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Neologism as Theoretical Innovation in Economics: The case of 'Financialisation'

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Neologism as Theoretical Innovation in Economics: The case of 'Financialisation'

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Abstract

The term 'financialisation' is a recognition that finance has come to play a key role on the modern capitalist economy. But users of the term do not agree on its meaning and recognition of the growing scale of finance has not brought about an increased understanding of financial processes. The paper examines the reasons for increased turnover in financial markets. The main themes in the literature on financialisation are examined and shown to lack a coherent account of financial processes that goes beyond the evidence of financial activity.

JEL classification: B26, E11, E12

Keywords: Financialisation, debt, credit

'… little more than a series of definitions and phrases together with a mass of detailed material that often seems to have little connection with … overall generalisations. What is lacking is a *theory* that would connect the two' (Brewer 1980, p. 167).[2]

Introduction

Spurious theoretical innovation (neologism) in economics may be defined as a form of theorising in which a school of thought finds the theory that defines that school is inadequate for understanding events in the world. A manifestly new economic situation is declared to have arisen which previous theories are said to be unable to elucidate. A new system of theory is therefore declared appropriate for the new economic order. The new theory turns out to be an eclectic combination of old elements with added ingredients under a new name, which constitutes the theoretical innovation. As the new term gains currency, it comes to be used in order to give the appearance of novelty to ideas, and comes to have different meanings according to the context and the individual using the term. With different

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[2] Anthony Brewer wrote this about the work of Emmanuel Wallerstein on imperialism. However, his remark aptly summarises the arguments in this paper.

meanings, the term loses its efficiency as a device for communicating ideas: Users of the term believe that they are communicating effectively because other people are using the term, whereas in fact they may be communicating about different ideas. In recent years, for example, 'globalisation', which has been used to justify monetary policy and theoretical innovations that in many instances (for example, interest rate management, or open market operations) are hardly novel.

The most recent case of this kind of theoretical innovation is that of 'financialisation' which emerged among critics of finance and, in the throes of the controversies aroused by the recent financial crises, has been adopted by even mainstream commentators such as the economic journalist Martin Wolf. Among the critics of finance, 'financialisation' is often a convenient way of incorporating financial factors into theories that themselves offer little scope for the operations of finance. In large part this is because economists have traditionally viewed both microeconomics and macroeconomics as occurring with 'real' variables, and money and credit operations are supposed to occur in a separate analytical sector. The economic transactions are supposed to have financial counterparts that correspond to money used in exchange. In fact credit systems have always been more complex than the 'real' economic transactions with which they are associated. Investment, and especially cross-border investment using different currencies, involves more financial transactions than it does in textbook accounts of financing. These additional transactions are only new to economists who think of economic transactions as financially simple, or have a simple 'banking' view of company finance along with what Schumpeter called a 'monetary theory of credit (Schumpeter 1934). Such economists are therefore prone to appeal to nebulous processes of financialisation to explain the more complex financial operations that they find in the real world. The use of the term in different contexts and with different meanings makes it of dubious analytical value.

Thus Ricardian Marxists, who view capitalism as an economy of factory production, have in the past overlooked the credit operations of a credit-based capitalism, or have viewed them as subordinate to such production and exchange. 'Financialisation' allows them to note credit activities, without revising their factory production theory of capitalism. Similarly, Post-Keynesians, traditionally theorising with a financially primitive Marshallian theory of the firm, have often restricted their analysis to financial rent-seeking and speculation. Ignorance of credit operations and the balance sheet operations of firms, makes economists vulnerable to having their imaginations seized by the dramatic events in the financial markets of the 'financially-advanced economies' in the twenty-first century. It is then easy to conclude that financial developments are key factors in the continuing dysfunctions of capitalism. But such impressions are frequently reactions to events rather than *prima facie* evidence of particular financial processes. Financial developments are often responses to policy and balance sheet adjustments that go beyond mere speculation and rent-seeking.

Analytically, the paper argues that the flaw in using the term 'financialisation' lies in its failure to distinguish between 'endogenous' changes, due to some exogenous shift in a more fundamental element of the economy. As a result, the analysis of a general term, such as financialisation, is unable to distinguish between policy, market process, structural change and financial outcome. In the case of financialisation, its proponents (below) attach a determining significance to more active banking and financial markets, and largely overlook the possibility that the more active banking and financial markets are themselves endogenous, or the results of routine or even more fundamental changes in the economy.

In the section that follows it is argued that the increased financial turnover that is routinely advanced as evidence of 'financialisation' may arise simply because transactions in the real or non-financial sector entail more credit operations than in the past, and need not necessarily mean that real transactions are now in the service of financial markets. Following this, another section examines particular theories of 'financialisation' and argues that in most cases the processes identified as financialisation are endogenous to some other policy or real economic process.

1. Increasing turnover in the financial markets

At the core of financialisation theory is the empirical observation that there has been increased turnover in the financial markets of countries that are deemed to have 'financialised'; that financial balance sheets in those economies have expanded rapidly; that the financial operations of firms and households have increased in relation to income; and that financial assets and liabilities make up an increasing share of balance sheets in the economy. ('Financialisation is … a broad set of changes in the relationship between the "financial" and the "real" sectors which give greater weight to financial actors or motives. … [It] thus describes an increasing volume of financial transactions, relative to "real" transactions and the direct and indirect effect these changes have on the non-financial sectors.' Stockhammer 2012). These measurable phenomena are supposed to be symptomatic of the increasing dominance of finance.

Most of these financial transactions, and accompanying inflation of financial balance sheets, are the liquidity and 'hedging' requirements of financial intermediaries and their customers (Grahl and Lysandrou 2003). In this sense they are endogenous to the modern capitalist economy, rather than driving it, as argued by financialisation theorists. In those economies with the most complex financial systems, such as the United States, or the U.K., and in 'emerging markets', most financial transactions may be accounted for by a combination of market finance, financial innovation, active monetary policy, and 'hedging'.

Market finance, the traditional system of long-term finance in North America and the U.K. is an excellent example of how a relatively simple financial transaction entails a number of subsequent other transactions. A bond is issued, arrangements are made to place it, and a secondary market in the bond emerges and needs to be sustained if subsequent bonds are to be issued by companies or governments. Financial balance sheets are more actively turned over and a given 'real' investment transaction thus gives rise to financial transactions worth many times more than the initial transaction. In a simple, closed economy, firms have to move funds from reserves to current accounts in order to invest (Kalecki 1933, p. 95). In an open economy, and especially a developing economy with a modern sector dominated by multinational firms, a number of balance sheet operations may be required to effect a particular investment project, or to transfer funds between countries (Levy 2012).

With financial innovation, credit transactions take place without financing any real economic activity. Financial innovation is the advance of credit to buy assets such as land and housing (but later financial instruments as well) in which there was previously no market. Once credit may be used to buy an asset, that asset can also be used as security against future loans. Financial innovation therefore develops markets in assets. Financial transactions increase, and balance sheets expand (Toporowski 2010, chapter 4). The major financial innovation of the second half of the nineteenth century was the emergence of markets in long-term finance for industry, following the passing of Companies Acts that allowed companies as a matter of legal routine to issue long-term securities. In the economy as a whole, productive capital was able to secure a financial counterpart in long-term securities or liabilities held against industrial or commercial assets. Those securities were assets for their owners, had value and could be traded in financial markets. It follows that they could be used as collateral (or security, hence the term ‘securities’) against bank loans. Such bank loans or credit created a second layer of financial intermediation on the underlying ‘real’ assets. In its turn, bank credit may be used as security for further loans, adding a third, and possible a fourth level of intermediation. More people became economically active in financial markets in an ‘unproductive’ way, as defined in classical political economy. But this does not mean that finance is more dominant over the real economy, unless some further theory is advanced about the operations of the real economy. Far from being dysfunctional, such innovation may be said to be functional, for an economy that requires liquidity for business solvency, in providing liquidity against a wider range of assets.

A third factor affecting turnover in financial markets is more active monetary policy, a virtually permanent feature of economic policy-making since the 1970s. In a complex financial system, monetary policy activism also gives rise to increasing turnover in financial assets and liabilities. Again, many economists have been lulled by the simplifications of monetary theories with simple intermediation models of credit, into believing that a change in monetary policy causes one-off adjustments in financial and non-financial economic activity. In fact, because of the complexity of financial markets, a change in interest rates, or any central bank financing operation, gives rise to complex additional transactions through arbitrage along the yield curve and between different financial instruments, followed by further rounds of arbitrage as the prices of financial instruments are affected by the first round of arbitrage. In banking markets, borrowers refinance if lower interest rates become available or ‘hedge’ (see below) if higher interest rates seem imminent. For economists used to thinking in terms of equilibrium, rather than market process, the eventual equilibrium in which no further arbitrage is possible, may be the essential state of the economy after a change in monetary policy. But experience shows that such a final state is never achieved if only because, at that point, the absence of further transactions would drain the liquidity out of the markets.

More active monetary policy induces even more financial transactions when the central bank engages in open market or sterilisation policies. Given market expectations and portfolio preferences, financial investors (fund managers acting on behalf of major financial institutions which now hold the majority of financial securities) will enter the financial markets to rebalance their portfolios, either to recover the previous portfolio distribution, or to change their portfolio composition in line with expectations and preferences revised by central bank operations. These financial operations, in response to central bank operations, feature particularly large in emerging markets following capital account liberalisation and the resulting capital movements.

Finally, higher turnover in the financial markets is caused by 'hedging' transactions, or transactions undertaken to cover possible future liabilities of businesses and corporations. At the time of classical political economy, until the time when Keynes was writing about speculation, it was common to use cash or bank deposits as the sole efficient hedging instrument. This appears in Keynes's analysis as a 'precautionary' demand for money, that is the money held against the possibility of illiquidity. With the development of futures markets it becomes possible to 'hedge' commitments in the futures markets, or with forward contracts, thereby increasing the possibilities for profitable hedging, if the cost of the 'hedge' contract is less that the revenue from the commitment that it is hedging (Toporowski 2000, part III). With the shift in hedging from cash to other financial instruments and the emergence of futures contracts that have a market value, and hence can be used as collateral for further credit, the number of financial transactions set off by any individual bank or capital market issue increases enormously, as does the value of financial balance sheets.

These autonomous or endogenous transactions in the financial markets manifest themselves as increased financial turnover, larger financial balance sheets, and increased revenue in financial markets. Because financial intermediaries do so much credit business with each other, a given payment to an intermediary may then appear in payments to other intermediaries. In this way, the gross profits of financial intermediaries may increase without any actual increase in net profits of the financial sector as a whole. A rising share of profits being paid to financial intermediaries may appear without revealing that much of the rising share is either the revenues from the financial operations of non-financial firms, or the increase in profits being paid by one financial intermediary to another. This swelling of financial turnover and revenues reflects the changing structure of the financial system, financial balance sheets, and banking and financial markets. But by itself it is not evidence of any fundamental or structural change in capitalism. For that it is necessary to examine what is happening inside the capitalist enterprises that determine what is happening in capitalism. With the elimination, in the 1980s, of restrictions on the marketing of financial services, the greater activity in the financial markets and the expansion of financial balance sheets and revenues have given finance a much greater visibility that, along with financial crises, have created an impression that finance is now the motor force of the capitalist economy.

2. Themes in Financialisation

It is impossible in a paper like this to do full justice to all those who have contributed to the literature on financialisation. As indicated above, the term is used differently by different authors with diverse approaches to finance. But the papers discussed below cover the main themes appearing in that literature.

At its most general, financialisation is presented by Gérard Duménil and Dominique Lévy as the condition that gives rise to the present 'Crisis of Neoliberalism', the title of their most recent book (Duménil and Lévy 2011). Here 'financialisation', 'neoliberalism' and 'globalisation' are presented as three mutually reinforcing trends resulting in a 'financial hegemony' that is now in crisis. In Duménil and Lévy's account, the three trends are overlapping with, for example, foreign capital deregulation appearing as features of all three (and, indeed, the 'leadership of Finance' being anticipated in Marx and Engels' *Communist Manifesto*). The evidence of financialisation and its crisis is common to virtually all authors writing about financialisation: the rise in bank intermediation and household indebtedness, the slow-down in economic activity since 2008, and the declining rate of productive capital accumulation. These are undoubted features of the present economic conjuncture. But it is not clear which are the determining factors, and which ones are endogenous. Duménil and Lévy state clearly that 'financialisation is not an end … but a tool in the … maximisation of the income and wealth of the upper classes.' This is demonstrated by a fall in the wage share of total income (see also Stockhammer 2012). An argument of François Chesnais', that the crisis is due not so much to declining capital accumulation but to productive over-accumulation, and the expansion of fictitious capital, is cited somewhat inconsistently (Chesnais 2010). Furthermore, the Duménil and Lévy argument clearly contradicts an older, pre-crisis, view of Robert Boyer, according to which the higher rate of financial return leads to an overall increase in economic growth (Boyer 2000).

As mentioned above, the increase in household debt is common currency among the theorists of financialisation, and the more Ricardian Marxist Boyer and Duménil and Lévy unite with Post-Keynesians such as Eckhard Hein and the Minskyans of the Jerome Levy Institute in their emphasis on the significance of the rise in household debt (Hein 2011; Wolff 2007). Here the data on the gross indebtedness of household is presented as evidence of the squeeze on household incomes. In fact the rise in indebtedness has its counterpart in the rise in housing values, at least until the present crisis. This asset inflation means that a considerable portion of the rise in indebtedness is endogenous to the household sector and its financial operations, rather than being an externally imposed debt bondage, as appears in this financialisation literature (Toporowski 2010, chapter 12).

A significant portion of the discussion links up with older debates about capital account liberalisation in developing countries (Epstein 2005). The criticism of capital account liberalisation expresses the traditional Minskyan Post-Keynesian preoccupations with rent-seeking and speculation with the increase in foreign direct investment and the rise in cross-border capital flows in developing countries (Milberg and Winkler 2010, Arestis and Glickman 2002). This part of the financialisation literature is unanimous in linking financial deregulation with financial instability. Such deregulation is deemed to be an exogenous policy choice imposed on developing countries at the behest of the International Monetary Fund for the convenience of international banks. This forced liberalisation is supposed to be the key issue for political economy. However, this leads to the neglect of other aspects of capital flows: their role, positive as well as negative, in exchange rate management and in the management (refinancing) of international debt. Most crucial of all those aspects, from the point of view of understanding the evolution of capitalism, is the role of capital flows in capital accumulation, both financial accumulation in the financially advanced capitalist countries, and the function of these capital movements in the capital accumulation in the developing countries themselves.

Perhaps the most financially-informed view of financialisation is the one that comes out of the work of William Lazonick, who has emphasised the trend in the American corporate finance since the 1980s to give greater priority to ‘shareholder value’, at the expense of more ‘managerial’ goals such as maintaining market shares, cultivating customers, and keeping the loyalty of employees (Lazonick and O’Sullivan 2000. See also Van Treeck 2009). In Lazonick’s view, demands by shareholders to maximise the returns that they receive from the companies they own were reinforced in the 1980s by the widespread use of share options to reward senior managers in those companies, and the easing of regulations controlling the buying back of shares. The result has been to drain the liquidity of corporations in order to pay dividends and buy-back shares in order to keep share prices high. This has resulted in under-investment in fixed capital and even the reduction of industrial capacity, the business strategy of 'downsize and distribute'. There are obvious parallels here with the rent-seeking rentier that features in Post-Keynesian contributions to the financialisation literature (e.g., Stockhammer 2004, Hein 2011), although its analysis of corporate finance makes Lazonick's work considerably more serious and insightful.

However, there are two limitations to the 'shareholder value' approach to understanding the significance of finance today. First of all its scope seems to be restricted to the Anglo-American, capital market system of finance (the shareholders of Europe seem to extract their more modest rents much more discreetly). Even in the Anglo-American sphere, the capital market system of finance is limited to providing finance for corporations, i.e., larger non-financial businesses, and the refinancing business of banks and financial institutions. In developing countries and emerging markets, capital market finance operates within a much more complex system of corporate finance, concentrated to a much greater extent around the operations of multinational corporations, state-controlled enterprises, and a relatively small number of national businesses, and much more vulnerable to foreign capital flows (Levy 2012). But even in these less mature markets business registers its tribute to the value of its stocks. When the Chinese government floated the minority shareholdings of its banks in 2005, the prospectuses contained the usual references to shareholders' value. But this was because the phrase is part of the litany that comes with share flotations. Maybe it means that China is 'financialising' under its Communist government? Or maybe it is not financialising, and just using the style? Whichever is the case, it illustrates the ambiguities of the term 'financialisation', if it can cover the tendencies to financial feudalism in the United States as well as the politicised banking of China.

The Chinese case points to the second limitation of 'shareholder value' as a basis for financialisation, namely the reliance of this approach on the stated intentions of participants in the financial markets. These intentions inevitably reflect the money-making opportunities in those markets. After all, this is why people enter the markets. However, the commentary that accompanies their transactions is part of their money-making business, rather than a discourse on the nature and significance of modern finance. The rhetoric is not the analysis. The 'shareholder value' approach to financialisation therefore uses appearances in the financial markets to explain the reality of industrial decline, without addressing the reality of finance.

In reality shareholder value is not just obtained by draining the value out of industry. In a process of capital market inflation share prices may rise without any money being taken out of the companies whose shares are increasing in value. The increase in value that shareholders get when the capital market is being inflated is from the credit or money that is being put into the market by other participants in that market. The buying back of shares became significant when capital market inflation faltered at the end of the 1990s. Despite the claims of senior corporation executives to be in control of their corporations, and of shareholders to be in control of their portfolios, their decisions take place in markets and are therefore endogenous to market processes in finance industry and commerce. In the case of finance, the key process is the inflation or deflation of the capital market (Toporowski 2000, Part I).

Conclusions

Financialisation is an example of a kind of theoretical conservatism that offers a new name in place of the new theory that is needed. The developments in finance in the last decades of the twentieth century, and in the twenty-first century require a financial macroeconomics that goes beyond Ricardian Marxism, Post-Keynesianism, and the variants of New Classical and New Keynesian macroeconomics that now dominate the mainstream. What is needed is a proper analysis of how modern finance and capitalism function, identifying endogenous factors and the key determining variables in the system, rather than speculatively linking up of incidents in how business is done today. There is a reality behind the rise of finance. This lies in the emergence of asset inflation, and its consequences on the balance sheets on the respective balance sheets of financial intermediaries, non-financial firms, governments and the property-owning middle classes (Toporowski 2010). The addition of financial variables to theories based on forms of capitalism predating the present emergence of asset inflation, and giving that hybrid the name financialisation, are not sufficient to identify the key relationships associated with the dominance of finance in the twenty-first century. Without identifying and explaining those key relationships, 'financialisation' cannot provide any insight beyond the evidence adduced for its existence. The challenge for users of that term is to provide analysis that reveals more than just what is already known.

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