

## **BEWARE FINANCIALIZATION, ATTRACTIVE AND DANGEROUS, BUT MOSTLY DANGEROUS<sup>1</sup>**

*Abstract.* One of the central projects of neoliberalism has been the financialization of the global economy. Financialization refers to both the rising political and economic power of financial service firms and the growing importance of financial, rather than production, strategies in the rest of the economy. In the US case at least, financialization also accompanied a shift from values associated with employment and production to a normative elevation of financial investment. In the US the financialization dimension of neoliberalism has increased national and global systemic risk, increased income inequality between sectors of the economy, capital and labor and among classes of workers, and at the same time has led to decreased employment and a less productive economy. The lesson is that, despite the surface attractiveness of globalized finance, financialization is a particular dangerous dimension of neoliberal politics and policy.

**Keywords:** financialization, neoliberalism, inequalities

Despite the 2008–2010 collapse of much of the world economy as a result of financial speculation, financial firms and principles remain ascendant in much of the contemporary world. This reflects in part the centrality of global financial institutions to the organization of the world economy (Vitali, Glattfelder and Battiston, 2011). Ironically, the same centralization of global economic power that led to the global financial crisis (Battiston, Stefano et al., 2012), generates the considerable economic, political and social allure associated with global finance.

In routine interactions power and wealth are self-legitimizing. Wealthy organizations and people are treated with deference, are assumed to be smarter and serve as powerful decision making models for people, states, and firms. The ascendance of large financial institutions as well as the

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<sup>1</sup> Research and writing of this paper were supported by the U.S. National Science Foundation and the Institute for New Economic Thinking. Ken-Hou Lin commented on this paper and was central to much of the research reviewed in this paper. An earlier version of this paper was presented at the 2014 annual meeting of the Slovenian Sociological Association.

ideology and practices of financialization have just this kind of power over global political and economic policy. Legitimate organizational forms and practices tend to spread through normative, mimetic and coercive channels (DiMaggio and Powell, 1993) and so it is not surprising to recognize that the allure of financialization is powerful and spreading rapidly across the globe.

In this paper I summarize research demonstrating that the ascendance of financial power and beliefs in the United States has been socially and economically destructive. Despite the allure of legitimated wealth and power, financial principles and financial elites are dangerous sirens to follow. In the next section I provide an institutional explanation of the rise of neoliberalism in general and finance in particular. The point of this section is that the naturalizing stories of neoliberal market models mask a more prosaic political evolution. The market is not a force of nature, it is an ideology naturalized through the scientific lens of economic theory, the force of state policy, and the allure of wealth. I then turn to the inequality, employment and growth consequences of financialization. These are in the US all quite negative and so lead to my conclusion: Despite the glamour of power and wealth and the often uncritical endorsement of economic experts, financialization is dangerous. It is a socially and economically destructive development strategy.

## **Neoliberalism and Financialization**

Neoliberalism is a global phenomenon in which public and private policies are increasingly premised on the superior efficiency of market solutions to problems of investment, production, and distribution. These market ideologies diffused from a number of sources. Although it is tempting to go back to intellectual sources, such as influential academic economists Fredrich Hayek and Milton Friedman who fostered modern market fundamentalism among economists, for ideas to be powerful they must move out of the academy and into firms and states and perhaps eventually the common imagination of ordinary citizens. My understanding of how this process evolves globally is that in specific countries at specific historical moments these ideas gain traction and become lodged in organizational practices and imaginations. I chart for the reader how this happened in the United States, which in addition to an early and deep commitment to financialization, serves as a policy example for many other countries. In addition, it is the home country of many of the most powerful global financial service firms that now dominate the world economy.

Like many other countries in the mid-20<sup>th</sup> century, the US embraced a vision of the economy in which social peace between capital and labor and state centered economic coordination were ascendant principles.

Institutional arrangements varied considerably across countries, and the US was among the least state and socially coordinated of advanced nations. But even in the liberal capitalist US there was an expansion of the welfare state, increased power of organized labor in both production and polity, and a capital-labor accord which included a commitment to Keynesian economic policy by labor, capital and the state (Rubin, 1995; Mizruchi, 2013).

With the rise of a globally competitive economy and OPEC price shocks in the 1970s corporate actors began to reject this capital-labor compromise. In the US the state had begun to intrude on the autonomy of capital in production through legislation to protect the environment, workers' health and safety, and gender and racial equity in employment (Mizruchi, 2013; Stainback and Tomaskovic-Devey, 2012). This configuration of threats led to the mobilization of the large firm corporate sector to reinvent the system demanding economic deregulation, lower taxes, weaker unions, and a smaller state (Miller and Tomaskovic-Devey, 1983; Useem, 1983). The corporate offensive was successful and all of these goals were at least partially realized. It is the realization of these goals which created the institutional preconditions for both neoliberalism and in the United States the deregulations of financial services which I examine in this paper.

At the same time the low-growth, high-inflation, macro-economy undermined the legitimacy of Keynesian economic solutions and led to the ascendancy of the neoliberal market model in policy and public discourse (Harvey, 2005). This neoliberal model diffused across the globe for too many reasons to chart here, but some of the most important included the attractiveness of these ideas for an increasingly global capitalist class, the collapse of the alternative state centered socialist model in eastern Europe, and the increasing importance of US trained economists in policy making roles in state and global institutions around the world (Fourcade Gourinchas and Babb, 2002; Harvey, 2005; Prasad, 2006). Harvey (2005) concludes that one of the defining aspects of neoliberal state policy in the U.S. was to protect financial institutions at all costs. But it is important to understand that neoliberalism as a set of ideas is only powerful as the ideas become embedded in the design of national regulatory institutions.

U.S. bank regulations were instituted in the 1930s in response to the US bank led financial speculation that led to the world-wide depression of that decade. In the U.S. these regulations limited the economic power of financial service firms, prevented banks from growing too large or operating across state lines, required different firms for different financial service activities, and imposed tight regulation on financial service firms. As a result the U.S. financial service sector was small, stable and boring from 1935 to around 1980. Beginning in the late 1970s and accelerating through the 1990s the U.S. dismantled its regulatory structure and prohibitions on

risky financial activities. A few integrated financial service firms came to dominate the U.S. and increasingly the world economy. This economic power was not the result of invisible hand market processes, but of specific political pressures from financial services in the context of the growing power of neoliberal ideas. Regulators came to be captured by economist's efficient market theory, which stated that financial markets were inherently self-regulating and efficient, allowing new organizational arrangements and financial instruments to flourish without regulatory oversight (Fligstein and Goldstein, 2010; Hacker and Pierson, 2010; Krippner, 2011; Tomaskovic-Devey and Lin, 2011).

Together these institutional shifts reduced state regulatory oversight over current and emerging investment devices, encouraged financial investment over physical capital investment, and unleashed speculation in financial assets. Because these policies led to increased volatility in interest rates and stock market performance they also encouraged the creation of new financial instruments to profit from risk, including variable rate mortgages, credit default swaps, and mortgage backed and other derivative securities (Harvey, 2010; Krippner, 2011).

The collapse of the U.S. financial service industry in 2008 and subsequent rescue by the state led to further concentrations of power and wealth in fewer firms. By 2012 the three largest U.S. banks controlled 35% of all banking assets and the top-10 systemically important financial service firms over 50% (Tomaskovic-Devey and Lin, 2013).

The growth of financial power and status in the United States was not an inevitable product of neoliberal free market capitalism. Rather it was a product of politically induced institutional shifts in the context of rising neoliberal market ideologies. The power, prestige and privilege of financial services should not be interpreted as a signal that they are the smartest, most efficient actors in the modern global economy. On the contrary they are merely powerful, and power is often both misleadingly attractive and easily confused for efficiency.

## **The Rise of the Financial Service Sector**

One consequence of the increased economic centrality of the finance sector in U.S. society was the flow of income from households, the state and other sectors of the economy into the coffers of financial service firms. From the end of World War II until the early 1980s financial services realized between ten and fifteen percent of corporate profits in the U.S. economy. After 1980 the share of profits in this sector soared rising to over 40% in the mid-2000s (Tomaskovic-Devey and Lin, 2011). Although finance profits crashed with the world economy in 2008, they have since rebounded. In

2011, the most recent date for which we have numbers, almost a third of the profits generated by the private sector in the U.S. were controlled by financial firms (Tomaskovic-Devey and Lin, 2013).

Similarly, financial service sector employee income as a share of national income was remarkably stable prior to 1980 but grew rapidly afterwards. The growth in employee income in the Securities, Commodities and Investment industry was particularly steep. In 2007 workers employed in this industry earned \$6,891 per week nationally, \$16,918 per week if employed in New York city, compared to the national average of \$884. Between 2006 and 2007, just prior to the collapse of the financial system, first-quarter wages in the securities and commodities industry grew a remarkable 16.4% nationwide and 21.5% in New York city (Sum et al., 2008).

Employees on Wall Street, including CEOs and investment managers in commercial and investment banks, banks holding companies, and hedge funds made up an increasing share of the very highest earners in the U.S. economy (Rauh and Kaplan, 2010; Godechot, 2012 discovered a similar pattern for France. Lin (forthcoming) found that in the 1970s financial service firms tended to pay their lowest skilled employees wages slightly better than comparable employees in other industries. Across the period of financialization low skill employees earnings dropped, and it was the top 10% of employees in this sector that captured all of the excess employee income generated by the rising economic power of financial service firms.

In the US during the post 1980 neoliberal-financialization period there has been a large transfer of income into the financial services industry (Krippner, 2011; Phillipon and Reshef, 2012), but no increase in financial service productivity (Phillipon, 2012). The financialization of the U. S. economy has produced a tremendous transfer of income and wealth from both households and the real economy into financial sector firms, their owners, and, to some extent, their top employees.

### **The Financialization of the Rest of the Society**

That the financial service sector took advantage of its rise in economic and political power to extract income from the rest of the society may not be surprising. That the idea of financial investment has become more generally attractive is perhaps more alarming. Davis (2009) argues that financial ideologies have replaced production goals in government policy, non-financial firm performance evaluations, and even citizens' world views. For many Americans houses are now assets, rather than homes; college educations are investments in human capital, not knowledge. The imaginary world of economic theory and neoliberal ideology has become the cultural touchstone of ordinary Americans.

During this period household debt has skyrocketed as financial service firms have created new technologies of income extraction from families (Hyman, 2012). In non-financial firms increased shares of income now accrue through financial channels (Krippner, 2005; Epstein and Jayadev, 2005). As a result financial investments have crowded out investments in production in these firms as well (Orhangazi, 2008; Davis, 2014). The management of non-financial firms is increasingly responsive to and disciplined by financial rather than product markets (Fligstein and Shin, 2003, 2007; Fligstein, 1990). US economic policy is increasingly oriented toward the well-being of large financial service firms (Krippner, 2011; Hacker and Pierson, 2010). Shareholder value goals now dominate corporate strategy and market share as the metric of CEO success was displaced by goals of short term profitability and stock price gain (Dobbin and Zorn, 2005; Krier, 2005; Useem, 1996).

The financial turn in non-finance firms led to declining employment and rising income inequality. Corporations that invested in financial instruments had dramatically lower employment. Increasing rewards to shareholders displaced investment in production and made labor expense a primary target of corporate cost-cutting strategies. In the presence of financial investment strategies production and service workers are more likely to lose jobs than managers and professionals (Lin, 2013). When production and service firms pursue financial investment strategies the relative bargaining power of workers declines, while that of top managers and owners increase. Capital shares of income, executive pay, and income inequality among employees all increase dramatically with increased financial investments by non-finance firms (Lin and Tomaskovic-Devey, 2013). Coopting shareholder value pressures, executives managed stock prices over production, tied their income to stock performance, and executive compensation soared (DiPrete, Eirich and Pittinsky, 2010; Zheng and Zhou, 2012).

The inequality producing effect of financialization is not limited to the U.S. A good deal of research has now shown that national financialization is associated with increased income inequality across a range of countries (Godechot, 2012; Kus, 2012; Düenhaupt, 2012; Nau, 2013; Zakewski and Whalen, 2010).

Increased inequality and the sectoral dominance of finance might not be a problem if it also produced rising standards of living more generally. This, however, is not the case. In the U.S. rising financialization is associated with declining investments in production (Orhangazi, 2008; Davis, 2014; Stockhammer, 2004). General Electric (GE), for instance, increased its financial assets in the 1980s by redirecting profits from production towards investment in corporate debt (Hyman, 2012). Sears, a large retailer, redirected cash from stores into international currency speculation (Lin and

Tomaskovic-Devey, 2013). Not surprisingly this investment strategy is associated with declining total value added in the economy (Tomaskovic-Devey, Lin and Meyers, forthcoming). Even as total production was depressed, the owners of financial instruments realized increased income from non-financial production.

Conventional finance economics concludes that the development of a robust financial service sector is a prerequisite for sustained economic growth (King and Levine, 1993). Positive impacts are not, however, automatic, but require institutions that prevent fraud and excessive risk taking (Levine, 2005). In the US the rise of financial services has been strongly tied to both fraud and exploitation, and excessive risk. Phillipon and Reshef (2012) argue that increased financial investments eventually reach a point of diminishing returns.

There is mounting evidence of similar economic destruction in other countries as well. Cecchetti and Kharroubi (2012) show that the influence of finance sector size on economic growth turns negative when financial services become too large a share of an economy, and in those cases rapid growth in financial services are associated with declines in non-finance sector growth as high levels of financial activity crowd out investment in the real economy. Aizenman, Pinto, and Sushko (2013) conclude that expansion of the financial sector in high income countries is not associated with economic growth, but the contraction of the financial sector adversely affects the real economy. Importantly rapid growth in the financial sector tends to be followed by a strong contraction, in a boom bust cycle. This pattern was not present in the world economy until after the 1980 neoliberal turn and is more dramatic in countries whose financial system is relatively open to the international financial system.

## **Conclusion**

Financial principles, investments, and institutions can appear to be natural products of the global economy. They are not. Like all economic ideologies, markets, and institutional forms, financialization is the result of political and organizational processes embedded in fields of institutional power (Fligstein, 2001). Countries need modest, prudent, and trustworthy financial service firms to help convert savings into investment. This was the case in the United States prior to the institutional dismantling of regulations preventing speculation and limiting market concentration. Given the contemporary power, wealth and status associated with global financial firms there is a tendency to both naturalize and admire financial principles and their organizational elites, but to ignore that this power to extract income is a result of national institutions. This glamour hides multiple real dangers.



The U.S. example provides clear evidence that the growing power of financial firms and financial ideologies can lead to rising inequality, declining employment and production, a strengthened capital class and a weakened public sector. The evidence for other countries suggests that without institutional limits to financial power increased income inequality and systemic instability can accompany unrestrained growth.

Financial capital, like labor, is a fictitious commodity (Polyani, 1957), existing only under the umbrella of state institutions. One of the profound failures of neoliberal financialization in the US and elsewhere, is to imagine that financial capital exists outside of institutions. Austerity policies in Europe exist, not in reaction to some natural law of the movement of capital, but because EU institutions are protecting the integrity of German, French, and British banks at the expense of debtor nations. Countries can, at least to some extent, choose their institutions. When banking crises spread from the U.S. to other countries in 2009, countries with strong institutional controls on their financial systems like Sweden, Canada, and Australia were left intact.

We have long known that the fundamental risk of capitalism is that it is driven by the interests and influence of investors and so runs the risk of immiserating citizens. This risk has been seen as tolerable when capitalism delivers growing standards of living to counterbalance inequalities of reward. The collapse of the financial system has drawn our attention to a second type of fundamental risk, this one systemic in nature, embedded in the high-risk behavior of a concentrated, interconnected global banking system. Financialization presents systemic risks to stability of the global economy as well as to the social efficacy of local economies.

Financialization is at its root a system of income redistribution which favors the finance sector over the non-finance sector, financial investments over investments in production, and shareholders and top executives over workers and other citizens. Financialization is a product of regulatory decisions, both decisions to deregulate and encourage the concentration of financial power in a few large institutions and the failure to regulate new financial instruments or strategies. As a result income increasingly is diverted from investment, employment, and production into financial instruments, and the economic surplus of the society pools in the accounts of the owners of financial instruments and financial service firms.

From the point of view of less dominant nations the influence of global finance should be curtailed through prudent regulation. Well regulated national financial service industries are a prerequisite for growth and a hedge against control by global finance. A reasonable approach is to create one or more government-owned corporations to directly provide affordable credit to small businesses and households in competition with local and



global financial services. A public option might force the financial sector as a whole to become competitive and more efficient, provide prudent loans, and protect households and small business from predatory lending and fee-based financial services.

Financialization is a dangerous model for national economic policy. It may be the most dangerous aspect of neoliberal ideology and policy in that its financial success, produced as a result of state sanctioned economic and political power, tends to reinforce its charm and legitimacy. That in many countries policy elites have been trained in an increasingly finance oriented and influenced economic discipline probably magnifies and reinforces the attraction. The allure of wealth and power obscures the social and economic destruction that lies in its wake.

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