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THE ECONOMICS AND CULTURE OF FINANCIALISATION

Jan Toporowski

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economics@soas.ac.uk

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THE ECONOMICS AND CULTURE OF FINANCIALISATION

Jan Toporowski

SOAS University of London, and the Research Centre for the History and Methodology of Economics, University of Amsterdam

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Abstract

This paper examines some of the social, economic and political consequences of financial inflation for the activities of companies and the operations in debt markets of an increasingly financial middle class. In this paper 'financialisation' is broadly defined as the inflation of capital markets. The first section of the paper explains the Kalecki-Steindl theory of enforced company indebtedness in a middle-class society. The second section of the paper shows how financial inflation makes companies over-capitalised, resulting in a decline in the trend of long-term investment. The third section shows how forced company indebtedness is modified when the middle classes start to operate in inflating asset markets. A conclusion sketches out some of the consequences of this financialisation for politics, social policy, and moral and cultural attitudes.

Introduction

Financialisation is usually defined in rather strictly industrial terms, as an increase in the remuneration of shareholders, and an increase in their influence in firm decision-making, especially capital expenditure decisions. This increase is held to occur at the expense of workers, consumers, or even the management of the firm. Such an increase in shareholder influence is usually identified with a particular American or U.K. style of financial market capitalism, as opposed to the bank-financed capitalism that used to be characteristic of Central Europe. In this paper I put forward a much broader view of financialisation, as a major shift in the structure of economic activity towards turning over capital in financial markets. Such a shift alters the financial structure of capitalist firms, which in turn affects the nature and the dynamics of capitalism. This change in the nature and the dynamics of capitalism is discussed in greater detail in the first, second and third sections of this paper, dealing respectively with the business cycle in a pre-financialised economy; the effects of financialisation on capital accumulation; and the credit cycle in a financialised economy. The paper concludes with some reflections on the politics, culture and social policy of a financialised middle class capitalism.

1. The Middle Class and the Business Cycle

Economic theory has, since the times of classical political economy, considered questions of production, economic efficiency, trade and distribution in the context of a stylised economy made up of capitalist businesses. Foreign trade was regarded as a naturally-occurring complication and, at least until the twentieth century, the state entered into the analysis as a source and regulator of money, and as a major source of expenditure financed by taxes and debt. With the exception of the work of Malthus, the middle classes did not play a significant role in economic analysis.

This situation was to some extent remedied in the twentieth century in the work of Michal Kalecki, and his friend and research associate, the Austrian Josef Steindl. There is a hitherto largely un-remarked aspect of their work in which they explain the impact of middle class saving behaviour on the dynamics of the capitalist economy

(Kalecki 1943, pp. 85-86; Steindl 1952, pp. 113-121). The version that is presented here is the one Steindl later put forward (Steindl 1982; Steindl 1989).

Consider the Keynesian saving identity, in which saving (S) is the sum of firms' gross fixed capital formation (I), the fiscal deficit (G – T), and the foreign trade surplus (X – M). If we divide up total saving into Household Saving (S_H) and Firms' Saving (S_F), we get the following identity:

$$S \equiv S_H + S_F \equiv I + (G - T) + (X - M) \qquad (1)$$

These are all flow variables over a given period of time. Household saving is broadly related to income. In their pioneering studies of saving behaviour, Michał Kalecki and Josef Steindl confirmed Hobson's observation that the middle classes and those on higher incomes account for the vast bulk of household saving, for the obvious reason that they have higher incomes than people on lower incomes, and it is easier to save out of higher income.

In the theory of saving, household saving is the residual income of households that is not consumed. In the case of firms, their saving is the residual profit that they have, after their expenditure on the costs of producing their goods and services, and after payment of income commitments to holders of their financial liabilities (i.e., debtors, and holders of equity). In other words, firms' saving is the retained profits of all firms in the economy.

Firms' saving plays a crucial part in the dynamics of the capitalist economy. The vast bulk of capital accumulation by firms is financed out of retained profits. This was first noted by Kalecki, and was confirmed in studies by Locke Anderson, Victoria Chick and by recent research that I have done with Marilyn Polena (Anderson 1964, Chick 1993). Through its influence on capital expenditure, firm saving is a crucial factor in capitalist dynamics, i.e., inflation, employment and business fluctuations. This is apparent if equation (1) to re-arranged to give:

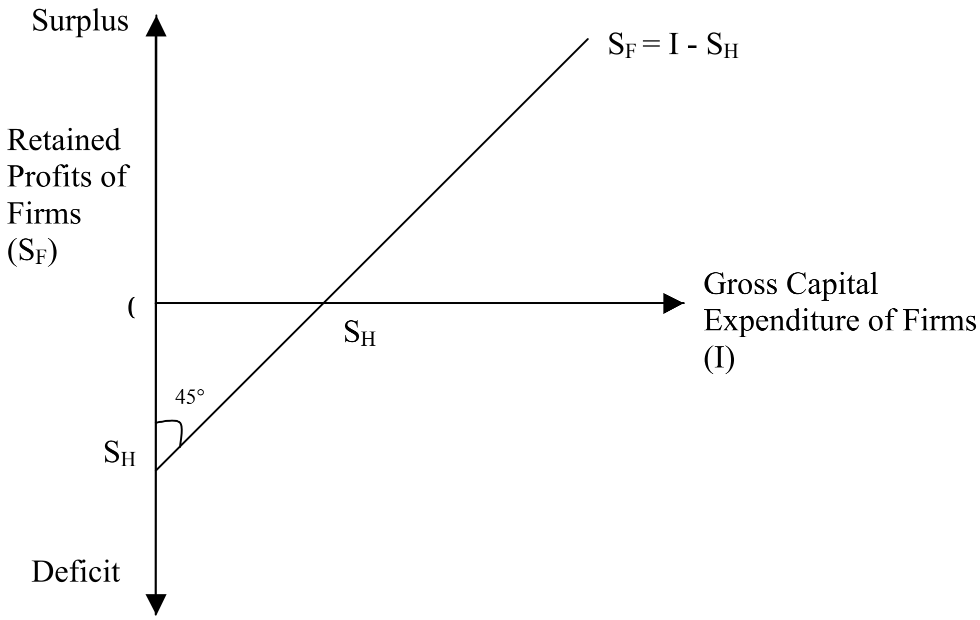
$$S_F \equiv I - S_H + (G - T) + (X - M) \qquad (2)$$

For the sake of simplicity, it can be assumed that (G – T) + (X – M) is equal to zero. This yields an identity in which Firms' retained profits (S_F) are equal to their gross capital expenditure minus household saving. Behind this national income identity is a causal relationship which becomes apparent if the components of the equation are examined to see which may be influenced by firms' decisions. 'Now, it is clear that (firms) may decide … to invest more in a certain short period than in the preceding period, but (firms) cannot decide to earn more. It is therefore their investment … decisions which determine (retained) profits, and not vice versa'. (Kalecki 1943 pp. 48-49). This follows fairly obviously from the circular flow of income analysis with which all students are introduced to macroeconomics, and which is largely forgotten, or dismissed as too elementary, by the time they become proper economists.

An implication of this is the Keynesian formulation that Investment determines Saving. In the Steindl formulation given above, investment determines the retained profits of firms. However, household saving is a financial barrier to retained profits: Firms will only end up with retained profits amounting to the difference between firms' investment and household saving. If household saving exceeds the level of investment, then firms' saving becomes a net financial deficit. In this way, saving at all times equals investment. But the factor which equalises them in practice is not the rate of interest, as most text-books teach, but the net retained profits or financial deficit of the business sector.

This is illustrated in figure 1 below:

Figure 1: Household Saving & Firms' Retained Profits in Pre-Financialised Capitalism



Saving = Firms' saving (S_F) +Household Saving H_s = Gross Capital Expenditure of Firms (I)

The figure shows the dependence of firms' net cash flow (retained profits – the curve S_F in the diagram) on investment and the level of household saving. If investment falls below the level of household saving, firms as a whole experience a financial deficit.

According to Kalecki, this relationship between household saving and the financial surplus or deficit plays a key part in the business cycle. If investment falls below the level of household saving, firms find themselves paying out more in costs, and payments to holders of their financial obligations, than they receive in income. Firms will then borrow to make up the deficit, and the rise in their indebtedness will tend to reduce investment further. Kalecki argued that this is caused by the 'inelasticity of saving' with respect to investment (Kalecki loc.cit.). In other words, when investment falls, this does not immediately affect the incomes of recipients of higher incomes who account for the bulk of saving. Their continued saving prevents the money that firms throw into circulation, in the process of production, from returning to firms as sales revenue equal or greater than their costs of production and financing. In order to cope with this unexpected financial deficit firms continue to reduce their investment, driving the economy into recession, until household saving falls below the level of investment.

In his pioneering study *Maturity and Stagnation in American Capitalism* Josef Steindl gave a more detailed account of household saving, and showed that it was largely accounted for by rentier incomes, and the incomes of the middle classes (Steindl 1952, pp. 113-121). Rentier incomes are largely received through the intermediation of banks and financial institutions, which stabilise those incomes through diversification. The saving of rentiers is therefore largely unaffected by a rise in the financial deficit of firms. Some humbler, investors whose wealth does not allow them to diversify their portfolios, may find their incomes affected by the financial difficulties of firms. But such investors are marginal in economic and saving terms.

The remainder of household saving is accounted for by the savings of the middle classes, i.e., those employed in public administration, education, the liberal professions and, increasingly today, the managerial bureaucracy engaged in the administration of financial, industrial and commercial corporations. This social group is largely disconnected from the industrial business cycle, which does not affect those working in public administration, education, the liberal professions. Even the management of financial, industrial and commercial corporations may, if those corporations are large enough, insulate their incomes from industrial fluctuations by diversifying the business of those corporations.

This high and stable level of middle class saving forms a threshold that forces firms into unanticipated debt, when their gross capital expenditure approaches that threshold, and then falls below it. In contrast to anticipated debt incurred, for example, to finance and expansion of production, unanticipated debt signals to firms that they have been over-optimistic in their planning. Firms respond to such 'enforced indebtedness' by cutting back on their expenditure, most notably by postponing investment (it is much more difficult to reduce the costs of current production) and using the money saved to repay debts. This merely prolongs the industrial crisis, because it reduces investment even more below the household saving threshold. Total investment in the economy is then further reduced. The crisis continues until public sector projects or replacement investment (depreciation) induces a rise in investment.

This prolonged industrial crisis is typical of the difficulties that affected industries in Britain and the United States in the 1950s and the 1960s. At the time, these difficulties were attributed to a lack of competitiveness against industrial producers in East Asia, the greed of trade unions and so on. But the true cause of these crises was the thrift of the middle classes, with memories of their difficulties in the Great Depression.

The situation changed in the 1970s with developments that laid the basis for a new financial cycle. The proliferation of unregulated credit (most notably in the Euro-markets) and the ease with which credit can be expanded against rising collateral values, undermined financial regulation and created a new spirit of competition and innovation in banking and financial markets. Legislation greatly expanded the scope of funded pension schemes, in part at least on the grounds that this would direct more finance into industrial investment and thereby revive the industrial fortunes of the U.K. and the U.S. As we now know, the industrial revival did not happen, for reasons outlined in the next section. But the inflow of money into pension funds and its placement in financial securities set off a prolonged financial boom. At the same time, the removal of restrictions on housing credit inflated house prices.

2. The theory of asset price inflation

(This section of the paper outlines the theory of capital market inflation that I put forward in my two books *The Economics of Financial Markets and the 1987 Crash*, and *The End of Finance* [Toporowski 1993, chapter 3, and Toporowski 2000, part 1]). The systems of general equilibrium that are commonly used to analyse asset markets routinely ignore what Minsky early on identified as the market process that actually occurs in such markets. Those markets do not fix prices that make supply equal to demand, except in a notional sense. Financial markets typically operate for extended periods out of equilibrium. When the demand for financial securities exceeds the amount of money that holders and issuers of those securities are prepared to take out of the market, prices rise. As prices rise, demand for those assets, far from falling off, is enhanced by a speculative demand for assets to benefit from capital gains. However, prices of securities do not rise equally across all markets. Short-term securities and bonds usually have the price at which they are repaid written into the terms of the bond. As the date of their repayment approaches, their market price converges on their repayment price. The market price of such bonds will only exceed that repayment price by a small margin reflecting any differences between the interest payable on such a bond, and the interest payable on equivalent new issues. Excess demand for new securities will therefore inflate most of all equities (common stocks) that do not have any guaranteed repayment value.

The majority of securities are issued by financial intermediaries and bought by other financial intermediaries. This issue therefore does not constitute any net expansion of credit, or of the balance sheets of non-financial businesses, such as would take out of the markets any excess net inflow of money into those markets. The non-financial sectors that do take money out of the markets are governments, and corporations. The finance that governments take out of the markets is limited by their fiscal position (the balance between government income and expenditure). An excess demand for securities, such as was set off by the inauguration of funded pension schemes in the U.K. and the U.S. therefore impacts most directly on the balance sheet operations of corporations. During the 1980s, corporations that issued securities in the capital markets found that they could issue shares cheaply. In particular, with capital market inflation, shares came to be held not just for the sake of their dividend income, which is paid by the company, but also for capital gains, which are not paid by the company but by other buyers in the market for the shares.

As a result of the excess demand for shares, corporations have issued capital in excess of what they need to finance their commercial and industrial operations. In the past the over-capitalisation of companies might have been avoided because it would have involved the 'watering down' of profits (sharing a given amount of profits among more shareholders), or loss of control by the directors of a company who could no longer control the majority of shares at a company general meeting. However, today's shareholders are mostly institutions whose large diversified portfolios are sub-contracted to professional fund managers and rated on financial returns, rather than on their active running of companies. By and large they have too many diverse holding to take any other than a financial interest in a company. At the same time, new techniques of senior management remuneration have tended to replace profit-related pay with share price-related pay, through stock options. Along with new techniques of debt management, stock option remuneration has removed inhibitions about the over-capitalisation of companies.

Excess capital has been used to replace bank borrowing with cheaper long-term capital. Replacing borrowing with shares also has the advantage that pre-tax profits can be made to rise by the reduction in interest cost. Where excess capital has not been used to reduce debt, it has been used to buy short-term financial assets. Alternatively, excess capital is committed to buying and selling companies. Hence the extended festival of merger and takeover activity and balance sheet restructuring that has characterised corporate finance since the 1980s.

One may wonder what happened to the hopes of industrial revival, entertained at the end of the 1970s, when it was argued that funded pension schemes would make more long-term capital available for industrial investment. These hopes have by and large not materialised. Britain and the U.S. remain economies with weak industrial investment and performance, for which the cause is fairly obvious to anyone who has followed recent changes in corporate finance. Large corporations, which account for the vast bulk of private sector investment, now have excess capital and engage more in balance sheet restructuring (buying and selling financial assets; issuing and repaying liabilities). Such restructuring leaves corporations with larger risky financial market exposures, which therefore require the holding of greater amounts of liquid assets (short-term deposits, holding of financial paper). If a company finds itself with too much liquid assets, profits can be immediately increased by using the excess liquid assets to repay debt. Indeed, this is a far more certain way of raising profits than the prolonged and uncertain business of investment in plant and equipment. Industrial regeneration is a dream of engineers, from which companies are awoken by their finance directors to face the irrefutable realities of balance sheet restructuring as the only financially viable way forward for all companies.

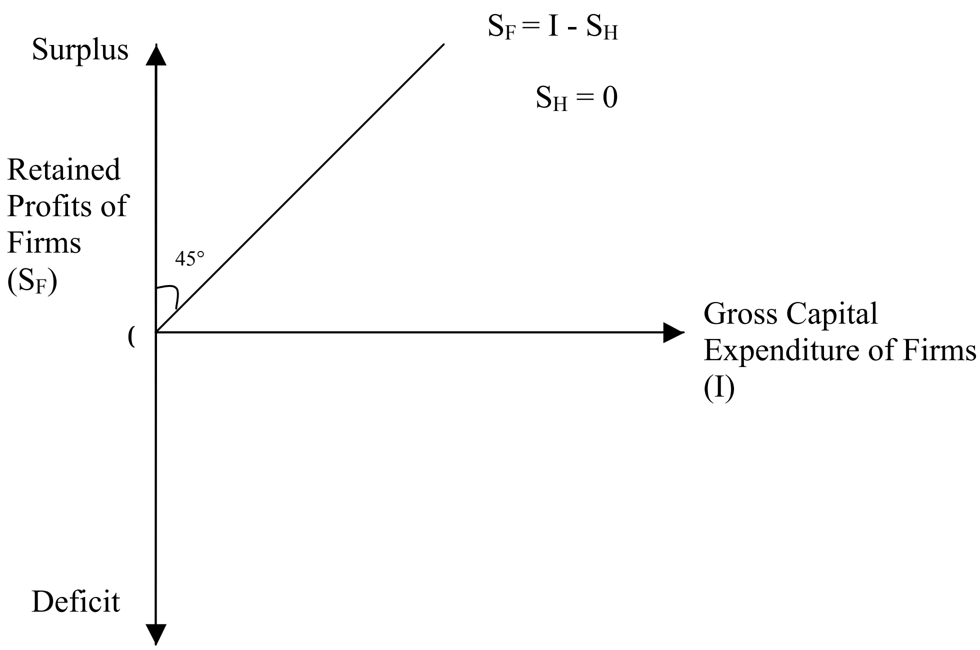
The overall effect of company over-capitalisation on banks has been to make them more fragile. Before the 1970s, the largest, most reliable borrowers from banks were large corporations. From the end of the 1970s, such corporations found that they could borrow much more cheaply by issuing their own bills (company paper) or directly from the inter-bank market. If banks wanted to hold company loans, they have to buy them in the market at yields that gave banks no profit over their cost of funds in the capital or money markets. The loss of their best customers has turned banks towards fee-related business in derivatives and debt obligations markets, and towards lending into the property market and to other risky customers that banks had hitherto treated with much more caution. The overall effect, from the savings and loans scandals of the early 1980s, to the sub-prime market crisis since 2007, has clearly been to make banking markets much more fragile.

3. The Middle Classes and Asset Inflation

The rise in the value of their real estate and financial assets has induced a change in saving behaviour of the middle classes. Hitherto the middle classes saved more or less passively, along lines loosely related to the Life Cycle Saving Hypothesis, or the New Classical consumption function: Income was put into savings to support future consumption in retirement. Only among the small minority of the wealthy upper classes was wealth used as a substitute for income, with legacies and realised wealth being used to support current expenditure. From the 1980s onwards, active use of their balance sheets to generate cash flow became much more common among the middle classes. Asset inflation allowed the emergence of an alternative 'welfare state of the middle classes' based on issuing financial liabilities against rising asset values, or the sale of inflated assets. Private health care, fees for education, replacement income in periods of unemployment, have increasingly, among the middle classes, been accommodated by borrowing against wealth whose value has conveniently been rising much faster than current expenditure, or selling such wealth.

When assets are no longer largely held long-term, to be realised only on death or retirement, but come to be held more briefly, for capital gain purposes, their turnover inevitably increases. The more common use of debt or asset sales to pay for current expenditure has brought down saving rates in the household sectors of the United States and Great Britain to negligible or negative levels. This in turn has removed the household saving threshold which firms' investment must exceed in order to provide the business sector as a whole with a financial surplus. Now the total amount of firms' capital expenditure is realised as net cash flow in the form of retained profits. This is illustrated in figure 2 below.

Figure 2: Household Saving & Firms' Retained Profits in Financialised Capitalism



The business cycle is now different. Industrial crises no longer play a part in bringing economic booms to an end. Such crises are largely eliminated by the over-capitalisation of corporations, which increases the liquidity of large companies and thus makes it easier them to maintain payments on their commitments. Industrial crises have now been replaced by a less dramatic under-investment in fixed capital by those companies. Booms are increasingly driven by middle class consumption, sustained by capital gains extracted from inflating asset markets. The end of a boom is marked by a financial rather than industrial crisis. But the resilience of consumption, which in wealthy countries remains one of the most stable elements of total expenditure, ensures that economic recessions are weak.

5. Conclusion: The political culture of the propertied classes

The relative economic stability of the financialised capitalist countries outlined above should not be interpreted as a new era of stability and prosperity in capitalism. This paper has concentrated on domestic and social class factors in that relative economic stability. It has not considered the consequences of the decline of industry in the financialised economies, with manufacturing being the main industrial casualty of financial inflation. Nor has this paper considered the extent to which financial inflation in the U.S. and the U.K., by backing their currencies with inflated asset values, has accommodated the macroeconomic imbalances that have resulted from a weakening industrial performance in those countries. There are other more domestic concerns to which the present situation gives rise. Among them are:

a) The intellectual hegemony of investment bankers. As financial markets inflate, their apparent success contrasts with the lagging performance of under-invested industry. At this stage, far from concentrating resources on industrial renewal, financial innovation concentrates on mobilising financial resources to sustain rising asset prices. Thus, in an era of finance, finance mostly finances finance. This narrows the worldly experience of bankers and financiers. Nevertheless, the dominance of financing arrangements in household and company affairs makes practitioners in finance increasingly sought-after policy advisers. In this capacity, their *deformation professionelle* inclines them even more to providing a standard solution of balance sheet restructuring to complex social and economic problems.

b) An enhanced delusion of successful thrift among the middle classes. Individuals who enjoy the benefits of asset inflation only directly experience the purchase of the financial asset which gives them a claim on a capital gain, rather than the money coming into asset markets that allows that gain to be realised. Capital gains are therefore 'naturally' attributed to provident and well-calculated asset purchase, rather than generalised asset inflation, and the propertied classes succumb to a comforting illusion, carefully cultivated by their financial intermediaries, that their foresight and financial acumen have secured them their gains. In fact, the situation is quite the reverse. The benefits which the propertied classes obtain from inflated property and financial asset markets are increasingly capital gains on wealth rather than accumulated saving out of income. As property markets inflate and pension funds mature, it is the propertied classes who dissipate on their own consumption the capital gains that they are able to take out of property and financial asset markets through the enforced saving of the young buying accommodation at prices that swallow up most of their incomes, or lower paid workers obliged to subscribe to pension funds. (An implication of zero net saving in the household sector is that households forced by debt to consume less than their incomes have their counterpart in households that consume in excess of their incomes.) The delusion of thrift increases a growing sense of financial self-reliance and independence of the state welfare system.

c) The emergence of inflated property and financial asset markets as a 'welfare state of the middle classes'. Inflated asset markets act as a welfare state in that such markets socialise the financial risks of those owning such assets. Inflated asset markets allow owners of such assets to cross-insure each other against extraordinary liabilities for health care, holidays, school fees, the purchase of housing, or the repayment of inconvenient debt. Such extraordinary liabilities may be accommodated by taking out of those asset markets money that is being put into them by those acquiring such assets. This has the political consequence of alienating those with property from a state welfare system for which they pay but from which they derive little benefit. Middle class taxpayers' demands to reduce the cost of that welfare state by concentrating benefits more narrowly on 'those in need' then reinforces that middle class alienation from the state system.

d) The marginalisation of those without wealth. They may be home-owners in places where wealthy property-owners do not wish to buy housing, or in places where wealthy property-owners are buying housing. Where property-owners transfer capital into the housing market, the increase in house prices obliges the young and migrant workers to live in over-crowded conditions, because housing has become a perquisite of property-owners, rather than being available to all. Not having property denies marginalised sections of society the opportunity to operate balance sheets actively: debt is more likely to finance current consumption, rather than the acquisition of inflatable assets. These are the lower class counterparts of those among the propertied classes whose possession of inflated assets allows them to consume in excess of their incomes. An unequal distribution of income is thus enhanced by a growing distinction between the 'balance sheet' rich, and the 'balance sheet' poor.

e) State-administered social welfare as a system for prosecuting the poor. While the official welfare state may provide some minimum income for them, it increasingly does this with a degree of institutional bullying and hectoring, designed ostensibly to make claimants more active in securing their financial independence but, in reality, designed to reassure propertied tax-payers that those claimants are being penalised for their improvidence in not having property to support them. (No-one penalises the propertied classes for their improvidence in living on unearned income from capital gains.) This is a natural consequence of a state welfare system that is no longer comprehensive because the middle class is increasingly opting out of it.

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