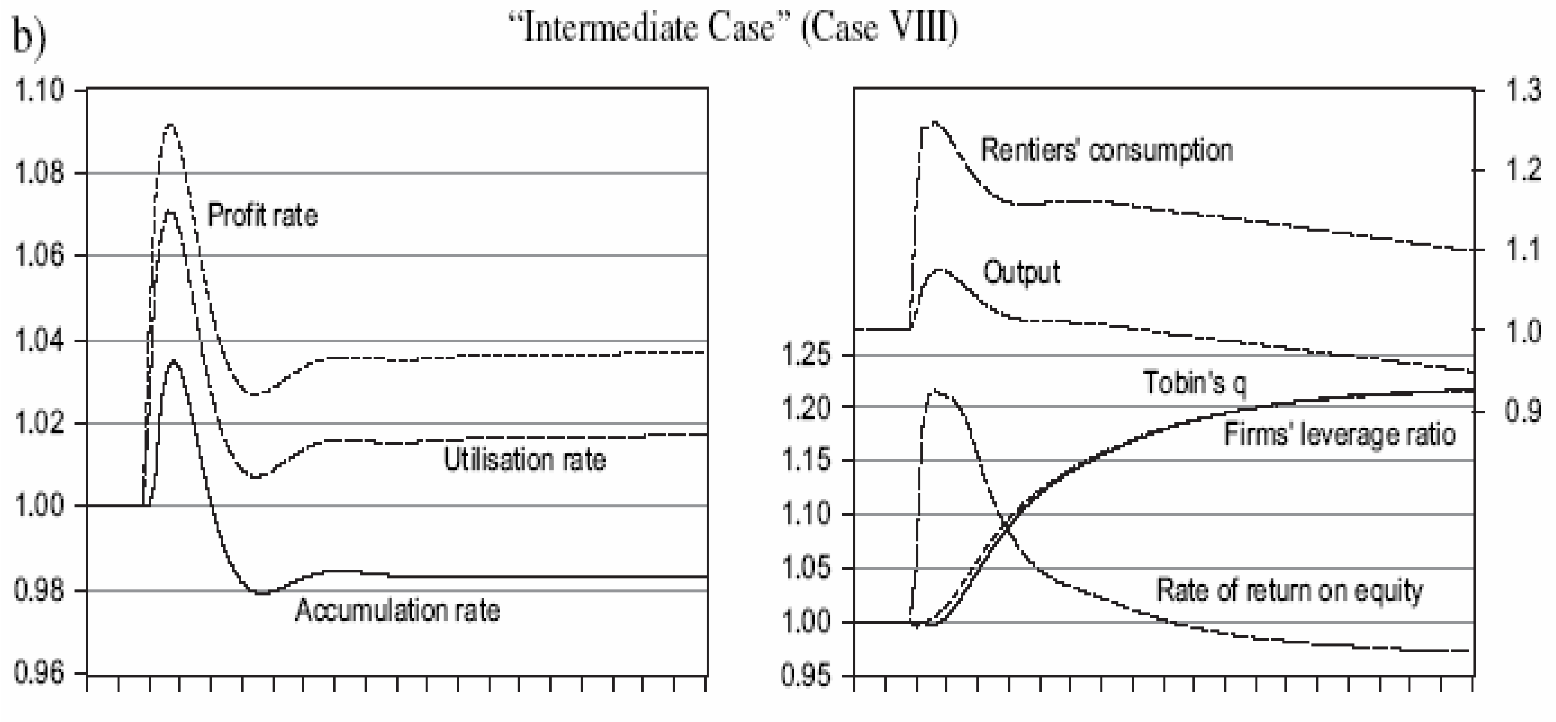

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➲ **“Financialisation” and the world economic crisis**

Profits = Investment + Consumption out of profits – Savings out of wages + Government deficit + External surplus

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- **USA: strong growth and financial fragility**
  - Relatively positive development of profits,
  - despite relatively weak physical investment,
  - dependent on wealth-based and debt-financed consumption (as real mass incomes stagnate)
  - dependent on foreign financing of domestic borrowing.
- **Germany: weak growth and financial fragility**
  - Relatively positive development of profits,
  - despite relatively weak physical investment,
  - despite weak private consumption demand (weak wealth effect, falling real wages),
  - dependent on external goods demand and profit opportunities in foreign financial markets.

The crisis and the “3 I’s”: Insufficiency of financial deregulation – Imbalances in international trade – Inequality of incomes

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- **“In the current financial crisis the limits of these opposite growth models become evident: both are based on the necessity to compensate the sluggish trend resulting from an increasing income inequality with other sources of demand. These consisted either in increased household borrowing (USA, UK, Spain) or in export-led growth (Germany, Japan, China).”**

  (IMK 2009, IMF/ILO 2010)

Stagnating incomes of consumers were compensated by expansion of credit

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- **„In the US the compression of low incomes was compensated by the reduction of household savings and by mounting indebtedness that allowed spending patterns to be kept virtually unchanged.“**

  (Fitoussi and Stiglitz 2009)

The crisis and the "3 I's": Insufficiency of financial deregulation – Imbalances in international trade – Inequality of incomes

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- **"Therefore, the political response to rising inequality—whether carefully planned or an unpremeditated reaction to constituent demands—was to expand lending to households, especially low income ones. The benefits—growing consumption and more jobs—were immediate, whereas paying the inevitable bill could be postponed into the future. Cynical as it may seem, easy credit has been used as a palliative throughout history by governments that are unable to address the deeper anxieties of the middle class directly.“**

  (Rajan 2010)

Deregulation, debt & crises (Financial Times, Reinhart and Rogoff 2008)

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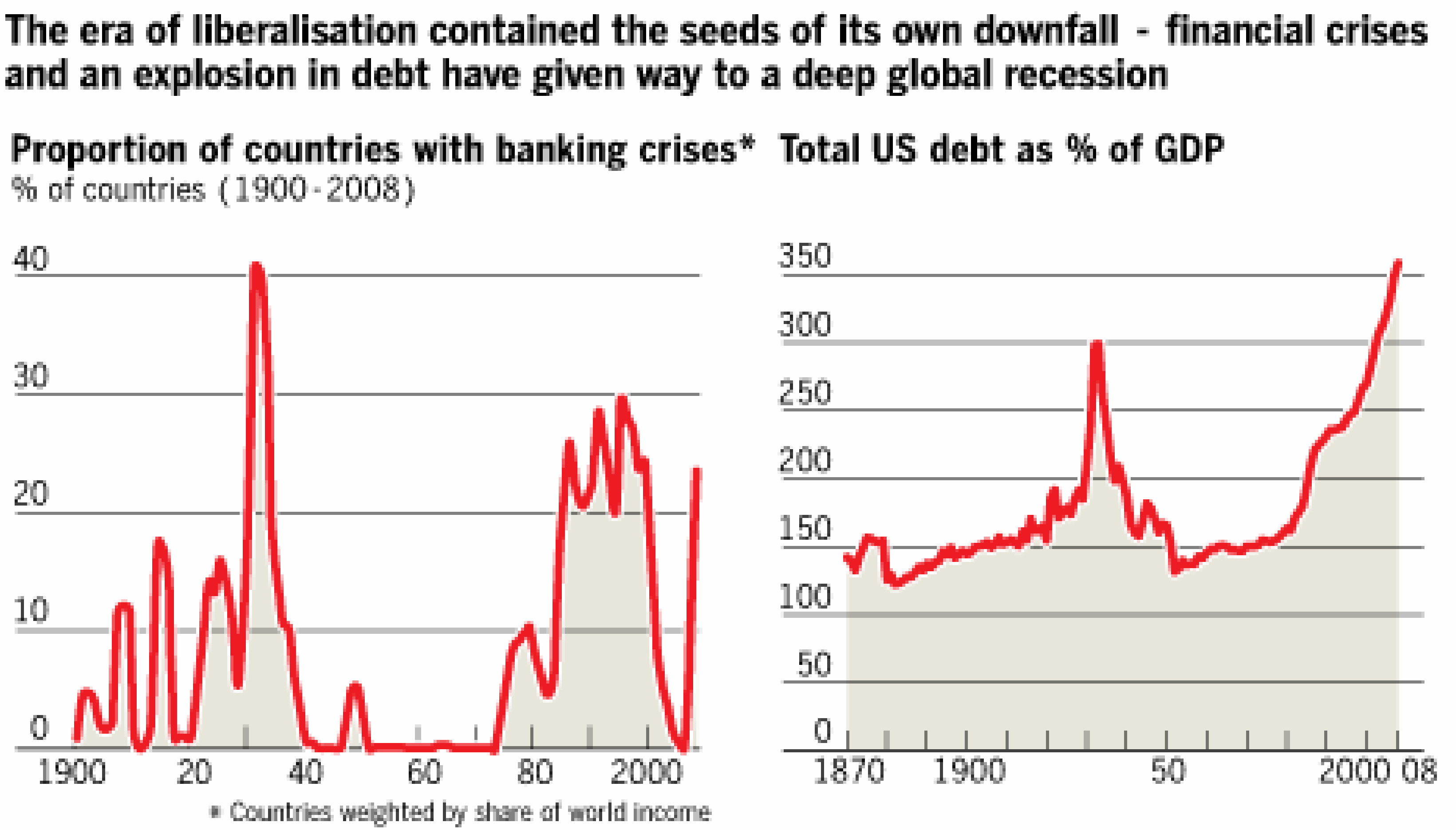

Conclusions

- **“Financialisation” has microeconomic risks: short-term performance obsession through shareholder value orientation and negative productivity effects through rent seeking in the financial sector**
- **“Financialisation” has macroeconomic risks: overindebtedness of firms and households, transition from debt-led to debt-burdened economy**
- **Post-crisis policies must address the “3 I’s”: Inefficiency of financial market regulations – Imbalances in international trade – Inequality of incomes**

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- Thank you