Financialisation and the welfare state

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To be covered…

- Financialisation
  - Surface phenomena
  - Possible causes and consequences
- The welfare state
  - Questions of sustainability, with particular regard to pensions
- Financialisation of the welfare state
  - A pathway to growth, or more bloating and warping of the capital markets?

Financialisation

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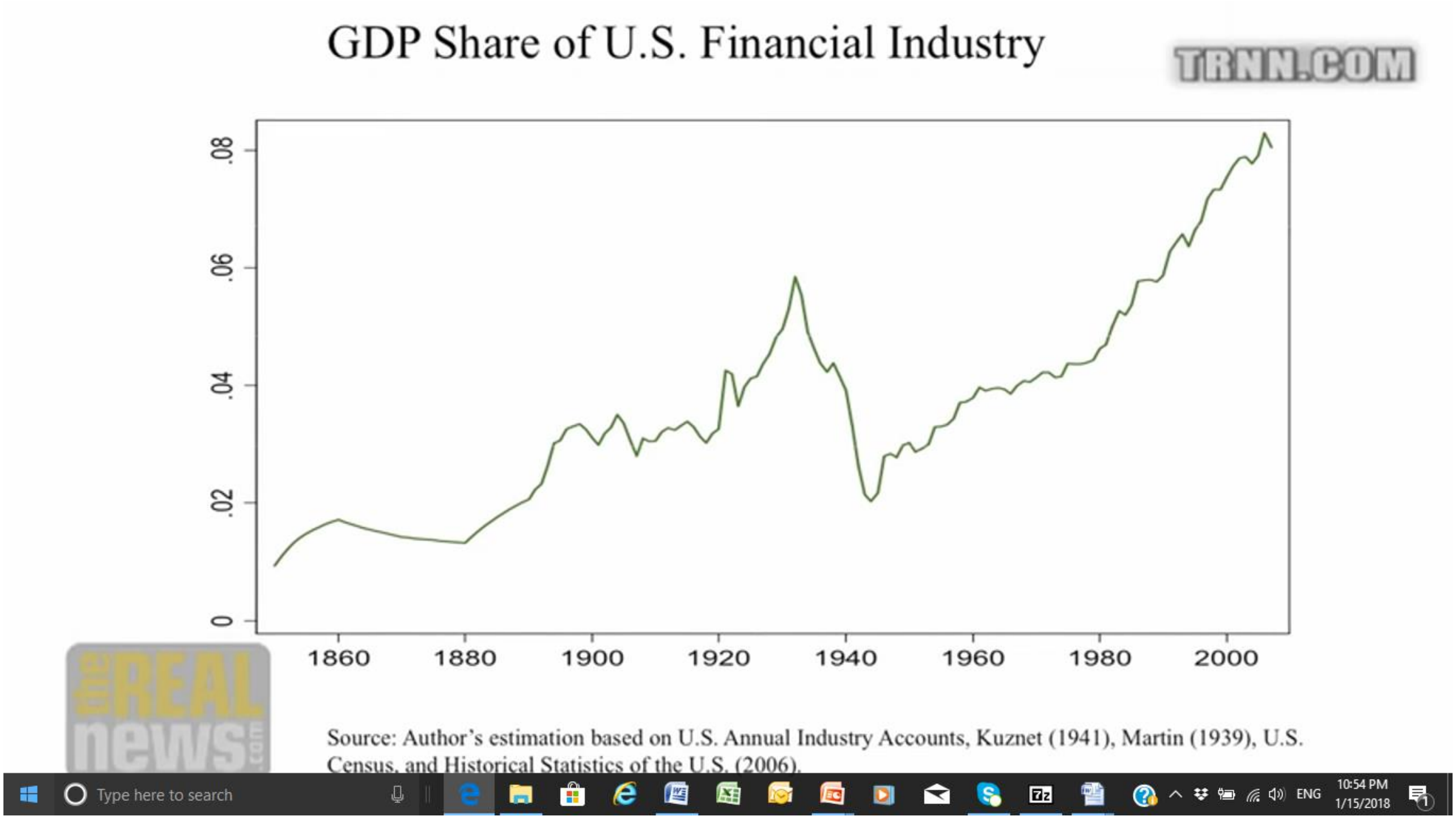
Financialisation: surface phenomena

- **Accelerated growth** in financial services sector over last 30/40 years, reflecting (and reflected by) change and growth in financial activities by firms and households and the accommodating attitude of governments

Lapavitsas on The Real News(!)



What's Behind Financialisation?
some causal hypotheses

- **Marxist/political economy:** new accumulation regime
- **Post Keynesian:** Rise of the Rentier and shareholder value
- **Alternative view:** just endogenous processes in a growing monopoly capitalism

New accumulation regime: a structural shift

- For some Marxists, a shift from manufactoring-led to finance-led Capitalism is inevitable, due to profits falling in the productive sphere
  - "The tendency of the rate of profit to fall"
  - Competition forces firms to invest in order to increase productivity through labour-saving techniques. But these techniques ultimately reduce profit, because profit comes from extracting more value from labour than is paid out to labour in wages
  - "the gradual growth of constant capital in relation to variable capital must necessarily lead to *a gradual fall of the general rate of profit*, so long as the rate of surplus-value, or the intensity of exploitation of labour by capital, remain the same." Vol III chp 13

Shifting corporate behaviours: shareholder value

An alternative, less materially deterministic view relates to changing behaviours – the adoption of "shareholder value"

"Our long-term plan is to find another short-term plan"

http://macromarkets.ie/vw-maximising-shareholder-value/

Shareholder value: Lazonick and O'Sullivan (2000)

An attempt to "understand the evolution and impact of the quest for shareholder value in the United States over the past two decades" – a management choice, not inevitable

From "retain and reinvest" to "downsize and distribute"

- Downsize: restructuring of labour forces
  - "In 1969 the fifty largest US industrial corporations by sales directly employed 7.4% of civilian labour force. In 1991, reduced to 4.2%"
- Distribute: Distribution of profits so as to support stock prices
  - "In 1980, when profits declined by 17 per cent (the largest profit decline since the 1930s), dividends rose by 13 per cent"

Marxist example: Krippner (2005)

- “In this paper I propose an *accumulation-centered* view of economic change, in which the focus is on where profits are generated in the economy”

- “financialization ..[..]..comes sharply into view when profit data rather than employment or GDP are the focus of analysis.”

Relative industry shares of corporate profits in US Economy 1950-2001

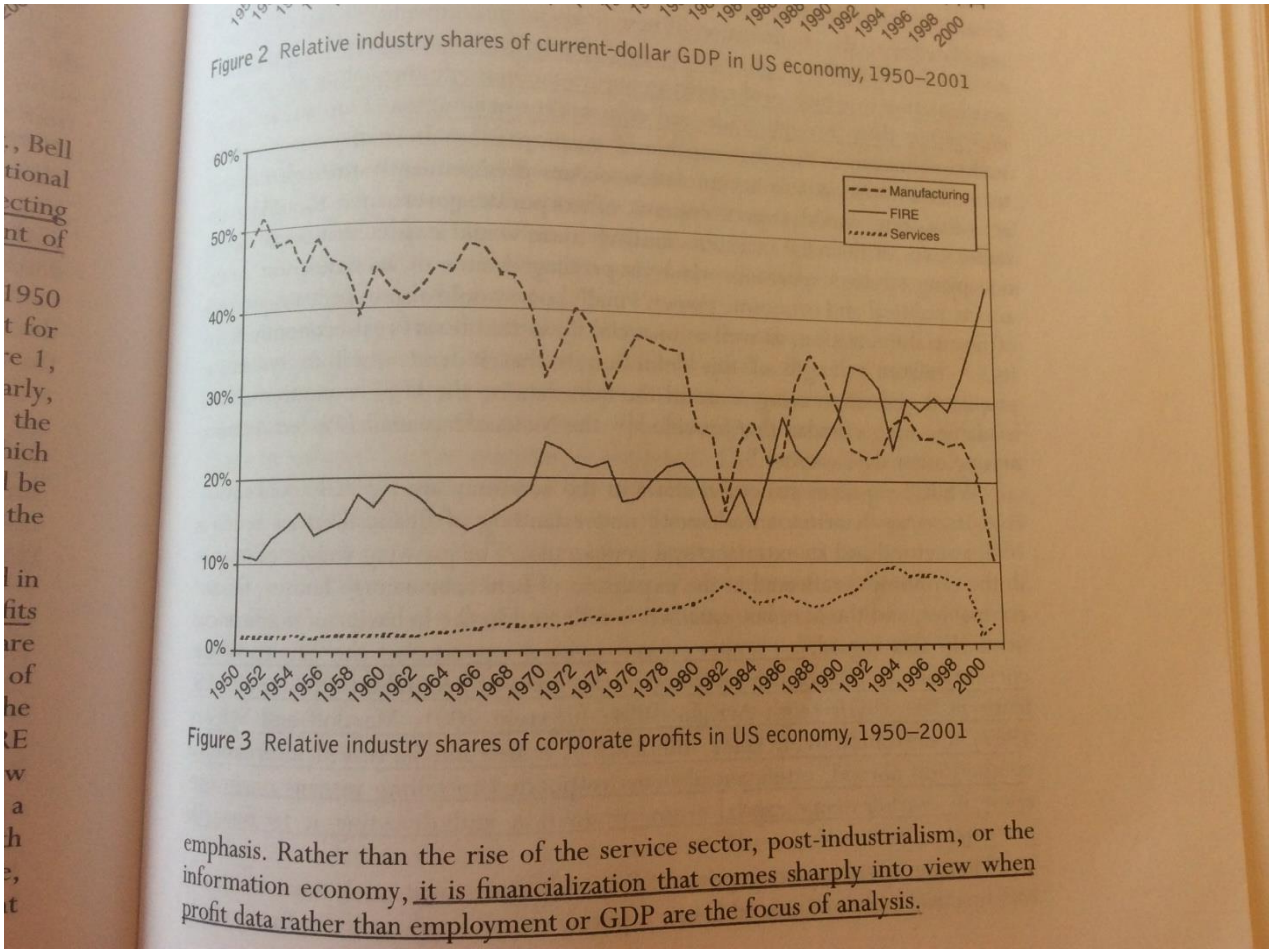
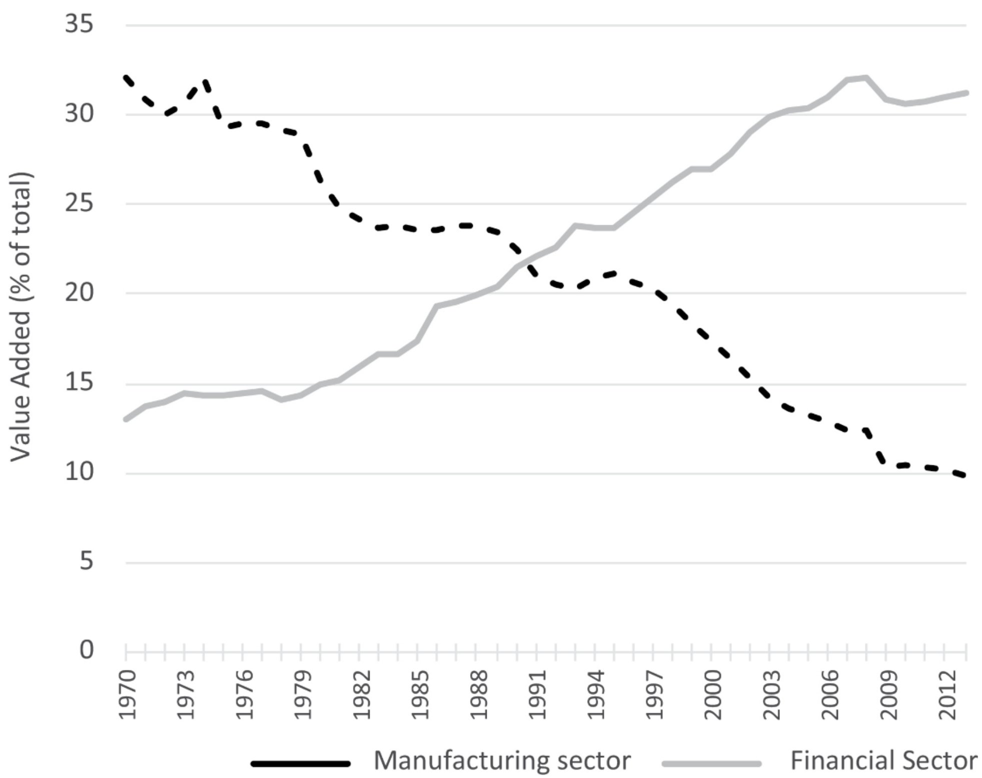


Figure 2 Relative industry shares of current-dollar GDP in US economy, 1950–2001

Figure 3 Relative industry shares of corporate profits in US economy, 1950–2001

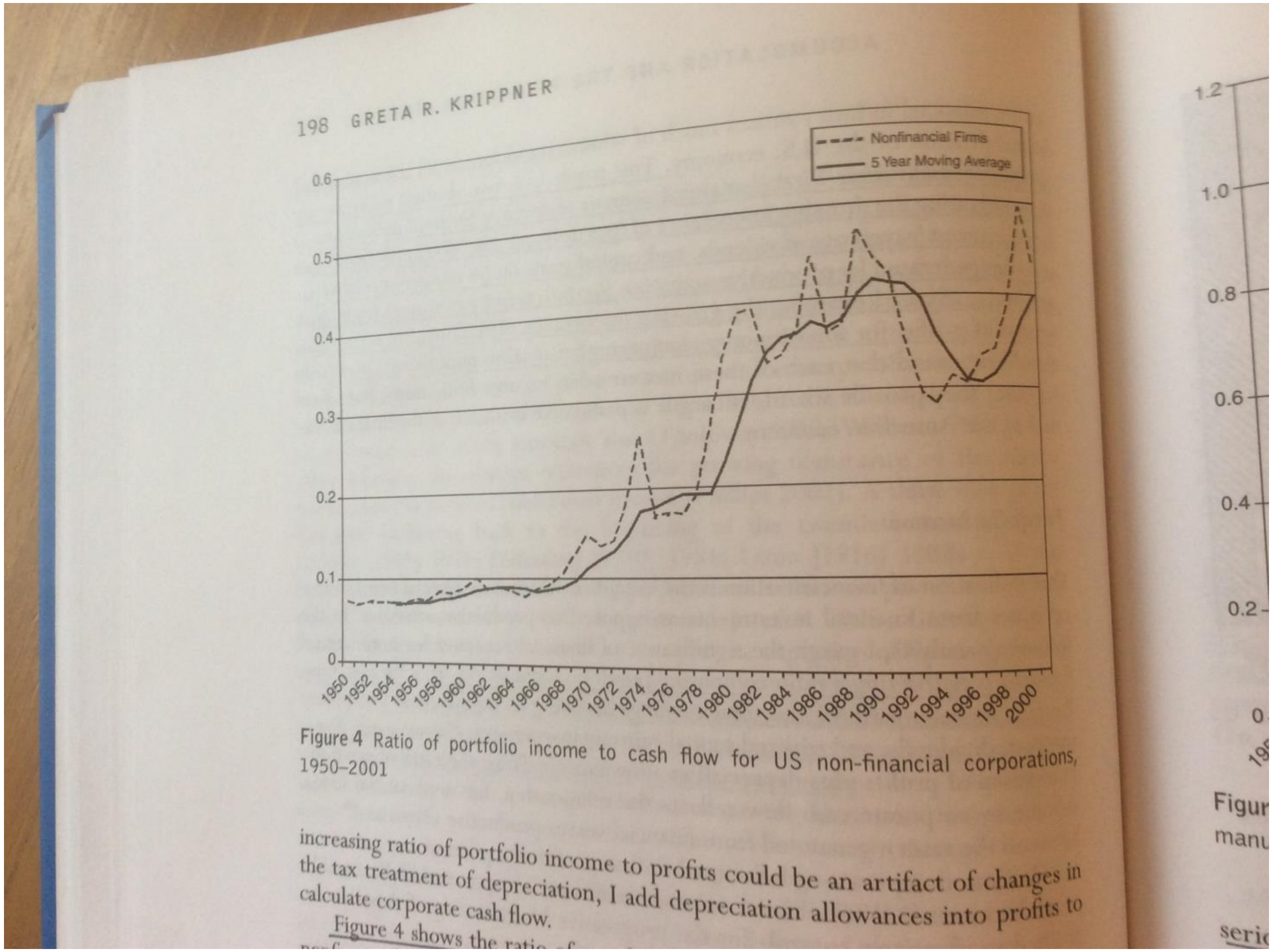
emphasis. Rather than the rise of the service sector, post-industrialism, or the information economy, it is financialization that comes sharply into view when profit data rather than employment or GDP are the focus of analysis.

Similar effect in UK, Tori & Onaran (2018)



From: The effects of financialization on investment: evidence from firm-level data for the UK
Cambridge J Econ. Published online January 24, 2018. doi:10.1093/cje/bex085

Krippner's additional measure: Ratio of portfolio income to cash flow for US non-financial corporations



Post Keynesian example: Stockhammer (2004)

Typically we think of managers wanting growth, and shareholders wanting profits

Alignment of management's interests and shareholder's interests through:

- New financial instruments to ease takeovers (stick)
- Changes in pay structures (carrot)

- "If our story were true, one would expect managers and consequently non-financial businesses to identify increasingly as rentiers and hence also to behave as such. We should expect higher dividend payouts, lower growth and more financial investment by non-financial business"

Stockhammer (2004)

- Stockhammer’s results when testing for a slowdown in accumulation, given changes in the behaviour of firms
  - Strong support in USA and France
  - Some support in UK (already low accumulation rates)
  - No support in Germany (shareholder value still very new phenomenon)

A cumulative effect: “Crowding out” (Tori & Onaran (2018))

Level of investment

- Lower growth plus higher payouts mean lower retained profits

  [Post Keynesian theoretical and empirical work points to the role of retained profits in inducing/enabling physical investment]

Form of investment

- Liquid markets offer a “fallback option to firms to invest in reversible short-term financial assets instead of irreversible long-term fixed assets”

Leila E. Davis (2016)

"Pronounced changes in NFC financial behavior in the post - 1980 U.S. economy"

- Three key stylized facts
  - NFCs are holding a <u>growing share of financial assets relative to fixed capital</u> in their portfolios
  - Large NFCs have become <u>increasingly leveraged</u>, whereas the majority of NFCs have deleveraged their balance sheets
  - There has been a <u>change in the role of equity</u>, reflected in a dramatic increase in stock buybacks, also concentrated among large firms

In opposition to this view
Endogenous Process example: Rabinovich (2017)

The conclusions of prior literature on financialisation of the NFC point to

- the primacy of shareholder value orientation AND
- the increased acquisition of financial assets – at the expense of fixed investment - from which NFCs derive a growing proportion of income

Conclusion of prior literature is that “non-financial business becomes more rentier-like abandoning growth-oriented priorities and investing in financial markets”

Rabinovich critique

- This is a bit of a stretch
- Financial assets have not been measured appropriately
- Instead of a new story of “financialization”, are we seeing a continuation of the story of capital concentration through M&A (monopoly capitalism..) and additional global capital mobility (globalisation..)

Michell and Toporowski (2013)

- Echoes in Rabinovich of earlier contribution by Michell and Toporowkski
- credit systems have always been more complex than the "real" economics transactions with which they are associated."
- "Ignorance of credit operations and the balance sheet operations of firms makes economists vulnerable to having their imaginations seized by dramatic events in financial markets in the twenty-first century.
- It is then easy to conclude that financial developments are key factors in the <u>continuing dysfunctions of capitalism</u>. But such impressions are frequently reactions to events rather than *prima facie* evidence of particular financial processes."

Michell and Toporowski (2013)

The financialisation literature fails to distinguish between:

- Exogenous shifts in more fundamental element of the economy
- Endogenous changes
  - “most financial transactions may be accounted for by a combination of market finance, financial innovation, active monetary policy, and hedging.

Maybe we don’t need a new “-isation” concept……..

But…

- “Our main finding is that much of the growth of finance is associated with two activities: asset management and the provision of household credit”

Greenwood & Scharfstein (2013)

counter counter view

There are further layers to this story…

- One being that the nature and extent of this growth in finance has been ENABLED and ENCOURAGED and then TURBO CHARGED by the state

Growing our financial sector: the consequences

- Marxists/Political Economists = just draws out the whimpering last gasps of capitalism, which was always going to trip over its inner contradictions with fatal consequences.
- Post Keynesians = financialisation will crowd out fixed investment, impede accumulation, and increase functional and income inequalities, suppressing consumption. Depressed demand will do nothing to overcome stagnant growth
- Toporowski = as explored by the critical financial theorists over the last century, there are a number of ways that finance will negatively impact on macroeconomic functioning

The welfare state

The welfare state: emergence

- Theory of the welfare state: adding nuance to Whig histories
- Theories offer causal hypotheses with a mixture of agency and material forces
- Agency example: outcome of conflicting political agendas (liberals, socialists, feminists)
- Functionalist argument: all down to industrialisation
  - Rising infanticide and infant mortality alongside the feminisation of labour in industrial areas. Marx quotes Dr Simon, the author of a report on public health: "*My knowledge of such evils may excuse the profound misgiving with which I regard any large industrial employment of adult women*"

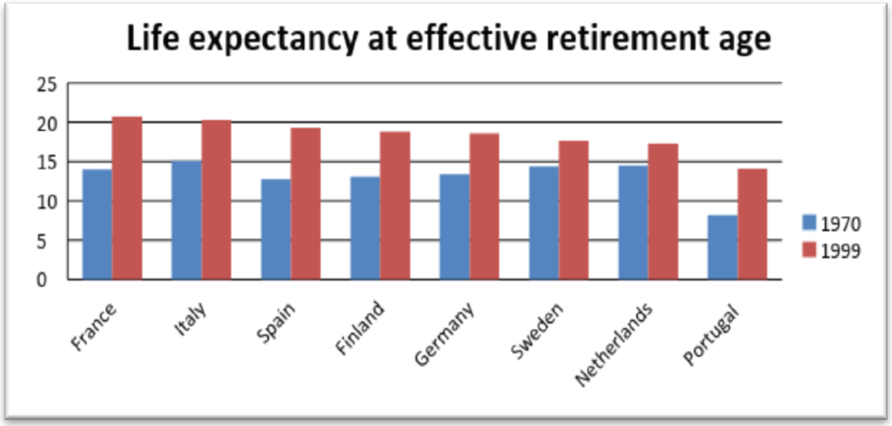
retrenchment

- Material underpinnings: Welfare sustainability, particularly PAYG pensions part of it, relies on growth, and wage growth

- What's up with growth? – well, we sort of covered that to explain growth in finance…..
  - New accumulation regime view: falling profit rate etc etc
  - Post Keynesian view: growth hampered by adoption of neoliberal values: lack of understanding by politicians and technocrats that economy as demand determined
  - Slightly different version: all about move from industrialisation to de-industrialisation. Productivity and growth slow down as manufacturing share declines relative to services [bit Kaldorian, taken up by Storm more recently] – but not necessarily inevitable

Pension debate

- We’ve somehow stopped talking about the sustainability of the welfare state, and have switched to talking about the sustainability of pensions
- Everyone is still talking about how to address growth, right???
- Wrong. The only story is town is one about demographics



Data adapted from OECD Economic Outlook, 2000

Financialisation and the welfare state

- A broad question of political economy has been reduced to a question of demographic trends and dependency ratios
- Argument is that **PAYG rendered unaffordable by all those pesky old people**
- But not to worry! There is a solution!

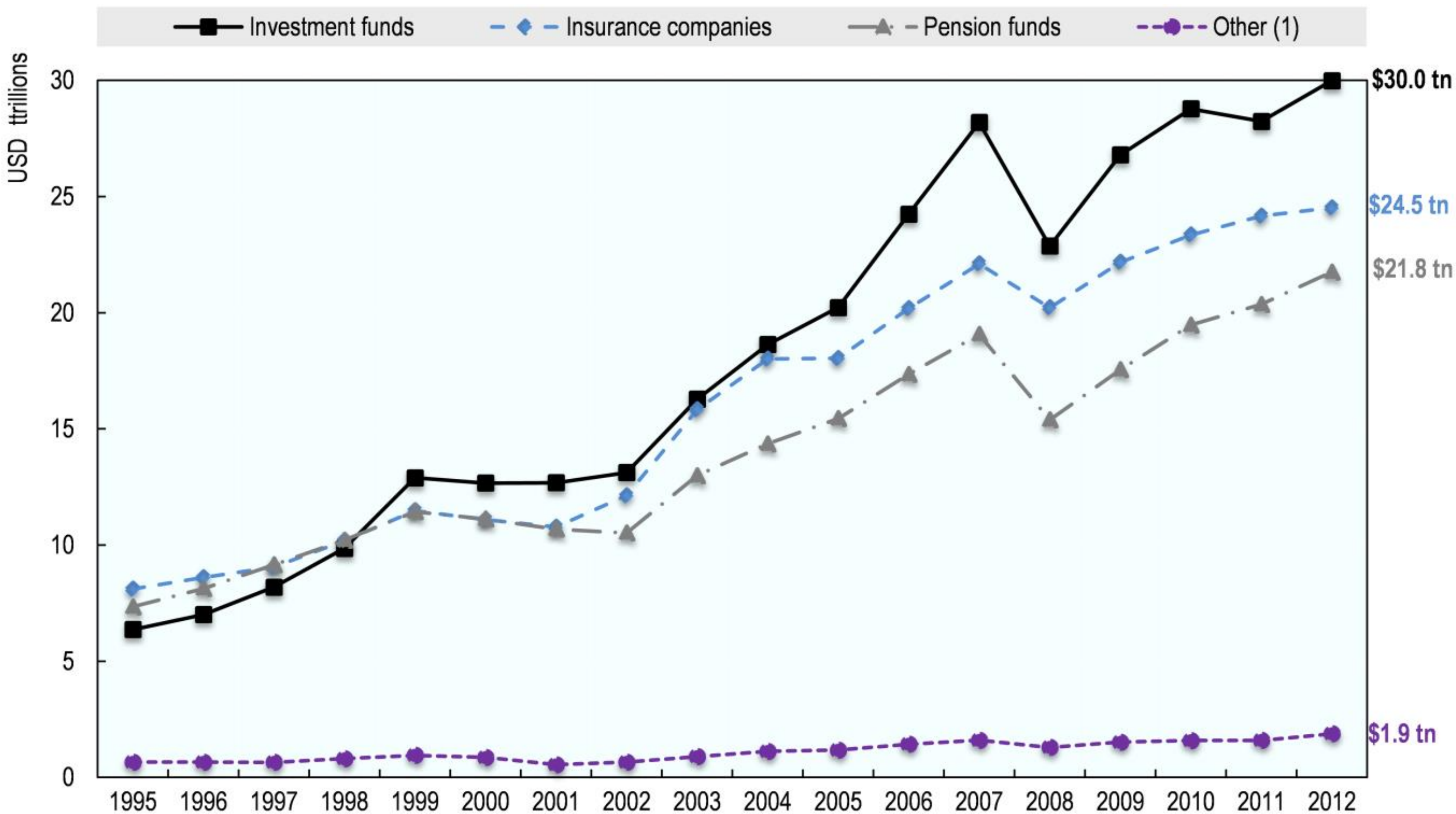
Switch from PAYG to Funded Pensions!

- Funded pensions could ease the strain placed on a state by an ageing demographic, whilst at the same time induce wider economic benefits through driving financial market development and innovation.
- Higher savings, invested by professionals, who use modern methods of diversification, will lower the cost of capital, increase investment and so enhance growth
- As we saw earlier, these ideas regarding the benefits of finance are contested by Marxists, Post Keynesians and Toporowskians alike
- Switching to funded pensions will just exacerbate the problems arising from overgrown finance sector

How exactly?
Addressing the call for detail on the processes

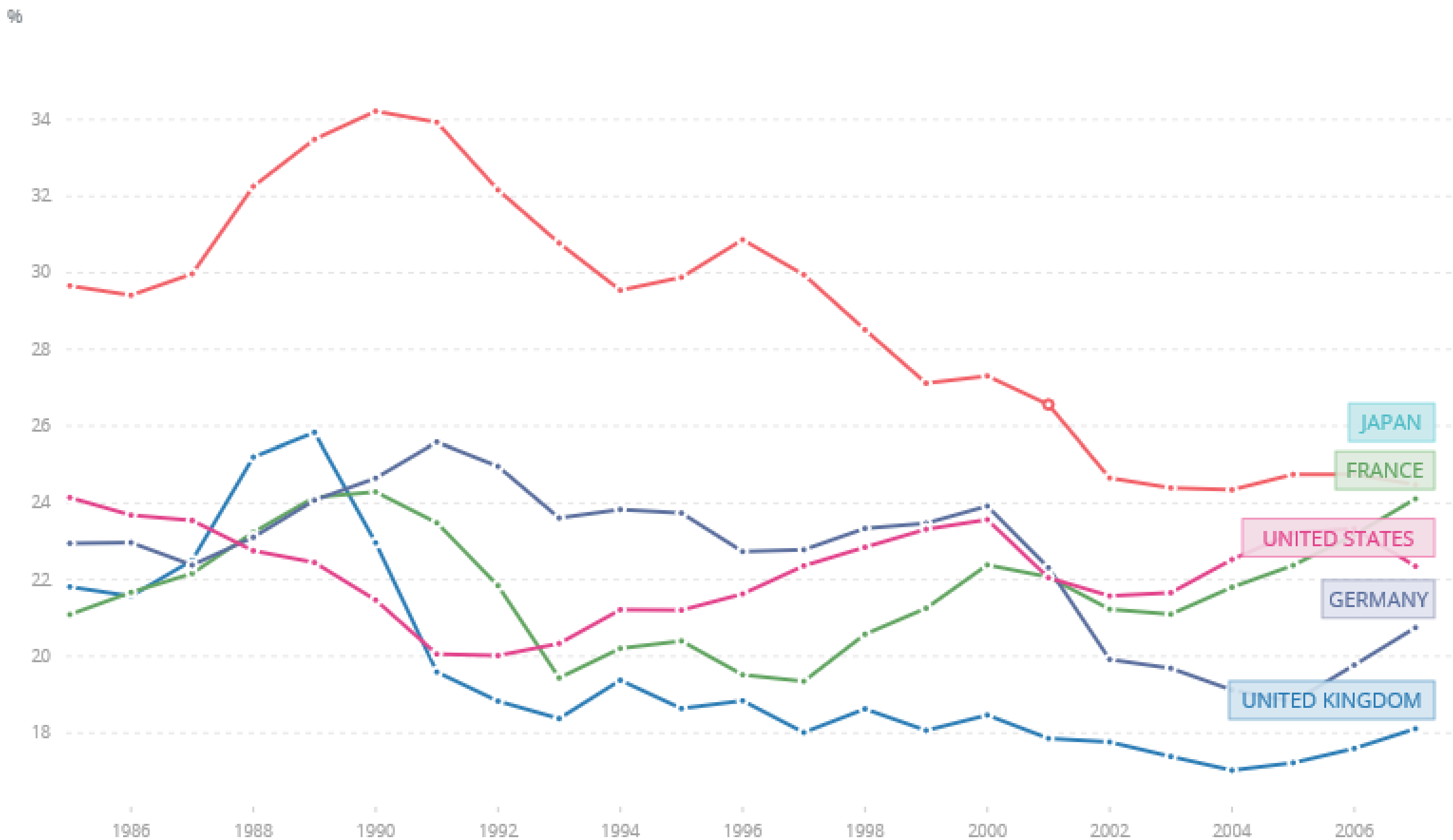
Pension funds are BLOATING and WARPING capital markets

TOTAL ASSETS BY TYPE OF INSTITUTIONAL INVESTOR; OECD, 1995-2012 (US$)



SOURCE: *Pension Markets in Focus* OECD (2013)

World bank
Gross Capital Formation % GDP



THE BLOATING PROCESS:
Asset market inflation (Toporowski 2000)

- Inflow of funds into capital markets at a time when firms reluctant to withdraw liquidity and engage in fixed investment leads to asset market inflation
- This adds to the "crowding out" effect
- Financialisation turbo-charged…

From Greenwood and Scharfstein (2013)

- “Market capitalization of equities nearly tripled as a share of GDP between 1980 and 2007……[..]..

- “By contrast, the *book value* of equity of publicly-traded firms normalized by GDP was essentially flat for the same period”

THE WARPING PROCESS: Financial innovation

- What causes financial innovation?
  - Endogenous developments to meet needs of industry?
  - Response to other demands i.e. inflows into institutional investors?

Innovation, according to R.C Merton, speech from 2017

Risk explosion in 1970s

- Fall of Bretton Woods currency system
- Two oil crises
- High inflation, high interest rates
- High unemployment

This risk explosion drives an explosion of financial innovation, aided by the new finance “science”: Option exchange; Financial futures for currencies, interest rates and stocks; Money market funds, high-yield and floating rate bonds; Debt securitization; Interest rate swap…..

Innovation

- “In the United States, **pension funds** and life insurance companies became the **main forces behind financial innovation** after.....1974........**New instruments have been tailored to the needs of pension funds** (such as zero-coupon bonds, collateralized mortgage obligations, mortgage-backed securities, indexed futures and options, and guaranteed income contracts)”

World Bank, 1994

Consequences of this “innovation”
(timeline stolen shamelessly from Dr Karwowski)

- ***13/09/2007*** Northern Rock (UK) crisis begins
- ***12/2007*** Banks publish third quarter losses, coordinated intervention of Central Banks (liquidity injections)
- ***02/ 2008*** Northern Rock nationalised
- ***17/03 2008*** JP Morgan Chase takes over Bear Stearns.
- ***12/07/2008*** The mortgage lender IndyMac collapses
- ***09/08 2008*** ECB injects 95bn Euros into the banking market
- ***07/09/2008*** Fannie Mae & Freddie Mac rescued
- ***09/09/2008*** Bradford & Bingley nationalized in the UK
- ***15/09/2008*** Lehman Brothers files for bankruptcy. Total chaos breaks outs across global markets


THE WALL STREET JOURNAL.

Bailout Plan Rejected, Markets Plunge, Forcing New Scramble to Solve Crisis

Down 777.68 points The tale of the Dow's largest point loss on record

What's News

Citi, U.S. Rescue Wachovia

Latest Shotgun Deal Creates Nation's Third-Largest Bank

Industry Is Remade

And now??

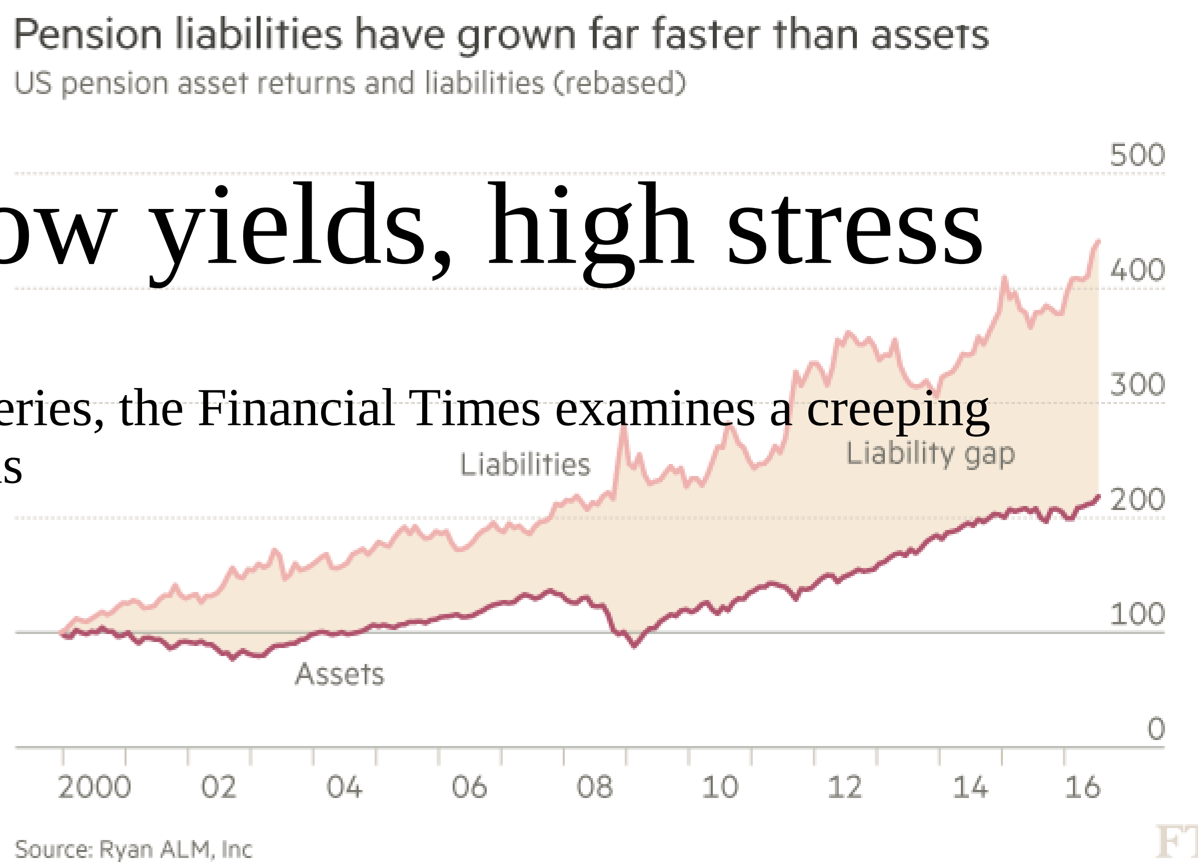
- Pension fund behaviour again raising questions
  - In mature market systems, as well as newer entrants

Actual Pension Crisis

FINANCIAL TIMES

Pensions: Low yields, high stress

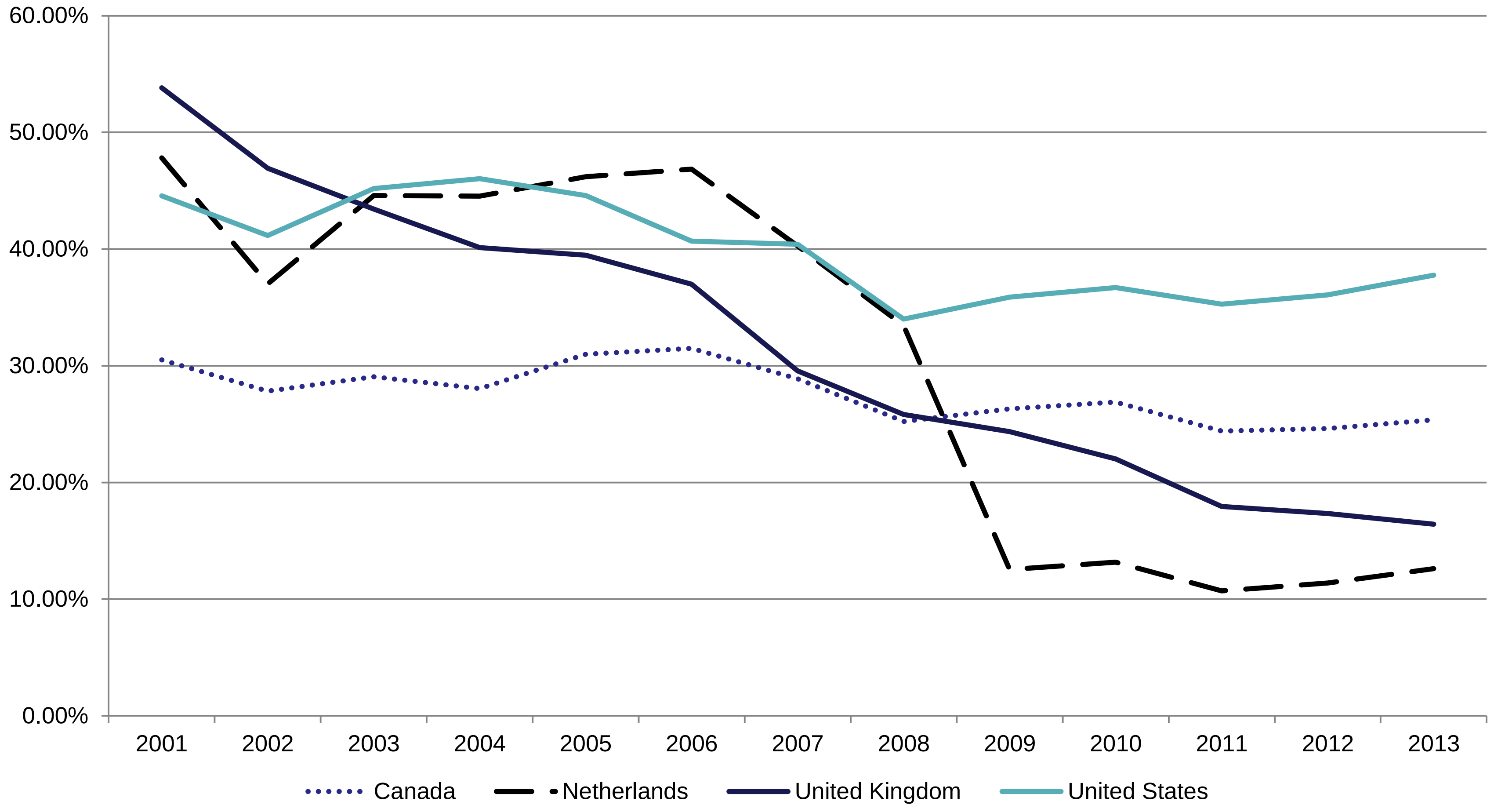
In the first article of a series, the Financial Times examines a creeping social and political crisis



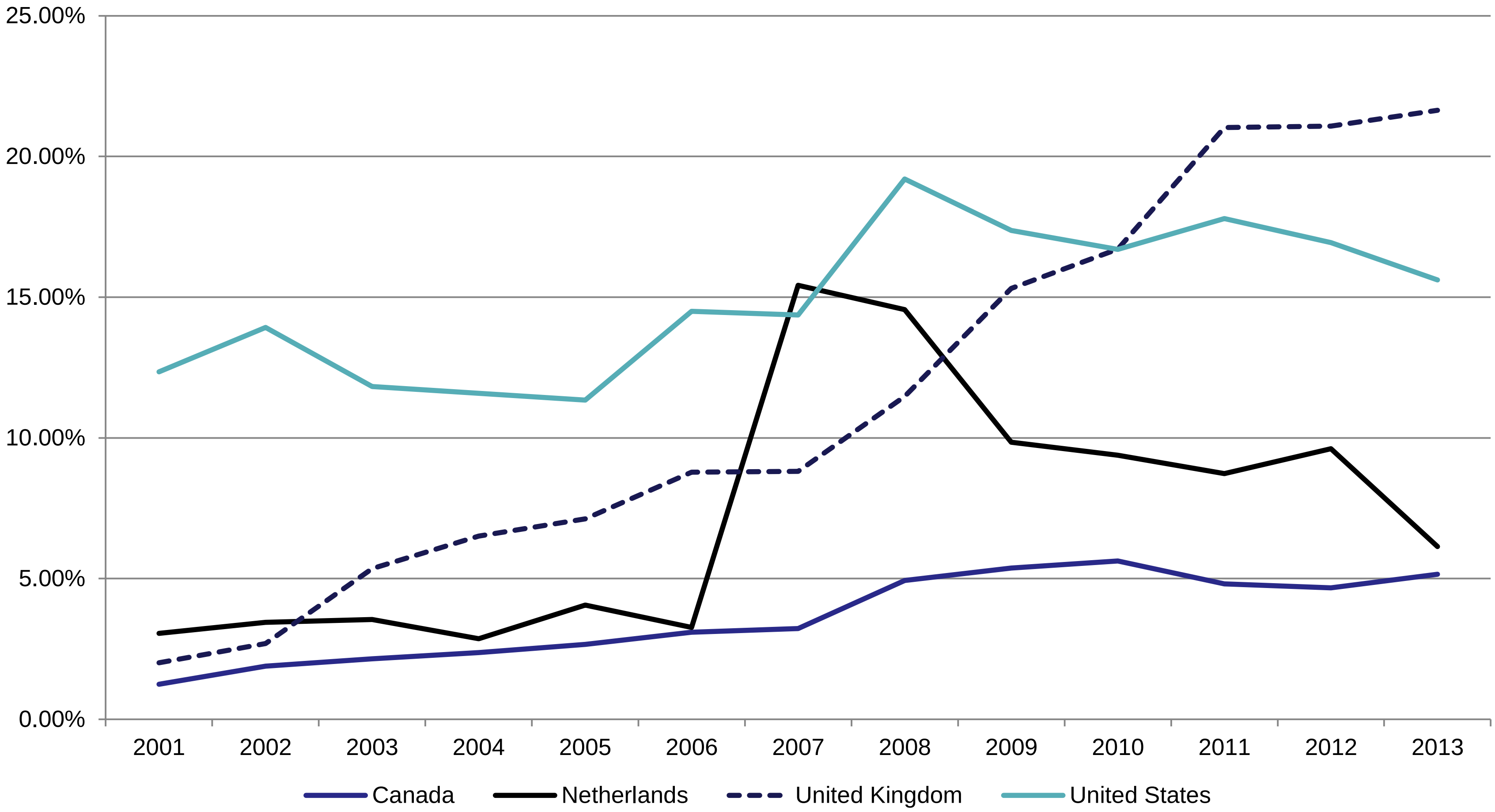
August 22 2016

Equity share of pension funds

From Bonizzi, B. and Churchill, J. (2017)



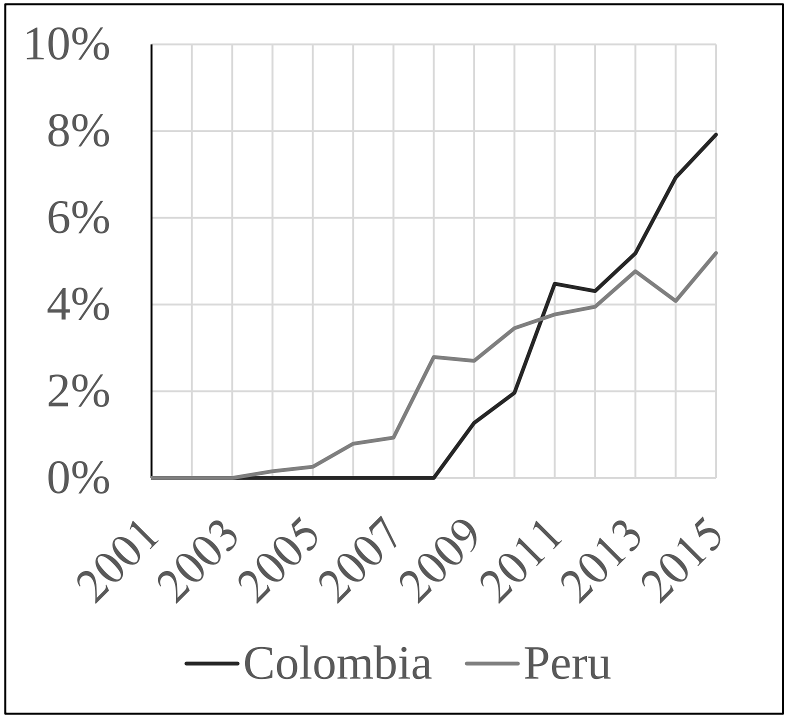
"other" share of pension funds total assets
From Bonizzi, B. and Churchill, J. (2017)



distribution within the 'alternative' asset class – LGPS example from 2012

Asset Class	Share of Alternatives %	Share of Total LGPS Assets %
Private Equity	46	3.22
Hedge Funds	35	2.45
Active Currency	5	0.35
Commodities	5	0.35
Infrastructure	5	0.35
GTAA (global tactical asset allocation)	3	0.21

Allocation to alternatives, %



"Alternative" investments now explicitly allowed: 25% in Colombia 15-20% in Peru

Private equity

- *better aligning the incentives of corporate managers with those of their shareholders…..*
- Highly leveraged takeovers and restructuring
- "…The company that has been taken over will, through the reduction of its interest costs, appear to be more profitable without any change in its circumstances or management. Of course, this is not an increase in operating profits….Our company will now join the ranks of successfully growing companies whose expansion thrills the stock market but adds nothing to the productive capacity of the economy." Toporowski (2005) p52

key policy thinkers beginning to get with the programme..

- "There is no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability, and it is possible for financial activity to extract rents from the real economy rather than to deliver economic value."

Adair Turner (2010)

Conclusions

Moves to privatise and prefund pensions add to the bloating and warping of financial sectors, to the point that they hinder rather than helping growth.

Demand is undermined:

- Firms are induced to invest even less in fixed capital
- WHAT NOT MENTIONED….The added insecurity facing individuals might reduce consumption
- There is also a gendered impact

Question is, can we address the underlying issues of growth? Is there anything we can do other than throw capitalism in the bin?

NO (hardcore Marxists) ⟷ YES (optimistic Post Keynesians)

Just find your place on the theoretical spectrum…..

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