Financialisation, Economy Society and Sustainable Development: An Overview

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Preface

The nine chapters draw together the research results of the Financialisation Economy Society and Sustainable Development (FESSUD). FESSUD has been a 5 year research project starting on 1st December 2011 and involving 15 partner institutions. It had ten research work packages (plus one on management and one on dissemination. The following nine chapters cover Work Packages 2 through to Work Package 9. Work Package 11 on Foresight in Deliverable 11.07 has its own overview of the work of that work package which is not repeated here. Work Package 12 is the synthesis work package of which this is the final deliverable.

Chapters 1, 2 and 3 draw heavily on Work Packages 2 and 3, and elements of Work Package 9. Chapter 4 on Work Package 6, chapter 5 on Work Package 8, chapter 6 on Work Package 5 and elements of Work Package 8, chapter 7 on Work Package 7, chapter 8 on Work Package 4 and Chapter 9 on Work Package 9.

This document should be referred to as:


Authorship

The overall responsibility for the drafting of this deliverable was held by Professor Malcolm Sawyer as the Principal Investigator. Stefanos Ioannou (then University of Leeds) prepared drafts on much of the work of FESSUD; and he is a major author of Chapter 1,2,3 and 9. Sections and chapters were taken, with minor amendments from a range of FESSUD deliverables, and the origins of such sections and chapters are indicated in relevant footnotes.

Key words: financialisation, crisis, economic development, environment, financial structures, monetary policy, regulation, social well-being

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Chapter 1: The processes of financialisation in the present era

1.1 Introduction

The term ‘financialisation’ has only come into wide use by social scientists in the past 20 years or so, though similar terms such as financialised capitalism were in much earlier use\(^1\). Terms such as finance-led capitalism, finance-dominated capitalism are also in use and convey similar sets of ideas. ‘Financialisation’ is still not a term in wide use amongst mainstream economists and social scientists even though they may be discussing features of what may be termed financialisation at least in respect of the expansion of the financial sector. Even amongst those social scientists who use the term, there are different conceptualisations of financialisation. This chapter then discusses what is meant by financialisation, and specifically how that term will be used in this report (section 1.2). One of the foci of the FESSUD project has been on the economic, social and political importance of the financial sector, and section 1.3 delves into that. Section 1.4 provides some overview of the economic impacts of financialisation.

1.2 Financialisation: past and present\(^2\)

It is incontrovertible that the economic, political and social scope of the financial sector has grown significantly in the past three to four decades. The term ‘financialisation’ has been a widely adopted term to refer to such developments. A widely cited definition is: “financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies” (Epstein 2005a: 3). And to that definition the FESSUD project would add the operation of domestic and international societies and polities. This Epstein definition indicates the scope of financialisation: however, it is then required to explore the forces behind the growth of the financial sector etc., the forms which that growth has taken, and the consequences of that growth for economy and society.

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\(^1\) See, for example, Sawyer (2013) for discussion on this point.

\(^2\) A substantial part of this section is taken directly from the synthesis for Work Package 7, D7.25.
In terms of how financialisation has been approached, van der Zwan (2014) identifies three broad approaches: these are ‘financialization as a regime of accumulation’, ‘the financialization of the modern corporation’, and ‘the financialization of the everyday’. A further dimension would be de-regulation and liberalisation of the financial system. Lapavitas (2011) views financialisation “as a systemic transformation of mature capitalist economies that comprises three fundamental elements: first, large non-financial corporations have reduced their reliance on bank loans and have acquired financial capacities; second, banks have expanded their mediating activities in financial markets as well as lending to households; third, households have become increasingly involved in the realm of finance both as debtors and as asset holders” (pp. 611-2).

Financialisation (in the sense of the general growth of the banking and financial sectors) has been a long-standing feature of capitalist economies. Indeed, it would be difficult to envisage capitalism without a substantial financial sector. Commercial banks and stock markets date back before the 19th century, and their growth gets underway during the 19th century alongside industrialisation. Indeed, “financialisation is hardly a new phenomenon in circuits of capital. What is perhaps relatively new is the extent to which finance has found its way into most, if not all, of the nooks and crannies of social life” (Lee et alia, 2009, pp. 727-8).

The historical evidence suggests that the process of financialisation may be seen as a long-run tendency characterizing the evolution of market relations. This process has been driven by innovations that progressively increased the choice flexibility of decision makers by relaxing the constraints to the available option set. This trend, however, has always been undermined by constraints of religious, ethical and political nature. In consequence of these contradictory forces, we observe in history an alternation of periods characterized by considerable financial constraints, as in the Bretton Woods era, and periods characterized by a systematic relaxation of financial constraints leading to an acceleration of financialisation, as in the neoliberal era. Following the rise of neoliberal policies in the 1970s, the process of financialisation started in the early 1980s and is still going on notwithstanding
the subprime financial crisis and the ensuing Great recession (see Clark and Hermele 2014 for further discussion).

Processes of financialisation are historically and spatially determined as their features depend on conditions that change over time in the same place (country or geographic area), and are often discordant in different places at a given time. Financialisation should thus not be considered as homogeneous or invariant through time and space but as involving variegated processes (Brown, Spencer, Veronese Passerella, 2015, 2016). It is however useful to start the analysis of financialisation by trying to capture what is, broadly speaking, common in the historical episodes that we would be inclined to call processes of financialisation. It is possible to detect in the development of market relations a secular tendency towards financialisation:

“The driving force of this evolutionary process is rooted in a progressive, though discontinuous, flow of financial innovations meant to remove the existing constraints to the flexibility of economic transactions. According to received wisdom, the adoption of money as medium of exchange has removed the strictures of double coincidence of wants, while the modern forms of credit have been developed to relax the cash-in-advance constraint to economic transactions. As these examples suggest, financial innovations aim to extend the set of exchange options in time, space and contents for the decision makers who introduce them. Financial innovations are adopted because, ceteris paribus, a larger option set is positively correlated with higher expected returns. Their systemic effects, however, may have negative implications such as financial instability, underinvestment in the real sector, unemployment, stagnation. When the negative consequences accumulate beyond a tolerable threshold, the remedy has been sought in stricter rules of self-regulation, or rather of regulation by law, or even in severe measures of financial repression.” (Vercelli, 2014a).

The analysis of a particular episode of financialisation would be misleading without thoroughly investigating its specific characteristics since financialisation has never been homogeneous through time and space as it is affected by cultural, material, and political conditions that vary in different times and regions. However, an ideal-type (in the sense of
Weber) of the first and second Financialisation aiming to capture in abstract terms some features that are similar in a few prominent countries in the same period. To this end, two channels through which finance influences the real economy are distinguished: one extrinsic and one intrinsic. The extrinsic channel is as old as credit itself and aims to remove the cash-in-advance constraint characterizing any monetary economy. In this sense, finance has always had a crucial power as a permissive condition of political and economic decisions. In the mercantilist period, big banks assumed a systematic role in supporting and conditioning the colonialist and imperialist policies of the most powerful states. This kind of extrinsic power exerted by finance is thus pre-existent to capitalism. However, this power became more systematic and more influential after the industrial revolution when credit became a crucial condition for industrial investment, in particular the most innovative ones, as was well understood by Schumpeter (1934 [1911]). During the First Financialisation, this power started to be exerted in a more systematic way, leading finance to play the role of coordination and orientation of capitalistic decisions (as emphasised by Hilferding 1981 [1910]). At the turn of 19th century, a few major investment banks became sufficiently powerful to play the role of private planning authorities. The influence of finance on the real economy, however, affected mainly which of the possible decisions would be implemented rather than their contents. However, the influence of finance became increasingly intrinsic during the Second Financialisation by systematically affecting the choices of non-financial firms and households in reference to their very contents:

“As Keynes [1936] foresaw in chap.17 of the [General Theory], the logic of choice of any subject in any field is becoming more and more influenced by the financial paradigm of portfolio selection within a time horizon that is compelled to become as short as that of financial choices. The choices consistent with sustainability are thus becoming increasingly non-competitive as compared with alternative choices since they imply immediate costs and significant benefits only in a relatively distant future.” (Vercelli 2014b).

A second significant difference between First and Second Financialisation is rooted in the distinct role of banks: the First Financialisation may be viewed as ‘bank-based
financialisation’ while the Second Financialisation is rather more a ‘market-based financialisation’ (see Orléan, 2009, and 2014). This is not to say that in the Second Financialisation big banks had a subordinate role as they played, on the contrary, a crucial role in shaping and manipulating financial markets both directly (as clearly revealed by the scandals of Euribor, the unreliable ratings of crony agencies, the systematic use of creative accounting, and so on) and indirectly (through governments and policy agencies conquered by regulatory capture). The crucial difference has been, however, that in the Second Financialisation bank and non-bank financial institutions have exerted their power in a more indirect way, while the financial motivations have become decisive even within the real economy.

A third crucial difference may be seen in the strategy of expansion of capital investment. During the First Financialisation, the prevailing capitalist strategy pointed to an expansion, with the help of the state, in new geographical areas (imperialism and colonialism). During the Second Financialisation, the expansion was not so much territorial, although new forms of imperialism and colonialism continued to play a significant role, but aimed mainly to the systematic invasion of the territory formerly occupied by the Welfare State (health, education, pensions, and so on). In particular, the rules underlying the introduction of the Euro and the austerity policies implemented after the crisis went a long way towards the dismantling of the Welfare State in the EU, and the systematic privatisation of health, education, and social security services (including pensions). (Vercelli, 2014b).

Finally, a fourth crucial difference has to do with the active role of powerful central banks in the Second Financialisation since the monetary policy inaugurated by Greenspan in 1987 and pursued afterwards by Bernanke and most other central bankers, has significantly undermined the expected profitability of industrial investment as compared to that of financial investment. Central banks reacted immediately to any inflationary symptom observed in the real economy by adopting restrictive monetary measures (in particular by promptly increasing the rate of discount), while on the contrary asset inflation was not repressed but rather encouraged by massive creation of liquidity whenever the upward trend
of asset prices seemed undermined. This policy of “asymmetric monetarism” translated in an implicit insurance to financial investment and speculation crowding out industrial investment (Orhangazi, 2007; Cecchetti and Kharroubi, 2013). The wealth increase of financiers and rentiers sustained to some extent aggregate demand but not enough to compensate for the declining profits and wages in the industrial sector. The stagnation tendency that has prompted the process of financialisation has been eventually strengthened by financialisation itself (Vercelli, 2014c; Vercelli 2017).

Based on the preceding analysis, it may be concluded that during the Second Financialisation: “the logic of finance has acquired an increasingly significant role in the economic decisions of all economic units: financial and non-financial corporations, government and households. Usually formulated with a negative connotation, the notion of financialisation as an ‘excessive’ growth of finance, however, remains elusive and with vague operative implications. Financialisation generates a range of sources and risks of non-sustainability such as a short-term orientation in investment decisions and governance, lower incentives for productive real investments, regressive distributive effects, excessive financial leverage, systemic risks in financial markets as well as new challenges for protection of environmental services and their users.” (Gabbi and Ticci, 2014)

In this view, the nexus between financialisation and its concrete consequences in time and space are not a case of direct causality. Both may be seen, at least in part, as joint effects of the existing development and technological trajectories as shaped and orientated by the existing policy strategy. The ultimate cause of the crisis itself is not so much the direct effect of financialisation but of the existing development and technological trajectories, their interaction, and the underlying policy strategy.

Distinct eras of financialisation can be identified, and also periods of de-financialisation such as the 1930s and 1940s. Understandings of the features of the present era are elaborated below. The eras of financialisation involve different structures within the financial sector and different interrelationships with the non-financial real sector, which itself has different structures. This can be illustrated by reference to some ideas of Minsky. Minsky (1988, 1993)
spoke in terms of four capitalist stages, which he labelled: commercial, financial, managerial, and money manager, and in each stage the relationship between finance and the real economy differ in significant ways. Whalen (2012, p.257) indicates that Minsky’s “discussion of each stage centered on three questions: What is being financed? What is the pivotal source of financing? What is the balance of economic power between business and banking?”. Minsky (1988) envisaged that the post war era managed money capitalism emerged from the success of managerial capitalism. It involved the growth of pension funds, mutual funds such that “a large portion of the outstanding shares of major corporations is now owned by these large institutional holders.” A second aspect is that managed money capitalism diminishes the financial independence of corporate management. Money managers are a large and active part of the market for securities with the trend towards an increase in the proportion of financing taking place through markets rather than through financial intermediaries. “A second aspect of managed money capitalism is that these funds, presumably managed for the benefit of some future pension receiver or annuitant, need to accept ‘good offers’ for their holdings if such offers are made. This means that take overs (friendly and unfriendly) and financial restructuring, such as leveraged buyouts are facilitated. ...Managed money capitalism has diminished the financial independence of corporate management. Managed money capitalism is part of the trend towards an increase in the proportion of financing that takes place through markets rather than through intermediaries....Money managers are a large part of the market for securitized instruments. Sophisticated instruments can be created that mete out the cash flow from a corpus of assets with given cash flow properties to various claimant—the essence of securitization—in a way that is tailor made to suit the objectives of particular funds.’ ‘Managed money capitalism in international in both the funds and the assets in the funds. It has rendered obsolete the view that trade patterns determine the short run movements of exchange rates” (Minsky, 1988). These ideas from Minsky are reflected in the present era of financialisation in terms of the ‘pursuit of shareholder power’ and the growth of securitisation.
Financialisation in the present era has not been limited to industrialised countries or to North America and Europe. Indeed, it is one of the remarkable features of the era of financialisation since circa 1980 that financialisation has been a near global phenomenon. In our studies the focus has been on European countries where the Central and Eastern European Economies experienced particularly rapid financialisation after 1990. The review of the processes of financialisation below covers a full range of European countries as well as drawing on the FESSUD studies for South Africa and Turkey. Bonizzi (2013) provides a survey of financialisation in developing and emerging economies. He views financialisation as a non-linear process which assumes different forms in developing countries as compared with advanced countries and has country-specific forms. He views as a key theme being the implications of financialisation for non-financial investment, with firms increasingly engaging in financial rather than productive investment. There is a transition to a more market-based financial system in many countries which had often relied on forms of directed credit through the banking system. The expansion of foreign banks into the domestic market is a common development. Financialisation has its impact on developing countries through the indirect route of commodity prices and their fluctuations. In Chapter 4 the relationships between the financialisation processes in individual countries and globalisation are considered under the heading of dependent financialisation.

1.3 Features of financialisation

In our Description of Work, drawing on the work of Fine (e.g. 2012), eight features of the present era of financialisation were outlined. Ashman and Fine (2013) provide a brief summary of the main features of the era of financialisation since circa 1980: “the phenomenal expansion of financial assets relative to real activity (by three times over the last 30 years); the proliferation of types of assets, from derivatives through to futures markets ...; the absolute and relative expansion of speculative as opposed to or at the expense of real investment; a shift in the balance of productive to financial imperatives within the private sector whether financial or not; increasing inequality in income arising out of the weight of financial rewards; consumer-led booms based on credit; the penetration of finance into ever
more areas of economic and social life such as pensions, education, health, and provision of economic and social infrastructure; ...” These authors continue that the consequences of financialisation have been perceived to include: “reductions in overall levels and efficacy of real investment as financial instruments and activities expand at its expense ...; prioritising shareholder value, or financial worth, over other economic and social values” (p. 156).

The first feature identified is the rapid expansion of financial institutions and financial markets. This feature has been shared with earlier periods of financialisation. It has, however, been particularly noted that financial markets have grown in relative importance as the range of financial assets being traded expands. The volumes of trading and the turnover of financial assets have also grown rapidly. There have been dramatic rises in the ratio of financial assets to GDP and also of financial liabilities to GDP, at the national and global levels (for some illustrative figures see below).

The second feature has been the de-regulation and liberalisation of the financial system. This has gone alongside the general trends towards de-regulation of the economy. Financial liberalisation has involved de-regulation of domestic financial systems and liberalisation of capital movements between countries. Pressures from the financial sector to throw off the restrictions of its operations played a major role. Mainstream economics and finance theories helped to promote financial liberalisation as efficiency enhancing (as discussed in Chapter 2). Many others, particularly drawing on the work of Minsky, have pointed to the de-stabilising effects particularly in the form of unsustainable credit booms.

Thirdly, the present era of financialisation has involved the expansion and the proliferation of financial instruments and services. It has been associated with the birth of a whole range of financial institutions and markets, developing and trading a spectrum of new financial instruments with corresponding acronyms, and which are bewilderingly complex. The complexity of the financial instruments has meant that the risk evaluation of the financial instruments becomes virtually impossible. The development and growth of
financial derivatives and securitization (such as mortgage backed securities) has been particularly significant in their consequences for risk and crisis.

At a systemic level, financialisation has been located in terms of the dominance of the financial sector over industry which is the fourth feature. Nonfinancial corporations have necessarily been caught up in the process of financialisation as they have increasingly derived profitability from their financial as opposed to their productive activities. Financial institutions increasingly become owners of equity.

The financialisation of the modern corporation is closely related with the emergence of shareholder value as the guiding principle of corporate behaviour. Shareholder value refers to the idea that the primary purpose of the corporation is to make profit for its shareholders. In some respects, this could be viewed as a return to profit maximisation after a period in which the rise of managerial capitalism has postulated corporations run more in the interests of their managers than owners. However, in recent decades the immediate owners of corporations have become financial institutions even when it is the funds of savers and households which the institutions are using. The pursuit of shareholder value is one of the key features of the era of financialisation as indicated below.

Fifth, the present era of financialisation is strongly associated with market mechanisms, neol/liberalism and globalisation. Globalisation and financialisation have seen much greater capital flows between countries and gross flows on a much greater scale than net flows. The period of financialisation has also been associated with generally rising inequality. The financial sector itself contributes to inequality through, for example, payment of large bonuses. In many countries, the wage share has declined substantially, with consequent effects on the level of aggregate demand. Rising income inequality has often added to pressures for consumer credit to maintain consumption levels.

Sixth, there has been substantial rises (relative to income) of household borrowing and the extension of credit. Household debt to income ratios have generally rise. Rising property prices, particularly in the years preceding the global financial crisis, enabled the use of housing as collateral for borrowing.
Seventh, there is the penetration of finance into a widening range of both economic and social reproduction – housing, pensions, health, and so on, has been a continuing feature of financialisation, leading to societal transformation. For example, a trend away from social provision of pensions to private provision through funded schemes draws people into complex financial decisions and expands the scale of the financial sector. The ‘financialization of the everyday’ involves the incorporation of “low-income and middle-class households in financial markets through participation in pension plans, home mortgages and other mass-marketed financial products…. By participating in financial markets, individuals are encouraged to internalize new norms of risk-taking and develop new subjectivities as investors or owners of financial assets” (van der Zwann, 2014, p.102). This penetration of finance and financial motives into social life has many dimensions – it can be considered in terms of financial inclusion and exclusion, the reliance of households on debt, the privatisation of pension provision etc.

Finally, financialisation is associated with a particular culture which is to be interpreted broadly. It ranges, for example, from the shifting from admiration and envy to antipathy to those who work in finance, but equally is attached to an ethos of reliance upon the market and the use of the state merely as an agent of last resort. As has been highlighted by literature within political science, usually in an attempt to understand the diverse forms and rhythms associated with neo-liberalism of the past thirty years, there has been a rolling back of the state as markets were first heavily promoted followed by a rolling out of piecemeal interventions as dysfunctions emerged. Thus, the material culture of financialisation is much more than a set of ideas or images, or an ethos of being for or against the market, but is closely integrated with the public and private institutions that have evolved during the course of the rise of finance itself\(^3\).

1.4 Financialisation in practice

In Work Package 2, 17 country reports on the financial systems were produced covering Estonia, France, Germany, Greece, Hungary, Ireland, Italy, Netherlands, Poland, Portugal, Spain, Sweden, and the UK. See Fine (2013) for further discussion.
Romania, South Africa, Spain, Sweden, Turkey, UK, USA: the country reports are listed in the bibliography. In Work Package 3 18 country reports on financial crisis were produced (with Japan an addition to those covered by the country reports). The financial systems reports provide a rich source of data on the processes of financialisation in the countries concerned, which was utilised in Brown, Spencer and Veronese Passarella (2015) and which is summarised here.

Summing up, the process of financialisation of EU economies is not clearly reflected in their shares of employees in the financial sector\(^4\). Central and Eastern European countries (Poland, Hungary and Estonia) are those in which the share of employees in the financial sector has grown faster in the last two decades. As one would expect, the UK is marked by a high share of employees in the financial sector, even though its recent trend is rather flat. France shows a similar pattern for the broadly-defined financial sector, but the financial sector *per se* has remained relatively small. Similarly, in the Mediterranean’ countries (Greece, Italy and Spain) and Portugal the share of employees in the financial sector *per se* has remained rather low, with a predominance of employees in the banking sector. Northern European countries as a whole have not recorded significant increases in employment, but they usually started from very high initial absolute percentages of employment in financial activities. The trend in the number of employees in the financial sector to total employment ratio seems, therefore, not to (wholly) capture the process of financialisation of European economies. Leaving aside the effects of the crises of 2001 and 2007-2008, one reason for the above trends could be that banking and financial sectors have recently experienced a switch of ‘orientation from labour intensive to technology intensive driven with the introduction and development of automatic teller machines, cash dispensers, point of sales, phone banking, remote banking, TV banking, internet banking, where a large number of employees have been transferred from financial divisions to outsourcing and/or off-shoring companies’ (Consolandi *et al.* 2013: 25-26). In any case, jobs have been lost in finance due to technological progress.

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\(^4\) The following paragraphs are taken from Brown, Spencer and Veronese Passarella (2015).
In spite of the flat trend in employment share, the increase in the share of value added of the financial sector has generally been quite remarkable⁵.

Summing up, a preliminary data analysis shows there has been a generalized increase in the share of value added of the financial sector to total value added in the last four decades, though with a few exceptions. This is consistent with the findings of Philippon and Reshef (2013: 74-75), who argue firstly that, “finance’s share of income today is significantly higher than it has been during the last 150 years”; secondly, the overall trend is upward; and thirdly, while in Anglo-Saxon countries and the Netherlands ‘finance continues to increase after the 1980 [...] it seems that in other economies the financial sector’s income share reaches a plateau, and even declines somewhat”. In other words, financialisation has affected the process of creation and distribution of value added in each and every country, but it has been doing so in different socially- and geographically-related forms.

The trend in [gross] financial assets to GDP is usually considered one of the key indicators of the process of financialisation. In some economies, such as Luxembourg, the Netherlands and Ireland, the financial assets to GDP ratio recorded astronomical values in the last decade. The Euro Area (EA17) average was almost 600% in 2011 (OECD and Eurostat 2013). Surprisingly enough, by looking at major European economies, Germany is the one in which this ratio has historically been the highest. It has accounted for about seven times the German GDP since the early 2000s. In fact, the value of financial assets in the German economy “grew rapidly in the 1990s, both in absolute terms as well as relative to GDP. While in the 1980s the ratio of financial assets to GDP grew on average by 1.6% a year, this increased in the period from 1991 – 2000 to 6% a year” (see Detzer et al. 2013: 19). However, its growth has been slower compared to that of other major economies and, recently, the UK’s ratio of financial assets to GDP has caught up (and overtaken) the German one. Notice also, in this regard, that the bulk of financial assets are owned by banks. Even in the case of the UK, bank assets alone “have grown five fold since the 1970s; they were about 100% of

⁵ Notice that this is ‘value added’ in the national accounts sense, i.e. as a contribution to GDP. However, it should not be inferred either that the financial sector is here regarded as valuable or that it is a ‘creator’ of (macroeconomic) value.
GDP in the late 1970s, amounting to 520% of GDP in 2010” (Shabani et alia 2015: 118). In 2007, monetary financial institutions as a whole controlled around 60% of financial assets in the Euro Area, compared to less than 20% of the US (see Altuzarra et al. 2013: 23). Among major European economies, France and Italy are those with the lowest ratios, even though the French one has boomed in the last two decades. Besides, if we look at the financial interrelations ratio, in 1980 the Italian financial sector was not significantly different from the German and the Japanese cases’. This ratio was 0.87 in Italy, 0.80 in Japan and 0.81 in Germany, whereas it was 1.35 in the UK, and 1.05 in both France and the US. Two decades later, the values were 1.34 in Italy, 1.31 in Japan, 1.39 in Germany, 2.09 in the US and 2.86 in the UK (Consolandi et al. 2013: 24), therefore confirming the last place of Italy in this ranking. As for Spain, between 2000 and 2008, ‘the balance sheet of [credit] institutions [measured by the size of the assets as a percentage of GDP] increased by 64.7%’ (see Amaya et al. 2013: 57-59). In 2007, the total value of financial assets accounted for 413% of GDP (see Amaya et al. 2013: 23) and it remained rather high in the subsequent years as well.

Turning to the other economies of the Euro Area, in Portugal financial assets accounted for around 700% of GDP in 2011, i.e. one of the highest percentages among the European countries. The growth of financial assets in the period 1995-2010 was massive (around 140 percentage points) and similar to that of the EA17 (see Lagoa et al. 2013: 36-37). The Greek case is not that clear. According to Argitis and Michopoulou (2013: 135), “[m]onetary stability and banking liberalization made possible the rapid growth of capital and money markets in the 1990s and the private non-banking financial assets were rapidly expanded during this period (from around 100% in 1987 to 300% in 1999)”. Yet, OECD statistics reveal that Greece, along with Italy, is the European economy with the lowest financial assets to GDP ratio (113% in 2011). Finally, Central and Eastern European countries represented a sort of middle

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6 In some countries that percentage was even higher (for instance, it amounted to 80% of financial assets in Spain, see Altuzarra et al. 2013: 23).
7 This ratio has been suggested by Goldsmith (1955). It is defined as the ratio of gross financial assets to real wealth.
8 According to both OECD and Eurostat statistics, this percentage would be even higher (reaching almost 580% in 2007, and reducing to a slightly lower value in 2011).
ground. For instance, Estonia has been “one of the leaders among Baltic and CEE countries” (Juuse and Kattel 2013: 26). The ratio of the banking system’s assets to GDP ‘doubled in eight years and reached 132% at the beginning of 2008 [whereas the ratio of financial sector as a whole exceeded 150%]’, mostly driven by ‘the expansion of the banks’ loan and leasing portfolio, which has led to a consistently increasing share of the loan portfolio in the structure of assets’ (Juuse and Kattel 2013: 35). In Poland “[t]he assets of the financial sector amounted to about 20% of GDP in 1991, to about 50% in 1995, whereas in 2011 it already exceeded 120% of GDP” (see Alfred et al. 2013: 8). To sum up, besides the ‘special case’ of the UK, the financial assets to GDP ratio has increased remarkably in each and every European country since the 1980s, though with some relevant national differences.

A surprising finding relates to profitability where the trends of bank profitability are broadly constant or decreasing. It has often been a perceived feature of financialisation that financial sector profits have risen at the expense of non-financial sector profits. These statistics do though refer to banks and do not encompass the broader financial sector and the degree to which the profits of the financial sector were dependent on rising asset prices.

‘These findings … are consistent with the idea that an uneven and variegated (as opposed to smooth and uniform) financialisation process has been taking place. This is a specific application of the idea of ‘variegated capitalism’ (Peck and Theodore, 2007). Variegated financialisation captures two key things. One is the idea of financialisation as a systemic process operating within and across nations. The other is the idea of financialisation as a variegated process – how it unfolds within and impacts upon particular nations and regions is mediated by the institutions, politics, and culture of those nations and regions. It captures, in other words, the differences in the process of financialisation as it develops and is developed across diverse nation states and regions, and across diverse systems of provision, while recognising at the same time that there is a common process of financialisation connecting this diversity at a global level. While there are differences between countries in term of the nature, extent and depth of the financialisation process, there are some clear common features to the above process across nations. That is, there is variegation in the
financialisation process which data are able to draw out. To sum up, EU countries have gone through a process of financialisation in the last three decades. This process has affected their economic and social structures, materialising in different historically- and geographically-related forms’ (Brown, Spencer and Veronese Passarella, 2016). Bonizzi (2015) summarises the main points coming from the financialisation literature relating to emerging and developing economies along the following lines:

‘An increasing proportion of income is in the form of financial ‘rents’. This is either interest income, resulting from very high-interest rates, or asset price inflation....

The State and other public institutions present an important degree of diversity across different countries with respect to their intervention or passiveness in the take off of financial development. While everywhere financialisation is facilitated by policy changes such as privatisation and reduced welfare provision, in some countries state policy is directly aimed at creating a “finance-led” regime of accumulation, whereas in others seems to be a more “unplanned” consequences of liberalisation policies coupled with increasing foreign influence. Specific country changes in the mode of regulations and/or changes in power and class relations may account for such diversity.

Non-financial corporations engage with financial markets more directly. They hold more income-generating liquid assets, and sometimes even speculate in the derivatives market. At the same time their reliance to bank credit has weakened. In some countries the pressure to create shareholder value by distributing dividends has increased.

Decreasing investments have often exacerbated existing inequalities and fostered employment insecurity.

In some countries capital markets have expanded dramatically. In many of them this is the result of both capital account opening and the rise of domestic institutional investors. Banks have re-oriented themselves towards non-lending activities, such as fee generating businesses and trading, and increased their credit allocation to households. In many countries, this has been the result of the increasing competition pressures from foreign banks entry.
Households have increased their borrowing for both consumption and housing needs. This is often mirrored by a rise in the value of their property and financial assets. Nevertheless their borrowing needs often are the result of social security shifts. Microfinance is increasingly ‘financialised’, through the increasing commercialisation, as a result of the pressure of financial investors. Moreover it has created situation of financial instability and distress in some countries.’ (Bonizzi, 2015, pp.27/8)

1.5 Financialisation and economic growth

There is a long-standing set of literature on the relationship between the size of the financial sector (often summarised in terms of ‘financial development’ and ‘financial deepening’) and the pace of economic growth. The growth of the financial sector has often been evaluated under terms such as financial development, financial deepening, and the perceived role of financial development as a promoter of savings and investment (in terms of raising the level of savings through the provision of liquidity and financial assets, an assumed causal relationship from savings to investment, and the monitoring roles of financial institutions). Financial deepening, often measured by variables such as bank deposits to GDP, focuses on the growth of the formal financial sectors and also are dimensions of financialisation. That literature has generally found a positive relationship between financial development and economic growth, though the causal relationships involved are matters of debate. A more recent literature has tended to find a much weaker relationship, and often finding an inverted U-shaped relationship such that industrialised countries are often operating on the negative part of the curve.

Levine (2005) in his extensive review of the empirical literature concluded that “a growing body of empirical analyses, including firm-level studies, industry-level studies, individual country-studies, time-series studies, panel-investigations, and broad cross-country comparisons, demonstrate a strong positive link between the functioning of the financial

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9 This section draws heavily on Sawyer (2014, 2017), Creel (2015): see those papers for many further references.
system and long-run economic growth. While subject to ample qualifications and countervailing views noted throughout this article, the preponderance of evidence suggests that both financial intermediaries and markets matter for growth even when controlling for potential simultaneity bias. Furthermore, microeconomic-based evidence is consistent with the view that better developed financial systems ease external financing constraints facing firms, which illuminates one mechanism through which financial development influences economic growth. Theory and empirical evidence make it difficult to conclude that the financial system merely—and automatically—responds to economic activity, or that financial development is an inconsequential addendum to the process of economic growth” (p. 921).

Authors have reported on at least some weakening of the links between financial deepening and economic growth. Rousseau and Wachtel (2011) argue that they show that the finance-growth link is not as strong in more recent data as it was in the original studies with data for the period from 1960 to 1989. Arcand, Berkes, and Panizza (2012) find that their results suggest that finance starts having a negative effect on output growth when credit to the private sector reaches 100% of GDP. Cecchetti and Kharroubi, (2012) reached two significant conclusions. The first is that the size of the financial sector has an inverted U-shaped relationship with productivity growth and that after some point further enlargement of the financial sector tends to reduce growth. They interpret these findings in terms of a large financial sector drawing scarce resources away from the rest of the economy and the adverse effects of financial booms and busts on growth. They conclude that “more finance is definitely not always better” (p. 14).

Cournède, Denk, and Hoeller (2015) in an OECD study note that “over the past fifty years, credit by banks and other intermediaries to households and businesses has grown three times as fast as economic activity”. Based on 50 years of data for OECD countries, they conclude (p.6) that further growth of the financial sector as far as most OECD countries are concerned is likely to slow down the rate of economic growth rather than raise it.

10 For other studies see, for example, Barajas et alia (2012, 2013), Rioja and Valev (2004, 2005), Aghion et al. (2005), Dabla-Norris and Srivisal (2013).
Altuzarra et., alia (2015) use data for 17 euroarea countries over the period 1970 to 2013 to examine the relationship between measures of financialisation and economic growth. Rate of growth of GDP per capita is related with initial GDP per capita, set of control variables including inflation and education, and a range of financial variables. A significant element is the finding that there were important changes in the relationship between the financial sector and real sector between the 1970s & 1980s and the period since then. In the earlier period, during which the ratio of credit to GDP was moderate, credit growth had a positive effect on real growth. In the 1990s onwards in general credit grew rapidly and the credit ratio reached historically high levels, and the links between credit growth and real growth came to a halt. This ‘vanishing effect’ confirms for the euroarea countries findings which have been briefly surveyed above. The authors analyse financing gaps and the external funds of non-financial corporations (NFCs) and conclude that ‘a main reason explaining why increasing financial deepening stopped to have a positive effect on growth might be due to NFCs having used an important part of their external resources for the acquisition of securities instead of financing real investment.’

“As we have mentioned before, the relation between the size of the financial system and the impact on the macroeconomic performance is not a linear one. Therefore, we need to know whether the size of the financial system has exceeded the threshold from that point on a larger size of finances exerts a negative impact on economic activity and growth (and, obviously, welfare). If we focus on the case of the European Union countries, the answer would be that such a threshold has been exceeded in most of these economies. Thus, in the year 2012, the (unweighted) mean of financial liabilities in the EMU-11 countries reached 1,088 percent of the GDP, 672 percent of the GDP in the EMU-6 countries, and 1,421 percent of the GDP in the EU-10 countries. Moreover, this size of financial liabilities had increased during the Great Recession, and thus, since the year 2008, the size of financial liabilities had increased in 114 percentage points of the GDP in the EMU-11 countries, in 111 percentage points of the GDP in EMU-6 countries, and had only declined in the case of the EU-10
countries where the size of financial liabilities had fallen in 70 percentage points of the GDP” (Carrasco et al., 2016).

Creel (2015) argues that “finance can also have its own potential negative effects. Indeed, liquidity and maturity transformation from deposit and savings to long-term investments can improve economic performance but can also be damaging. Deregulation and information asymmetries have encouraged banks to take more risks in recent years. Combined with financial deepening, it led to excessive lending, and reinforced bubbles that create conditions for financial fragility.”

Creel, Hubert and Labondance (2014a) examine the relationship between macroeconomic performance and financial stability using a dynamic panel estimation methodology dealing with endogeneity. They tested whether financial stability affects economic performance. Several types of indicators that measure the macro and micro dimensions of financial stability including one calculated by the ECB, two are based on banking aggregate prudential ratios, one is market-related (it measures stock market volatility) and finally one constructed with a principal component analysis. In most cases, the use of these indicators shows that financial instability has a negative effect on economic performance, and their inclusion does not affect the financial depth effect. Financial instability independently from financial deepening is found to have has a negative effect on the economy. Financial depth is found not to have a positive effect in the Eurozone. It therefore appears that financial depth in the Eurozone has reached a level such that finance effects are not favourable to economic performance.

Creel, Hubert and Labondance (2014b) focus on the cross determinants of financialisation and financial instability. Using a system of simultaneous joint data generating processes, a positive relationship between financialisation and financial instability is found. The ratio of bank credit to GDP is shown to be a significant determinant of the level of non-performing loans. The effect of financial deepening on financial instability is also found when the size of financial markets is used. Long-term interest rates have a negative effect on financialisation but positive effect on financial instability. Market capitalisation has no effect on
financialisation and a negative effect on financial instability. No effect of general taxes and deregulation on financialisation and financial instability is uncovered.

The empirical studies conducted within FESSUD which have just been reviewed provide support to the recent literature with findings of the broadly negative relationship between financial deepening and economic growth.

3.2 Financialisation and crisis

In the present era of financialisation there has been a burst of financial crises, and the occurrence of these crisis can be linked with financial liberalisation and the ways in which the financial system has developed. Laeven and Valencia (2013) identify 147 banking crises, of which 13 were borderline events, over the period 1970-2011, and a further 211 currency crises and 66 sovereign debt crises. In the recent global financial crisis, the authors identify 13 systemic banking crises and 8 borderline cases in the period 2007 to 2011. Financial crises impose severe costs on the economy reducing output and employment, and are part of the general costs of financialisation. Laeven and Valencia (2013) [Table 4] cover the outcomes of banking crises over the period 1970 to 2011. They report the output loss as 23.2 per cent of GDP for all the countries involved with advanced economies and emerging economies having losses around 33 per cent while developing countries were immune to significant output losses. The fiscal costs were estimated at 1.7 per cent of GDP for all countries ranging from 8.3 per cent in advanced economies to 1.3 per cent and 1.1 per cent in emerging and developing countries respectively. There were substantial increases in debt averaging 12.1 per cent of GDP across all countries.

Epstein and Montecino (2016) report the estimates from the Dallas Federal Reserve (Atkinson, Luttrell, and Rosenblum, 2013, Luttrell, Atkinson, and Rosenblum, 2013) for the costs of the 2007/09 financial crisis in the USA. They report the cost of the crisis ranges from 40 percent to 90 percent of 2007 output over the period 2008 and 2023 during which output is forecast to remain below long-term trend as a consequence of the financial crisis.

3.3 Financial liberalisation and growth
A feature of the era of financialisation (and of others) has been financial liberalisation and de-regulation (see Arestis, 2016, for further references and discussion). At the theoretical level, McKinnon (1973) and Shaw (1973) propounded the ‘financial liberalisation thesis’ arguing that government restrictions on the banking system restrain the quantity and quality of investment. The financial liberalization thesis argues for the removal of interest rate ceilings, reduction of reserve requirements and abolition of directed credit programmes. In short, liberalise financial markets and let the free market determine the allocation of credit. With the real rate of interest adjusting to its equilibrium level, low yielding investment projects would be eliminated, so that the overall efficiency of investment would be enhanced. Further, as the real rate of interest increases, saving and the total real supply of credit increase, which induce a higher volume of investment. Economic growth would, therefore, be stimulated not only through the increased investment but also due to an increase in the average productivity of capital. Moreover, the effects of lower reserve requirements reinforce the effects of higher saving on the supply of bank lending, whilst the abolition of directed credit programmes would lead to an even more efficient allocation of credit thereby stimulating further the average productivity of capital.

“Under pressure from the International Monetary Fund and the World Bank, several developing countries have directly pursued policies of financial liberalisation, by both deregulating their own financial system and by opening it to foreign investments. These policies are informed by theoretical viewpoints suggesting the positive impact of the financial sector on development. However frequent episodes of financial crises have led to growing concerns about the role of a fully liberalised financial sector, which may breed instability and thus effectively offsetting any potentially positive impact of finance on growth” (Bonizzi, 2015). He further notes that “The IMF and World Bank actively promoted liberalisation of the financial sector as part of structural adjustment programs”.

Bumann, Hermes, and Lensink (2012) undertook a meta-analysis based on 60 empirical studies. Their meta-regression analysis leads them to the following main results. “First, we conclude that although our results indicate that, on average, there is a positive effect of
financial liberalisation on growth, the significance of this effect is only weak. Second, for most of the variables that may help explaining the heterogeneity of results about the relationship between financial liberalisation and economic growth we do not find any significant results. There are two exceptions. Our analysis suggests that data from the 1970s generate more negative financial liberalisation coefficients which suggests that financial liberalisation policies carried out during the 1970s seem to have a stronger negative relationship with growth. Moreover, our results show that studies that take into account a measure of the level of development of the financial system report lower t-statistics for the relationship between liberalisation and growth” (pp. 43-5).

3.4 Shareholder value, Investment and Industrial Re-structuring

Financialisation has been associated with the rise of the push for the maximisation of shareholder value, as for example in the formulation of van der Zwan (2014) quoted above and reflected in Minsky’s notion of money manager capitalism. Financialisation often involves the growth of the financial sector’s ownership and dealings in equity, and the growth of financial markets. There has been the speed-up in the trading of equity (as with other financial assets), and emphasis on short-term share-price performance rather than on longer-term growth prospects. The particular significance of these developments here comes from the impact on decisions on investment, employment, output etc., as made by corporations.

The advocacy of the pursuit of ‘shareholder value’ is a route through which shareholder interests are imposed on managerial interests. It also acts in the interests of the financial sector who gain from increasing stock market valuations. Lazonick and O’Sullivan (2000) provide “an historical analysis of the rise of shareholder value as a principle of corporate governance in the United States” (p.13) with a shift of corporate strategy from focus on retention of corporate profits and their reinvestment in corporate growth in the 1960s and 1970s to a strategy of distribution of profits to shareholders with pressures for reduction of labour employment.
Hein (2012) summarises a range of arguments on the generally adverse effects of ‘shareholder value’ under financialisation on investment. It is argued that shareholders (most of whom are financial institutions) impose on corporations a larger distribution of profits and hence a higher dividend payment ratio. The lower retention of profits ratio, and on occasions share buybacks mean reduced internal finance for real investment. Hein labels this the ‘internal means of finance channel’. A further channel, labelled “preference channel”, arises from the weakening of the preference of managers for growth (which translates into firms pursuing growth) as managerial remuneration schemes are based on short-term profitability and share price.

Hein (2012) views the overall effect of financialisation on investment (and thereby on growth of capital stock) to be negative. “Financialisation has been associated with increasing shareholder power vis-à-vis management and labourers, an increasing rate of return on equity and bonds held by rentiers, and decreasing managements’ animal spirits with respect to real investment, which each have partially negative effects on firms’ real investment” (p. 116).

The often observed rises in profit rates and shares in industrialised countries over the past three or more decades can be compared with a tendency for investment to slow. As van Treeck (2009) observes, a popular microeconomic explanation of that association is the pursuit of shareholder value “has induced firms to develop a larger preference for profitability at the expense of investment (and potentially jobs and growth)” (p. 908).

Concluding comments

In this chapter the key features of financialisation in the present era have been set out and illustrated. The processes of financialisation in terms of the growth of the financial sectors in economic, social and political terms have been shown as near universal. Yet there are differences in scope and speed which is encompassed using the concept of ‘variegated financialisation’. These features of financialisation and their impacts on economic and social life, on the environment and development have been set out, and will be further examined in the chapters to come.
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Chapter 2 Understanding finance, financialisation and the financial sector

2.1 Introduction

Analyses of the roles of finance, the operations of the financial sector and the processes of financialisation have been informed by a wide range of theoretical perspectives ranging over what may be termed mainstream and heterodox approaches. It is then important to have understandings of these different theoretical perspectives and how they inform (or otherwise) our analysis. A major strand of work within Work Package 2 was the review and comparison of a wide range of theoretical perspectives on finance and the financial sector. Although the focus here is on the analysis of finance and of the financial sector, the analysis inevitably cannot be fully separated from analysis of the economy in general. There is, though, a tradition within much of mainstream macroeconomics analysis which can be summarised under the phrase ‘classical dichotomy’ which separates the real from the monetary. In its simplest form, the stock of money set the level of prices but would not affect the levels of output and employment. It is generally associated with the notion that savings provides loanable funds which flow through the financial sector to investment in ways which are the reflection of the preferences and desires of the savers and investors (in capital formation). These elements of the mainstream approach, particularly noticeable in macroeconomic analysis, place the real sector in the driving seat and finance and the financial sector facilitating exchange (of goods and services and of loanable funds) without impacting of what is exchanged. In contrast, the heterodox approaches in general view as money as credit money created by the banking system, and the ways in which bank loans are allocated and the volume of bank loans mould the path of the economy, that is path dependency.

The different theories and analytical approaches which have been reviewed can be considered from a range of perspectives and questions. These include:

(i) What do the theories suggest on the mechanisms of cycles and of crisis?
(ii) What insights do the theories provide on the growth of the financial sector and financialisation?
(iii) How do the theories suggest on the efficiency of the financial sector and its contributions to economic well-being?

The theories of finance reviewed are broadly grouped under mainstream economics and heterodox economics, and these are now discussed and compared in the following two sections. It is not the intention here to rehearse in great detail the different theoretical approaches as this has already been undertaken in the deliverables and working papers. It is rather to draw out their implications for the issues listed above.

2.2 Mainstream analyses of finance¹

2.2.1 Efficient markets and rational expectations

Although not a separate theory on their own, efficient market and the rational expectations hypotheses (EMH and REH respectively) provide some cornerstone material for what has come to be mainstream economics since the 1970s.

Starting with the first, the key message of EMH is that in financial markets returns cannot be predicted using past and present information, as this is already reflected in current prices.

The key conditions for the hypothesis to hold are the free flow of information, the absence of transaction costs and the homogeneity of expectations, i.e. the consent of the public regarding the effect that a certain piece of news will have upon current and future prices (Consolandi, 2015).

The EMH is not a new idea of the late 20th century. Rather, it is the direct offspring of Louis Bachelier’s finding, dating back in 1900, which shows that the returns in the stock market follow a random walk. Nonetheless it was primarily out of the contributions of Eugene Fama in the 1960s and 1970s that EMH came to obtain the formal status it holds today (e.g. Fama, 1965). In particular, Fama was the first to suggest the name Efficient Market, while he also put forward the classification of weak-, semi-strong and strong forms of market efficiency. Out of these, the weak form suggests that prices fully reflect information incorporated in past prices, the semi- strong form claims that prices reflect all publicly available

¹ This section synthesizes the following papers: Consolandi (2015); Vercelli (2015a); Fontana and Passarella (2014; 2015); and Gabbi (2015a; b)
information, while the strong form suggests that prices fully reflect all relevant information, whether public or private.

The above classification has proved to be popular among relevant empirical studies, which to their biggest part confirm that EMH holds in financial markets, at least in its weak and semi-strong form. At the same time, evidence of certain ‘market anomalies’ (e.g. value and momentum effects) has also appeared, casting some doubt on the validity of the EMH. Much more important however are the criticisms against the underlying assumptions of EMH. In particular, the assumption of homogenous expectations completely neglects the possibility of behavioural biases, such as overconfidence and herding (the exploration of the implications of such phenomena is in turn the major field of contribution of Behavioural Finance; see below). Given that those biases essentially arise out of decision making under uncertainty, it follows that EMH neglects the implications of uncertainty too.

The EMH postulates that market prices will quickly change in response to ‘news’, and that ‘news’ becomes incorporated into the price. In that way, the course of a market price follows the course of the ‘news’. The stability or otherwise of the market price then depends on the way ‘news’ arrives – a dramatic change in the ‘news’ would lead to a similarly dramatic change in the market price. But any instability of market price would be a reflection of instability of ‘news’ and not arising from the operations of the financial market itself. The EMH has been tested through the correlation of the movement of prices over short periods of time, and this has said little on the over- or under-valuation of prices on a longer term basis. In a world of risk as envisaged in the EMH, there is an underlying model of the world from which prices based on future outcomes can be calculated and deemed to correspond to fundamentals. However, in a world of fundamental uncertainty there is no such model. Studies such as the work of Shiller (1981, 1990, 2000) have though argued for the persistent over- or under-valuation of stock market prices through examination of price-earnings ratio and the like.

The way in which the term ‘efficient’ is used in the context of EMH has to be noted – namely in terms of the incorporation of information into price. This notion of ‘efficiency’ is limited in
application to organised markets (and hence not to operation of financial institutions), and in
now ways relates to the efficiency with which resources employed in financial markets are
utilised or to the benefits arising from trading in financial markets.
Coming to the REH, the essence of the hypothesis is that decision makers’ forecasts of
economic variables are not systematically wrong, but can only exhibit random errors. The
hypothesis was first introduced in a formal way by Muth (1961), and was also utilized by Fama
in setting up the EMH discussed above.
While the REH went relatively unnoticed for about a decade, what marked a shift in its
applicability and popularity was Lucas’s blending of the hypothesis with the Arrow-Debreu
general equilibrium (GE) model (for example, Lucas, 1972). Most importantly, aiming to make
the concept suitable for macroeconomic analysis, Lucas added a further component in the
REH definition. According to the updated version of REH, although agents might indeed
conduct random errors, these should cancel out with each other at the aggregate level.
Hence rational expectations could be assumed to be true on average. Such extension is
crucial in that it allowed Lucas to show that there exists a unique and stable equilibrium point
towards which the economy converges.
The result of Lucas’s project was a model using the rational expectations hypothesis was
able to justify the complete disregard of disequilibrium dynamics. It provided the foundations
for what Lucas labelled as New Classical Economics (NCE). This new stream of thought
completely rejected the Keynesian macroeconomics of the time. It also gave new life to the
principles of classical (pre- Keynes) economics of money neutrality and classical dichotomy
in a way that could now be supported not only for the long- but even for the short-run period.
In other words, money (and finance) come to be seen as irrelevant in explaining real variables
such as output and employment. In this new approach, the market is perfectly capable on
its own to achieve and maintain a full employment equilibrium, while economic fluctuations
and divergences from equilibrium are nothing but the result of exogenous shocks.
Furthermore, in this context, interventionist policies are not only seen as unnecessary, but
are even taken as a primary source of shocks, given their discretionary and unpredictable
nature. Instead, the key policy proposals that come out of Lucas’s analysis focus on structural policies and institutional reforms, with the terms mainly used here to denote the promotion of privatization and deregulation policies.

A number of critical comments can be raised against the REH, notwithstanding its widespread acceptability by mainstream economists. First, the main definition of the hypothesis, as outlined above, fails to separate between *ex ante* and *ex post* errors. This is an important distinction in that even if agents were assumed to perform the best possible predictions *ex ante*, there is nothing in the REH that eliminates the possibility of systematic *ex post* errors. Especially in view of uncertainty, and the corresponding incompleteness of information available to agents, a divergence between the subjective (ex-ante) and the objective (ex-post) probability distributions might turn out to be a very real and systematic outcome. Soros (2013) argues that financial markets can create misguided expectations, which then change the market reality, that, in turn, create new expectations, and so on. When this feedback loop is positive, divergence between expectations and reality continues to widen. Thus, market equilibrium appears only in extreme situation in which subjective market expectations correspond to objective reality. Since it is so extreme, it is unlikely to prevail in reality. Moreover, despite the several variations of the hypothesis’s definition put forward by REH supporters (for an outline see Vercelli, 2015a: 17- 20), nowhere is the issue solved in way that would validate the stability properties that are later built upon the hypothesis.

Second, and in conjunction with the first point, the existence of a unique and stable equilibrium put forward by REH advocates and NCE can be seriously questioned. At a micro level, even if one were to assume that an equilibrium point really exists, and that it can be traced by fully rational decision makers who would eventually get there through a process of learning and correcting of their expectations, its uniqueness and stability properties could still be challenged. Furthermore, at a macro level it could only exist subject to the assumption discussed above, whereby individuals’ errors compensate each other at the aggregate level. Nonetheless, such assumption lies on weak grounds. Most notably, it
excludes the possibility of individuals' expectations getting highly correlated at times, for instance due to waves of optimism or pessimism. It is also underpinned by the unrealistic idea that relevant idiosyncrasies, such as learning capabilities and scope of information sets, are randomly distributed over the population, without any dependence on factors such as income, education, and so on. As a recent paper has argued “expectations do not appear to be rational in the sense that—both in the aggregate and at the level of individual firms—expectational errors are consistently predictable from highly relevant publicly available information, such as past profitability” (Gennaioli, Ma and Shleifer, 2016. p. 381). “At the most basic level, direct survey estimates of expectations are useful: they have a well-defined structure across different surveys, and they predict fund flows as well as future returns. Second, to the extent that survey estimates actually measure expectations is accepted, the evidence points against rational expectations models of stock market valuation. Actual expectations are strongly negatively related to the measures of expected returns that these models generate” (Gennaioli, Ma and Shleifer, 2016, pp. 383-384).

Overall, both the EMH and the REH give rise to an understanding of the economy as an inherently efficient and stable system. In both cases decision makers are assumed to behave rationally in the sense of utilizing all available information at any point of time, as well as having the capacity to correct their mistakes and update their expectations whenever they need to do so. As pointed out by Dodig and Herr (2014), the essential result of these hypotheses is the removal of expectations as an independent variable from economic theory and modelling. However, even if such development comes to be seen as attractive by model builders due to the stability properties it entails, it comes at the price of neglecting all those factors that can affect expectations, and most importantly at the price of removing the implications of fundamental uncertainty. It should thus come as no surprise how in such a context mainstream economists were unable to predict and explain the recent crisis. Such events are by construction left outside the scope of mainstream neoclassical economics so that they can at best be conceived as exogenous shocks to the economy.

2.2.2 New Consensus Macroeconomics and Financial Accelerator Models
The new consensus in macroeconomics (NCM) is, as the name suggests, an approach to macroeconomics. As with most (all) mainstream macroeconomic analysis it has a ‘stripped down’ financial sector, and specifically the NCM departs from the previous consensus (whether seen as IS/LM Keynesianism, monetarism or new classical macroeconomics) in its use of a version of endogenous money rather than exogenous money – that is money created by private clearing banks as part of the loan processes rather than money created by the central bank and related to the funding of government expenditure. In NCM, macroeconomic policy is dominated by monetary policy [rather than fiscal policy which is deemed ineffectual] which itself is viewed, sometimes positively, sometimes normatively, in terms of inflation targeting undertaken by an independent central bank.

In respect of the financial crisis of 2007/09 (and particularly the USA component), the NCM has some particular relevance. It became associated with the idea of the ‘great moderation’, the notion that there had been a simultaneous decline in the volatility of output and inflation\(^2\) (and the phrase ‘end of boom and bust’ was used in UK in a similar way) as proponents, particularly of the inflation targeting element, viewed the NCM as providing an effective policy framework. In turn that perception of ‘great moderation’ may have helped generate an atmosphere of low risk perceptions. Monetary policy is often represented in terms of Taylor’s rule under which the policy interest rate of the central bank would be adjusted in light of inflation relative to target and the output gap with a bench-mark of the ‘natural rate of interest’. Taylor’s rule can be taken as a ‘bench mark’ as to whether monetary policy is tight or loose, and indeed John Taylor himself was amongst those who argued that US monetary policy had been too loose in the first half of the 2000s and interest rates ‘too low’ feeding asset price inflation and credit expansion (a view critically examined by Varoufakis (2014) and discussed in Chapter 3). It does though illustrate an important feature of the NCM, namely its focus on price inflation without regard to asset price inflation and more generally financial

stability. This is further illustrated in Chapter 9 when the monetary policies of the European Central Bank are discussed.

The NCM can be broadly seen as an equilibrium approach which introduces random shock elements. It gives the appearance of a stable model with monetary policy behaving in a manner which adjusts to departures from equilibrium (e.g. output above potential, positive output gap leads to higher interest rates which tends to depress demand). Although the NCM is often represented as a three or four equation model, this is a simple representation of a model based on life time optimisation generally in the context of a representative agent; an approach usually labelled dynamic stochastic general equilibrium (DSGE). As such it has some close links with the efficient markets approach in drawing on optimisation and full information, albeit with the introduction of some adjustment lags. While NCM can allow for some non-neoclassical results primarily thanks to the introduction of market imperfections, these are always treated as short-run results, so that in the long-run the model still converges to the classical ideas of full-employment equilibrium and money neutrality.

2.2.3 Remarks on the financial accelerator theory

The Financial Accelerator Mechanism (FAM) theory, a sub-class of New Keynesian economics, pioneered by Bernake, Gertler and Gilchrist during the 1980s and 1990s (for overview see Bernake, Gertler and Gilchrist, 1999) bypasses many of the critiques of the New Consensus Macroeconomics made above. Although still using the benchmark DSGE model as a starting point, this branch of literature introduces certain real effects of finance over production and the economy, and distances itself from the concept of a naturally given long run equilibrium. The two key hypotheses that underpin the relevant theory are the following: i) information asymmetries between borrowing firms and financial intermediaries have an impact on the cost of external finance in the form of agency costs; ii) everything else being the same, the higher the amount of the net worth of firms, the lower the cost of external finance. Additionally, another interesting feature of FAM is that it allows for heterogeneous agents in the model.
The implication of the above is that as long as the net worth of firms moves pro-cyclically, the premium on external finance will fall in periods of growth and will increase during recessions. In turn, this will have an impact on investment fluctuations and will enforce cyclical persistence. It follows that a demand shock capable of affecting the net worth of firms will also trigger real fluctuations in the economy. Moreover, the effects of an initial shock will be amplified by the change in the perceived creditworthiness of firms, a development that introduces nonlinear dynamics into the model. Such dynamics can be further augmented by the heterogeneity of agents, if for instance a recession brings along a reallocation of credit from firms with falling net worth to other safer destinations.

Despite its superiority compared with the mainstream NCM theory, FAM still constrains the understanding of finance and financial crises. This is because relevant models only address one of the numerous possible channels through which financial instability can be generated. Specifically, the FAM models treat fluctuations in net worth as exogenous rather than explaining how those fluctuations come above. It also holds that FAM models still view financial instability and recessions as the outcome of certain market frictions, such as information asymmetries, instead of conceptualizing them as endogenous outcomes of capitalist dynamics. With this said, it is nevertheless the case that the FAM model highlights the need for a different approach to central banking. If it is true that the quality of balance sheets of firms matters for the stability of the economy, then “the stabilization of the market value of assets (especially those used as collaterals) should be the priority of the central bank” (Fontana and Passarella, 2014: 33; emphasis in the original).

2.2.4Behavioural Finance

Behavioural Finance primarily relates with the third of the three questions outlined in the first page of this chapter. Although it does not constitute a separate theory capable of explaining how the financial sector grows and how a financial crisis can be endogenously generated, it does provide a set of empirical results showing how investors’ behaviour can actually diverge from what mainstream economics assumes, and how such divergences can potentially destabilize the market (for a detailed discussion, see Gabbi, 2015a).
Most notably, in contrast with the efficient markets and rational expectations approaches outlined earlier, Behavioural Finance rejects the view that investors act in a fully rational manner. Rather, financial decisions can be governed by emotions, sentiments, habits, rules of thumb, and so on. Such factors are usually classified as either individual or social biases. Some of the most well-known examples of individual biases include pride and overconfidence, as well as optimism and wishful thinking. Moreover, some characteristic examples of social biases include social consensus and social learning, crowd hysteria, herding and peer pressure (for a more analytical break-down, see Gabbi, 2015a: 45-49).

Especially with regards to social biases, it becomes evident that Behavioural Finance has something meaningful to say about the concrete ways in which a financial crash might come along. Nonetheless, Behavioural Finance does not go deeper than the empirical examination of surface phenomena, and in that sense does not contribute much in explaining what paves the ground and creates the conditions for a financial crisis at the first place (indicatively, is there an otherwise stable financial system that collapses due to people’s panic or due to their over-optimism, or are there any underlying processes that contribute to the build-up of financial instability, such as excessive private lending and unregulated financial trading?).

Furthermore, as pointed out by Gabbi (2015a) the insights offered by Behavioural Finance are not always compatible with each other (e.g. are investors risk-averse or overconfident?). As a result, Behavioural Finance often tells us more about what people will not do (e.g. investors will not be rational), rather than offering a concrete and consistent alternative as to how they actually behave.

All in all, despite the useful insights offered, Behavioural Finance lacks the internal coherence that would allow it to stand as a theory qualitatively different from the mainstream. What such a theory would require would be a consistent model of investors’ behaviour that would include its own causal processes, underlying mechanisms and testable propositions.

2.2.5 New Institutional Economics
Arising out of the seminal contributions of Ronald Coase, New Institutional Economics (NIE) is a stream of economics that pays particular attention to the role of social and legal norms and rules that underlie economic activity (Gabbi, 2015b: 2). In contrast with traditional institutional economics, NIE does not reject the usefulness of neoclassical economics, but rather seeks to expand its scope by relaxing one or more of its assumptions. Its most notable deviations from neoclassical economics focus on bounded rationality, transaction costs, uncertainty (usually understood either as the lack of information, or as the consequence of limitations in the cognitive capabilities of agents), and the importance of historical context and institutions.

The idea of transaction costs can be considered the main theoretical achievement of NIE (Gabbi, 2015b). Although there have been various definitions suggested as to what the term really means, in principle one can think of it as one that encompasses all those frictions that prevent competitive prices from reaching the neoclassical equilibrium and the market from being efficient. Relevant examples include costs of enforcing and protecting property rights as well as bargaining and decision costs. Most importantly, the actual transaction costs that exist in a certain time and place are seen by NIE as a function of the historical development of the associated institutions. The latter include both ‘informal constraints’ such as customs, taboos and culture, as well as ‘formal ones’, such as economic and financial regulations.

With regards to financial markets, NIE suggest that their key features are a) the low costs with which financial products can be traded; b) the high costs of acquiring reliable information about counterparty’s hidden information and actions (relating with the idea of asymmetric information); c) the importance of liquidity for the holders of financial assets and d) the links with the real sector of the economy. From such a viewpoint, it arises that the stability of the market crucially depends on the credibility of borrowers, and it is exactly such credibility that institutions should enforce. In turn, institutions such as banks exist for exactly that purpose, given that they are in a position to benefit from economies of scale, and thereby reduce transaction costs for market participants.

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3 The idea of transaction costs though predates the NIE: for example, Commons (1931).
As to the questions of what gave rise to the recent financial crisis, NIE authors have been on a similar footing with other mainstream scholars in pointing out that monetary policy in the US was too loose during the 2000s (as discussed above). They have also highlighted the complexity of financial products, such as the CDSs and MBSs, which made it hard for banks and rating agencies to track the underlying risks and price such products accordingly.

Moreover, NIE proposals have primarily focused on improving the quality of the regulatory framework by switching from micro- to macro- prudential regulation. Some of the most noteworthy suggestions put forward include the increase in the quality and transparency of banks’ capital base, the supplement of risk-based capital requirement of banking institutions with a leverage ratio, and the promotion of countercyclical buffers. Interestingly, a number of such proposals have recently been adopted by international regulatory bodies such as the Basel Committee and the European Commission.

2.2.6 Overall comparison and Points of Critique

Mainstream approaches fall short in providing us with a coherent narrative of how can financial instability and crises can arise as endogenous outcomes of the capitalist economy. In all their variants, mainstream theories either exclude in advance any relevant consideration (e.g. Efficient Market and Rational Expectations Hypotheses), or at best only manage to touch the ‘light surface’ in explaining how a crisis can occur (e.g. Financial Accelerator Theory and Behavioural Finance).

Those parts of mainstream theory that are based on the assumptions of market efficiency and rational expectations fails to adequately justify the complete neglect of a number of phenomena associated with fundamental uncertainty. These include the possibility of systemic errors made by decision makers, the potential correlation of their expectations, and correspondingly the possibility of behavioural biases, such as overconfidence and herding. It follows that the idea of a unique and stable macroeconomic equilibrium that is built upon the above hypotheses and that stands as a cornerstone feature of neoclassical economics, provides us with very little understanding as to how the actual economy functions.
Furthermore, despite the steps forward taken by other mainstream branches, such as the Financial Accelerator Theory and the Behavioural Finance stream, these still fall short in addressing financial instability, fragility and crises in a comprehensive manner. Indicatively, the Financial Accelerator Theory does indeed distance itself from the idea of a naturally given long run equilibrium, and manages to set up a mechanism whereby finance can have real effects upon the economy. Nevertheless, the mechanism provided is based on the existence of market frictions, rather than the consideration of any inherently unstable financial dynamics. As such it implicitly assumes that the mere reduction or elimination of frictions, such as the identified information asymmetries, would manage to promote financial stability. Similar remarks can also be made about the proposals put forward by the school of New Institutional Economics. Lastly, the school of Behavioural Finance limits its scope in providing us with a set of some otherwise very important empirical findings related with individual and social behavioural biases (e.g. optimism, wishful thinking, crowd hysteria, peer pressure, etc.), without however going any further in supplementing these with an alternative model of investors’ behaviour.

2.3 Heterodox analyses of money and finance

What may be termed heterodox analyses of money and finance cover a wide spectrum, and the boundaries and dividing line between mainstream and heterodox are not unambiguous. In this section there is an identification of some of the main themes amongst what is thought to be heterodox analysis.

2.3.1 The nature of money

Although it is not a universal feature of heterodox analyses (and its status within Marxian economics disputed), a frequent theme is the credit nature of money, the endogeneity of money (as being created by commercial banks and not subject to the control of the central bank) and the links between bank loans and money creation. The post-Keynesian

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4 The section is based on Hein et al. (2013); Fontana and Passarella (2015); Pasotti and Vercelli (2015); Michell (2015); and Argitis et al. (2014).
endogenous monetary analysis, and the circuitist approach have been at the forefront of such analyses.

Bank loans and credit and thereby, when bank liabilities are regarded as money, the creation and destruction of money, play an important, indeed crucial, role in the expansion of expenditure – simply expenditure can only occur when backed by possession of spending power. With this endogenous view of money, the banks play a key role in the enabling of spending power through loans. It is the degree and nature of loan creation, rather than money creation and destruction as a side result, which is of particular significance. Banks make decisions on who received loans and on what terms. Those decisions on the volume of loans become a significant factor in the cyclical behaviour of the economy, on which more below when Minsky (and others) are discussed. It is also the case that the decisions made by banks on loans impact strongly on the path of the economy – which investments are financed and which are not, what type of firms are financed and which not, and which social groups are financed and which not. In later chapters these themes are returned to in more general forms—for example, how are credit allocation decisions made, who benefits and who loses from such decisions, and how do different forms of financial institutions make such decisions.

The circuitist analysis concerns the credit nature of money, the financing of investment and other forms of expenditure and the creation and destruction of money. Financialisation has involved, inter alia, the growth of banks, financial institutions and financial markets. Sawyer and Veronese Passarella (2014, 2016), have explored the ways in which some key features of financialisation can be incorporated into the circuitist framework. The creation of money by banks (and the subsequent destruction of much of that money) is linked with the ‘initial financing’ of investment (and other expenditures) whereas ‘final financing’ relates to the funding of investment.

2.3.2 Bubbles, Crises and fundamental uncertainty

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5 See the 30 chapters in Arestis and Sawyer (2006) on these and related analyses.
6 See also Sawyer (2013, 2016)
Prices of financial and other assets fluctuate over time. In the EMH approach above (as in others), the price fluctuations are in some sense small and do not follow much of a pattern—indeed follow a random walk. Further, the price movements are treated as akin to random and exogenous shocks. In contrast, the idea of price bubbles can be seen as self-generating and liable to burst. In financial markets the development of bubbles is viewed as a sign and source of instability. In respect of designing policies to limit bubbles, whether a bubble can be identified until its bursts – and it is a frequent observation in markets (such as housing, stock exchange) when prices have risen much faster than previously and prices in the relevant market are high relative to some benchmark (e.g. for house prices, a benchmark could be house prices relative to average earnings) that ‘this time is different’. That is to say some explanation (e.g. shortage of houses) is put forward as to why now prices could be expected to be higher – and hence the rise in prices is an adjustment of those prices towards a new higher ‘equilibrium’ level.

Generally, until the outbreak of the financial crisis in 2008, mainstream economists were arguing that a price bubble cannot be identified not only ex ante, but also after the fact. (see e.g.: Bernanke and Gertler, 1999, p. 19; Greenspan, 2004; Dudley, 2010, p.22).

2.3.3 Keynes, Fundamental uncertainty and the ‘Beauty Contest’

Fundamental uncertainty is at the epicentre of Keynes’s theory. In contrast with the mainstream approaches described earlier, uncertainty for Keynes is not a synonym for risk or for the lack of some otherwise existing piece of information. Instead, it is taken as a term describing what we simply do not know, referring to that part of knowledge that does not exist until actual events take place (see Keynes, 1936; 1937). Investment is probably the most typical example of economic decision-making under uncertainty for Keynesian theory, given the impossibility for accurately foreseeing the play-out of all relevant parameters. As put forward by Keynes (1936: 149- 150):

“...Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield
ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence…"

In this context, probabilistic forecasting and the *a priori* collection of information are not enough to capture all possible outcomes, the probabilities of their occurrence and the distribution of such probabilities. As a result, expectations and the confidence that surrounds them can have real effects upon investment and financing decisions.

The Keynesian understanding of uncertainty gives rise to a number of important ideas for conceptualizing the functioning of the financial market. These include the notion of social conventions and the description of the stock market as a beauty contest. In essence, social conventions suggest that given their ignorance, investors will set up practical rules of thumb in order to govern their actual decision-making. A key convention in the market for Keynes is the assumption that the future will not be radically different from the past. As found in Keynes (1936: 152), “[w]e are assuming, in effect, that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge of the facts which will influence the yield of investment, and that it will only change in proportion to changes in this knowledge” (emphasis in the original).

It is remarkable how close the Keynesian description of such convention is to the definition of the Efficient Market Hypothesis discussed earlier. This point aside, it is important to note that despite their functionality in providing some sense of stability to investors and facilitating their decision-making, social conventions are nevertheless prone to a sudden collapse, once one or more unexpected events occur.

In extension to the above, Keynes points out that the way the stock market is organised, with the pursue of short-term profit from buying and selling being the main objective of participants, resembles the game of music chairs, or following the more popular metaphor, a beauty contest. In other words, rather than concentrating on the tangible features of the investment projects underlying particular shares, stock market participants will go after the shares they expect others to find worthy, hoping that their market value will pick up. This
implies that expectations and preferences will tend to get highly synchronized, contrary to the assumptions of the efficient market and rational expectation hypotheses. In conjunction with the fragility and artificiality surrounding social conventions, this kind of synchronization is in turn what paves the ground for the occurrence of bubbles, bursts and panics.

Kindleberger is another prominent scholar that attempts to explain how financial panics and crises occur, with his most well-known books Kindleberger (1973, 1978). In comparison with other intellectuals such as Keynes and Minsky, what stands out of his analysis are his emphasis on economic history and his focus on the international dimension of financial crises (Pasotti and Vercelli, 2015).

Focusing here on the second book mentioned, Kindleberger examined empirical evidence dating from the 18th century, and provides a general “literary model” that aims to be applicable to any recorded episode of financial crisis. In brief, three key features of his model can be highlighted. First, Kindleberger assumes that people behave more or less rationally during normal times. Nonetheless, there are occasions where coordinated departures from rationality take place, leading to a rise and burst of bubbles, and often to financial crises. The concept is very similar to what Behavioural Finance describes as ‘herding behaviour’.

Kindleberger identifies a number of possible factors that can lead to such collective departures from rationality. These include the illusion that others are rational or have access to better information, and the prevalence of hysteria among the otherwise heterogeneous groups of market participants as asset prices increase. Second, expectations tend to be fragile. Investors tend to be over-optimistic during the expansionary phase of the cycle, and can suddenly shift to over-pessimism. Third, Kindleberger distinguishes between insiders and outsiders. On one hand the insiders, primarily referring here to professional traders, are seen as well-informed leaders of the market, both in its boom and in its bust phase. On the other hand, outsiders are the ones who follow the market. These are the ones that according to Kindleberger lose the most when the market collapses. They are also seen as the ones who inflate asset prices substantially when stepping in the market, due to their relatively higher ignorance and irrationality.
Kindleberger identifies three phases in the typical bubble: the rise, the peak, and the crash. He associates the rise with an exogenous major shock, such as the discovery of a new market, the establishment of a new law, a major technological innovation, and so on. Whatever the cause, the genesis of the bubble is interlinked with self-fulfilling over-optimism, whereby asset prices rise, banks expose themselves to riskier loans and the overall liquidity in the economy falls. This crescendo leads the market to a peak. When the peak is reached, all ingredients required for a crash are there. Hence a small change, such as a single piece of bad news, or the financial distress of a particular institution, is enough to cause a crash.

2.3.4 Hyman Minsky

Two particular strands of ideas are drawn from the work of Hyman Minsky. The first relates to his ‘Financial Instability Hypothesis’ which is theory explaining why capitalist market economies are prone to instability (Minsky 1982, 1986, 1994). Financial fragility refers to the build-up of debt that precedes the break-down in economic activity, in a market capitalist economy with a sophisticated debt-based financial system. The crisis then bequeaths a legacy of unsustainable debt to succeeding periods until a boom revives expenditure and sales revenue sufficiently to make the debt burden manageable, whereupon the cyclical build-up of debt resumes.

The liabilities side of a balance sheet represented the financing of the asset side, with the combination of the two providing a ‘financing structure’. It could be a ‘hedge’ financing structure, if the income derived from the assets covered financial commitments at all times; or it could be a ‘speculative’ financing structure, if income at times fell short of commitments, but overall covered those commitments; or it could be a ‘Ponzi’ financing structure if income overall would not cover commitments, so that the firm would end up with expanding liabilities relative to assets. Financial fragility was marked by ‘deteriorating’ financing structures, with ‘hedge’ financing becoming ‘speculative’ and ‘speculative’ financing becoming ‘Ponzi’ finance. Further, periods of stability are eventually destabilising. A period of stability creates willingness on part of borrowers and lenders to engage in greater risks. There is the
tendency to shift from hedge (income expected to cover interest and principal repayments) to speculative (income covering interest only in the short term), and to Ponzi finance where interest payments are not even covered by receipts.

The second strand which featured in his later writings relates to a stages of finance capitalism and a representation of the recent stage of finance capitalism. Minsky (1988) argued that modern capitalism had developed out of ‘mercantile capitalism’ in which banks provide finance for trade, into ‘finance capitalism’ to finance fixed capital on a longer term basis as industrial capitalism grew. This was effectively a kind of capitalism in which investment bankers played a key role in the issue and management of long-term debt securities and stocks. “The great crash of 1929-1933 marked the end of the era in which investment bankers dominated financial markets” (Minsky 1992, p. 109). After the 1929, capitalism evolved into what Minsky called ‘managerial capitalism’ in which financial pressures on firms were minimised in the interests of corporate management, with governments guaranteeing stable cash flows through the management of aggregate demand. Minsky (1988) envisaged that the post war era of managed money capitalism emerged from the success of managerial capitalism. It involved the growth of pension funds, mutual funds such that “a large portion of the outstanding shares of major corporations is now owned by these large institutional holders.” Minsky argued that the stability and welfare created under post-war capitalism (or as he calls it ‘paternalistic capitalism’) gradually gave rise to an environment that underestimated risk and thereby encouraged financial innovation and deregulation. Minsky identifies several features of this new era. These include the appearance of large financial players, such as mutual and pension funds, the growth of leverage ratios and the prevalence of short term investment behaviour. It is worth noting that Minsky’s observations come primarily out of his last paper in 1996 (see Minsky, 1996). As such it can be said that Minsky was to an extent aware of the emergent financial instabilities long before these became widely evident.

2.3.5 Joseph Schumpeter
It is not possible to understand Schumpeter’s insights on the role of finance without any reference to his broader economic theory (pointed out by Michell, 2015). This is because in the Schumpeterian analysis the importance of finance is found on its connection with the funding of innovation, which in turn is the key variable driving economic development. In particular, innovation is driven by the class of entrepreneurs, who being primarily new rather than existing firms do not have access to any internal source of financing. This means that the realization of their investment plans is dependent upon the provision of banking credit. In that regard, the banking sector comes to play a crucial role in facilitating innovation, and thereby economic development. It is interesting to note here that Schumpeter’s view on banks is closer to the endogenous money perspective discussed above, rather than the mainstream perception of banks as simple financial intermediaries.

It is interesting to note here that Schumpeter’s view on banks is closer to the endogenous money perspective discussed above, rather than the mainstream perception of banks as simple financial intermediaries. He distinguishes two categories of credit playing fundamentally different roles in economic process. The first one (called ‘normal’) is defined as a credit ‘that “creates claims to the social dividend, which represent and may be thought of as certifying services rendered and previous delivery of existing goods”. Contrary to this, the second kind of credit (called ‘abnormal’), “creates claims to the social product, which, (...) in the absence of past productive services could only be described as certificates of future services or of goods yet to be produced” [Schumpeter 1934, p. 101]. In other words, ‘abnormal’ credit can be backed neither by money in the strict sense nor by products already in existence” and thus “consists in creating a new demand for, without simultaneously creating, a new supply of goods”. At the same time it enables the entrepreneur “to withdraw the producers’ goods which he needs from their previous employments, by exercising a demand for them, and thereby to force the economic system into new channels” (p. 106). “The creation of purchasing power characterises, in principle, the method by which development is carried out in a system with private property and division of labour. (...) It is
only thus that economic development could arise from the mere circular flow in perfect equilibrium” (p. 107).

For Schumpeter, the process of innovation is not only the key driver of development, but also the real cause of economic recessions. This is because once new goods and/or new techniques of production have been introduced and established, certain firms will find themselves operating with obsolete methods of production and will thereby run at a loss. Unavoidably, these firms will sooner or later get liquidated. Hence the term “creative destruction”.

In this scheme, the importance of finance is that it can postpone and prolong such an endogenously created recession, by causing further disturbances to the ‘normal’ functioning of the economy. Such disturbances can include the financing of unprofitable businesses for a period of time, the excessive and misallocated supply of credit, the rise of speculation in the stock market and the generation of asset price bubbles. Schumpeter notes that it might appear that a financial crash is what leads to a recession, given that it is usual for such event to take place prior to any change in the real economy. Nonetheless, rather than identifying causality Schumpeter argues that such evidence should instead be related with the fact that stock market prices are by definition much more flexible than the prices of consumption and capital goods. Hence it makes sense for the stock market to move first, without this implying that it creates the recession.

Overall, while the banking sector and the stock market on their own are not the cause of the recession, their role in creating disturbances will determine the severity and duration of the recession phase. In other words, while for Schumpeter economic recessions cannot be avoided, they can be contained to their “natural” levels by means of responsible banking practices. What Schumpeter understands as responsible banking is not related with mechanical measurements of balance sheet structure, such as liquidity and capital ratios, but with the bankers’ knowledge regarding the details of the particular investment projects that are to be undertaken out of the funding provided (Michell, 2015: 51).

2.3.6 The classical dichotomy again
Detzer and Herr (2014) consider how the insights of different schools of thought regarding financial crises can be separated into the ones that consider financial crises as a disturbing factor to an otherwise stable real economy, and the ones that remove the neoclassical dichotomy between the monetary and real sides of the economy. Some of the most prominent figures of the first camp are Wicksell, Hayek, Schumpeter, Fisher as well as the early Keynes. On the other hand, the later Keynes along with Minsky stand as two of the most notable theorists of the second group. While both sides consider the importance of the money interest rate in affecting economic dynamics, they differ as to what to contrast it with. In particular, most of the scholars of the first group focus on the comparison of the money interest rate with what they understand as the ‘natural’ interest rate, which is in turn supposed to be determined in the real economy. In contrast, (late) Keynes and Minsky reject the concept of the natural interest rate, and instead focus on the expected rate of return for investment. Such an approach allows uncertainty, expectations, social conventions, herd behaviour, etc. to have real effects upon the economy. More recently, Behavioural Finance has provided some interesting evidence regarding phenomena related with psychology and expectations, without however getting to the point of providing an alternative paradigm to standard mainstream theory.

2.3.7 Old institutionalists (Veblen and Mitchell)

The old institutionalist approach has its own distinct contribution in conceptualizing the role of finance and the mechanisms propagating financial crises. Similar with other heterodox approaches it also views financial markets as inherently unstable and capable of having real effects in the economy, albeit with different underlying mechanisms and dynamics. Following Argitis et al. (2014) the current sub-section focuses on Veblen and Mitchell, two of the most prominent figures of that school.

Veblen

Veblen sees the origin of financial instability in the culture of the business enterprise system. According to his logic, businessmen’s desire to enhance the social status and prestige of themselves and their corporations act as a strong incentive in their demand for credit. Social
status however primarily relates with the monetary rather than the productive value of their property. As a result, businessmen’s motivations will not necessarily be in line with the actual needs of the production process. Firms will therefore have a tendency for over-investment and over-leveraging. From its side the financial market is likely to support such process. This is because its evaluation criteria in supplying credit can be manipulated by factors such as the prestige and goodwill of the firm, rather than concentrating on the actual value of the firm’s tangible assets. In turn, this can lead to overoptimistic expectations about the firm’s prospective profitability.

For Veblen financial leverage can have two conflicting effects. On one hand, it can give rise to a self-enforcing spiral, allowing a firm to expand and over-invest. Over-investment will boost the firm’s market value and expected profitability, and will further facilitate its access to credit. On the other hand, extensive leverage is capable of enabling the introduction of new technologies, and can therefore lead to lower prices. Such development will reduce the value of the firm’s existing assets and potentially its expected earnings too. In either case, over-leverage will create solvency and liquidity issues for the firm, which sooner or later will find itself unable to meet in full its debt obligations. A financial crisis is what follows.

Mitchell

Mitchell follows closely Veblen’s analysis in developing a macroeconomic and financial analysis of the business cycle. In his model, the supply of credit to a corporation depends on the latter’s tangible and intangible property, including assets such as goodwill. All assets are valued in terms of the profits they can generate, so that in essence expected profitability comes to be the cornerstone variable that determines credit provision.

As the economy enters into a phase of prosperity, the provision of credit increases, and in turn commodity prices and profits begin to rise. Such development makes firms demand further credit and a “pyramiding of credits” starts building up. Nonetheless, the rise in the demand of credit also pushes the interest rates upwards. Given the financial exposure of firms, the increase in interest rates will lower their expected profitability and raise their financial fragility. At this stage, certain firms will start facing solvency and liquidity problems.
as creditors will start rationing the supply of credit. Once these firms begin to deleverage
the financial market will get even more cautious and fear will start spreading. Eventually the
process of deleverage will turn into a general trend and the economy will enter into the crisis
phase.

2.4 Financialised capitalism

Several authors have reflected on financial and economic crises, paying particular
importance to the contradictions arising in the real economy and the historical context
surrounding each case. In that respect, relevant scholars identify the recent crisis as a
product of the ways capitalism has been developing since the late 1970s and the early 1980s,
particularly in the US. Given that the vast majority of relevant literature is influenced by the
works of Karl Marx, the section starts by outlining some of his own contribution in explaining
how crises are born, as well as some of the contributions of early Marxists.

2.4.1 Marx and the Early Marxists

Marx

Karl Marx was one of the first writers to explain how economic and financial crises can
emerge as endogenous outcomes of the capitalist economy. In his theory, profit arises out
of the extraction of surplus value in the field of capitalist production, and is the driving motive
of investment. Marx sets up a distinction between productive (industrial), commercial and
financial capital, and argues that all surplus value (and hence all potential profit) initially
arises out of the industrial field, and is then distributed between the three categories of
capital. Moreover, Marx points out that the interest rate is the key instrument that
determines the distribution of surplus value between productive and financial capital. As
being governed by the dynamics of the market, Marx expects the distribution of surplus to
fluctuate throughout the course of the economic cycle. Banks are for Marx the most
important institutions of the financial market, while his analysis also encompasses bonds
and shares which he considers as ‘fictitious capital’.

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7 The section is based on Argitis et al. (2014) and Hein et al. (2013).
According to Marx, following a major downturn in the economy, demand for credit is low and thereby interest rates are maintained in low levels too. This means that the net profit remaining to industrial capital is relatively large. Eventually this allows a period of expansion to start, with investment, output and sales on the rise. At some point the expansion boosts the demand for credit, which in turn pushes the interest rate upwards. Furthermore, the expansion of finance increases speculation in financial assets. Marx moves on to identify two key factors that can trigger a crisis. One scenario that describes the occurrence of a semi-autonomous financial crisis is that at some point banks start feeling nervous about their liquidity levels, and react by reducing the supply of credit. Given the demand for credit from industrial firms, this can result in a further increase of the interest rate, which will in turn squeeze industrial profits. A second scenario is that on top of the increasing interest rates, industrial firms also experience a pressure on their profitability out of the increased wages and prices for raw materials. The fall in net industrial profits can affect their ability to meet their financial obligations, which in turn sets the ground for a financial collapse. For Marx, the consequent crisis is characterized by a wide inability to sell commodities, a breakdown in credit supply, a desperate need for liquidity, a wave of bankruptcies and a rise in unemployment.

Hilferding

One of the early followers of Marx’s theory was Rudolf Hilferding. Based primarily on the historical development of German capitalism in the 19th century, Hilferding (1910, 1981) argues that once the credit system has been fully developed, industrial capitalists are forced by competition to take up debt and expand their operations, so as to benefit from economies of scale. In a later phase, the joint stock company or corporation is introduced, which allows a further expansion of production than what the individual capitalist could achieve. At that stage, however, banks come to acquire a permanent interest and supervision role on corporations. This is because banks provide the credit demanded by corporations, while also investing in corporate shares. Gradually, banks come to be the owners of industrial capital, with industrialists getting downgraded to a simple managerial role. Moreover, Hilferding
sees a natural and interlinked tendency towards market concentration both for the industrial and the banking sectors.

Hilferding’s narrative on cyclical fluctuations and economic crises is to an extent similar with that of Marx. One of his key innovations is the idea of ‘disproportions’. This is a term that refers to the sectoral divergences of production from the volumes necessary to maintain a robust capital accumulation. Having their root in the rising organic composition of capital (i.e. the proportional increase of fixed capital) that takes place throughout the expansion phase, disproportions become apparent when production fails to adjust to the differentiated price increases that occur across the various branches of the economy. Such failure results in a poor sales performance for firms. These might be able to postpone the effects of disproportionality for some time, thanks to their access to credit. However, once banks start containing credit supply, firms get desperate in selling off commodities and prices begin to fall. In turn, solvency and liquidity issues appear and trust begins to crumble.

Luxembourg

Rosa Luxembourg is another intellectual that is heavily influenced by Marx. One of her most distinctive contributions to economic theory relates with her reflections over the realization problem. More specifically, Luxembourg criticizes Marx for playing down the issue of adequate demand for consumption goods and for developing his analysis within a closed-economy framework. From her standpoint, the main obstacle in converting produced surplus value into profits (or else in realizing expected profits) does not relate with the source of the money, but rather with the source of the necessary demand. According to her scheme, the total demand generated by capitalists and workers together is not enough for all consumption goods to be sold. The way out of the conundrum for capitalism is the colonial expansion towards the non-capitalist world and the corresponding creation of new markets for the absorption of the goods produced in the capitalist metropolis. However, the simultaneous process towards a universal capitalist production comes at odds with the need of non-capitalist markets, and therefore comes to threaten the future of capital accumulation itself.
2.4.2 Post War Marxist Schools of Thought

Monthly Review

Monthly Review (MR) is an American school of Marxist economic analysis, originally born in the late 1940s. Paul Sweezy and Paul Baran are two of its most prominent figures of its initial phase. Their 1966 book, entitled as *Monopoly Capital: An Essay in the American Economic and Social Order*, is considered as one of the cornerstone contributions of the school. More recent scholars include John Bellamy Foster and Harry Magdoff. Outlined briefly, MR’s key insight is that capitalism (mainly referring to the case of the US) has entered in its monopoly phase, where the conglomerate monopoly firm is the typical unit of analysis. At this stage surplus value has a tendency to rise due to the monopolistic organisation of the industry, and due to the corresponding capacity of the monopoly firm to act as a price maker. However, such a tendency co-exists with a scarcity of productive investment outlets. As a result, the system has a natural tendency towards stagnation. This can only be avoided by means of exogenously given counter-tendencies, such as military and advertisement expenditures. Being a product of the particular historical context in each time, these counter-tendencies act in a way that allows the excessive surplus to be absorbed.

Finance does not have a central place in MR theory. Partly this is because in the above analysis, which is primarily built around the experience of the post-war era, internal financing is seen as the most important source of finance for the monopoly firm. It is from the late 1970s and on when MR authors start attributing more emphasis to the role of finance, commenting on the growing indebtedness of US firms and the rise of financial speculation. Most importantly, MR authors claim that financialisation has been the means to avoid the stagnation that would otherwise occur throughout the period of neoliberalism. In other words, the growth of financial markets is seen as the historically-specific counter-tendency that allowed the absorption of the excessive volume of surplus generated by monopoly capitalism. While such development allowed corporations to sustain their profitability, it also made them more dependent on the financial market. Moreover, the profits realized were to a great extent circulated within the financial sphere, instead of being invested back in the
real economy. Overall, MR authors note that the rise of finance produced an increasing volume of financial instability which eventually led to the recent crisis.

_French Regulation and Social Structure of Accumulation_

French Regulation (FR) and Social Structure of Accumulation (SSA) have also been two influential schools of Marxist analysis. The two streams have been developing in parallel since the 1970s across the two sides of the Atlantic, and share a number of common features. Following the key insights of Marxist theory, FR and SSA share a common starting point in understanding capitalism as an inherently unstable system, prone to episodes of financial and economic crises. Moreover, despite their methodological differences and their differences in terminology, the two schools ground their analyses upon a specific historical and spatial context, paying particular attention to the role of institutions. In both cases, institutions are seen as capable of supporting capital accumulation by containing social conflict and economic instability for a prolonged period of time. For both schools the term ‘institutions’ is understood in a broad sense, so that relevant analyses encompass not only economic, but also social, political and cultural elements. Relevant contributions focus in identifying concrete epochs of capitalist development (usually taken to last around thirty to forty years each), and highlight the role played by the particular set of institutions in each case. Moreover, they provide insights as to how the transition between different eras unfolds, and how such change is capable of explaining the recorded episodes of economic and financial crises.

Regarding the development of capitalism throughout the last three decades, the FR and the SSA stand on a similar footing in detecting an era of neoliberal and financialized capitalism, especially in the USA and the UK. For both schools, the demise of the institutional arrangement of the post-war period, and the crisis of the late 1960s and early 1970s are seen at the root of the subsequent rise of the power and influence of finance. According to both narratives, some of the key features of the era of financialized capitalism have been the internationalisation of trade and the process of financial liberalisation. Other features include the deregulation of the labour market and the consequent erosion of trade unions...
and stagnation of wages, the shift of corporate planning towards a more short-term horizon under the influence of finance, and the ballooning of household debt. On the whole, both schools identify the recent financial and economic crisis as the intrinsic outcome of those developments.

Other Heterodox Authors

A number of thinkers, not strictly affiliated with any of the above schools have also made their own distinct contributions in discussing the rise and implications of financialized capitalism. Some of these include Ricardo Bellofiore, Makoto Itoh, Costas Lapavitsas, Gerard Dumenil, Dominique Levy.

Bellofiore

Bellofiore is a heterodox economist whose theoretical framework is broadly placed within the tradition of the monetary circuit. Marx, Keynes and Minsky are some of his main influences. One of his key theoretical contributions is the concept of ‘real subsumption of labour to finance’. Taken as an updated version of the labour theory of value, the idea here is that the fundamental capitalist relation is not the one between workers and capitalists as the owners of the means of production, but instead between workers and the ones with access to money. Regarding contemporary capitalism, a key part of Bellofiore’s narrative can be captured by the interaction between the following three concepts: the ‘traumatized worker’, the ‘manic saver’ and the ‘indebted consumer’. Considering each one in turn, the traumatized worker relates with the deterioration of workers’ living standards that took place during the neoliberal era, due to the rolling back of the welfare state and the fall in real wages. In addition, the manic saver describes the incorporation of households’ savings into the financial system and the corresponding inflation of financial asset prices. Such development gave rise to an increasing collateral basis which in turn supported the expansion of debt-financed consumption. Hence the concept of the indebted consumer. Taken in conjunction, Bellofiore argues that the manic saver and the indebted consumer went hand-to-hand and together provided the mirror reflection of the traumatized worker.

Itoh and Lapavitsas
Itoh and Lapavitsas are two scholars that have made significant contributions in the analysis of money and finance from a Marxist perspective, particularly through their 1999 book entitled as *Political Economy of Money and Finance*. One of their most noteworthy contributions is the idea of the ‘credit pyramid’, reflecting the existent hierarchy in different forms of money. According to their analysis commercial credit stands at the bottom of the pyramid, banking capital and the money market are to be found above, with the central bank sitting at the top of the triangle. Moreover, a network of credit chains runs across and within the different layers of the pyramid.

The pyramidal scheme plays an active role in the conceptualization of the business cycle provided by Itoh and Lapavitsas. The expansion phase of the economy is associated with an upward extension of credit across the pyramid, while credit chains are seen as effective transmission mechanisms of illiquidity and insolvency problems across the credit system.

More recently Lapavitsas has authored a number of books and articles on financialisation and the recent crisis (for further details see Argitis et al., 2014). From his perspective, the crisis has had its roots on developments related with workers’ income, borrowing and consumption as well as with the transformation of finance. In brief, Lapavitsas identifies a shift of corporations towards open market and retained earnings financing during the neoliberal era. This has had negative implications on banks’ profitability, which now had to look for alternative activities to maintain their profits. One of these new lines of business was the exponential increase of household debt, which Lapavitsas classifies as a form of exploitation and correspondingly labels as ‘financial expropriation’.

*Dumenil and Levy*

Dumenil and Levy are two French scholars who have also reflected extensively on the recent crisis. According to their narrative, US capitalism since the early 20th century can be broadly divided into three distinct eras: i) the period of financial hegemony; this was characterized by a free market economy and a dominance of finance over industry and is seen to have lasted up to the New Deal; ii) the period of the post-war compromise that involved a more powerful managerial authority, and an improved standard of living for the working class; and iii) the
period of neoliberalism, which is essentially taken as the bounce back to financial hegemony. In all cases the transition from one era to the next has been accompanied by structural and prolonged crises, with some exhibiting similar features. In that respect, Dumenil and Levy argue that as with the crisis of the 1930s, the current crisis can be seen as the offspring of financial hegemony. More distinctively, the authors identify three fundamental contradictions in the workings of neoliberalism which in their opinion contributed to the recent crisis. First, the pursuing of high incomes instead of investing in production. This is seen as responsible for the fragility of the financial system. Secondly, the shrinkage of the influence and authority of the state as a result of financialisation and globalization. Third, the fall of investment and the rise of imports, which together contributed to the exponential growth of household debt and the development of risky financial assets.

2.5 Not Exactly Heterodox, but not Mainstream Either*

Any classification is always constructed as an ex-post schema, helping us to organize literature. It allows us to classify literature not in an abstract and ahistorical way, but subject to the actual path that ideas and theories have followed across time. Authors such as Marx and Keynes had no idea about the distinction between mainstream and heterodox economics, and would have probably felt uncomfortable to the idea of grouping them together, given the diversity of their social backgrounds and motivations. Such discomfort however does not pose a serious problem. As Catephores (2004) argues while a thinker can control his aims and motivations, it is much harder to control the logic of his own analysis, and the implications that can come out of it. What does present an important issue on the other hand is that a literature classification might often need to be stretched in order to encompass all authors and schools of thought. The alternative solution is to allow it to exist as it is and acknowledge its limitations.

In our case there are two writers that do not strictly fall neither in mainstream nor in heterodox economics. These are Irving Fisher and Friedrich Hayek. While both of them could prima facie be seen as closer to the mainstream than to heterodox economics, their

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* The section is based on Vercelli (2015b) and Michell (2015).
contributions go far beyond the boundaries of classical economics. Even more, some of their insights, such as their understanding of the real effects of money, could be seen as primarily related with ideas that are nowadays classified as 'heterodox'.

2.5.1 Fisher

According to Vercelli (2015b), Fisher was one of the most influential economists of his time. He was also recognized by Keynes as one of the first to identify the real effects that money can have. Fisher is nowadays acknowledged for a wide variety of contributions (for a full list, see Vercelli, 2015b: 1- 2), but probably what mostly stands out of his work is his debt-deflation theory of great depressions. As outlined by Vercelli, debt-deflation theory can be understood through three feedback mechanisms. First and most importantly, there is the feedback mechanism between debt and prices. As agents realize their over-indebtedness, they start liquidating their assets in order to pay back their debt. However, this process brings down the volume of deposits and the money circulating in the economy. As a result, the overall price level falls, so that the outstanding debt increases in real terms. The second mechanism is between finance and the real economy. In particular, Fisher argues that during the debt-deflation process, the profit rate and the net worth of businesses keep shrinking, while bankruptcies are in the rise. Eventually this leads to a fall in output and employment, which further deteriorates the net worth of businesses and increases their real over-indebtedness. Third, Fisher sees a simultaneous fall and rise in nominal and real interest rates respectively, arising out of the first two mechanisms. This causes real debt to escalate further. Moreover, he describes the possibility of a flight to safety. This can cause a differential response of nominal interest rates in safe and unsafe loans, which nevertheless is expected to be asymmetric due to the zero-bound that contains the downward movement of the nominal interest rate. Overall, Fisher expects the second and third mechanism to be triggered by the first, and further reinforce its effects. Nonetheless, Vercelli (2015b) points out that according to recorded evidence the second mechanism can also function independently of price deflation.

2.5.2 Hayek
Hayek is another prominent economist who has reflected on the ways that booms and bursts can arise as endogenous outcomes of the economy. Although as pointed out by Michell (2015) his theory only includes little consideration over phenomena associated with financial distress, such as insolvency, illiquidity and deleverage, money and banking hold a central place in his analysis of how the real economy fluctuates.

Michell (2015) provides an extensive review of Hayek’s theory, showing how Hayek developed and updated it throughout his career. Our focus here is on the main mechanism of his account of the business cycle. Some of Hayek’s key ideas are the following: first, Hayek separates between capital goods and consumption goods, as well as between capital goods of different orders. Simply put, the higher the order of a capital good, the earlier the time when it enters the production process. By the same token, consumption goods are taken as first order goods. The purchase of capital goods is meant to be funded out of the savings of the economy, which in turn are a function of the abstention from consumption that individuals are willing to undertake. It follows that high order capital goods require a greater sacrifice of current consumption, as they will be involved in production for a lengthier period of time.

Secondly, Hayek argues that what is important for economic analysis is not the overall level of prices, but rather the relative prices between goods of different orders, and particularly between capital and consumption goods. Third the rate of interest affects relative prices due to the influence it exerts over the discounting of the returns of the various goods. Given that the earlier a good enters the production process, the higher the impact of discounting on its expected returns, a drop of the interest rate will produce a differentiated effect on prices. More specifically, a lower interest rate will increase the prospective yield of high order capital goods, thereby boosting their demand and their relative prices.

Based on these ideas, Hayek shows how disequilibrium dynamics can occur. From his perspective, the “natural” interest rate is supposed to equilibrate the investment and saving decisions of individuals. In that respect, a fall of the interest rate will only be sustainable if it is accompanied by a conscious decision of consumers to increase their level of patience and thereby increase their savings. If instead it comes out of the expansion of banking credit,
it will constitute a divergence from its natural level. The prices and demand of high order capital goods will increase, but this will occur despite the negation of individuals to reduce their current consumption. Eventually, the re-allocation of resources to longer production processes will produce a scarcity of consumer goods, as compared with their actual demand. This will increase the prices of consumer goods, as well as the profitability involved in their production. Hence resources will be shifted back to short term production processes. To counteract this tendency, the banking system will be required to provide further credit to businesses, and as a result the disequilibrium dynamics will deepen even more. When at some point banks decide to restrict their supply of credit the boom will burst, and a recession will occur. The demand of capital goods will decline, leading to idle capital equipment and unemployment. Overall, as Michell points out it is interesting to observe that contrary to the Keynesian theory where the inadequate level of investment is seen as the primary cause of unemployment, for Hayek the root of the problem seems to lie at the opposite direction.

2.6 Different structures of financial sector: bank based vs. market based

It is readily apparent that the structure of the financial sector varies between countries. The FESSUD Studies in Financial Systems reveal those different structures. Different types of ownership – private, public, mutual – is one dimension of that, and those will be discussed in a later chapter. The financial sector can be thought to be composed of financial institutions and financial markets, though it has to be acknowledged that financial institutions engage in market activities and that financial markets are institutions.

As Levine expressed it ‘For over a century, economists and policymakers have debated the relative merits of bank-based versus market-based financial systems.’ (Levine, 2002, p.398). He continued by stating that ‘since the 19th century many economists have argued that bank-based systems are better at mobilizing savings, identifying good investments, and exerting sound corporate control, particularly during the early stages of economic development and in weak institutional environments’ (Levine, 2002, p. 398)

One view of the perceived differences between a bank-based system and a market-based system is expressed as follows: ‘The bank-based view highlights the positive role of banks in
(i) acquiring information about firms and managers and thereby improving capital allocation and corporate governance ... (ii) managing cross-sectional, inter-temporal, and liquidity risk and thereby enhancing investment efficiency and economic growth ..., (iii) mobilizing capital to exploit economies of scale ... Thus, the bank-based view holds that banks—unhampered by regulatory restrictions on their activities – can exploit scale economies in information processing, ameliorate moral hazard through effective monitoring, form long-run relationships with firms to ease asymmetric information distortions, and thereby boost economic growth.’ (Levine, 2002, p.2)

In contrast, ‘the market-based view highlights the growth enhancing role of well-functioning markets in (i) fostering greater incentives to research firms since it is easier to profit from this information by trading in big, liquid markets ..., (ii) enhancing corporate governance by easing takeovers and making it easier to tie managerial compensation to firm performance ..., and (iii) facilitating risk management. ... Moreover, the market-based view stresses problems with banks. Specifically, powerful banks can stymie innovation by extracting informational rents and protecting established firms with close bank–firm ties from competition ... Furthermore, powerful banks with few regulatory restrictions on their activities may collude with firm managers against other creditors and impede efficient corporate governance ... In contrast, competitive capital markets play a positive role in aggregating diffuse information signals and effectively transmitting this information to investors, with beneficial implications for firm financing and economic performance ...Thus, proponents of the market-based view stress that markets will reduce the inherent inefficiencies associated with banks and enhance economic growth’ (Levine, 2002, p. 3).

The market-based/bank-based terminology is rather misleading in that all the financial systems being considered are part of what may be termed market economies. The financial systems themselves involve trading in which financial assets and liabilities are exchanged at a price. A bank-based system can be represented in simplistic form in terms of the supply of funds and the demand for funds (with the former arising from savings taking the form of bank
deposits and the latter arising from investment and taking the forms of loans): this is undertaken in many macroeconomic text books, and in the ‘financial repression literature’. It is evident (Table 2.1) that banks expanded in size (as measured by ratio of bank deposits to GDP) in the financialisation era, which is not surprising given the notion of financialisation. The size of financial markets also tended to expand (as measured by, for example, stock market valuation relative to GDP, stock market turnover). In general growth of stock markets has been faster than growth of banks, though the former is sensitive to market valuation which is generally pushed up through asset price inflation, though subject to sharp decreases as in the global financial crisis.

Table 2.1 near here

Within the general growth of the financial sector, there has been more rapid growth of financial markets, engaged in an expanding set of financial assets, derivatives and securities. Further banks have generally become more engaged with financial markets, and the demarcation between banks and markets increasingly blurred. Authors such as Christophers (2015), Hardie and Howarth (2013), Hardie et alia (2013) for the arguments on the fusion between banks and markets.

Hardie and Howarth (2013b) talk of market-based banking which is contrasted with traditional banking (cf. their Table 2.1). Drawing on that table, they talk of traditional banking which has commercial and savings banks (under different names in different countries) where loans are retained on the balance sheet with customer deposits as major source of funding. Credit risks of loans retained are not hedged, and are valued at cost. The central bank provides official support through its role of lender of last resort. In the market-based banking, the distinction is drawn between commercial banks who continue to receive official support from the central bank and parallel banks (which include investment banks) where (outside of crises) no official support is offered. In other respects, the two types of banks are viewed as sharing the common features of (i) loans are sold in loan markets via securitization or to shadow banks: the originate to distribute model; (ii) funding is through the wholesale
markets, (iii) the credit risk of loans is hedged through CDS (credit default swaps), (iv) loans are accounted on a mark to market basis.

In a similar vein, it is argued that ‘[p]reviously, market-based banking has been applied to the ‘shadow banking system’: those parts of the financial system that provide credit, but are not commercial banks, such as investment banks and money market funds. In this usage, shadow banking focuses on the ‘originate and distribute’ business model. In this model, banks ‘disintermediate themselves’ by not keeping loans on the balance sheet but selling them to other financial market actors – or are disintermediated by those other financial market actors providing credit directly. This familiar story of the disintermediation of banks involves loans being market-based.’ (Hardie et alia, 2013, p. 703)

The bank-based/market-based typology can give a misleading impression in that all financial systems involve a payments system and money creation via banks as part of the loan processes, and hence all financial systems involve banks. The typology (as reflected in the quotes above from Levine) reflects a loanable funds approach in which financial intermediaries whether banks and financial institutions or financial markets are viewed in terms of the savings—investment nexus. The statistics in Table 2.1 and the arguments of authors such as Hardie et alia (2013), Christophers (2015) point towards the dichotomy of bank-based/market based having lost its power. It is also argued that the differences between banking institutions in terms of, for example, ownership, role and scale have to be further explored.

Concluding comments

The mainstream theories as examined in section 2.2 are in the main equilibrium theories, which creates difficulties in providing endogenous explanations of cycles and of crisis. Cycles can be ascribed to the effects of ‘shocks’ which are exogenous. Crisis can be ascribed to policy mistakes by government, whether in the over-expansionary fiscal policy and the build up of sovereign debt or monetary policy with ‘too low’ interest rate (as put forward as explanation of the financial crisis, see Chapter 3). The mainstream theories generally promote the notion of the efficiency of the financial sector. This is particularly evident with
the ‘efficient market hypothesis’, albeit that it refers to financial markets (and not explicitly to financial institutions) and to a narrow notion of efficiency in terms of the incorporation of information into asset prices. The general literature on financial deepening and economic growth, as referred to in the previous chapter, has strong tinges that growth of the financial sector (a component of financialisation) is a driver of economic growth, and facilitates savings, links savings with investment and monitors investment.

Many of the heterodox theories are focused on the instabilities of the capitalist market system, and prone to cycles and crises. Those theories provide different mechanisms which generate cycles and crises. In the theories examined here the emphasis has been on the actions and operations of the financial system with respect to cycles and crisis. The work of Minsky, in particular, highlights inherent instabilities within the financial system. These can interact with instabilities within the real sector coming from cyclical movements in investment demand along the lines of the accelerator principle. Other analyses have pointed to tendencies for asset price bubbles to develop which can lead to crisis when there is the inevitable bursting of the bubbles.
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Chapter 3. Understanding financial crises

3.1 Introduction

This chapter is centred around understanding financial crises in general, and the 2007/09 financial crisis in particular. In the previous chapter, there has been consideration of how theories of finance were relevant in understanding financialisation and financial crises. The 2007/09 financial crisis is the most recent large scale crisis: the past few decades have been filled with many crises, as discussed in the previous chapter. Many of those crises were contained within a single country with little contagion, and some were relatively shallow. Others were much more widespread effecting many countries directly and through contagion: the East Asian crisis of 1997 being a notable example. Many, particularly banking crises have had major effects on output and employment as indicated in the previous chapter.

In section 3.2, the lessons to be drawn from some previous major financial crises are examined, covering the Great Depression of the 1930s in the US, the Latin American debt crisis of the 1980s, and the Japanese crisis of the 1990s and 2000s.

Section 3.3 provides examination of the 2007/09 financial crisis. At one level, the 2007/09 financial crisis can be viewed as a further illustration of the tendency for financialised capitalism to involve periods of crisis, and the extent of financial crises in the era of financialisation was indicated in the previous chapter. The theories of financial crisis reviewed by Detzer and Herr (2014) and in Chapter 2 are suggestive of the endogenous generation of financial crisis. At another level, many specific explanations were advanced for occurrence of the 2007/09 financial crisis, and often came with implicit or explicit policy recommendations to avoid or alleviate future crisis. An example of that would be the notion that American monetary policy had been ‘too loose’ with interest rates ‘too low’ with the policy implication of adhering to the Taylor rule under which policy interest rate used to target inflation is based on the ‘natural rate of interest’, output gap and deviations of expected inflation from target rate. The investigations of these explanations for the crisis were placed under eight headings, and in section 3.3 an overview of the FESSUD investigation of these
explanations is provided. Section 3.4 on generation of crisis in individual countries, and the export-led/debt-led distinction.

3.2 Observations on previous financial crises

Dodig and Herr (2014) provide a comparative study of a selection of some major past financial and economic crises. These include the Great Depression of the 1930s in the US, the Latin American debt crisis of the 1980s, and the Japanese crisis of the 1990s and 2000s. The authors concentrate on a set of questions related with the triggering factors of crises, the subsequent intensifying elements, as well as the factors that prevented return to prosperity for those countries.

The Great Depression

Starting with the background of the Great Depression, Dodig and Herr (2014) point out that throughout the early 1920s, industrial production in the US experienced an unprecedented expansion. Nonetheless, economic growth went along with a rise in income inequality, so that it was mainly the upper income households that gained from such prosperity. Functional income distribution followed a similar trend too, with the profit share increasing relative to wages. At the same time, aggregate consumption was significantly maintained by household debt. Overall these developments led to an increased spending of top income classes, and fed the growth of speculative activities. In 1926 the first signs of the upcoming crisis appeared. The real estate bubble which had been building up collapsed, and the rate of house foreclosures escalated. Following, the New York Stock Exchange (NYSE) staged a new bubble with stock market prices going through the roof in 1928 and 1929. In early 1929 the Fed unsuccessfully attempted to contain the bubble by raising interest rates. A few months later, a drop in industrial production was recorded, and the sentiment of the stock market turned negative. In October, the NYSE bubble finally collapsed, with the stock market declining by 23% in just one day, the so-called ‘Black Tuesday’ (October 29th, 1929). The stock market crash quickly expanded to the real economy, causing one of the deepest recessions ever recorded in the history of capitalism. Within a three-year period, from 1929 to 1932, US national income had dropped to half. By 1933, industrial production had
experienced a similar fall, and unemployment had reached 25%. In turn, debt to income ratios of households reached record heights. Even more, price deflation boosted further the real value of the burden of debt. The fall in prices was clearly related with the simultaneous drop recorded in nominal wages.

Up to 1933, the policies adopted by US authorities were non-interventionist. The view that prevailed at the time was that fiscal policy would threaten the credibility of the government, while expansionary monetary policy was seen as dangerous for the value of the dollar. Moreover, the Fed did not take up its role as a lender of last resort. To make things worse, import tariffs were imposed in 1930. Although set with a view to protecting domestic production, the introduction of tariffs led other countries to react by following a similar policy, and therefore resulted in the collapse of international trade. The election of Roosevelt in 1933 marked a turning point. The US dollar was devalued and as a result gold inflows started increasing (and also due to the political instability arising in Europe, and the threat of a new war coming up). In addition, banks’ balance sheets were cleaned up, the Securities Exchange Commission (SEC) was set to supervise the stock market, and the Glass-Steagall Act was established, separating commercial from investment banks. Furthermore, the first basic social safety net was put in place, workers’ rights to organize and set trade unions were recognized, and a minimum wage was introduced.

All in all, while Roosevelt’s measures were effective in halting the further fall of wages and prices, they were not adequate to regenerate economic growth. Despite a temporary period of optimism and fragile growth in 1937, Roosevelt’s subsequent decisions to cut down public spending and raise taxes so as to re-balance the public budget paved the ground for a new fall in economic activity in 1938. Eventually it was only through the steep rise of public expenditure during WWII that the Great Depression was terminated.

The Latin American Debt Crisis

Throughout the 1960s and 1970s, a number of Latin American countries moved towards a regime of deregulated international capital flows. With positive expectations about their growth potential, Latin American countries soon became an attractive destination for foreign
capital. Such dynamic was further supported by the rise in oil prices, and the corresponding emergence of ‘petrodollar’ surpluses, as well as by the recession that spread during the 1970s in the developed world. Capital inflows consisted primarily of foreign loans and managed indeed to stimulate economic growth across the continent for a number of years. Nonetheless, the ballooning of capital inflows exposed Latin American economies to financial fragility. First, as Dodig and Herr (2014) observe, there was a currency mismatch, in that a great volume of foreign credit was denominated in foreign currency. As a result, debtors came to be significantly vulnerable to depreciations of their domestic currency. Secondly, in several cases the phenomenon of “dollarization”, whereby domestic wealth is kept in form of a foreign currency (particularly in US dollars), was observed. Dollarization is essentially a form of capital flight, which as such tends to destabilize the domestic currency and prevent the domestic economy from reaching a stable investment-income process. Third, capital inflows inflated Latin American stock markets. Fourth, capital inflows gave rise to significant current account deficits in recipient countries.

The growth of capital inflows created a great dependence of Latin American countries to international developments. One such event came in 1979 when the US authorities opted for a highly restrictive monetary policy that involved a substantial increase in interest rates. Higher rates increased substantially the debt burden for the indebted Latin American countries. In 1982, Mexico was the first to default. Shortly after, other Latin American countries started reporting solvency problems as well. The immediate result was the reversal of capital flows, followed by depletion of central bank reserves and credit stagnation. Moreover, Latin American countries received huge bail-out funds, particularly from the International Monetary Fund (IMF) and the World Bank. In all cases, rescue packages were accompanied by a list of conditions for domestic reforms. These programmes came to be known as the Washington Consensus and included dictates for privatisations, further financial liberalisation, deregulation of particular market sectors, and huge cuts in public spending. A prolonged process of debt negotiations between Latin American countries and their international creditors followed, lasting up to 1989.
For most of the Latin American countries the 1980s were a period of huge net capital outflows, and continuing over-indebtedness. Moreover, several countries had to depreciate their currencies and as a result increase households’ indebtedness. At the same time, hyperinflation was recorded in a number of cases. Overall, standards of living fell dramatically, domestic demand stagnated, while poverty and unemployment rates skyrocketed. Despite the temporary recovery in the early 1990s, the continent remained vulnerable to crisis episodes and instability up to the early 2000s.

The Japanese Crisis of the 1990s

From the end of the second World War and up to the 1980s the Japanese economy was an export-led economy, with a record of rapid economic growth and fast productivity development. It also had a relatively high degree of government intervention, as well as a highly regulated financial system. As of the 1970s Japan had established itself as one of the biggest trade surplus countries in the world, and was conducting a great volume of bilateral trade with the US, which at the same time was in a deep current account deficit. By the mid-1980s however a set of international agreements were put forward, aiming to protect the US dollar from devaluation pressures, and to rebalance the global imbalances that had been built throughout the previous years. These agreements forced Japan to deregulate its financial system, and to apply a highly expansionary monetary policy. The aim was on one hand to open the country to capital inflows, to stimulate its domestic economy and to increase its imports.

While the policies applied were successful in stimulating the domestic economy, they also paved the ground for asset bubbles, particularly in the stock market and the real estate sector. In addition, the inadequately supervised process of financial liberalisation let do a significant expansion of credit, part of which got channelled towards speculative activities. Asset prices in the two markets ballooned up until 1989 when the Bank of Japan decided to intervene and switch to a restrictive monetary policy. By containing the supply of credit and raising the interest rates monetary authorities managed to bring the two bubbles to an end. Nevertheless, the deflation of the stock and real estate markets also led to a series of loan
defaults. In addition, the high accumulated debt led Japanese firms to deleverage and as a result productive investment declined. Households followed a similar deleveraging behaviour. In conjunction with falling wages and rising unemployment this led to a stagnant consumption demand. Being a product of the deregulation of the labour market that had taken place since the mid-1980s, falling wages also contributed to price deflation. In turn, deflation further increased firms’ and households’ real indebtedness and thereby prolonged the deleveraging process and the recession.

The responses of the authorities to the crisis were too little, too late. First it took the Bank of Japan several years before it was convinced of the severity of the situation. Hence, interest rates were only reduced in 1995, when monetary policy was already ineffective. Despite the lower interest rates firms still abstained from further borrowing. At the same time, the government was ineffective in managing non-performing loans, and it was only in 1996 when it decided to take action. Moreover, although Japan was experiencing high budget deficits and an increasing public debt from the beginning of the crisis and on, no expansionary fiscal policy was systematically put forward. Indicatively, shortly after a slight recovery of the GDP in 1995 and 1996, the Japanese government endorsed a restrictive fiscal policy and initiated a process of cuts in public spending and raises in taxation. In combination with the spill-over effects of the Asian and Russian crises, this led to a new slump in GDP.

Four Lessons to be Learnt

Table 1 summarizes the key features of the three crises discussed above. Although different in many regards, the three episodes give rise to four important lessons (Dodig and Herr, 2014). These are:

i. Balance sheets of the private sector need to be cleaned-up very quickly, once a financial crisis occurs. This can facilitate the renewal of both the supply and the demand for credit. Moreover, despite its necessity, Dodig and Herr acknowledge the distributional difficulties that can arise out of such a clean-up process. For instance, if a private bank is unconditionally bailed-out by a government this can easily result to a further burden for the
average taxpayer. Hence, any such process needs to be part of a broader crisis management plan;

ii. From all three cases above, it becomes evident that authorities should be alert to the possibility of price deflation. As shown earlier price deflation is capable of prolonging a recession due to its reverse effect on real indebtedness of households and firms. Given the importance of nominal wage developments in explaining deflation, in practice the lesson here is that governments should directly and indirectly support nominal wages. Relevant examples can include the enforcement of a minimum wage, and the support of the bargaining power of workers;

iii. After a systemic financial crisis, there is a great need for active government monetary and fiscal policies. Despite their historical and socio-economic differences, all crisis events discussed above show that a quicker and more expansionary policy stance would have helped in containing the recession from an early stage;

iv. An international financial crisis requires international stabilisation. Most notably, there needs to be an institution willing and capable of acting as an international lender of last resort. Such institution should also be able to guarantee the provision of counter-cyclical long term financing. Furthermore, there needs to be a mechanism that manages international current account imbalances (including surpluses), and that is capable of stabilizing international capital flows.
3.3 Financialisation and the Recent Crises in the US and Europe

In this section the focus is on the key developments that led to the recent financial and economic crises. The main macroeconomic effects that have been attributed to...
financialisation are set out. Some of the effects of financialisation that have been recorded upon particular markets are then outlined. There are then reflections on the separate factors that have been pointed out as causes of the financial crisis in the US during 2007/09. This is followed by discussion of some of the most essential aspects of the subsequent European crisis.

### 3.3.1 The Macroeconomic Effects of Financialisation

The process of financialisation has been identified as a key development of the recent decades which underpinned the recent financial and economic crises. In that sense this subsection aims to elucidate some of the relevant arguments put forward in a relatively abstract way, before moving on to ground the discussion on particular geographical contexts. Hein and Dodig (2014) identify four channels through which financialisation came to affect the macro-economy, namely: i) the effect on income distribution; ii) the effect on household debt and consumption; iii) the effects on investment; and iv) the effects on current account imbalances.

Considering each one in turn, Hein and Dodig suggest that financialisation was effective in re-distributing income at the expense of labour. In their report the authors present a significant amount of data, showing how on one hand the labour share of income declined in a number of developed countries, while at the same time the share of income and of wealth of wealthiest sky-rocketed. Most importantly, top incomes encompass financial revenues such as interest and dividends paid out by the corporate sector. An important factor explaining such a shift in income distribution was the decline of the bargaining power of organized labour. The increasing influence of finance in corporate management, the internationalisation of trade (which was backed up by financialisation), and the deregulation of the labour market were some of the key causes of such decline.

In view of stagnant or falling incomes, large parts of the population in several developed countries, and particularly working class people, increasingly engaged into debt. Financialisation played a key role in allowing such a credit expansion to take place. As a result, the aggregate demand was maintained in relevant countries far beyond the consumption levels which actual incomes could justify. Nonetheless such a pattern also gave
rise to unsustainable debt structures, a fact that became evident in the aftermath of the recent crises.

With regards to the influence of financialisation on investment, Hein and Dodig highlight the increasing shareholder power vis-à-vis corporate management. The rise of the influence of shareholders had two separate effects: on one hand, it pushed corporate planning towards a more short-term horizon, and put financial targets at the forefront of the corporate agenda. In addition, it resulted in a higher share of profits going to dividends and interest, thereby containing the available resources of internal financing for the corporation. The outcome of

Figure 3. 1. Current Account Balance, selected countries, 2000-2014, in billions of US dollars (source: Dodig et al., 2015: 40)

channels was a decline in real investment and an increasing engagement of non-financial corporations with financial activities.

In combination, the above effects led to extensive current account imbalances across the globe, and gave rise to ‘two types of capitalism under financialisation’ (Hein and Dodig, 2014: 45). In particular, several countries came to be dependent on exports for the continuation of their growth while several others were forced to accumulate debt. Labelled as ‘export-led’
and debt-led growth respectively, the two regimes were significantly supported by financial liberalisation. They also came to be mutually reinforcing, as the success of export-led countries crucially depended on the willingness of other countries to go into debt. Figure 1 provides a glimpse of such developments. The US was probably the most typical example of a debt-led economy, whereas Germany and Japan were the most conspicuous cases of export-led growth. Overall, the recent crisis exposed the unsustainable nature of both regimes and brought them to a halt for a number of countries (also see the discussion below on three regimes identified in the of Dodig, Hein and Detzer [2015]).

Figure 3.2. Current Account Balance, selected countries, 2000-2014, in billions of US dollars (source: Dodig et al., 2015: 40)

3.3.2 The global financial crises of 2007/09

Although the above developments provide a coherent picture of the broad macroeconomic effects associated with financialisation, it should also be noted that not all countries fit precisely the picture sketched here. Raza et al. [2014] discuss the ways financialisation played out in Ireland and Iceland. What is interesting to highlight in the present context is that these two countries can be seen as counter-examples, associated with dynamics that do
not exactly conform to the above narrative. Most notably, both countries experienced a significant financial deepening in the period prior to the crisis, with huge capital inflows and a rapid credit expansion. Ireland went through mounting household debt, while Iceland experienced a notable growth of non-financial corporate debt. Nonetheless, in neither of the two economies was financialisation associated with a fall in the wage share of income. Hence the stylized facts of the two countries are somehow at odds with the stagnation tendencies and the growth regime categorisation described above.

3.3.3 Some Meso-Economic Effects of Financialisation

The impacts of financialisation and deregulation have also been explored at the terrain of particular markets. Relevant FESSUD studies have focused on the currency (Simon and Szikszai, 2015), energy (Ruzzentenli, 2015) and housing markets (Lis, 2015). Evans and Herr (2015) provide a synthesis of these reports.

To start with, the markets for foreign exchange, energy and housing have all experienced a wave of deregulation throughout the recent decades, although at different points of time. Foreign exchange market entered the phase of deregulation already from the 1970s and the abolition of the Bretton Woods regime of fixed exchange rates. The housing sector also experienced an elimination of legal barriers in housing finance from the 1990s and on. Similar developments were also recorded in energy markets, including here the markets for oil, coal, gas and electricity.

In the case of the foreign exchange market, a crucial milestone was the liberalisation of the capital accounts of developed and developing countries that started in the 1980s. As Evans and Herr (2015) argue this process should be seen as part of the broader deregulation of the financial system that was taking place at the same time. Most importantly, the transition towards capital account openness and the associated growth of international capital flows established the financial market as the main driver of exchange rate dynamics. Thus, rather than being determined by macroeconomic stylized facts and long-term projections, exchange rates came to be influenced by the short-term expectations and the speculative
sentiment of financial market participants. Such link resulted in a great increase in exchange rate instability and paved the ground for sharp exchange rate movements. Concerning the energy market, financialisation was to a great extent brought into the fore through the enormous growth of energy-related financial derivatives. Those financial products experienced a huge rise in their popularity throughout the 2000s, and came to exercise a substantial influence over the pricing of the actual underlying commodities. Indicatively, in 2010 the volume of oil traded in a day in future markets was about six times larger than the daily oil production itself (Evans and Herr, 2015: 18). As with the exchange rate market, speculation has been recognised as a significant factor propelling the trade of energy derivatives. Moreover, the financialisation of energy commodities boosted the synchronization of their prices, and hence created the conditions for simultaneous booms and bursts across the entire energy sector. One such boom was recorded in the decade before the crisis.

As for the housing market, Evans and Herr point out that until the 1990s there was a relatively stable relationship between households’ disposable income and house prices. From the mid-1990s however house prices started exhibiting a strong rise in a number of developed countries, with some of the most remarkable price increases being recorded in the UK, Ireland and Spain. This trend kept on going up to the recent crisis, when housing prices experienced a sharp decline. The surge of mortgage lending, and the subsequent collapse, should be seen as the most important explanatory factor for such developments. While until the 1970s, housing finance was mainly provided through specialised institutions, deregulation resulted in housing loans being provided by market-oriented commercial banks. Countries such as the US and the UK were pioneers in such developments. Moreover, in several countries, as for instance Spain, the significant rise in capital inflows was another factor that supported the expansion of mortgage lending.

Overall, the above developments attracted speculative capital in all three cases, and established additional channels of transmission of financial instability towards the real economy. Volatile exchange rates and international capital flow movements came to affect
the competitiveness positions of several countries. The divergence of exchange rates from the underlying fundamentals also gave rise to persistent current account imbalances. Even more, sudden depreciations came to be associated with currency crises, especially in countries with huge outstanding debts in foreign currency. The volatility and hikes in energy and house prices were also effective in influencing domestic price levels and real incomes.

3.3.4 The US crisis of 2007/09

Several factors have been identified and advanced as responsible for the generation and transmission of the US financial crisis of 2007/09, and then the transmission of the effects of that crisis through international linkages and contagion into a global financial crisis. Financial and banking crises occurred in a number of other countries (e.g. UK, Iceland, Ireland) virtually simultaneously with and interacting with the US financial crisis, spiralling into a global financial crisis. Financial crises have been endemic in capitalist economies and the theories discussed in the previous chapter seek to provide explanations and understandings of that endemic nature of crises. The purpose was to investigate the specific factors which lie behind the global financial crisis of 2007/09 with particular emphasis on its source in the USA.

There has been a wide range of specific factors which have been advanced as causes or triggers for the global financial crisis. Those factors which had received heterodox economists. Some of the most attention was placed under eight headings. These were noteworthy ones include i) the rise of subprime mortgages and the process of securitisation, ii) the perverse incentives and the contagion links that arose out of securitisation; iii) the growth of hedge and private equity funds and the corresponding lack of regulation guidance; iv) the failure of risk management; v) an over-expansive monetary policy in the US prior to 2007; vi) the rise of global imbalances; vii) the process of financial deregulation; and viii) the underlying developments in the real economy, including the redistribution of income at the expense of labour economists (for an overview see Evans, 2014). The purpose was to critically evaluate each of the factors.

3.3.5 Subprime Mortgages and Securitisation
Jurek and Marszalek (2014) discuss the structure of the subprime mortgage market and the process of securitisation. Subprime loans were loans given out to low or even no income households, with weak credit histories. They became highly popular in the 2000s, and were often provided on the basis of housing collateral. In that sense, their repayment was closely dependent on the maintenance and rise of housing prices, i.e. on the continuation of the housing bubble that had started taking place in the US since the early 2000s.

The mounting of household debt required banks to find access to new funds. To do so, banks engaged into what has come to be known as ‘securitisation’. In the current context securitisation refers to the process of repackaging and selling to a third party loans that the bank has already given out. As conducted in the built-up of the crisis such amalgamation primarily consisted of subprime loans. In that way the banks managed not only to support their liquidity levels, but also to remove low quality loans, and hence the associated risk of default, out of their balance sheets. Moreover, securitisation gave rise to the now well-known initials of MBS and CDO products (referring to Mortgage Backed Securities and Collateralized Debt Obligations respectively). Due to the complicated structure of such products it was very hard to know the precise debt exposures lying behind them. Nonetheless, a great part of them was routinely given top credit rating scores by rating agencies. As a result, the trading of these products experienced a tremendous rise before the crisis. In essence, this exposed large number of investors to assets whose values were standing upon extremely shaky grounds.

Although an evident post-crisis reality, during the boom there was no concern about the fragility created in the financial system, as consumers, investors and regulators were holding highly optimistic expectations. In 2005 the first cracks appeared in the housing market. Even then however no one could tell whether this was the beginning of a major crisis or just a temporary halt in price increases. It was only in 2007 that the market collapsed, leading many borrowers to default on their loans. This resulted to a jump in the share of non-performing loans in banks’ balance sheets which gradually expanded beyond subprime mortgages. Major financial distress for a great number of banks and financial institutions
was the consequence. The 15th September 2008, the day when Lehman Brothers went bankrupt, probably stands as the most important milestone of those events.

3.3.6 Contagion Links and Perverse Incentives

In conjunction with the above discussion on securitisation, it is also worth considering the contagion links and the perverse incentives that were built in financial markets throughout the recent past. Gabbi et al. (2014) review and put together the relevant streams of literature. A central thesis in their analysis is that securitisation underpinned both developments. First, Gabbi and his colleagues argue that securitisation created more complex accounting links between financial market participants. In doing so it not only facilitated the transferring of credit exposure to third parties and the over-indebtedness of market participants, but also contributed to the speed and intensity in the transmission of shocks.

Secondly, securitisation substantially distorted the incentives of the institutions involved in evaluating the value and risks of the securitized assets. Given that they could provide a loan and quickly remove it from their books, banks were not incentivized to carefully scrutinize potential borrowers. Moreover, securitisation made it possible for banks to by-pass financial legislation. On top of that, credit rating agencies were trapped in a conspicuous conflict of interest. Operating on the basis of an “issuer-pays” model, those agencies were essentially providing rating scores to the same entities from which they were generating their revenues. At the same time the agencies had to face the pressure from competition in the ratings market. As a result, rated entities, and especially large banks, had some significant leverage that allowed them to push for inflated ratings for their products. Such phenomenon has also been described as ‘rating-shopping’ (for further discussion and empirical evidence see White, 2010; Bolton et al., 2012; and Hau et al., 2013).

3.3.7 The Growth of Hedge and Private Equity Funds

Szikszai and Badics (2014) concentrate on the remarkable growth of global funds throughout the recent decades. Their analysis includes a vast amount of empirical evidence and outlines the main trends in the development of conventional, alternative and private wealth funds (conventional funds include pension and mutual funds while alternative funds include hedge
funds, private equity funds and sovereign wealth funds). The paper points out how these funds contributed to the crisis by amplifying market volatility and drastically reducing liquidity in certain markets, such as the market for Collateralized Debt Obligations (CDOs). Although the global market is still dominated by conventional funds, the authors show how alternative funds also experienced a significant upswing. In particular, between 1998 and 2007 the compounded value of assets managed by hedge funds rose by 29.3%. Similarly, the value of assets owned by private equity funds increased by 27.2% between 2003 and 2007, while sovereign wealth funds experienced a rise of 21.4% between 2002 and 2007. In all cases, sharp declines in asset value took place in 2007, and the destabilizing nature of such funds came at the forefront of the policy agenda.

Especially in the cases of hedge and private equity funds, Szikszai and Badics claim that there was a lack of guidance for investors regarding their expected performance and the associated risks. This is attributed by the authors to the lack of transparency in the operation of such funds, and the inapplicability of the conventional risk-return measures that were utilized.

Two important factors that underpinned the growth in the trade of financial assets were the shift of non-financial corporations (NFCs) towards financial activities, and the expansion of proprietary lending, i.e. the amplified trading in securities conducted by banks. The engagement of NFCs with finance is not only relevant in explaining the increased demand for financial assets, but also aids our understanding of how the crisis transmitted towards the real economy. Similarly, the huge losses of US banking institutions that came out of proprietary lending, can be viewed as a factor that accelerated the effects of the financial crisis.

3.3.8 Failure of Risk Management

The crisis of 2007 exposed the inadequacies of the risk management practices of financial corporations. As operated within the context of deregulated financial markets, risk management had its own distinct contribution to the built up of instability and eventually to the emergence of the crisis. Lagoa et al. (2014) review the relevant literature and identify
three particular failures. These relate with i) the techniques and methodologies employed; ii) the model of corporate governance and strategy that was followed; and iii) the level of regulation and play out of factors that were external to the individual corporation.

Starting with the employed risk management techniques, Lagoa et alia (2014) point out that financial corporations came to rely too much on quantitative risk measurements and models. Quantitative analysis was effective in allowing market participants to set up practical rules of thumb and cultivate a feeling of euphoria in the market. As a result, a number of issues that would require a more qualitative judgement, such as the moral hazard and adverse selection issues related with the subprime housing market, were underplayed. Furthermore, certain risk metrics as the well-known Value-at-Risk, or else VaR, methodology turned out to be completely inappropriate for capturing actual risks. For example, VaR’s assumption of a normal distribution was at odds with the occurrence of extreme events and the possibility of social contagion, and hence led to an underestimation of risk.

On what has to do with corporate governance, Lagoa et al. mention that there was a failure of financial institutions to assemble all risks in a strategic and coordinated framework. Instead, a disaggregated vision of risk prevailed, with severe gaps in the communication between risk management staff, traders and senior management. In addition, management remuneration schemes favoured high risk/ high return investments. Along with behavioural biases as for instance ego, greed and “disaster myopia”, such schemes gave rise to a short-term/ high risk culture that significantly fostered financial instability.

Regarding regulation and external factors, there is by now ample evidence showing that the regulatory framework was particularly poor in preventing financial fragility from escalating (also see the discussion below). Lagoa et al. argue that the poverty of financial regulation was an offspring of the belief that banks could be trusted to regulate themselves. Another dimension relates with moral hazard. Especially in the US, the financial sector is known for donating vast amounts of money to political parties and for doing strong lobbying, while it was often the case where regulators ended up working for the private institutions they were
meant to regulate. Furthermore, competitive pressures were also effective in making financial institutions engage with risky lines of business.

### 3.3.9 Loose Monetary Policy

One of the main arguments put forward by several mainstream economists, such as John Taylor, is that excessively loose monetary policy, particularly in the United States in the years before the crisis was the key reason for what followed. As exposed in Varoufakis (2014) the line of thought is that the actual interest rates of the Fed throughout the 2000s were significantly lower than what the Taylor rule would have prescribed. Accordingly, the deviation of the interest rates fed an unsustainable expansion in real estate and finance, which subsequently collapsed in 2007/08.

Varoufakis lists a number of critical remarks against the above thesis. His analysis shows how the derivation of the Taylor-rule requires a certain cherry-pick of data. Most notably, Varoufakis argues that the precise calculation of the Taylor-rule rate depends on the choice of the price indices and output gap estimates that are used as input. For instance, while the gap between the actual and the Taylor Rule interest rates can be indeed identified if one were to use the GDP price deflator, a different picture emerges if one switches to the consumption deflator instead. What is also interesting to note is that the Fed itself utilizes the latter, due to the lower volatility that it contains. In a similar fashion, Varoufakis shows how a careful examination of unemployment and capacity utilization data contradicts Taylor’s assessment of a fall in the US output gap since 2002. It follows that the argument that puts the blame on loose monetary policy lies on weak empirical grounds. Even more, Varoufakis suggests that a closer inspection of data offers support to the claim that the Fed never actually violated the so-called Taylor Rule from 2001 and up to the crisis. Although interest rates were indeed low, so were the rates arising out of Taylor’s formula.

### 3.3.10 Global Imbalances

Another important aspect of Varoufakis analysis relates with the role of global imbalances. In combination with the above discussion on monetary policy, Varoufakis asserts that the prevalence of low interest rates in the years before the crisis and the ineffective monetary
policy of the Fed can be better understood by looking at the broader picture of global developments since the collapse of the Bretton Woods regime in the early 1970s. His analysis highlights the hegemonic role of the US and the corresponding functioning of the US economy as the ultimate absorber of global surpluses. Thus, on one hand as was seen earlier the US was running permanent current account deficits, while on the other Wall Street functioned as an attractive destination for exporters’ profits. As a result, major inflows of capital kept streaming in the US financial market. Varoufakis labels such system as the ‘global surplus recycling mechanism’. The other side of those inflows was of course the piling up of debt for households and corporations, and eventually the crisis of 2007/09. Given such a status quo, Varoufakis asserts that the Fed was essentially powerless in influencing capital flows, and thus in preventing the inflation of the financial market.

What is also interesting here is to consider here the stance taken by several mainstream economists in view of the growing global imbalances. As outlined in Carrasco and Serrano (2014), prior to the crisis economists broadly associated with the ‘savings glut approach’ were able to explain such imbalances on the basis of the excess savings that emerging economies were accumulating. From their perspective, the accumulation of savings was seen as the natural outcome of the structural changes that such countries had experienced in the near past, and their orientation towards an export-led strategy. As a result, emerging economies needed to accumulate reserves so as to be able to intervene in currency markets and support their currencies. An additional reason to accumulate savings was seen in the need of these countries to protect themselves from external shocks. At the same time, the export of the savings of such countries to the US was understood as the outcome of the underdevelopment of their domestic financial systems, and their need to diversify their assets portfolios. Overall relevant economists were able to identify a new equilibrium point in global markets and were quite reassuring of the sustainability of the pre-crisis situation.

3.3.11 Financial Deregulation

Carrasco and Serrano (2014) argue that what underpinned the ballooning global imbalances and the subsequent crisis was the creation of a fragile international monetary and financial
system. In turn, such fragility was to a great extent the product of the financial deregulation process that commenced in the late 1970s, particularly in the US. As listed in Orhangazi (2014) a notable milestone of this process was the shift to floating exchange rates that followed the collapse of Bretton Woods and the elimination of capital controls. The eradication of interest rate controls followed in 1980. Furthermore, some of the most recent reforms were the abolition of the Glass-Steagall Act in 1999 (which as discussed in the earlier part of the chapter was a response to the 1929 crisis), and the introduction of the Commodity Futures Modernization Act of 2000 which deregulated the market of credit default and equity default swaps. The relaxation of the retirement income constraints in 2000, allowing pension schemes to purchase subprime assets, should also be mentioned here. On top of these developments, Orhangazi (2014) notes that regulators were also very hesitant in controlling the financial innovations that were spreading across the market.

All in all, financial deregulation substantially supported the exponential growth of risky and speculative activities in the US financial market. It also paved the ground for the emergence of the phenomenon of securitisation described earlier and the growth of subprime mortgage lending. In addition, it allowed financial institutions to take up excessive leverage, and reinforced the belief that those institutions knew best how to diversity risk and protect themselves from financial distress. Lastly, it allowed the establishment of financial links with banks outside the US, and thereby facilitated the transmission of the crisis across the globe.

3.3.12 Aspects related with the real economy

While important in creating the conditions for the crisis, financial deregulation was itself a product of the developments of US capitalism since the crisis of the 1970s. Orhangazi (2014) emphatically stresses this point, by linking deregulation with the acceleration of inflation throughout the 1970s and the decline in profitability of the non-financial corporate sector. Some more concrete causal factors include the shift of large corporation towards market-based financing, the wave of US mergers that took place in the late 1960s, the internationalisation of production and banking, and the process of financial innovation.
Altogether, such changes opened the space for new profitable activities for large corporations and banks, which nevertheless were constrained under the existing legislation of the time. In that respect, Orhangazi argues that despite the ideological and theoretical support it enjoyed from mainstream economics, financial deregulation should not be seen as a simple change in policy preferences. Rather it should be taken as the concrete outcome of the successful lobbying of the US corporate and financial sectors.

In the broader picture, those developments should be seen as part of US capitalism’s transition towards neoliberalism. A further notable feature of this new era was the rise in income inequality. In that line, Michell (2014) argues that the pattern of increasing income polarisation can be seen as one of the deepest causes of the crisis. Propagated amongst other factors by the deregulation of the labour market and the globalisation of trade, falling wage shares and increasing income inequality were key elements in explaining the immense accumulation of debt by households. A number of arguments have been put forward to explain such link (for a detailed outline and discussion see Michell, 2014). From a micro perspective, it has been argued that households felt inclined to take up credit so as to protect themselves against income volatility. Another argument put forward is that in face of falling incomes households were motivated to engage in debt in order to support their social status. This suggestion relates with Veblen’s idea of conspicuous consumption (see Veblen, [1899] 2007). From a macroeconomic prism, it has been argued that the rise of household debt was essential in supporting aggregate demand and camouflaging the economic stagnation that would have occurred otherwise. Such view traces back to some of the heterodox theories discussed in Chapter 2.

Moreover, according to Michell (2014), income inequality was a key factor that fed the growth of financial assets. To see this, notice that rising inequality meant a huge accumulation of wealth for top income categories. To a great extent, such wealth translated into an increased demand for financial assets and was therefore channelled towards hedge funds and other short-term investment outlets. Financial innovation and deregulation can also be seen, at
least in part, as a response of the financial system to such an increasing appetite for quick profits.

### 3.3.13 Putting Everything Together

It could be said that elements of truth exist in most of the explanations and analyses of the 2007/09 financial crises mentioned above. Hence, a possible approach could be to claim that none of the listed factors should be considered in isolation from the rest. Instead one should think of a broader mosaic that encompasses all the arguments put forward and that provides a more complete narrative of what generated and transmitted the crisis in the USA and elsewhere, and transmitted around the globe.

While such stance is a good starting point, it is also important to get the lines of causality right. That is to say, while most of the above stand as observed realities, the way they relate with each other gives rise to a particular hierarchy in terms of explanatory significance. As argued by Evans (2014) some of the above factors, such as the failures of risk management and the prevalence of perverse incentives gained their importance out of the rise of finance and financialisation. In turn the increasing importance of the financial market relates with global imbalances and the subsequent wave of capital inflows in the US, as well as with the process of financial deregulation. Capital inflows are also important in explaining the low pre-crisis interest rates in the US. Furthermore, the developments in the real economy, most notably the fall in the wage share of income and the sky-rocketing of income inequality, stand as some of the deeper explanatory premises. While on one hand the stagnation of income for the vast majority of the population gave rise to a spectacular increase of consumer debt, the simultaneous accumulation of wealth at the top income percentiles was effective in feeding speculative, short-term oriented funds as well as asset bubbles.

### 3.4 The debt-led vs. export-led distinction

Dodig et al. (2015) synthesize fifteen FESSUD country studies¹ and attempt to spot the similarities and differences between these countries in the ways they developed throughout the recent decades, and the ways they came to be affected by the recent financial and

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economic crises. According to their typology, there are three separate growth regimes that can be identified. These are the debt-led private demand regime, the export-led “mercantilist” one, and the domestic demand-led one. Most notably the authors argue that while different countries opted for different growth strategies, in most cases they were attempting to tackle the same conundrum, namely the stagnation tendencies arising out of financialisation (see the discussion above). Furthermore, the writers point out that the various regimes that emerged were not independent from each other; to a great extent, they can be seen as complementary and mutually reinforcing.

Out of the fifteen countries discussed, USA, UK, Spain, Estonia, Greece and South Africa are associated with the debt-led model. Some of the key pre-crisis features of this group were the high levels of household consumption and debt accumulation, the significant current account deficits, and the high GDP growth rates as compared with the export-led economies. Moreover, in the case of Spain and Estonia, it was not only the household sector that was taking up increasing volumes of debt, but the corporate sector too. Especially in Spain such behaviour was related with the accelerating investment in real estate and the housing bubble that occurred. In addition, with the exception of Spain all debt-led countries were experiencing notable budget deficits.

Germany, Japan and Sweden appear to have been export-led (for an analytical discussion of the German economy also see Detzer and Hein, 2014 and Hein and Detzer, 2014). In contrast with the debt-led ones, these economies did not face rising domestic indebtedness. As their label suggests exports were the key source of their economic growth. With low domestic demand for imports and increasing price competitiveness, such countries managed to maintain robust current account surpluses throughout the decade up to the crisis. Those surpluses were of course nothing but the mirror reflection of the current account deficits of debt-led economies.

Out of the domestic demand-led countries Dodig et al. separate between the ‘mature’ economies, including France, Italy and Portugal, and the ‘catching-up’ ones, putting together Hungary, Poland and Turkey. Both sets of countries experienced current account and public
deficits, although with some variety in the precise magnitudes. In addition, catching-up countries came to be recipients of huge foreign capital flows which increased substantially their financial vulnerability. Moreover, while not the norm of the group, some of the domestic demand-led economies, such as Turkey, experienced a rising household debt in certain years. Overall, catching-up economies recorded higher GDP growth rates as compared with the mature ones in the years before the crisis.

Coming to the effects and implications of the recent crisis, and starting with the debt-led economies, Dodig and her co-authors show that in all cases households and corporations entered into an extensive process of deleveraging. Moreover, in most cases current account deficits were significantly contained, primarily through the collapse of imports. In countries such as Greece and Spain the depression of domestic demand led to negative average real GDP growth rates. This is a stylized fact that is also explained by the austerity policies and the policies of internal devaluation that were enforced in those countries by the IMF and the EU authorities. However even in the case of countries that have not exhibited a sizeable decline in their GDP growth, such as the US and the UK, post-crisis growth rates are on average much weaker than the pre-crisis period.

With regard to export-led economies, the transmission of the crisis was primarily through the falling demand for their exports. At the same time, recovery from the 2007/09 crisis was rather quick, mainly thanks to the early prevention of a breakdown of their domestic financial systems, and the application of fiscal stimuli, but also due to the shift of their exports towards emerging markets, such as China and India. Nonetheless, despite its positive sign GDP growth has performed rather poorly in all cases.

Mature domestic demand-led economies have also been unable to return to their pre-crisis growth rates. While the developments of their current account imbalances have been relatively heterogeneous, all three countries have experienced higher budget deficits. Moreover, in all cases austerity measures have further dampened economic performance, with Portugal standing as the most conspicuous case of the group. Overall, France stands as the only country that managed to maintain its domestic demand-led growth pattern and
to achieve a positive average GDP growth rate over the first six years of the crisis (2009-2014).

From their side, catching-up domestic demand-led economies were primarily affected through financial contagion. Poland and Hungary have drastically decreased their current account deficits, while Turkey has followed the opposite development. Furthermore, Hungary and Turkey have contained their public deficits. In all cases, domestic demand contracted substantially. Similar with the mature domestic demand-led economies, catching-up ones have also been experiencing a slow and weak recovery since 2009.

All in all, Dodig et al. argue that there is a remarkable difference in terms of the severity of the crisis in debt-led and domestic demand-led countries, depending on whether corresponding countries are members of the Euro or not. A similar distinction can also be found in Carrasco et al. (2015) whose report provides further empirical evidence for EU economies. While on one hand countries with monetary autonomy such as the US and the UK managed to maintain large parts of their current account deficits, countries such as Spain and Greece had to go through extensive adjustment programs that further contracted their economies. In addition, Eurozone governments were deprived from a proper lender of last resort facility. Furthermore, Dodig et al. (2015) spot an inconsistency in that although deficit countries have undertaken efforts to re-balance their accounts, export-led ones have not pursued a similar path. Besides the fallacy of composition involved in such a growth strategy, namely the omission of the fact that illustrates such developments in further detail.

Financialisation in the present era has not been a homogenous experience across time and space as argued in previous chapters, and in that sense not all countries accord precisely with the stylized facts outlined above. Indicatively, Iceland and Ireland are two small open surplus economies require by definition a deficit counterpart, Dodig and her co-authors also appear to hold their own distinct characteristics regarding pre-crisis developments and their post-crisis recovery (for discussion see Raza et al., 2014).

3.5 Concluding comment on the 2007-09 financial crisis

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2 This section draws very heavily on Evans (2014),
The financial crises of 2007-09 were detonated by the failure of complex securities based on sub-prime mortgages in the USA. Providing mortgages to households without a sufficient or secure enough income to meet service payments was unsustainable. Packaging these mortgages in complex securities displaced the impact of declining capacity to service the loans but resulted in even greater losses when the crisis finally erupted. While subprime mortgages involved a notoriously fragile financial structure, they represented only one dimension of the huge expansion of credit and securitisation.

There were failures of risk management in the financial sector – inadequate measures of risk, widely overlooked factors, an overconfidence in numerical models—all served to ensure that evolution of complex securities completely outstripped the development of risk management techniques. However, the failures of risk management only acquire their full significance as a result of the massive growth of financial capital, its expansion into ever more areas of economic activity and its increasingly short term focus on generating returns. At every stage, from the selling of subprime mortgages, to their packaging in securities, the constructions of complex CDOs and finally their rating by profit-driven credit rating agencies, the payment of rewards on the basis of short-term results encouraged a wilful disregard for any consideration of longer-term financial sustainability. In that way, perverse incentives played a role in promoting the unchecked accumulation of unsustainable credit structures in a context where legal restrictions were being relaxed and finance capital was staining to expand.

The claim that over-expansive monetary policy in the US prior to 2007 was examined. The Federal Reserve’s response of expansionary monetary policy to the 2001 collapse of the dot.com bubble helped to avoid a serious crisis at the time but at the costs of accumulating tensions which finally burst out in 2007 and 2008.

The widening global imbalances have been identified by many as a source of tensions which led to the crisis. A low savings rate in the US was viewed as leading to current account deficit but we a so-called savings glut in developing countries leading to large net inflows into American financial assets. It is argued here though that the inflows associated with
international imbalances could have been managed if there had been stricter controls on the expansion of credit. The origins of the crisis did not lie in current accoi8nt imbalances but in the fragility of the US monetary and financial system and the massive unchecked expansion of lending.

The deregulation of the financial system was not simply a result of a shift by governments to more neoliberal policies. The existing system of regulation had ceased to be fully effective as banks had increasingly circumvented the old order through innovation and internationalisation. Banks played a very active role, promoting the process of deregulation through extensive lobbying and, aided by the widespread influence of neoliberal ideas, governments responded by accommodating their demand.

Perhaps the most fundamental of the factors which has been identified as generating the crisis involves the rapidly growing sums of capital which were striving to obtain ever higher returns. Linked to the shifts in the distribution of income, there was a major accumulation of financial assets by the better-off sectors of society. This was reflected in a strong growth of institutional investors, and the rapid expansion of more speculative units, such as hedge funds and private equity funds all striving to raise their rate of return. There was also a major growth of large universal banks, and these succeeded for some years in extracting high profits from 'proprietary trading'. Nonfinancial companies were cutting back on their fixed investments and turning increasingly to investments in financial assets to generate a higher rate of return. Ultimately, this search for higher returns rested on the economy’s ability to generate an economic surplus. The creation of complex financial instruments could stretch and obscure this connection through impenetrable layers of financial transactions—but not sustainable.
Chapter 4. International Dimensions of Financialisation

4.1 Introduction

The present era of financialisation (since circa 1980) has been accompanied by neoliberalism and globalisation. Financialisation has been a near-global phenomenon with few countries exempt from the growth of the financial sector in economic, social and political importance. In Chapter 1 the idea of variegated financialisation was discussed in that there are processes of financialisation occurring in most (if not all) countries as the financial sector grows in economic and political importance. At the start of the present era of financialisation, the conditions differed across countries, the speed and structure of financialisation have varied across countries. Further, financialisation is not taking place amongst countries of equal economic status and power. Financialisation has long occurred in capitalist countries, and the processes of financialisation most powerfully established in the industrialised capitalist economies of Western Europe and North America.

In the next section (4.2), the general features of financialisation in relationship with global economy development are summarised. Section 4.3 is organised around on dependent financialisation and developing/emerging economies. The idea of dependent financialisation is explored. First the general outline of the concept is provided. It is then discussed with regard to developing and emerging countries, followed by some insights related with Central and Eastern European countries. The section is completed by summaries of future scenarios for four large emerging economies. Section 4.4 discusses some of the issues of finance and development which have been covered in the FESSUD project.

4.2 Financialisation and the global economy

The period of financialisation from 1980 onwards was characterized by major changes in developing economies. Accompanying their growth in GDP was growth in their domestic financial markets and their increased receipt of international capital flows. During the period 2000 to 2007 in particular, developing economies grew rapidly. But financialisation of their

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1 The material in this section has been taken from Tyson and McKinley (2014) with minor changes.
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Economies also intensified. While foreign direct investment (FDI) increased significantly during 2000-2007, boosting the prospects for increased investment, speculative flows of capital also expanded, causing more widespread instability. As a result, the bulk of research on financial flows has not identified a clear positive relationship between financialisation, on the one hand, and enhanced economic growth and development, on the other.

Cross-border private capital flows are comprised of three major components:
1) Foreign Direct Investment (FDI),
2) Portfolio Flows, which comprise equity and bond flows of various types, and
3) Financial Flows, which are primarily net bank lending.

The latter two flows are more short-term in nature than FDI and also more unstable. The patterns of these three kinds of private capital flows have been reviewed over four distinct periods: 1980-1990, 1991-2002, 2003-2007 and 2008-2013. In the first period, private capital flows were fairly limited. But in the second, 1991-2002, they experienced a cyclical upswing. FDI increased, but so did international bank lending. The latter type of capital flow was decidedly more unstable and helped trigger various financial crises in developing economies, especially in East Asia and Latin America. These crises were particularly damaging because they triggered sharp recessions and prolonged slumps in growth.

During the third period, 2003-2007, there was a sharp upswing in cross-border private capital flows, which coincided with the increased growth of GDP and the moderation of inflationary pressures in developing economies. The forces of financialisation peaked during this period, culminating in a global financial crisis in 2008, which was centred in developed economies.

The fourth period, 2008-2013, includes both an ‘inter-crisis’ and a ‘post-crisis’ period. During this period both international bank lending and portfolio flows contracted sharply. However, some regions, such as Developing Asia, experienced more stability than others. In general, though, Middle-Income Countries (MICs) faced the greatest problems since private capital flows had been concentrated in this income grouping during the period leading up to the global crisis. More recently, as central banks in the developed economies have begun to withdraw from policies of quantitative easing (such as during 2013), MICs have been
particularly hard-hit by large precipitous capital outflows. Despite experiencing distinctive patterns over the four periods from 1980 to 2013, cross border private capital flows have exhibited a general tendency of increasing volatility, particularly volatility of both portfolio flows and financial flows. This tendency has coincided with the general long-term trend of increasing liberalization of financial markets. As a result, speculative capital flows, which concentrate on short-term opportunities for profit maximization, have increased in importance, culminating in some cases in destabilizing `asset bubbles’, particularly in stock and real-estate markets. During the whole period 1980-2013 international trade also expanded rapidly. In fact, world trade expanded more rapidly than world production. But trade contracted very sharply during the global financial crisis beginning in 2008, driven mainly by plummeting global demand. But financial factors were also at work since there was a concomitant collapse in trade financing. Moreover, the on-going financialisation of tradable assets, particularly commodities, had led to greater financial and economic instability.

The most pronounced collapse in trade was in manufacturing, although services and agriculture also suffered setbacks. Arguably, the contraction of international trade had a more pronounced impact on developing economies (particularly Lower Middle-Income Countries and Low-Income Countries) than the crisis in financial flows. In addition, because the financial crisis was centred in developed economies, most developing economies had very limited ability to counteract its effects. Some of the major emerging economies, such as the Peoples Republic of China, used domestic countercyclical macroeconomic policies in order to counteract the negative effects of the global financial crisis and the concomitant collapse in its export trade. But most other developing economies did not possess adequate fiscal means to implement similar policies.

Many developing economies had managed to develop some degree of protection against instabilities in capital flows by building up their international reserves, particularly since the Asia financial crisis of 1997-1998. In fact, at the global level international reserves had increased in absolute terms by a factor of about 12 between 1980 and 2012. Despite some
setbacks after 2008, three regions (Developing Asia, MENA and the CIS) continued to account for a substantial proportion of all reserves in developing economies. After 2000, many of the increases in the capital accounts of developing economies were due to the accumulation of international reserves. Such an accumulation was regarded as an important form of self-insurance against trade and financial instability and a means of enhancing policy independence. In some major developing economies, such as China and the Republic of Korea, capital inflows outweighed the importance of the accumulation of reserves, though these were exceptions to the general trend.

Nevertheless, the ability of the United States to run large current-account deficits, because it issues the world’s dominant reserve currency (and thus is guaranteed to receive continuously large capital inflows), imparts a worrying degree of instability to the international monetary system. This condition thus tends to magnify financial instability at the global level.

The external debt burdens of many developing economies have been significantly reduced since the mid-1990s. The HIPC Initiative for Low-Income Countries was initiated in 1996 and was supplemented by the Multilateral Debt Relief Initiative beginning in 2005. Hence, external debt as a ratio to GDP began to fall appreciably, especially in sub-Saharan Africa. At the same time, debt in absolute terms continued to rise. But since GDP and export earnings were also generally rising, this trend did not counteract the overall fall in the debt ratio or in the debt servicing ratio of developing economies.

However, there have been some important structural changes in external debt. One is that bilateral financing, especially from MICs, has been on the rise vis-à-vis multilateral financing. China is now an important bilateral lender, for example. Another important structural change has been the displacement of debt owed to public lenders by debt owed to private lenders. This trend could portend serious problems for developing economies since the privately issued debt that they have been incurring is of a more short-term nature and it is more costly to service than concessional loans.
Though the current magnitude of ODA has been dwarfed by private capital flows, it still remains an important source of development financing, primarily for Low-Income Countries and fragile states. Despite the global financial crisis and constraints on the budgets of donor countries, ODA in 2011 reached, in fact, its highest level in real absolute terms. Despite a dip as a result of the crisis, ODA relative to donor GNI remained at a relatively high historical level in 2012, i.e., around 3%.

However, in the coming period ODA is expected to stagnate, even though Middle-Income Countries are likely to increase their share of the global total. In fact, an important factor that merits emphasis has been the recent rise in South-South development assistance, such as that provided by China, Brazil, India and South Africa. Though still small as a percentage of total global ODA, such assistance is likely to increase in importance in the future.

One of the more promising developments in recent years, in monetary terms, has been the dramatic increase in remittances. By 2012, for example, remittances were three times the size of ODA. While the trend of financialisation has been strengthening, causing greater volatility in the flows of private capital, remittances have been exhibiting, overall, strong and relatively more stable growth.

While five developing economies (India, China, the Philippines, Mexico and Nigeria) accounted for about 40% of all remittance inflows in 2012, there were many other countries that received significant inflows. Moreover, remittances have been of particular importance to many smaller countries and fragile states, such as Tajikistan, Nepal and Haiti.

The flow of remittances to developing economies was indeed impaired by the global financial crisis, particularly the flows to regions dependent on migration to the USA (such as Latin America and the Caribbean) and to Europe (such as Eastern Europe, the Middle East and North Africa). However, regions, such as South Asia, which relied on migration to some of the richer Gulf countries, were not dramatically affected by the crisis. Similarly, the flow of remittances within sub-Saharan Africa was fairly resilient. In fact, remittances within this region have been more stable than either FDI or private debt and equity flows.
Trends in the post-crisis period continue to develop and it remains to be seen what the long-term structural consequences of the international financial crisis will be for private capital flows to developing countries. However, the general assessment of the impact of private capital flows on developing economies has already been undergoing change, not only in academic circles, but also among policymakers in international financial institutions as well as in national central banks and regulatory bodies.

It is now more generally accepted that the impact of private capital flows will depend on a number of key factors, an important one of which will be the character of policy responses of recipient countries. For example, in response to increasing financialisation, the developing economies that have the wherewithal to do so have been accumulating sizeable stocks of reserves as a form of ‘self-insurance’ against the volatility of private capital flows. Also, there has been a growing acceptance among policymakers at both the national and international level that initiatives such as macro-prudential regulations and capital controls could play important stabilizing roles in this arena. Thus, implementing such measures could help provide national governments with some measure of policy independence and flexibility.

Such positive trends could also be strengthened as major emerging economies continue to grow in importance in the global economy and strive to maintain independence in their own policymaking. Such economies are also likely to assert greater influence within international policymaking bodies. For example, in recent years international bodies such as the G20 and the Financial Stability Board have expanded their board membership in order to include rising economic powers such as China and India.

In addition, the economic independence of developing economies has been strengthened by the increasing numbers of South-South economic pacts. The latter have included both regional pacts –such as the Chang Mai Initiative, which established inter-Asian cooperation including among central banks, and the East African Community, which has been seeking greater internal trade cooperation.

However, a noteworthy trend is that a significant number of other developing countries – largely those that are smaller and poorer – have remained largely marginalized from the
international financial system. Thus, their underdevelopment has acted as a form of protection against instability. In the future, however, as those countries seek increasing levels of private capital from international sources, they are also likely to experience greater financial fragility. But, at the same time, they are also likely to be less able to institute the necessary policy safeguards against such an adverse trend. Thus, the overall prognosis for such countries with regard to the impact of private capital flows is likely to more pessimistic.

4.3 Dependent Financialisation

To capture the way financialisation has unfolded in emerging and developing countries, Gabor (2015) introduces the idea of dependent financialisation, while Kaltenbrunner and Panceira (2016) refer to what they call subordinated financialisation. Both terms are conceptualised within the framework of international currency hierarchies, and are highly similar in what they attempt to describe, and hence, in the current discussion they are treated as one.

The theory of international currency hierarchies suggests that different currencies stand at different levels of the monetary hierarchy depending amongst other factors on their attractiveness as stores of wealth and their degree of acceptability as means of payment in international trade. A reflection of a currency’s placement in such hierarchy is the interest rate attached to it, which in turn is inversely related with the currency’s degree of liquidity (Kaltenbrunner and Panceira, 2016). In that respect, Kaltenbrunner and Panceira argue that the carry trade strategies often observed in currency markets are not a deviation from efficient markets, but an intrinsic feature of the contemporary international monetary system. The main idea in carry-trade strategies is to exploit discrepancies between the interest rates attached to different currencies so as to make a profit by borrowing in a low-interest rate currency and then using those funds to buy a currency yielding a higher interest rate.

Within the framework of currency hierarchies, dependent financialisation suggests that financial integration of developing countries takes place in a way that deepens their dependency on top currencies, thereby further consolidating such hierarchical structures.
At a more concrete level, the theory of dependent financialisation shows that in face of global financial interconnectedness and market-based banking models, foreign capital inflows can result in a loss of monetary autonomy for developing countries. Such flows are also seen as capable of augmenting financial instability and altering the behaviour of domestic economic agents.

Furthermore, to the extent that foreign capital inflows are governed by transactions between parent banks based abroad and subsidiaries based in developing countries, or by global non-bank financial institutions, the task of financial regulation gets significantly obscured. As pointed out by Gabor (2015), it is often the case that home regulators are aware of very little of what is going on inside or between global banks, whose businesses typically expand across a number of countries. Similarly, the activities of non-bank financial institutions, such as hedge funds, often involve a significant amount of off-balance sheet transactions which are hard to track down.

Kaltenbrunner and Painceira (2016) report that total capital inflows to developing countries increased from US$200 billion in 2000 to US$1.1 trillion in 2014. At the same time, the total stock of foreign currency reserves of the central banks of these countries experienced a rise from US$0.5 to US$8.1 trillion. The parallel rise of foreign reserves was aiming to protect the associated economies from episodes of sudden reversals in capital flows (Kaltenbrunner and Painceira, 2016), as well as to prevent domestic currencies from appreciating (Gabor, 2015).

The impact of such dynamics on the behaviour of a developing country’s banking sector is twofold. First, the intervention of the central bank in the money market, and the absorption of foreign capital flows essentially allows commercial banks to access reserves without paying the domestic interbank interest rate. This contains the influence of the relevant central bank and renders its monetary policy ineffective in controlling the expansion of credit, primarily in connection to those banks that can access the international money markets. In addition, as pointed out by Gabor (2015), if foreign reserves are denominated in a specific top currency, such as the US dollar and the Euro, the domestic central bank comes to be
dependent on the issuer of the currency for the provision of liquidity. This is something that becomes particularly evident in times of financial turbulence when international currency markets dry up.

Second, foreign capital inflows push commercial banks to expand their balance sheets by shifting towards more short term forms of credit (Kaltenbrunner and Painceira, 2016). In particular, the sterilization operations of the central bank result in an increased volume of short-term assets at the hands of banks, which they can use to increase their own short-term liabilities. Based on such borrowing, banks can in turn expand their lending activity. Moreover, as long as they are interested in matching the maturities of the asset and liability sides of their balance sheets, banks are forced to prioritise household at the expense of industrial lending. This is due to the relatively more short-term nature of the former. To the extent to which banks’ liabilities are fuelled by foreign capital flows, this process re-enforces itself and escalates further.

Additionally, Kaltenbrunner and Painceira mention that dependent financialisation comes to transform the behaviour of non-financial corporations (NFCs). Given the financial instability arising out of sudden stops of capital and volatile exchange rate movements, NFCs have an incentive to participate in the financial market so as to hedge their expected revenues and expenses. Nonetheless, in an environment of financialisation, there is a thin line that separates hedging from speculative activities. There is concrete evidence suggesting that in the years before the crisis NFCs in several countries were shifting from real to financial investments. Relevant empirical literature is also discussed in Bonizzi (2014: 20-22). Besides the substantial losses that can result out of the exposures taken up by NFCs, Kaltenbrunner and Painceira also note that the crowding out of domestic real investment adversely affects economic growth. The financialisation of NFCs’ activities can also result in the bifurcation of the associated sectors, as it is not all, but primarily the large and international corporations that have the capacity to access the financial market in relatively favourable terms.
The rising importance of finance has had a considerable impact on emerging and developing economies (EDEs). Most notably, a large number of EDEs were forced by global institutions such as the EU, the IMF and the World Bank to liberalise their capital accounts and deregulate their financial systems throughout the recent decades. Bonizzi (2014) reviews the mainstream theoretical and empirical literature that underpinned this process (see also Chapter 1 for discussion of financial liberalisation). The key idea of analyses of authors such as McKinnon (1973) and Shaw (1973), initially put forward in the 1970s, was that by allowing foreign capital to access the financial systems of EDEs, the depository base of these countries would increase. As a result, productive credit would expand, primarily towards otherwise marginalised sectors, such as agriculture and small and medium enterprises (SMEs). Throughout the 1980s and 1990s, and in face of the various episodes of financial crises in EDEs, the literature incorporated several points of critique and developed to the point where the positive link between finance and economic growth was accepted under certain conditions. These included the existence of appropriate regulation, supervision and taxation systems for banks, price stability, fiscal discipline, and competition in the banking sector. Throughout the 1990s a wave of empirical literature emerged, confirming the positive link between financial deepening and economic growth (see for instance King and Levine, 1993; Levine et al., 2000, and discussion in Chapter 1). On the other hand, there has also been new empirical evidence casting doubt on such link, particularly with regards to low income countries (see Tyson and McKinley, 2014). For instance, some of the relevant studies point out that the relationship between finance and development might look like a bell-shape, whereby the positive link between the two is maintained up to a point, beyond which there is a situation of ‘too much finance’ (for further discussion also see Van Waeyenberge and Bargawi, 2016 and chapter 1).

Despite the numerous financial crises that were recorded during the 1980s and 1990s, mainstream literature has not questioned the process of financial liberalisation itself (Bonizzi, 2014). Instead, most of the conventional narratives explaining those crises focused on issues related with weak domestic fundamentals and moral hazard considerations, and
on what has come to be known as the ‘original sin hypothesis’. The original sin hypothesis primarily relates with the inability of EDEs’ governments and firms to borrow in their own currency, and the corresponding increase in foreign currency lending. In that respect, it should come as no surprise that further financial deepening was suggested by a large number of mainstream scholars as the way to deal with the instability and crises that financial deepening itself had brought along (also see the discussion in Chapter 3).

Since the 2000s, an increasing number of emerging and developing countries have become surplus oriented economies, and have experienced a huge growth of their cross-border asset and liability positions. As pointed out by several authors, to fully appreciate this development one needs to focus on gross, rather than net, capital flows (Bonizzi et al., 2015b; Forbes and Warnock, 2012). Moreover, in contrast with their past accumulation of public debt liabilities, these countries have now shifted towards more diversified liability structures, with private debt and equity gaining ground. As documented in Bonizzi et al. (2015b: 10) by 2007 the majority of debt stocks of EDEs was held by the private sector, with the proportion steadily increasing thereafter. With regards to the dynamics of long and short term debt, Latin American and Caribbean countries have experienced the most rapid growth of long-term external debt throughout the last decade, whereas East Asian countries appear to be the champions of short-term external debt growth throughout the same period (Bonizzi, 2015b: 14-15).

Overall, such liabilities have resulted in a substantial surge in capital inflows towards EDEs from the turn of the century and on (for a detailed empirical breakdown by regions and income categories see Bonizzi et al., 2015b; Tyson and McKinley, 2014). The fact that numerous EDEs experienced a significant improvement in their fundamentals throughout that time (for evidence see Tyson and McKinley, 2014) might have allowed these countries and the global financial markets to treat such inflows as a ‘vote of confidence’. At the same time, most of these inflows have found their mirror reflection in the accumulation of foreign exchange reserves by domestic central banks.
In line with the theory of dependent financialisation and the dependence of EDEs’ central banks to issuers of foreign currency discussed earlier, one can also see how the accumulation of foreign assets raises the importance of capital gains and losses on international investment positions for such economies (Bonizzi et al., 2015b). Equally, despite the fall in net indebtedness, the exposure of EDEs to potentially volatile and procyclical forms of short-term capital, such as portfolio and equity, raises concerns regarding the transmission of financial instability towards their financial systems.

4.4 Country experiences

Work has been undertaken within the FESSUD Work Package 6 on a range of emerging and developing economies, and their experiences with financialisation and its effects on their development. The following sub-sections seek to summarise aspects of that work.

4.4.1 Turkey

Aydun et alia (2016) write on the case of Turkey and how the paradigm of development and its governance have changed in the era of financialisation in general and how these changes feed into transformation of Turkish economy and the change in the governance of Turkish economy, in particular. They point out that mainstream economic theory postulates that increased integration of the world capital markets is conducive to growth and is welfare-improving. But the historical experience suggests otherwise. The recent financial crisis episodes across Latin America and Asia, with short-sighted myopia and the speculative herd behaviour of domestic and foreign financial arbiters, show the dangers of premature liberalization attempts. However, countries that are “dependent upon capital inflows ought to adopt or maintain contractionary monetary policies in order to secure investor confidence and international creditworthiness. Thus, the governments of the emerging markets (EMs) who seek to attract and maintain inflows of foreign capital are severely constrained in the ex ante sense to adopt a set of restrictive monetary and fiscal policies” (Aydun et alia, 2016).

The post-1980 macroeconomic and political developments in Turkey have persistent difficulties and wide fluctuations in national income, with conflicting policy adjustments. “The most striking aspects of the current Turkish political economy context are the persistence of
open unemployment and price inflation under conditions of a crisis-prone economic structure; persistent and rapidly expanding external deficits; marginalization of the labor force along with the dramatic deterioration of the economic conditions of the working poor; and the severe erosion of moral values with increased public corruption.”

“The Turkish economy and society have been the subject of neoliberal agenda since 1980, and the crucial first three years of structural adjustment were under military rule. Executed under the direct supervision of the IMF and the World Bank, the last three decades have witnessed an extensive shift in the Turkish pattern of development with the rise to hegemony of the neo-liberal orthodoxy dictating “market rationality” over any other form of collective decision-making. It can be surmised that, not only the macro economy, but all aspects of social/institutional infrastructure were subjected to “structural adjustment”. Starting with a direct intervention to the legal system with a new constitution and a thoroughly revised Labour Law that radically limited the rights of the working classes and trade unions in the immediate aftermath of the military intervention, a series of administrative regulatory bodies were established, each with a specific task of specialization and with almost no democratic accountability... In contrast to the traditional stabilization packages that aimed at devaluation to restrain domestic demand, the new orthodoxy aimed at maintaining high interest rates for the purpose of attracting speculative foreign capital from the international financial markets with the effect of overvalued domestic currencies. The end results in the Turkish context were the shrinkage and commercialization of the public sector in a speculation-led growth environment, and the transfer of decision-making to “independent” supreme bodies of regulation, working under “global rules” of “governance”.

Turkey has been one of the test cases of the neoliberal transformation since the early 1980s where there has been significant changes in both the role of the state in the economy and its mode of integration with the world economy. One of the striking changes of the 1980s was the conception of the integration with the world economy as an end in itself, at least at the level of discourse (Yalman 2009: 250). There is, thus, a need to consider the redefinition of development paradigm in Turkey, as it came to reflect some of the features of the so-called
post-Washington Consensus. The modes of integration of the Turkish economy to the global economy in the 2000s have been shaped by a variety of interrelated global, international and domestic dynamics while the role of the EU and international financial institutions (IFIs) has been an important determinant. However, it is plausible to suggest that their role has been somewhat subdued since the global financial crisis of 2008” (Aydun et al., 2016). Aydun et alia (2016) see “financial movements as well as the recurring financial crises have become the main driving forces of neoliberal transformation in Turkey since the liberalisation of capital accounts in 1989. For financial markets have been the primary targets of the state to finance its budget deficits and recycle its debts, of capital groups for investment, and of individuals to either simply survive or buy assets like cars, flats, or voyages since then. Given the fact that all these parties have become dependent on the developments in financial markets for their reproduction, stability perceptions of the investors, investment advisors, rating agencies as well as the IFIs as the voices of “financial markets” have acquired utmost importance in the determination of state policies while other social, economic and political concerns have been treated as secondary.”

“Empirical studies on the macroeconomic effects of capital flows in the aftermath of capital account de-regulation did, in fact, highlight a number of stylized facts that could not have been foreseen by the theoretical abstractions of intertemporal optimizing. First, it was observed that a disproportionate portion of the rise in capital inflows has been trapped as foreign exchange reserve accumulation in the recipient countries. From 1990 to 1994, the share of foreign inflows channelled to accumulation of reserves has been 59% for Asia, and 35% for Latin America. Secondly, the surge in capital inflows have mostly been associated with widening current account deficits in the aftermath of external liberalization. This widening was the end of result not only of increased investment demand, but to a larger extent was due to a significant fall in national savings. In fact, as it has already been acknowledged by the World Bank, low domestic savings have not only adversely been affecting Turkey’s growth prospects, but they have been increasing its dependence on foreign financing, thereby fuelling doubts about the sustainability of its current account deficit and
jeopardizing the sustainability of growth (World Bank 2011). Consequently, the third observation was that there had been a rise in private consumption spending driven mostly by rising imports of durable goods. Fourthly, with the rapid growth in the monetary aggregates in the recipient countries in both nominal and real terms, the surge in capital inflows was accompanied by sharp increases in stock and real estate prices. Finally, even though the real exchange rate movements have displayed a mixed pattern across a wide variety of countries, those countries, which had on-going disinflation programs, had experienced a substantial real exchange rate appreciation. In fact, such appreciation has been referred to as a well-established empirical regularity of exchange rate-based disinflation attempts. The Turkish economy in the 2000s thus represents a model case for the validity of these findings. For the appreciated Turkish lira, steadily deteriorating current account deficits, cheap foreign credits, relatively high real interest rates, lower inflation rate, and the resultant deindustrialization due to the fact that industrial capital could not compete with the cheap imported goods have become the persistent characteristics of development in the post-2002 Turkish economy."

The “financialisation process under the AKP governments after 2002 has involved some discontinuities from the path set after 1989. Firstly, the recent period has been marked by a shift from state- to private-indebtedness. Thus, while private companies’ liabilities in foreign exchange used to be $6.5 billion in 2002, this figure rose to $176.2 billion in June 2015. This explains why the government’s discourse which associates political stability with the survival of the AKP rule has proved to be successful so far. Secondly, the shift from public to private indebtedness ultimately led to the state’s paying up its debts to the IMF in May 2013, curbing the Fund’s capability of intervention in state policies. Since then, even though the state’s vulnerability towards financial markets has not declined, its political room of manoeuvre has expanded in so far as the steady inflow of finance is ensured.” (Aydun et alia, 2016).

4.4.2 Brazil
Kaltenbrunner and Painceira (2016) focus on the case of Brazil. In line with the theory of international currency hierarchies discussed earlier, the authors show how dependent
financialisation has come to affect the structure and dynamics of the Brazilian economy. According to their evidence cumulative twelve-months net short term capital flows increased from an outflow of US$8bn at the beginning of 2000 to more than US$60bn at the end of 2007. The surge of foreign capital also implied a qualitative change in foreign investment, as new investment vehicles, such as hedge and mutual funds, entered the Brazilian economy.

In face of surging foreign exchange liquidity, the Brazilian central bank increased substantially its foreign exchange reserves and engaged in wide-ranging monetary sterilisation operations. Indicatively, the bank’s outstanding stock of repurchase agreements (repos) increased by almost fifteen times between 2004 and 2014 (Kaltenbrunner and Painceira, 2016: 16). As a response, commercial banks substantially raised their involvement in short-term borrowing and lending. A mounting amount of credit came to be directed towards household consumption and real estate, while at the same time the share of industrial lending declined.

Furthermore, capital flows and the Brazilian Real experienced significant volatility during the last decade, far beyond the fluctuations that the country’s fundamentals would justify. To cope with the corresponding uncertainty, large Brazilian NFCs got involved in an increasing volume of financial trade. Moreover, a great number of them increased their exposure to foreign currency borrowing, primarily by taking up loans denominated in US dollars. Kaltenbrunner and Painceira argue that in a number of cases such borrowing was used for carry-trade strategies, instead of being directed towards productive investments.

While the recent financial crisis did not affect Latin American countries as much as other regions of the globe, Brazil suffered a dramatic reversion of capital flows in 2008 (Jump and McKinley, 2015). As Jump and McKinley report, this shift in capital flows resulted in a sharp depreciation of the Brazilian real, which lost 60% of its value against the US dollar. Capital outflows were also accompanied by a huge fall in GDP growth and a sharp recession during the same year.

4.4.3 South Africa
South Africa has been heavily affected by financialisation throughout the recent decades. Isaacs (2015) provides a thorough account of the policies that were adopted since the transition to democracy in 1994, and the results that followed. Primarily, what stands out of these policies is the process of financial liberalisation that was initiated in the 1990s. Amongst others, relevant reforms included the government’s return to international financial markets, the removal of restrictions for foreign bank entry and foreign participation in the Johannesburg Stock Exchange and the relaxation of FDI requirements. As a result, financial markets experienced a notable growth up until the crisis. Indicatively, total bank credit increased from around 70% of the South African GDP in the early 1990s to 104% in 2008 (Isaacs, 2015: 14-15). Moreover, between 1970 and 2008 employment in the finance and insurance sector increased by more than three times.

The impact of financial liberalisation has been felt at various levels. First, in a similar fashion with the Brazilian experience, the opening to foreign investors attracted volatile short-term capital. Short-term capital inflows included portfolio flows and short-term loans and came to dominate as a share of total inflows. As Isaacs notes, despite the fact that the increased volatility did not result to banking and financial crisis, as elsewhere in the developing world, it nevertheless caused sharp exchange rate fluctuations.

To attract foreign capital South Africa had to offer high interest rates, relative not only to developed, but also to other developing countries. For the same purpose it also had to adopt a conservative macroeconomic policy agenda. Along with the vulnerability of the South African economy to volatile international capital flows, these developments show for Isaacs the subordinate placement of South Africa to the international financial system.

While banks kept being the main player in the provision of domestic credit, they came to rely heavily on foreign capital. Moreover, the vast majority of new debt was directed towards non-productive purposes such as household consumption and real estate purchases (also see Mudrovna, 2016). Isaacs (2015) notes that although South Africa has not experienced a household bubble burst as in the US, over-indebtedness is nevertheless a “slow-boil crisis, particularly amongst the poor” (2015: 41).
At the same time, South African NFCs came to be subject to a similar trend of shareholder value orientation as in the US. Most notably, the increase in the size of assets held by institutional investors grew from less than 100% of GDP in 1990 to almost 200% in 2014. Furthermore, the wage share of income exhibited a significant decline from the early 2000s and up to the crisis, while income inequality escalated throughout the same period.

As for the recent crisis, Isaacs notes that although it hasn’t resulted in a need for bailout funding, South Africa has experienced substantial negative effects through its international trade channels, particularly with the EU. At the same time the government has opted for fiscal austerity, thereby obscuring the growth prospects of the South African economy.

4.4.5 India

Mukhopadhyay and Chari (2015) provide an account of recent developments in the Indian economy. As discussed in their article, India initiated a process of market liberalisation, starting in the early 1990s. This transformation resulted in fewer investment activities for the state, and more space for private initiatives. In addition, new private banks were set up. New banks were also facilitated by the reduction in reserves requirements, the participation of foreign capital and the flexibility introduced in interest rates.

India experienced a persistent inflation for most of the 2000s. Moreover from 1993 to 2004 the country was running a significant current account surplus, which nonetheless started deteriorating in the following years, leading to an increase in India’s net external liabilities. As stated by Mukhopadhyay and Chari, although capital inflows towards the Indian economy have been relatively low, there has been an important increase throughout the last ten years. Such flows have been primarily led by FDI activities. Another interesting fact is that Indian firms have different levels of access to international capital markets. Despite the Indian capital account being open for foreign firms to participate in the Indian stock markets, and Indian firms being able to raise capital in international markets, the access of the latter in debt markets is still limited.

Overall, the process of liberalisation has managed to increase available credit in the economy. Most notably, credit rose from less than 100% of gross capital formation in 2006
to around 200% in 2012. Nonetheless, Mukhopadhyay and Chari point out that this has not yet materialised in a substantial increase in productive investment. One explanation pointed out in their paper is the demand-driven nature of the economy and thereby of corporate credit. Faced with insufficient demand, Indian corporations have mainly channelled the obtained credit towards financial investments and accumulation of inventories. With the particular historical and social context aside, it can be claimed that such developments present themselves as signs of financialisation of Indian corporations, broadly similar with the experiences recorded elsewhere.

4.4.5 The Franc Zone

The Franc Zone has been a monetary union between France and fourteen low income West and Central African countries, previously colonised by the former. In essence, it involves a common currency for all fourteen countries, labelled as ‘Communauté Financière Africaine’, or else CFA, and requires France to function as the central bank of the union through its budget (for more details see Laskaridis and Toporowski, 2015). Its four main principles are: i) convertibility of CFAs into Francs (nowadays Euros) under a fixed exchange rate; ii) a guarantee by France for such convertibility at all times; iii) in exchange for such guarantee Franc Zone countries are required to keep most of their reserves at the central banks of the Zone; and iv) capital mobility between France and the countries of the Zone. Despite the recent participation of France in the Euro, the zone has preserved its basic features. Unavoidably it has also come to be more integrated with EU development policies and surveillance mechanisms.

Laskaridis and Toporowski (2015) argue that the durability of the Franc Zone can be best understood in political rather than economic grounds. In that respect the authors point out that while the maintenance of the Zone is hard to explain in Optimal Currency Area (OCA) grounds, its impact in terms of policy credibility and fiscal discipline is easier to conceptualise.

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2 These include Benin, Burkina Faso, Guinea Bissau, Ivory Coast, Mali, Niger, Senegal and Togo, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon.
Throughout the 1980s a wave of instability and crisis episodes occurred, primarily related with the sharp appreciation of the Franc and the deterioration of trade for Franc Zone countries. As a response, structural adjustment programs were put in place for most of the members of the Zone. Some of the relevant policies that were introduced included the opening of market space for the private sector and the establishment of a number of convergence criteria primarily related with budget balances, debt levels and inflation. Such policies were also combined with the idea of financial deepening and integration. The way the project was applied was by prioritising the development of public debt markets in Franc Zone countries. The rationale here was that public debt markets provide a benchmark for the pricing of private debt securities, and in that regard paved the ground for the development of the second. Furthermore, the application of the project involved the prohibition of direct financing of governments by their central banks and the shift towards central bank independence. Such reforms were actively encouraged not only by France but also by global institutions such as the IMF and the World Bank.

4.4.6 Central and Eastern European Countries

In their transition to capitalism that was initiated in the 1990s, Central and Eastern European Countries (CEECs) also experienced a wave of Washington Consensus type of policies. Although there are differences in how these policies were applied across CEECs, in broad terms they included privatizations, anti-inflation and minimum deficit policies, deregulation of domestic markets, and financial liberalization (Juuse and Kattel, 2015; Gabor, 2015). As Juuse and Kattel (2015) note such policies were greatly supported by external institutions, such as the EU and the IMF. Most notably, the prospect of the EU membership was a crucial factor in pushing those countries to liberalize their financial systems and in opening the space for foreign banks to step in. Another important factor was the surging global liquidity and the boom in asset prices that was simultaneously taking place in the developed world. In such a context, Western European banks entered the markets of CEECs by establishing subsidiary branches and taking over large shares of domestic banking business. What followed was a substantial increase in credit provision, particularly throughout the 2000s.
The boom in credit supply was mainly oriented towards households. Indicatively, as reported in Juuse and Kattel (2015: 32) household credit increased from 10% to 15% in 1996, to figures between 45% and 60% in 2005. At the same time, despite some lines of credit towards medium and large enterprises, investment was not benefited much from the increased lending activity. Overall, Juuse and Kattel assert that the most important contribution of foreign banks was to introduce aggressive retail lending, mainly for the purposes of consumption and real estate purchases, and thereby sustain domestic demand and rapid GDP growth for the period up until the crisis.

In part because of the absence of a sufficient domestic deposit base and the underdevelopment of local currency markets, the expansion of lending in CEECs was crucially underpinned by international capital inflows. Due to the links of foreign bank subsidiaries with their parent-banks, a great part of those inflows took the form of cross-border interbank funding. Moreover, given that a large number of parent banks were based in the Euro area, CEECs came to be particularly exposed to the Euro as a foreign currency. The key outcomes were an increase in foreign liabilities and foreign currency denominated lending, as well as the creation of wide current account deficits in CEECs. Altogether, these elements increased substantially the financial fragility of CEECs, and exposed those countries to foreign financial turmoil (also see Gabor, 2015). Furthermore capital inflows augmented the dependency of CEECs on foreign capital.

In addition, despite the fact that none of the CEECs was by the time a member of the Eurozone, the exposure of CEECs’ banks to the Euro raised the ECB to the status of the ultimate supplier of liquidity for CEE central banks (Gabor, 2015). At the same time, CEE central banks became less effective in their exercise of monetary policy, as both the domestic and the foreign banks operating in their territories could now access reserves directly from the international currency markets.

When the financial crisis broke out, the dependency of CEECs on the ECB became evident. Straight after the collapse of Lehman Brothers CEE central banks faced a shortage of foreign currency liquidity, and particularly a scarcity of Euros. The ECB, instead of taking up its role
as a lender of last resort (LLR) for CEE central banks, decided to treat the latter as Euro-area commercial banks. This implied that it only provided them with Euro-denominated liquidity on the basis of ECB-eligible collateral, without accepting CEE governments’ debt to perform that role. Only a year later, in 2009, the ECB decided to establish direct currency swap lines with certain countries that had turned to the Troika (e.g. Hungary and Poland), of which the ECB was a member, along with the European Commission and the IMF. In that respect, the ECB used its role as the exclusive issuer of the Euro in order to facilitate the enforcement of Troika type of policies (Gabor, 2015).

Gabor asserts that this strategy was riddled with conflicts of interest. While the ECB was neither commissioned to function as an LLR for CEE central banks, nor to play the political role of the Troika negotiator, it nonetheless opted to expand its mandate towards the second direction.

4.5 Future prospects for four large emerging markets

The CAM global macro model has been used to present some alternative scenarios for four large emerging economies, namely Brazil, China, India and Indonesia.

4.5.1 India

The economic and financial trends in India reported by Mukhopadhyay and Chari (2015) differ in some important respects from those reported by the working papers for most of the other major Emerging Economies covered by Deliverable 6.07. Financialisation, both in its internal and external forms, appears to be at a much earlier stage of development in India. Moreover, its economy is projected to continue growing at a fairly healthy rate over the medium term. Yet Mukhopadhyay and Chari (2015) raise some major concerns about the country’s future prospects. For example, it warns that if current trends of financialisation continue, India’s rate of economic growth could be significantly slowed by the reliance of the economy on investment in the financial sector instead of investment in the productive sector, especially manufacturing.

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3 This section is based on McKinley (2016b) with minor amendments
At the global level India is still a very minor player in financial markets. The country’s share of external financial assets is projected, for example, to rise to only 1% of the global total by 2030. Yet if it continues to run sizeable current-account deficits, its net external liabilities will surely increase. In addition, the share of short-term portfolio liabilities in its total external liabilities is projected to increase by 2030 to over 30%—a share that would be much higher than that for China, for instance.

Credit as a proportion of gross capital formation in India had already risen to 200% by 2012 but one of the central arguments of the Working Paper is that much of this credit has been utilised for financial investments and inventory stock-piling instead of fixed productive assets.

As a result, economic growth has responded less than proportionately to increases in credit. Worryingly, the rate of return on financial investment is also likely to be higher than that for productive investment. Also, the build-up of inventories is likely to be a barometer of ‘over-production’, corresponding to a secular deficiency in domestic aggregate demand.

In view of these concerns, the Working Paper utilises the CAM global model in order to test the usefulness of an alternative policy scenario in which India’s economy would be boosted by an expansion of domestic demand and a concerted export push. The main levers are an assumed increase in private investment and, to a lesser degree, an increase in foreign direct investment (which is assumed to be more productively oriented than other forms of foreign investment).

Because India is projected to continue being plagued by current-account deficits, this alternative scenario also assumes a depreciation of India’s real exchange rate and an increase in its exports of manufactured goods.

But the scenario’s concomitant projected greater opening of India’s capital account to foreign investment would lead to a sharp increase in short-term unstable inward portfolio investment, which would rise to about one-third of the country’s external financial liabilities by 2030.
Hence, while India’s Net External Asset Position was still a positive 15% of GDP in 2015 (in contrast, for example, to the large negative positions of both Brazil and Indonesia), its move towards greater external financial liberalisation would likely heighten its future vulnerability to the instability of international financial flows.

4.5.2 Brazil and Indonesia

Jump and McKinley (2016) focus on two major Emerging Economies, Brazil and Indonesia, in which unstable international financial flows have been a major recent concern. Both of them are vulnerable to such instability because they have highly negative Net External Asset Positions. Such positions imply that the financial assets held by foreigners in these two countries are far larger than the financial assets owned abroad by their own citizens (or governments).

If the corresponding inward flows of capital by foreigners were used for long-term productive investment, such an imbalance would not necessarily be a matter of grave concern. Such could conceivably be the case, for example, for some forms of Foreign Direct Investment. But the two other categories of cross-border investment, portfolio investment and the residual category labelled ‘other investment’, tend to be short-term and often highly unstable.

When the financial rates of return for such short-term investment decline in countries such as Brazil and Indonesia, this capital is prone to quickly flee the country. This dynamic represents one of the most counter-productive aspects of the increased financialisation of such Emerging Economies.

When such rising economies are growing, they will tend to attract larger inflows of unstable capital because the rates of return on such investment would be higher than in Developed Economies. But when the economic growth of such Emerging Economies begins to falter—as has happened recently—this capital quickly floods back into global financial ‘safe havens’, such as US treasuries.
Jump and McKinley (2016) is able to place such financial flows within a global economic context through the use of the CAM global macro-econometric model. This model is particularly useful for making future projections based on long-term historical trends.

The general significance of the CAM’s resultant 10-year projections (from 2017 to 2026) is that the global economy is likely to be plagued by persistently slow GDP growth and continuing stark economic imbalances, especially current-account imbalances. Such a context implies that there would continue to be re-occurring financial imbalances, marked by unstable capital flows between countries, particularly between Emerging Economies and leading Developed Economies.

Under the CAM scenario, Brazil is projected to eventually recover from its current sharp recession and grow at a moderate rate, namely 2%-2.5% through 2026. The country’s current account would eventually regain its previous surplus position but, importantly, its rate of domestic investment would remain stubbornly low.

The composition of capital flows into and out of Brazil would also remain disadvantageous. Very little foreign direct investment would flow into the country while inflows of unstable portfolio investment would predominate. In addition, the government would have limited ability to counteract the effect of any rapid outflow of financial capital because it would hold a relatively small stock of foreign exchange reserves.

In some ways, Indonesia is projected to be in a somewhat stronger economic position than Brazil over the next ten years. By 2019 it is projected, for example, to begin maintaining a GDP growth rate of about 4%. Though its investment rate would tend to decline over the projected period, it would still remain at about 24% of GDP, far higher than Brazil’s, for example.

However, Indonesia’s current account would maintain a significant deficit throughout the projected period. Financial flows into Indonesia are projected by the CAM to decline from their current levels but then recover modestly by 2020. Most troubling, however, is that financial inflows would continue to be dominated by portfolio investment and ‘other investment’, the two most unstable forms of capital inflows. And, as would be the case in
Brazil, the government of Indonesia would command only a relatively small stockpile of foreign exchange reserves as a safeguard. So both Brazil and Indonesia are projected to recover economically, to some extent, from the instabilities that they confronted in 2015-2016. But, on the whole, these recoveries would not be strong. Moreover, their financial fragilities would remain daunting, both because their Net Foreign Asset Positions would remain stubbornly negative and any continuing inflows of financial capital would be dominated by the most unstable varieties. So their financial positions are likely to much more unstable that India’s.

4.5.3 China

McKinley (2016a) attempts to place China’s increasing financialisation within the context of a global economy that is slowing and continuing to exhibit wide disparities in current account balances (and accompanying instabilities in capital accounts). For example, the paper uses the CAM global macro-econometric model to project China’s future economic and financial trends over the next ten years within the context of the evolution of the global economy. Under the assumptions of a Baseline Scenario (which assumes no significant changes in policy), the CAM model projects, for example, that China would continue to grow fairly rapidly but it would also continue contributing significantly to global imbalances in current accounts, and thus associated major imbalances in capital accounts, i.e., international financial flows. While China would continue enjoying sizeable current-account surpluses, Developed Economies such as the USA and the United Kingdom (two leading global financial centres) would continue, by contrast, to suffer from large current-account deficits. Hence, McKinley (2016a) constructs an Alternative Policy Scenario that could slow China’s economic growth, change its pattern and narrow the country’s current-account surplus. This scenario is based, for example, on assuming an increase in China’s level of consumption (and a corresponding reduction in its savings rate) and an appreciation of its exchange rate. As a result of such policy-related assumptions, China’s rate of economic growth would slow significantly and its current-account surplus would narrow. But this adjustment of China’s future path, as well as the effect of the Alternative Policy Scenario as a whole, would not be
successful in helping to significantly lower the large current-account deficits of the USA and the UK.

What is also noteworthy is that the CAM projections suggest that China is likely to continue enjoying economic outcomes that would be superior to those of other Emerging Economies, such as Brazil, Indonesia, South Africa and Turkey.

The external financialisation of China would also likely be much more sustainable than that of other Emerging Economies. For example, under both the Baseline Scenario and the Alternative Policy Scenario, China would maintain a fairly stable position with regard to inward and outward financial flows.

It would continue to amass a sizeable external stockpile of foreign-exchange reserves while the inward flows of capital into its economy would continue to be dominated by Foreign Direct Investment instead of the more volatile and erratic flows of Portfolio Investment and Other Investment.

McKinley (2016a) also examines the external and internal debt dynamics of China, which have become a major area of concern for analysts since the outbreaks of financial instability in the country in late 2015 and early 2016. But the paper concludes that although China’s total debt, comprising both external and domestic, has risen sharply in recent years, it is likely to remain sustainable. In fact, its external debt remains fairly small. Moreover, the country continues to amass a large strategic stockpile of foreign exchange reserves and it maintains fairly effective capital controls, both of which would help to mitigate any financial difficulties.

The main areas of strategic weakness in China appear to be the domestic debts of local governments and the corporate sector. In contrast, the debts of the national government and households are not large. Moreover, China continues to have a fairly high household savings rate and the national government appears to maintain adequate fiscal space and retains the ability to exert significant influence over the financing of state-owned enterprises.

Hence, although many analysts in advanced capitalist economies and even international financial institutions such as the IMF and BIS have recently raised serious concerns about
the process of financialisation in China, the country’s future course still appears to be economically sustainable.

In this regard, conditions in China would likely continue to contrast with those projected for the other major Emerging Economies of Brazil, Indonesia, South Africa and Turkey, all of which have been reviewed in this Synthesis Report. The one exception appears to be India, although this country appears to be at a much lower level of financial development.

4.6 Finance and Development

Given the current state of affairs in the monetary union, a number of authors have channelled their thoughts towards the discussion of the conditions and initiatives that could further boost such inflows from developing countries. Most notably, Pitelis and Pitelis (2015) point out a plan for European recovery, including the termination of austerity, as a means to make the EU an attractive destination for such funds. From their side, Pitelis and Tserkezis (2015) argue that the stability of the European economy could be on its own an important motivation for SWFs to invest in Europe. In addition, Pitelis et al. (2015) claim that compared with the US, Europe holds two comparative advantages regarding its links with the BRICS, namely its social-democratic tradition that is relatively closer to the political aspiration of some of those countries, as well as its cultural links inherited from the past (e.g. links of Portugal with Brazil, Great Britain with India, etc.).

4.6.1 Ways to Self-Finance Industrial Development

Mudrovna (2016) discusses the alternative ways for developing countries to self-finance industrial development. Using examples from four countries, namely Brazil, South Africa, India and China, Mudrovna explores the different possibilities that exist in terms of mobilizing domestic resources and utilizing them in a beneficial way for the broader economy. Some of these possibilities include developmental banking, retention of foreign reserves and pension fund financing.

To start with the first, Mudrovna mentions the example of the Brazilian Development Bank (BNDES), an institution that has played a pivotal role for more than half century in providing

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4 See also Van Waeyenberge (2016b) for synthesis of policy recommendations.
long-term financing and in supporting the internationalisation of Brazilian companies. Within this context the author contrasts two different approaches to developmental banking that BNDES has followed in the recent past. Her points of reference for such comparison are the aerospace and automotive industries. In particular, while BNDES has supported aerospace financially in expanding abroad and generating knowledge at home, in the case of automotive sector its strategy has been aiming to attract FDI. The two approaches have delivered contradictory results. Murdovna argues that on one hand the support of the aerospace industry has been successful in promoting R&D activities and expanding abroad. On the other hand, the opening of the automotive industry for FDI has not delivered equal gains in economic growth and knowledge creation. One reason for this has been the fact that the attraction of foreign capital led to a crowding out of domestic producers. Another explanation is that foreign-owned enterprises usually do not have strong incentives to locate their R&D activities in developing countries. Furthermore, foreign companies appear to be keener in repatriating big parts of their profits and investing them elsewhere.

A reflection of the dominance of finance on EDEs can also be seen in the evolution of development policy and aid provision towards these countries. As reviewed by Van Waeyenberge (2016) and Van Waeyenberge and Bargawi (2016), overseas development aid (ODA) has lost ground both in absolute and relative terms compared with private capital flows. To add to such dynamics, the global financial crisis pushed ODA flows further downwards, with ODA recording a drop of 6% in real terms between 2010 and 2012. Van Waeyenberge (2016) shows how such an outcome was facilitated by the re-definition of the purpose of international financial assistance and the rhetoric that identified a great potential in private capital. Most notably, official aid ceased to be seen as a way of directly fostering economic development, and came to be recognised as a means to support private capital. In turn the latter was identified as the one responsible for delivering economic growth and supporting infrastructure. In that respect, various ‘blending’ mechanisms, including public-private partnerships came to be popular as a direction for ODA. Similarly, several leverage
mechanisms were put forward in order to facilitate the mobilisation of private flows. Some of these included interest rate subsidies, loan guarantees and technical assistance (for more information see Table 1 in Van Waeyenberge, 2016: 15).

Van Waeyenberge (2016) offers a number of critical remarks. First the author asserts that no convincing and coherent narrative has risen in support of the idea of private sector involvement in areas that are traditionally in need of extensive state intervention, such as infrastructure. Secondly, by turning infrastructure into an asset class, a need for competitive returns for investors is created. This can translate in a conditional provision of such works to the public, for instance by imposing fees or tariffs. Furthermore, it is often the case when the financing costs for the provisioning of public goods and services are higher for the private than for the public sector. At the same time Van Waeyenberge states that blending and leverage schemes as the ones described above can result in big parts of the risks and costs staying at the hands of the public, while big parts of the benefits are left for the private sector.

Bonizzi, Laskaridis, and Toporowski (2015a) assesses the Aid policy of the European Union. It highlights how this EU Aid provision has been intertwined with the process of financialisation in two main ways. Firstly, a non-negligible proportion of Aid flows are linked to the promotion of private sector, for-profit activities, which very often include the development of the financial sector in developing countries. Secondly, the provision of Aid itself has become closely linked to the financial sector through the process of “blending”, which effectively increases the Aid budget by means of leveraging. These two aspects highlight how even cooperation policies with developing nations cannot be considered immune to the process of financialisation.

In line with the above developments, it is worth noting that emerging and developing countries, and especially the BRICS (Brazil, Russia, India and China), have exhibited some significant demand for European assets. As discussed by Bonizzi and Toporowski (2015), capital inflows to the EU can be classified as either holdings of Euro reserves by governments of developing countries; portfolio investment in EU capital markets, including holdings of European assets by Sovereign Wealth Funds (SWFs); and FDI in European economies,
focused particularly on the financial sector (for discussion and evidence also see Pitelis et al., 2015).

4.6.2 New Ways of Global Engagement

There has been an increase of private non-guaranteed external debt (PNG) in developing countries and emerging economies in the last two decades reflects the increasing cross border flows of capital. The traditional literature, relaying on the current account, i.e. net capital flows, associates external debt in emerging and developing countries with deficits in current account, and cross border capital flows with global current account imbalances. This paper presents empirical evidences showing that during the 2000s that emerging markets have experienced a surge in private capital flows. As a result, emerging and developing countries cross-border asset positions have correspondingly increased, with the share of private sector claims on emerging markets increasing and the share of liabilities held by government and multilateral institutions decreasing. There is increasing involvement of the private sector in the developing countries’ external debt and the fact that the public sector, previously reliant almost entirely on official credit, has become able to access private debt markets reflects the increasing integration of developing countries into the global financial system. Gross capital flows data reveals that net capital flows do not explain and do not capture this global financial integration. The emerging and developing economies are at the margin of the process when it comes to cross-border financial flows that are still very much driven by developed economies, especially the EU and US and are concentrated in only a few countries. The surge in private capital flows within a context of current account surpluses has its mirror image in the accumulation of foreign exchange reserves. In turn this connects the capital flows towards these economies with factors such as the international monetary cycle. Lastly, it is discussed that the growing integration of developing and emerging countries into the global financial system is also the product of official development policy becoming more supportive of the private sector. The EU Aid policy has relentlessly supported the ‘pro-finance’ argument to achieve economic growth in these countries. Interestingly, one

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5 This sub-section comes from the summary of Alves et alia (2016).
of the main tools to promote the development of the financial sector in developing countries relies on the notion of ‘blended finance’, which rests on using public Overseas Development Assistance (ODA) funds to leverage private funds and on developing broader types of public-private partnerships. There is therefore increasing integration of Emerging and Developing Economies in the global financial system, emerging ‘financialisation’ in the economic and social development of developing countries and the increased role of the private sector, and inter-dependence between the European Union (EU) and the emerging countries and an assessment on the potential economic and social benefits for European sovereigns.

Similar trends can also be identified at the level of EU aid. As discussed in Bonizzi et al. (2015) EU aid policies have been interlinked with the processes of liberalisation and financialisation via two particular channels. First, as with the broader trend described above, the private financial sector has been allowed to participate in the provision of aid, primarily through the process of blending (also see Van Waeyenberge, 2016). Secondly, an increasing share of ODA has been dedicated to the promotion of the financial sectors of recipient countries. Indicatively, Bonizzi and his colleagues present evidence showing that from 2006 to 2012, the banking and financial sector has been the third most beneficiary sector in terms of ODA flows received, after energy and agriculture, and much higher than the support of the industrial sector.

In a similar fashion with Van Waeyenberge, Bonizzi et al. (2015) argue that the recent trends in financial aid provision have turned the attraction of private capital flows into a developmental aim in itself. In that respect, the rhetoric attached to aid provision has downgraded the debate on economic development into a discussion over the financial barriers that prevent capital flows from entering developing countries. Furthermore, with regards to the EU, it appears that the Union has seen the involvement of private flows as an additional means to apply political pressure to EDEs. This perspective is evident in European Commission’s own reports, where it is claimed that ‘blending can be used to leverage policy to support ’reforms in line with EU policies’ (Bonizzi et al., 2015a: 34).
References


5. Functioning of different financial institutions under financialisation

5.1 Introduction

Financialisation has been a near-global phenomenon, and taking place in different forms and at different speeds, for which the term variegated financialisation has been used. As the FESSUD Studies on Financial Systems\(^1\) have shown, there are many differences between financial systems in terms of the financial institutions and their relationships with the real sector. Financial institutions have different ownership forms, public, private, mutual etc., and hence may pursue different objectives. They have different relationships with regulatory agencies and the central bank. And the relative roles of financial institutions and financial markets differ across countries. One purpose of FESSUD studies has been to consider how these different structures of financial institutions and the financial sector impact of the real sector and its performance.

One of the key functions often ascribed to the financial sector is that of collecting savings together and providing firms with funds for investment. In doing so it allocates and monitors the use of funds. The allocation of loans, credit and funding by financial institutions is inevitably subject to forms of ‘credit rationing’. By this is meant that the terms on which finance and funds are provided depends, amongst other things, on the credit assessment made by the financial institutions (or by credit rating agencies on their behalf). The credit assessments relate to the likelihood of timely repayment of loans. The assessments take place in a world of fundamental uncertainty and asymmetric information and are inevitable strongly influenced by factors such as the state of the economy through to the social standing of individual applicants.

This chapter is organised in terms of three themes. The first relates to the effects of different forms of ownership of financial institutions. Under the era of financialisation, there has been a trend in the direction of privatisation (not surprisingly particularly evident in the Central and Eastern European Economies) and of internationalisation of ownership. On the other side of that coin has been some diminution of mutual and co-operative ownership and of state

\(^1\) Available at http://fessud.eu/studies-in-financial-systems/
ownership. The era of financialisation was closely associated with de-regulation, liberalisation and privatisation, and globalisation, and these forces also played themselves out with regard to the ownership and regulation of the financial sector (as discussed in Chapter 1). The question then to be examined is how different forms of ownership ‘perform’. The era of financialisation has also brought the growth of securitisation and derivatives, the easing of regulation and the rapid growth of shadow banking. An illustration of growth and reversal of securitisation is given in Figure 5.1. On what they regard as a narrow measure of shadow banking “that may pose financial stability risks”, FSB (2015) estimate its size $36 trillion in 2014 in 26 participating jurisdictions, equivalent to 59% of GDP of those jurisdictions and 12% of financial system assets, and “has grown moderately over the past several years”. More than 80 % of shadow banking assets are in a subset of advanced economies in North America, Asia and northern Europe. An aggregate measure of the assets of other financial intermediaries, pension funds and insurance companies was $137 trillion in 2014, representing around 40 % of total financial system assets in 20 jurisdictions and the euro area. Below there is a focus on the growth of sovereign wealth funds, private equity and investment banks and their effects.

Figure 5.1 near here

The third theme relates to some issues on the ways in which funds are allocated between sectors. These are in a sense old issues as the question of, for example, how well or otherwise banks allocate loans and credit to small and medium size enterprises (SMEs) has been a long-standing one. Another notable example has been the issue of the allocation of funds for long-term investment, technical innovation and research and development. It is though also important to view the allocation of funds and credit in a broader setting – whether involving discrimination by gender, ethnicity, area of residence etc.

5.2 Ownership of financial institutions

Three broad forms of ownership in the financial sector can be identified, namely private (usually corporate), public and mutual and co-operative. Within each of those categories

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2 This section draws very heavily on Sawyer (2016).
there are variants which are discussed below when each type of ownership is discussed. In addition, whether ownership is domestic or foreign, that is based on inward foreign direct investment is considered. The three forms of ownership are, not surprisingly, viewed as being potentially different in terms of their objectives, their scope of operations, and their efficiency.

The financial sector, perhaps more than any other sector, has had in many countries a mixture of different forms of ownership—public, private, and mutual and co-operative. Although under the recent decades of financialisation there has been a general shift away from public and mutual forms of ownership towards private, there remains a significant component of mutual ownership. The financial crisis and associated bail-outs involved significant components of public ownership, though most governments have intentions of the re-sale of these public owned banks. There has also been revival of interest in the roles of State Development Banks\(^3\), and the European Investment Bank has plays something of that role. The different forms of ownership have often arisen in different sectors of the financial system. For example, mutual and co-operative ownership has often been a feature of savings banks with a focus on home ownership. It is highly relevant to investigate the relative performance of the different forms of ownership. Performance here is to be viewed not only in terms of profitability (which anyway has different meaning for the mutual institutions as compared with private ones), and notions of efficiency but also in terms of how funds are allocated, which groups are included and which excluded from the financial system.

Consideration of different forms of ownership (and implicitly the impact of the shifts away from public and mutual forms of ownership to private ownership) may be considered under a number of headings:

(i) The relative efficiency of the different forms of ownership;

(ii) The relative extraction of profits under different of ownership, and who receives the profits;

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\(^3\) See, for example, Griffith-Jones (2014, 2015).
The differences in the nature of the relationships between financial institutions and their customers;

The differences in the objectives pursued by different ownership forms;

Stability/instability of the banking system including risk taking.

The scale of the role of co-operative banks in a range of countries is given in Table 5.1, which is reported in Tomidajewicz (2015) (and where further information is given in his Table 2 and the text), and for mutual and co-operative insurers in Table 5.2. The importance of these types of institutions in a number of countries is clear as is the variations across countries.

Dymarski with Tomidajewicz (2015) observe a steady trend towards corporatisation and privatisation in the financial sector in European countries commencing in the 1980s and intensifying in the 1990s. However, the scale of the ownership transformations differed from country to country and a variety of reasons and objectives were behind them, and different methods and tools were deployed. It should be added that the process of privatisation was alternated with temporary nationalization of non-performing banks or an increase in holdings of the State in those banks in times of financial crises. The countries differ markedly also in their approach to savings and cooperative segments of the banking sector.

Jurek (2013) argues that the importance of the structure of ownership in the financial sector comes from two directions. “First, changes in the structure of ownership in the financial sector reflect the progress of privatisation in many European countries, especially in the new member states. This process manifests itself in a transfer of ownership of financial institutions from the state to the private sector. Secondly, the above mentioned changes are a result of freedom of capital mobility in the whole EU.”

Jurek (2014b) notes that there have been arguments to the effect that “private ownership is generally preferred to public ownership, especially when incentives to innovations and to reduce costs are strong, as well as the competition in the market. Of course, perverse incentives are not absent from privately owned financial institutions, and indeed the incentives towards risk-taking in large interconnected financial institutions have been seen
as raising the likelihood of financial crash and a significant factor in the generation of the 2007/09 financial crisis (Dymarski with Tomidajewicz, 2015; Dymarski, 2016).

“Privatisation accompanied by liberalisation opens the door to banks’ growth and expansion beyond their traditional scope of activity and traditional markets. This has three negative consequences. First, as banks grow across borders, they have less interest in satisfying local borrowers. Second, the bigger the bank and the more hierarchical and complex its organizational structure the less it is able to use so called “soft” information in making lending decisions. The consequence is a loss of information on applicants for loan whose creditworthiness cannot be accurately assessed on the basis of “hard” information alone. The same can be said of small individual investment projects, where “soft” information is very essential in assessing whether or not the loan is NPV-positive. It concerns first of all SME and households on the one hand and innovative projects in the other hand. The empirical literature on small business lending gives evidence that in such situations large banks tend to shy away from such credits. Third, new opportunities urge large banks (not only private ones) to involve in more and more risky operations and transactions, for example replacing customer (retail) deposits as the main source of funding with potentially much more risky wholesale funding, i.e. short-term institutional deposits” (Dymarski with Tomidajewicz, 2015, p.75).

What may be labelled the development view of the role of State institutions is more than just a market failure approach and views a State bank as potentially able to pursue different objectives. In this view state ownership of financial institutions can be a response to institutional deficiencies. State-owned financial institutions have the potential to pursue a range of social goals and the funding of investment and other projects which private profit-seeking financial institutions would be unable or unwilling to fund. Jurek (2014b) identifies three types of missions of state-owned financial institutions. First, specialised missions aimed at filling market gaps left by private financial institutions; second missions investing

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4 “Soft” as opposed to “hard” information is contextual information collected in person; it is not codifiable and can be used only by its collector.
This project is funded by the European Union under the 7th Research Framework programme (theme SSH) Grant Agreement nr: 266800

in socially valuable but non-profitable activities and third missions to serve a specific geographical area.

Mutual and co-operative organisation and state-owned ones may be considered to have objectives other than the maximisation of profits, but do have to at least break-even (what exactly that would mean depends on how costs are evaluated) and in that sense pay regard to the ‘bottom line’. Further, such organisations have a range of other objectives – serving particular income groups, providing funds to specified groups etc. These organisations may be termed double bottom line institutions (DBLI).

Profit seeking privately owned banks vary considerably in sized though in many countries operate with a high degree of industrial concentration and increasingly on an international basis. DBLIs in general will tend to be rather smaller and more limited in the geographical range of their activities. It is then argued that large banks may be “less capable of processing and transmitting the soft and relational information through their hierarchical structures, DBLIs can better respond to the needs of smaller local enterprises.” Check quote Jurek (2014b) continues in arguing that DBLIs “can foster regional development by mobilising savings and lending the funds in the region where they belong, thus preventing a capital drain even if a region is less developed (Hakenes and Schnabel, 2006). In effect, countries, in which stakeholder banks play an important role, display low level of financial exclusion (Carbó et al., 2007). Moreover, local DBLIs provide stable tax revenue, since they are less prone than large multinational banks to shift profits to countries with a favourable tax regime (Demiorgüç-Kunt and Huizinga, 2001). For example, in 2000-2013 German savings banks paid 3.3 times more and cooperative banks two times more taxes on income and earnings than commercial banks (Dymarski with Tomidajewicz, 2015). They also aim at maximising the expected labour expenditures understood as a preference for expansion in order to fulfil the social goal of providing access to credit to certain categories of the population, or as a preference for maximizing the expected salary pay to the workers (Akella and Greenbaum, 1998). Finally, accountability of the managers of mutual DBLIs to owners may be greater than that of managers of private organizations, because each claimholder can exercise the right
to withdraw funds if he or she assess management to be inefficient (Fama and Jensen, 1983, Girardone et al., 2009). As a result, the presence of stakeholder banks increases systemic financial stability and social welfare.

DBLIs have often been argued to exhibit lower efficiency on the grounds that private owned banks have incentives to reduce costs in pursuit of profits and face capital market discipline. “However, the empirical support for this argument is rather blurred. Despite the fact the private-owned institutions and DBLIs in the EU countries have competed in the same markets, under the same regulatory framework (Iannotta et al., 2013) they at the same time have followed different paths of development. This is why it is hard to provide an unambiguous proof of the superiority of one form of the ownership over other, as results of research remain highly dependent on the sample as well as the period and the region under study” Jurek (2014b). However, German public savings banks (except Landesbanks and cooperative banks turned out to be “a source of stability during the [2008] financial crisis” (Finanzgruppe, 2015, p. 27). Contrary to the big private banks, Landesbanks public savings banks and cooperative banks increased considerably long-term lending to the non financial sector between 2007 and 2012. While the former went in the red during the 2008-2009 crisis, the latter registered only temporary decrease in profitability. It is also worth to notice that the study of the CEE banking sectors conducted by Allen et al. (2013) has shown that “an impact of financial crises on banks” lending activity is weaker in banking sector consisting of government-owned, private domestic, and foreign-owned banks than in the sector in which one form of banks’ ownership dominates” (Dymarski with Tomidajewicz, 2015, p. 73).

Isaacs (2016) covers alternative (to shareholder financial institutions) forms of financial institutions, which include cooperative bank, savings banks, building societies, and more recent developments such as peer-to-peer lending and alternative currencies. In the main, the alternative financial institutions have served the needs of non-elite households and small businesses, where those needs include access to affordable credit and financial services. He

5 See also authors such as Groeneveld (2015).
"considers the extent to which various financial institutions have been able to escape the pressures or imperatives that have come with financialisation"  

Isaacs (2016) reviews the experience of a range of alternative financial institutions within Europe. He argues that “contrary to market perceptions, this lack of an exclusive focus on profit maximization does not hurt efficiency. ... Proponents of STV [stakeholder value] banks argue that they also serve to improve overall stability within the banking sector through greater diversity which is itself valuable in that it spurs creative and dynamic competition.” (p.12). The advantages of STV banks is underpinned by the specific structures of ownership, control, operations and benefits. “Critics of STV banks argue that cooperative ownership or public management may weaken members” incentives to monitor managers’ performance (as cooperative members cannot sell their shares) … or lead to political capture [in the case of publicly run savings banks]. But these dangers are purportedly obviated in the case of SHV [shareholder value] bank. While capture by special interests is possible, a principle benefit of the STV is precisely that they are not subject to shareholder value maximization pressures and “market discipline”. While this may lead to difficulties in raising wholesale finance, STV banks are able to pursue a stable banking model orientated towards the long term without incentives to take excessive risks. ...Overall, the presence of STV banks offers significant economic, systemic and welfare benefits’  

However, “STV banks have not been immune to the changing business environment and the competitive challenges posed by large commercial banks. This has, in some instance, led to them pursuing profit maximisation as aggressively as their SHV rivals and straying from their local, local risk and retail organisation”. “The evidence comparing how STV and SHV banks during the crisis is mixed”, and Isaacs provides outline of that evidence.  

Isaacs (2016) is concerned with the potential that the alternative organizational forms have. He finds from the case studies undertaken in his paper that “the business model of savings and cooperative banks have proved resilient due to their local low-risk, retail orientation and that lending by these banks to businesses has helped to mitigate recession. ... The cooperative, public or quasi-public nature of traditional building societies, cooperative banks
and savings banks therefore do stand out as potential alternatives to the financialized nature of commercial banking” (p.23)

Private owned financial (as other) institutions are generally taken to be profit maximisers (or at least seeking to gain the highest profits). It should though be noted that there has long been a stream of thought where managers are the effective decision makers in a firm and their interests are not necessarily aligned with profits – leading to arguments that managers would be more rewarded by size of their institution and its growth. The emphasis that a key element of financialisation has been the pursuit of shareholder value, as indicated above, has reinforced the pursuit of profits. Mutual, co-operative and public owned institutions, in some contrast, have objectives other than profits, though will generally have requirements to at least break-even.

More typical of cooperative financial institutions than the choice of a generally understood business sector is the choice of the market sector (group of target customers) to which financial services are offered. From this point of view, it should be first of all emphasised that, in the statement of their mission and declared directions of their activity, the majority of cooperative financial institutions emphasise concentrating their offer on meeting the financial needs of entities (households, companies, and local communities) that have financial problems and experience difficulty in obtaining access to financial services provided by commercial (usually private) financial entities.

Tomidajewicz (2015) presents data which suggest that there is great diversity in profitability though there is “no clear trend can be seen towards cooperative banks’ lower level of profitability.” The paper reports that “co-operative banks are characterized by strong capitalization (high solvency ratio), by moderate risk levels, and stable profit levels, as emphasized in the reports by Standards & Poor’s, Fitch and by FMI. The FMI report in particular points out that co-operative banks act as a buffer against any crisis in the banking system. The S&P report equally highlights their regulatory function: co-operative banks have
demonstrated their capacity to consistently produce operational results, (...) such a capacity being linked to their minimum involvement in more volatile transactions.“ 6

As Tomidajewicz (2015) indicates public banks often perform roles of savings banks with a focus on low- and middle-income customers, and others act as development banks providing access to finance for major long-term development projects.

Tomidajewicz (2015) argues that the most important aspects of the behaviour of public financial institutions include a lower focus on achieving high profitability, services offered to those who can encounter difficulties in obtaining finance from private financial institutions and can offer a strong focus on supporting development projects at local, regional, national and international scale. A unique feature of public financial institutions is also their relatively high involvement in the funding of projects characterised by a long payback period.

Tomidajewicz (2015) argues that public banks often have lower profitability and higher operating costs than private banks. “However, this does not necessarily spell a poorer achievement of social and developmental aims. As Micho et al (2004) have put it, “The paper finds that in the case of industrial countries there is no correlation between bank ownership and bank performance, but that there is a strong correlation between bank ownership and bank performance in developing countries. In particular, we find that state-owned banks located in developing countries tend to be characterized by lower profitability, higher overhead costs, and higher non-performing loans than their private counterparts. [...] We are not able to test whether the lower profitability of public banks is due to mismanagement or a development mandate and hence we cannot express any value judgment on the desirability of having state-owned banks.”

Dymarski with Tomidajewicz (2015) conclude that “in most of the cases of privatisation carried out in the European countries since the early 1980s as part of their economic policies

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this kind of analysis has not been made, and because the basic rationale and impetus for privatisation activities were broadly-understood ideas of efficient market and property rights theories, it can be concluded that these theories [of efficient markets and property rights] has been transformed from a scientific analysis of the implications of various forms of ownership into an ideology of economic policy. Also privatisation itself has been transformed in practice from a means of rationalising the economy into an instrument of an ideologically motivated restructuring of the socio-economic system. [For the Central and Eastern European countries after the fall of the socialist system in the 1990s], privatisation was transformed from a tool for achieving specific efficiency objectives into an independent aim of economic transformation policy.”

5.3 Microcredit, microfinance and mutual ownership

Microcredit differs from traditional credit because of the small size of loans, alternative collateral requirements, and non-traditional credit evaluation. Although often associated with co-operative or public ownership, microfinance can also involve private ownership. Two types of microcredit can be distinguished: microcredit for business start-ups and social microcredit. The latter type of microcredit intends to help excluded persons to finance expenses in their social and economic integration.

Microfinance Institutions (MFIs) have distinctive characteristics from commercial banks, namely they aim to obtain social impact together with a reasonable return/risk relationship; practise higher interest rates; have higher cost-to-income ratio due to the small dimension of loans; grant uncollateralised loans; sometimes use group lending; have a closer relationship with borrowers; combine credit with advisory; and use step lending techniques where larger loans are successively granted after successful repayments. Indeed, in general MFIs pay little attention to their profitability, operational costs are covered and institutions depend on public subsidies and private charity funds. See Table 1 of appendix of Lagoa (2014) for mission statements of micro finance

Lagoa (2014) draws some overall conclusions with regard to micro finance. The first concerns how the general economic environment affects the development of microfinance.
These range from public policies, structure of tax regime, bureaucracy in Sweden hampering the development of microcredit, the effects of the financial crisis of 2007/09 (examples given as Spain and Romania), and the development of the banking system recognising that there is a degree of substitutability between the banking system and the microcredit sector. Lagoa (2014) points to the factors influencing positively or negatively the growth of MFIs. “national public and EU funds and support are a key element to create and sustain the sector, filling the gap left by a market failure. Other Government policies to foster microcredit include the creation of guarantee funds and coverture of risk, simplification of processes to create micro and SMEs, tax incentives to microfinance, and the orientation of social policies to favour self-employment. Public policy is also important in creating a friendly regulatory environment for MFIs and micro-entrepreneurs”. However public policies can also create difficulties for the microcredit sector. A significant threat to the sustainability of microcredit programmes comes from their dependence on public grants, and the consequences of their ending of such grants.

“Non-profit financial institutions tend to focus on receiving deposits and making loans—the primal banking activities—and they do not normally enter the field of securities management like most mainstream banks nowadays do. As a consequence, they are less prone to large losses and some people see this as something that makes them have more trust in non-profit banks. Reinforcing this is very often their proximity to customers and the network of personal linkages that connects these banks and the local communities” (Janc, Leao, Lagoa, and Marszalek, 2014)

The poverty reduction aspect of micro-finance is intended to come from the provision of credit to those previously excluded from credit which enables them to establish a business (even if a one person business). Micro finance could also be seen as using peer pressure within local groups of borrowers as a means of reducing default rates. It has often been promoted as promoting financial inclusion and addressing gender inequalities through a focus on female participation.
However, the successes or otherwise of MFIs in poverty reduction and (self) employment creation have hotly disputed. By way of examples, consider the following. On the one side: “The emerging microfinance revolution—the large-scale provision of small loans and deposit services to low-income people by secure, conveniently located, competing commercial financial institutions—has generated the processes needed to democratize capital.... Appropriately designed financial products and services enable many poor people to expand and diversify their economic activities, increase their incomes, and improve their self-confidence. Financial institutions knowledgeable about microfinance can become profitable and self-sustaining while achieving wide client outreach. Governments and donors no longer need to provide ongoing credit subsidies; they also need not cover the losses of state banks providing credit subsidies. Over the past 20 years these characteristics of the microfinance revolution have been demonstrated in widely differing country environments.” (Robinson, 2001, p. xxx). On the other, “By the early 1990s, however, it was becoming clear that the original Grameen concept – microcredit provided to establish or expand income-generating projects – was transmuting into the much wider concept of microfinance, meaning the supply of a whole range of financial services to the poor, including microcredit, micro-insurance, micro-savings, and so on .... In particular ... it was becoming quite clear that most microcredit is actually used not so much for income-generating projects, but mainly to facilitate consumption spending.” (Bateman and Chang, 2014, p. 4). They organise their doubts on micro-finance under three headings: the construction of “hugely optimistic narrative constructed around the microfinance model [which] is actually rather seriously flawed”; that the dominant microfinance model “has not unambiguously resulted in a sustainable poverty reduction and economic development episode anywhere”; and the “intimate relationship [of microfinance] with neoliberalism and the globalisation project.” (pp.4-5) Many would argue that MFIs suffered from ‘mission creep’ and became more focused on profit than on poverty relief. Micro finance institutions have suffered from financialisation in being sucked into operating as profit-seeking financial institutions, and from the financing of consumer debt rather than provision of investment.
The ‘development model’ which lay behind micro-finance could be seen as groups (whether because poor, on grounds of gender etc.) could not otherwise secure credit, and this acts as a constraint on their economic activities. The reasons why they could not otherwise secure credit would include transactions costs for small loans, discrimination etc. Providing those groups with credit would then enable investment to be undertaken. But there is the need for support (education, management skills, infrastructure) and the need for demand for what they produce. Further, MFI represents the allocation of existing funds which detract from their use elsewhere: that may of course be socially preferred.

5.4 Foreign ownership and Internationalisation

The involvement of the financial sector with the global economies is necessarily of long-standing: after all international trade has to be financed. It is also the case that banks operating internationally is also of long-standing. However, within the European context, national owned banks have until recent years been the norm. This was re-inforced by the licensing and regulation requirements and by capital controls. Foreign ownership and foreign direct investment in the banking sector has largely taken the form of the acquisition of existing banks (‘brown field sites’) rather than the entry of new banks (‘green field sites’).

The internationalisation of the banking system has a long history, and indeed some forms of finance would accompany international trade. Janc and Marszałek (2014) identify three stages of internationalisation. They note that it had already started in the 19th century, and accelerated during the 1960s. Internationalisation of the banking and financial institutions can be seen as a necessary part of the globalisation processes, and also part of processes of financialisation, and “contributed to profound changes in banking systems of individual countries, especially developing ones. Banking institutions which took part in the process transformed into large multinational banks, conducting their businesses globally.”

In the first stage of internationalisation, from circa 1830, “the main factor that stood behind the beginning of going abroad by banks was attempts to improve financing of trade between Great Britain and its colonies.” Similar developments occurred with other colonial countries and banks developed as multinational institutions, though coming to a close at the time of
the First World War. The internationalisation process returned during the 1950s and accelerated during the 1960s as banks from the USA expanded overseas. This second stage of internationalisation were responses to “specific regulations [which] came into force in the United States. They were aimed at restoring stability in the balance of payment and boosting the American economy. They limited to a large degree opportunities to run banking activity (e.g. they not allowed to lend US dollars to finance foreign direct investments by US multinational enterprises) as well as discouraged foreigners from issuing bonds in the United States. ... It must be noticed here that enforcement of restrictions in the export of capital from the USA contributed to development of the so-called Euromarket.” However, this “second wave of internationalization was influenced not only by political and economic factors, but also by development of new technologies, especially from the IT sector. Implementation of new solutions and devices from this area into banking business caused significant decrease of its costs and strengthened competitive position of banks from industrial countries. Thus, conducting banking activity in less developed countries became much more profitable” Janc and Marszatek (2014).

Janc and Marszatek (2014) identify a third stage of internationalisation beginning in the 1990s. “Banks involved here are mainly from Europe, with special attention paid to the institutions form Spain. Expansion of the latter ones in Latin America constitutes the main strain of the third stage. As a result, Spanish banks, focused on retail banking, have become the most important players in this region.” A particular feature of this third stage was the extent to which banks were conducting retail banking operations. “It is also worth noticing that this third wave was accompanied by deregulation and liberalization of capital flows, characteristic of economic life and intellectual climate of (neo)liberalism during the 1990s. It is conducive to unification of banking services and makes so-called universal banks dominant organizational form on the financial market” Janc and Marszatek (2014).

Janc and Marszatek (2014) note that internationalization of banking can be viewed in two ways: “as a process of expanding activities by a domestic bank through expansion on foreign markets or as a process of entering foreign investors into domestic banks. The authors add
Internationalisation, whether of the banking system or more generally, has been viewed in rather positive terms by mainstream writers. One aspect of that comes from a perceived increase in competition. Internationalization is viewed as increasing the number of banks operating in a particular market – though that depends on the mode of entry – that is whether through establishment of new bank or the acquisition of existing bank. “Larger becomes the very market, on which banks may run their operations. Additionally, international scope of banks’ activity enforces improvements in safety net and supervisory frameworks. Moreover, through its interdependencies with deregulation, internationalization contributes in a way to international cooperation between supervisors from individual countries. That cooperation, in turn, is conducive to consistency of regulatory frameworks worldwide.” (Janc and Marszatek, 2014)

Janc and Marszatek (2014) note that it is often assumed that “Foreign ownership results in a positive influence on financial sector efficiency and stability. The dominance of the foreign ownership in the financial sector may have negative consequences. ...foreign-owned subsidiaries react not only to changes in the host country economic (“pull factor”), but also to changes in the parent institution’s home country (“push factor”). Therefore worsening economic conditions in the home country can force a parent institution to scale down foreign activities. Foreign institutions may be also be less inclined than their domestically owned peers to provide financing for domestic companies, having difficulties in lending to borrowers that lack the hard information to prove their creditworthiness. The small domestic banks tend to be better at relationship-lending that is based on “soft information”, such as reliability of the firm’s owner. It has to be mentioned, however, that surveys of empirical research do not provide a clear-cut answer to these concerns.” Jurek (2014b).

Janc and Marszatek (2014) conclude from their literature review that “foreign ownership seems to have a positive influence on financial sector efficiency and competition, enhancing stability of this sector through bringing capital and knowledge. At the same time, it may limit
access to credit, especially for SMEs and individuals, and import economic disturbances from their host country. Moreover, tough competition with foreign banks can put into danger the functioning of the smaller domestic banks, with DBLIs among them.” While “multinational banks have played a key role in the financial integration of global financial markets and the economic integration of individual countries ... they have also been important actors in financialization process”.

The assessment of the internationalisation process appears rather ambiguous. “Multinational banks contributed to the emergence, proliferation and transmission of financial innovations and highly risk prone operators. All activities of those institutions connected with spreading and distributing products of financial engineering on individual domestic markets (often offered to agents with lack of sufficient knowledge) contributed to greater risk (political, operational, etc.) in the individual markets as well as to great instability of the overall financial system” (Janc and Marszalek, 2014)

“The EU banking sector is dominated by domestic credit institutions, which control more than 70% of total assets”, though that would represent a considerable fall from earlier figures. “Only remaining 30% total assets is controlled by non-domestic subsidiaries and branches of credit institutions. Particularly high level of foreign ownership is observed in the new EU member states, raising concerns regarding the degree of concentration and competition.... As a result, the outburst of the global financial crisis proved the new EU member states’ banking sectors vulnerable because of high levels of foreign ownership. Policymakers in these countries became increasingly concerned that foreign-owned banks, despite their declared long-term interest in the region, would seek to cut their losses and run” (Jurek, 2014b).

Jurek (2014b) argues that foreign financial institutions are expected to pressure governments to improve regulation and supervision, and that foreign ownership may contribute to improvement of the risk management and decline in costs of financial intermediation. The presence of foreign institutions may increase competition.
5.4 Private equity companies, hedge funds, sovereign wealth funds and investment banks: roles and effects

Private equity companies, hedge funds, sovereign wealth funds and investment banks were examined in some detail in Work Package 8. Some common features of these four types of financial institutions are:

(i) with the possible exception of investment banks) they would be regarded as part of a shadow banking system and hence not subject to close regulation and not within the orbit of central bank;

(ii) as they are not clearing banks they are not creators of money and hence are providing funds on the basis of prior savings;

(iii) these financial institutions provide funds to the real sector (and other financial institutions) on different bases, but it is an inevitable feature that there are governance implications from the provision of funds, and the involvement of these financial institutions has impact on the behaviour of the real sector;

(iv) these financial institutions, as with other forms, are not passive owners of the companies acquired but in a variety of ways are involved in management etc.

(v) these financial institutions are frequently involved in the buying and selling of existing corporations which has implications for the restructuring of those corporations and of industry more generally.

(vi) They are often highly leveraged operations, where a component of their profits comes from being able to borrow at rates of interest below the rate of profit.

5.4.1 Nature and scale of these financial institutions

Although the terms of private equity companies, hedge funds, sovereign wealth funds and investment banks are in common use, there is often a lack of precise definitions of those terms and within each of the categories there is diversity.

Private equity and venture capital

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7 This section draws very heavily on the synthesis prepared for Work Package 8
There are different types of private equity companies differentiated by the businesses in which they invest in and the degree of control exercised the investment. On the one hand, private equity investments, made to a company at a ‘seed’ stage, are typically performed by an ‘angel investor’ or venture capital firms and offering minority control. On the other hand, private equity firms, invest in companies that are well established and take majority control. Further, “there are private equity funds of funds that consolidate investments from many individual and institutional investors to make investments in a number of different private equity funds. This enables investors to access certain private equity fund managers that they otherwise may not be able to invest with, which diversifies their private equity investment portfolio. Private equity funds of funds represent the largest portion of committed capital in the private equity market” (Pitelis and Anthopoulos 2014).

One of the distinguishing features of private equity is the fixed life aspect. A fixed life of 10 years, extendable for up to three additional years is usual for a private equity fund. Within this time frame, “the private equity firm has up to five years to invest the raised capital into its targeted companies, and then has the remaining five or eight years to return the capital to its investors. Once this capital has been committed, the limited partners have little control on how the general partners’ use the investment capital, as long as the contract of the fund agreement is followed” ". Private equity leverage up the funds through loans, which leads to higher but riskier returns on equity [provided that the rate of return exceeds the rate of interest on loans].

Venture capital also does not have a strict definition. There are though distinct features which serve to distinguish venture capital investments from other investment classes. “Most importantly, the main function of private capital is to provide direct financial intermediation, taking investors’ capital and investing it in the form of an equity investment, to potentially high growth business developments. Legally, a venture capital fund is often organised as a limited partnership, where the venture capitalists act as the general partners of the fund and the investors act as the limited partners. Since the ERISA provision changes in 1980, 44% of the funding provided by the limited partners has been pension funds, with the next major
group classified as financial institutions (such commercial banks, investment banks and insurance companies) providing 18% of the committed capital. Venture capital firms receive their compensation in two ways; through management fees and carried interest. General partners earn an annual management fee, expressed as a percentage of capital raised, and also a share of the profit of the fund, known as ‘carried interest’, often at circa 20%” (Pitelis and Anthopoulos, 2014).

Pitelis and Anthopoulos (2014) find that prior to the 1980s, private equity funds grew out of venture capital partnerships. “In the 1980s however, a number of partnerships were exclusively formed to provide capital for non-venture financing, giving rise to the so called ‘buy-out’ funds. These funds by 1986 overtook the capital raised by venture capital partnerships by almost $5 billion. Acharya, Franks and Serves, (2007) report the private equity (leveraged buyout market) in Europe and the USA growing from $7.5 billion in 10001 to $500 billion in 2006.

In the second half of the 1990s the venture capital market grew rapidly along with the dot.com bubble. Metrick and Yasuda (2011) report a boom of venture capital investment from $7.9 billion in 1995 to a peak of $104 billion in 2000. Venture capital investments as a percentage of GDP from 2002 to 2008 for example, averaged 0.2%, well above the levels in the 1980s and about the same as those experienced in 1997 and 1998. Pitelis and Anthopoulos (2014), drawing on working of Acharya, Franks and Servaes (2007) report that “From 2001 up to 2006, these private equity funds experienced an astounding growth marking the second buy-out boom; specifically, new transactions in 1991 amounted to $10 billion and by 2006 this value reached $500 billion”.

Hedge funds

The term ‘hedge fund’ is defined in a range of ways and the term is used to refer to a number of different vehicles sharing a range of similar features. An overarching definition that may be used is that a hedge fund is “any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public” (Report of the President’s Working Group on Financial Markets (1999), p.1). There are though
some common characteristics that all hedge funds share. “Firstly, it is usually the case that these funds are organised as limited partnerships or limited liability companies in order to give the hedge fund manager full control in his investment strategies. Secondly, the investors of the fund are organised as limited partners and are attained only through private offerings. Thirdly, as recent media stories have highlighted, hedge fund managers often charge a management fee (2% of fund profit) and performance fee (20% of fund profit) (Ibid). … A last common characteristic that hedge funds share is a lock in period that could be up to two years; this period restricts investors from taking out their money from the fund and allows the fund manager to buy and keep illiquid assets without them being forced to sell at short notice.” (Anthopoulos, Pitelis and Mathioudaki, 2016)

Anthopoulos, Pitelis and Mathioudaki (2016) note similarities of hedge funds and private equity, as both pay high management and performance fees, and both are lightly regulated. They report from the work of Stowell (2010) that hedge funds have over $1.9 trillion in investor capital at the end of 2007. Leverage coming from debt and derivative positions, the total investable assets were estimated to be $6.5 trillion with an implied leverage ratio. By way of comparison, this amount was slightly less than one third of the total investments controlled by insurance companies and slightly more than one-fourth of the investments held by pension funds.

**Sovereign Wealth Funds**

The International Working Group on Sovereign Wealth Funds (IWGSW) established under the support of the IMF, specify that SWFs are ‘special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, sovereign wealth funds hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts resulting from commodity exports” (IWGSW, 2008, p.27). SWFs are growing according to Aizenman and Glick (2008), representing $3.1 trillion of major
global investment pools, while at the same time hedge funds were at $1.9 trillion and private equity funds at $0.8 trillion.

Anthopoulos, Pitelis, Liakou, (2016) report on the range of size of SWFs “from under $1 billion to as large as an estimated $737 billion in the case of Norway’s Government Pension Fund Global. They calculate based on 2013 data from Sovereign Wealth Fund Institute that “seven countries (Norway, China, Kuwait, Russia, Saudi Arabia, Qatar, Singapore and the UAE) accumulate over 80% of the total SWF assets, with each of them possessing funds of over $100 billion. SWFs assets reached $4.5 trillion by the end of 2010. In contrast, private equity funds reached $2.6 trillion and hedge funds reached $1.8 trillion .... Moreover, by the end of 2013, SWFs are estimated to control assets totalling nearly $6 trillion.”

“In Kern’s (2009) study the author examined the geographic destination of SWF investments from 1995 to 2009 and found that it is rather equally shared between Asia, which receives 31% of all transactions, Europe, which receives 30% and the US, which receives 20%. The United Kingdom attracts the greatest portion of SWF investments in Europe, equalling to almost 50% of the total amount invested; Germany is the second largest recipient, but far behind the UK, with less than 15% of total EU investments. Kern (2009) argued that the distribution in the EU is consistent with the emerging SWF investment trend in the financial sector that appeared before and during the financial crisis.

Kern (2009) showed that in the period from 1995 to 2009 SWFs investments were mainly directed to the financial sector, which attracted 42% of total investments or $78 billion of the total. Kern (2009) showed that the rest of the investments made by SWFs in 2009 went to the: manufacturing industry ($25 million or 14% of total), services and retail sector ($24 million or 13%), real estate sector ($21 million or 11%), energy and raw material sector ($18 billion), technology sector ($17 million or 9%), and defence sector ($2 million or 1%).” Anthopoulos, Pitelis, Liakou, (2016).

The IMF identifies five types of SWFs. These are:

- stabilization funds, that try to smooth boom or bust cycles and stabilize the fiscal impact
savings funds, that focus on the spread of wealth in current and future generations evenly
reserve investment funds, that aim in the increase of return
development funds, that focus on investments in policies in the home country
contingent pension reserve funds, which aim to build assets in order to add towards future funding liabilities.

Investment Banking

“The activities of investment banking, on the other hand, can be grouped into three main areas, all of which are supported by a research department. These are:

i. Underwriting and advisory
ii. Asset management
iii. Trading and brokerage

The first activity, underwriting and advisory, is considered the core task of an investment bank and is handled by the investment banking division. Underwriting is considered the most important task of an investment bank as it works with corporations or even government agencies in need of financing by raising capital in the financial markets by issuing securities. Securities can take the shape of a wide number of financial instruments such as equity, debt or “hybrid” securities such as debt with warrants” (Anthopoulos and Pitelis, 2016).

Providers of funds

The financial institutions considered above are in effect drawing of the funds of households and firms to pass on to corporations. The source of funds is often rich individuals, and the funds supplied to corporations come with control attached. The significance of these financial institutions comes from the terms on which the funds are provided.

“Venture capital is shown to intersect with the mezzanine section; mezzanine refers to a type of late-stage funding that venture capital funds, along with hedge funds and buy-out funds, provide in the form of subordinated debt that includes some equity participation. Most recently, mezzanine financing is usually only provided in high leveraged buyout transactions by non-venture private equity funds (buyout funds). The next group, buyout funds is the
largest category of private equity, with total funds under management estimated to be three times more than venture capital. A key feature of a buyout fund is its use of high leverage and also the fact that they almost always take majority control in their targeted company. On the other hand, a venture capital fund does not use leverage in financing its investments and usually only takes a minority stake in its portfolio company. Moreover, buyout funds, in contrast to venture capital, does not aim to achieve internal growth; in fact, buyout funds seek to invest in an existing company in an old and established industry where the fund’s aim is to create liquidity for the portfolio company. In addition, these non-venture private equity funds may also execute a strategy called “buy-and-build”, where they focus on acquiring a chain of firms in one industry with the intention of merging them together, in order to foster revenue growth and gain a larger market share” (Pitelis and Anthopoulos, 2014).

“The previous findings support the idea that availability of credit affects booms and busts in the private equity market. When private equity firms buyout at market peaks and use high leverage, we expect industries with heavy buyout activity to experience an intense subsequent downturn.” (Pitelis and Anthopoulos, 2014).

**Performance of the financial institutions**

The financial institutions covered here, and notably hedge funds and private equity, are promoted on the grounds that they are able to move funds into areas of high returns and through intervention and purchase of underperforming companies enhance efficiency. Anthopoulos, Pitelis and Mathioudaki (2016) conclude that the literature on the performance of hedge funds (relative to the stock market) does not provide a clear answer. They remark that the unregulated nature of hedge means that unbiased data on their activities is difficult to find. “This problem is referred to as the survivorship bias and refers to how the data available to researchers might be skewed since only well performing hedge funds have the incentive to voluntarily declare their earnings.” Further, “in calculating a hedge fund’s performance is the difficulty in adjusting the performance to market exposures. For example, if a hedge fund has a similar performance to the S&P 500 index in returns and volatility, then
it could be said that the investor could have just invested in an indexed mutual fund with lower fees whilst receiving the same return. However, due to the multiple strategies a hedge fund can use, such as going short/long or make use of derivatives, the fund’s exposure to the market varies over time, making it difficult to calculate these exposures over a short period of time.”

Anthopoulos, Pitelis and Liakou, (2016) conclude that “on the whole, the academic body of literature suggests that SWF investments help create value in the firms they invest in at the time of the announcement [of acquisition].” This may be similar to the usual finding that the share price of a firm subject to acquisition rises. Further, “since SWF invest in large underperforming companies with financial difficulties, any announcement to invest in these distressed companies will be highly welcomed as positive information is spread to investors.” However, studies on the longer term effects of SWF investment have found differing results. “On the whole it is clear that more empirical research is needed to give a clearer answer as to whether the effects of SWFs on financial markets are stabilising or not.” They suggest, following Curzio and Miceli (2010) that “SWFs up until now exhibit behaviour typical of an economically rational investor seeking profit maximisation” with some exceptions where “SWFs have acted with a political agenda in mind”, and give some examples of such behaviour.

**Regulatory issues relating to these institutions**

The financial institutions being covered in this synthesis have often been outside the main frameworks of regulation and operating as what would now be termed ‘shadow banks’. These financial institutions were not involved in the payments system nor in general deposit takers. As such they do not have the relationships with central banks and with regulators that commercial banks have had. In this section some of the ‘peculiarities’ of the regulation of these financial institutions is covered.

**Sovereign Wealth Funds**

“SWF investments are subject to varying regulation policies, which are greatly shaped by the recipient country’s view on what challenges these funds present. Thatcher (2012) argues that
broadly, there are two perspectives that have dominated the regulatory framework of a country towards SWF investments, a concern over economic governance or one over national security. He claimed that the EU and UK have regarded SWF investments more as an economic governance issue, with the policy ideology and choice leaning towards ‘free trade’ rather than ‘protectionist’ measures. On the other hand, the US policy debate is highly contested, with views separated between the presidency, which favors an open free trade measures and Congress, which view SWFs as a national security issue. Lastly, in recent years a convergence towards a coordinate multilateral framework has emerged, which has been supported by both recipient countries and SWFs.’ [Anthopoulos, Pitelis and Liakou, (2016)]

The regulation of investment banking has, particularly in the context of the United States, been bound up with the range of activities which investment banks can be involved in and their relationship with clearing banks. The Glass-Stegall Banking Act of 1933 imposed a strict legal separation between commercial bank activities and investment banking. Under the Act commercial banks deposits were guaranteed by government with commercial banks prohibited from taking equity positions in firms and underwrite corporate securities. „Proponents of the Glass Steagall Act argued that this separation was crucial since it was the aggressive practices of commercial banks that encouraged reckless issuance of speculative securities and the credit expansion produced by these securities that followed, plunged the economy and inflicted severe losses to investors”.The Glass –Steagall Act was repelled by the Gramm-Leach-Biley Act enabling the growth of universal banks, and the involvement of banks in securitisation etc.. “In the aftermath of the financial crisis, a spate of regulations has evolved which are expected to have an impact on multiple facets of the investment banks’ business. The following exhibit provides a summary of these regulations along with the regions in which they are expected to have an influence and the areas of business that they are expected to impact” [Anthopoulos and Pitelis, 2016]

Hedge Funds

“Hedge funds in the United States were traditionally under- regulated as they were exempted from the Securities Act of 1933 (which regulates public offerings), the Securities Exchange
Act of 1934 (which imposes disclosure on public companies), the Investment Company Act of 1940 (which regulates mutual funds) and the Investment Advisors Act of 1940 (which regulates investment advisers). However, they were held accountable to the Commodity Futures Trading Commission (CFTC), state level securities laws, anti-fraud provisions, anti-laundering requirements and other legal considerations.” (Anthopoulos, Pitelis and Mathioudaki (2015)

Private Equity

“Historically, private equity and venture capital funds in the United States were under-regulated as they were exempted from the Investment Company act of 1940 and the Investment Advisors Act of 1940. However, they were held accountable to the Anti-Fraud laws, ERISA-Related prohibitions, and other legal considerations.”

Restructuring

Financial institutions as partially or total owners of companies have direct and indirect effects on the operations of the companies concerned. The indirect effects which have been much discussed concern pushes towards the ‘pursuit of shareholder value’ (where, of course, the financial institutions are the shareholders) and ‘short-termism’.

In the Anglo-Saxon world at least with what was deemed to be a more market-based financial system than others with a bank-based system there has been a long history of concern over acquisitions and take-overs. On the one side, takeovers and acquisitions and the threat of them have been seen in terms of the ‘market for corporate control’, the disciplining of management etc.. On the other side, as a route through which market power was enhanced. There has been a long literature of the roles of acquisitions, take-overs etc on performance. The idea of a ‘market for corporate control’ focused on the notion that the potential purchase of a company by another would have beneficial effects on the performance of the company concerned. As Pitelis and Athopoulos (2014) argue these arguments can be applied to the case of private equity companies. “Jensen (1989) first adopted a conceptual framework to explain why a change in the ownership structure resulting from a private equity buyout may result in a positive impact on a firm’s performance. He maintained that private equity funds
have stronger incentives and capabilities to enhance the firm’s efficiency by closely monitoring the firm’s management, incentivizing managers with equity and restricting wasting resources through the disciplining role of debt. Lastly, he also hypothesized that leveraged buy outs not only affect the bought out company but also increase competition in the industry by forcing competitor companies to improve their own operations.” (Pitelis and Anthopoulos (2015))

**Employment and wages**

Pitelis and Anthopoulos (2014) find that the results of research in the private equity literature is mixed with respect to both wage and employment and they summarise a range of findings. They do though further report that a comprehensive analysis by Davis et al. (2011) reports “that employment growth is lower among private equity–backed firms and plants in the aftermath of such transactions. However, job growth at such firms start to improve four years after the deal. Bruining et al. (2005) find that MBOs resulted in the United Kingdom and the Netherlands in an improvement in human resource management practices. Specifically, they found that there were higher levels of employment, employee empowerment, and wages. “These effects were found to be stronger in the United Kingdom than in Holland and point to the importance of recognising different institutional contexts even within Europe.

Davis et al. (2011) constructed a dataset covering US private equity transactions over the period 1980 to 2005 tracking 3,200 target firms. They find that “relative to controls, employment at target establishments declines 3 percent over two years buyout and 6 percent over 5 years. ... But target firms also create more new jobs at new establishments, and they acquire and divest establishments more rapidly. ... In short, private equity buyouts catalyse the creative destruction process in the labor market, with only a modest net impact on employment.” (Abstract). In a further paper Davis et al. (2013) found that “buyout also bring TFP [total factor productivity] gains at target firms and reductions in earnings per worker. Productivity gains arise mainly from an accelerated exit of less productive establishments and greater entry of more productive ones—that is, from a directed reallocation of jobs within target firms.” (abstract)
Harris et al (2012), based on performance of nearly 1400 US private equity funds find “average U.S. buyout fund performance has exceeded that of public markets for most vintages for a long period of time. The outperformance versus the S&P 500 averages 20% to 27% over the life of the fund and more than 3% per year. Average U.S. venture capital funds, on the other hand, outperformed public equities in the 1990s, but have underperformed public equities in the 2000s”

5.5 Allocation of Funds

Small and medium sized enterprises

Microfinance (MF) plays a particularly important role in meeting the financial needs of SMEs (Tomidajewicz, 2014; Janc et al., 2015). Some of the most noteworthy institutions involved in MF include savings banks, cooperative organizations, credit unions, and the public sector (see for instance Lagoa, 2014). Moreover, as pointed out by Tomidajewicz (2015) and Lagoa (2014), the level of MF development in each country is particularly affected by the general economic environment, while there also seems to be some substitutability between MF and the formal banking sector.

Lagoa (2014) discusses the development of MF in eight European countries. As the author asserts national differences are large, while the precise institutions involved in MF also differ across countries. France and Spain appears to have two of the most developed MF sectors in terms of total value of loans and number of loans, whereas in the UK MF appears to be rather small. Janc et al. (2015) provide further discussion for the cases of Poland and Portugal. Overall, Lagoa and Suleman (2014) show that although young, the MF sector has grown fast since the 2000s with the number of loans rising by seven and a half times between 2003 and 2011 and the total funds provided increasing by five times.

Lastly, as asserted by Lagoa (2014) one of the key threats to the sustainability of MF is its dependence upon public grants.

Research and development

Urbania and Mamede (2015) examine the impact of the crisis upon European R&D expenditures. In particular, the authors note that the crisis has had an uneven impact across the European economies, mostly affecting developed countries such as the UK and Spain. As
a result, a trend of convergence can nowadays be detected across the EU. On average however both the EU15 and the EU28 have experienced a continuous increase in their R&D expenditures since 2004, with only a temporary halt in 2009. Moreover, given the quick recovery from the crisis, Urbaniac and Mamede point out that despite certain exceptions, the EU as a whole has achieved a positive and counter-cyclical trend in its R&D expenditure. A breakdown of the data by sector is also included in their report.

Green investment
Gabbi and Ticci (2014) review the literature on financialization and green investments. According to their findings the impact of financialization can be seen from different viewpoints. On one hand it can be argued that financialization brings along a shift towards a short-term investment horizon and thereby drives away funds from green investments, which usually involve more medium to long run projections. On the other hand, it can be stated that the wave of borrowing that came along with financialization can increase the overall resources available for green projects. As Gabbi and Ticci note the actual impact of financialization is not an automated one, but crucially depends on the underlying institutions, policies and information transmission mechanisms.

Papandreou (2015) asserts the impact of the crisis on the transition towards a low carbon economy. As he notes the outburst of the crisis coincided with a relative peak in climate action. Nonetheless the crisis has brought along a shift of focus and policy priorities, away from climate action and towards economic recovery, so that a lost opportunity to propel the low carbon transmission can be identified. On the other hand, Gouldson et al. (2015a) and Gouldson et al. (2015b) attempt to think of possible funding opportunities for investments in energy efficiency and low carbon development within the current context of austerity. Most notably the authors put forward the idea of revolving funds. Key element of the idea is to capture savings from green investments and reinvest them either in order to reduce the need for new finance, or to expand the impact of the already available financial resources. Furthermore, the authors point out that public and civic sector (e.g. grassroots movements) initiatives have a significantly higher potential to benefit from revolving funds in terms of
levels of investment and spillover effects, as compared with the market-led private sector ones.

5.6 Corporate Social Responsibility

As discussed amongst others by Consolandi et al. (2016) and Jurek (2014a), corporate social responsibility (CSR) initiatives have seen a significant growth throughout the last three decades, while Stakeholder Theory (ST) has emerged as a key theoretical anchor. Although often identified as a vague and all-inclusive concept, CSR’s main idea is that a corporation should incorporate environmental, social and governmental (ESG) concerns as part of its long term horizon, and focus not only on the wellbeing of its shareholders, but also on all of those who have a legitimate interest in its performance (e.g. employees, creditors, suppliers, customers, local communities).

Despite the growth of CSR initiatives, a countermovement associated with the process of financialization has also been identified (Consolandi and Cupertino, 2015a; Consolandi et al., 2016). As Consolandi and Cupertino discuss, financialization has promoted the culture of short-term investment behaviour, driven by a speculative rather than an entrepreneurial mentality, and has therefore imposed a barrier to the promotion of CSR, since the latter is usually seen as a more long term concern.

Besides the virtue that CSR can have on its own sake, it also appears to matter for business-related purposes. Consolandi and Cupertino (2015a) offer evidence showing that socially responsible companies tend to face lower leverage (i.e. debt to equity) ratios. Moreover Consolandi and Vercelli (2015) conduct some experimental work and show that not only expected returns, but also CSR performance plays a role in influencing investors’ decision making. In addition, Consolandi and Cupertino (2015b) offer supportive evidence for the idea that reputation (which is crucially affected by CSR factors) is positively related with firms’ market performance. For the case of banks, they also show that when shareholders’ and managers’ interests are aligned (measured by the fraction of shares held by managers) the overall reputation of a bank can be negatively affected, due to the short-term focus that such alliance can reflect.
Moreover, the recent global crisis exposed the inefficiencies of the current CSR regulation framework in the financial sector (Jurek, 2014a). As Jurek points out, despite the expenditure cuts undertaken by lots of financial institutions, there is at the same time an effort to focus on CSR as a means to restore confidence and regain their reputation (a phenomenon labelled as the ‘wake-up call’ effect). All in all the author asserts that there needs to be an optimal combination between formal regulation and self-regulation in order to create a sustainable financial system. Public authorities should supervise CSR in the financial sector, while also creating a fertile environment for the dissemination of CSR ideas. In addition, a transition towards a more global regulatory system is required.
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Table 5.1 Cooperative Banks – Market shares of assets 1994-2003 (as % of total banking system assets)

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Austria</td>
<td>...</td>
<td>29.4</td>
<td>29.5</td>
<td>35.6</td>
</tr>
<tr>
<td>Finland</td>
<td>18.5</td>
<td>17.5</td>
<td>16.2</td>
<td>15.9</td>
</tr>
<tr>
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<td>28.4</td>
<td>27.9</td>
<td>28.1</td>
<td>24.1</td>
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<td>14.3</td>
<td>12.4</td>
<td>9.8</td>
<td>10.3</td>
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<tr>
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<td>...</td>
<td>0.2</td>
<td>0.3</td>
<td>0.6</td>
</tr>
<tr>
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<td>...</td>
<td>17.0</td>
<td>16.8</td>
<td>14.9</td>
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<tr>
<td>Netherlands</td>
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<td>21.2</td>
<td>29.0</td>
<td>26.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>...</td>
<td>3.5</td>
<td>3.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Spain</td>
<td>3.0</td>
<td>3.5</td>
<td>3.7</td>
<td>3.9</td>
</tr>
</tbody>
</table>

1/ Including savings banks, before and after their conversion to cooperative banks in 2000


Table 5.2

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate of return on assets (%)</th>
<th>Domestic market share deposits (%)</th>
<th>Domestic market share loans (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>-0.1</td>
<td>35.15</td>
<td>33.74</td>
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<tr>
<td>Bulgaria</td>
<td>0.17</td>
<td>5.83</td>
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<tr>
<td>Cyprus</td>
<td>0.30</td>
<td>26.90</td>
<td>21.20</td>
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<tr>
<td>Denmark</td>
<td>0.04</td>
<td>4.90</td>
<td>32.00</td>
</tr>
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<td>Finland</td>
<td>0.57</td>
<td>34.00</td>
<td>32.80</td>
</tr>
<tr>
<td>France</td>
<td>0.28;0.42;5.40</td>
<td>61.80</td>
<td>59.00</td>
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<tr>
<td>Germany</td>
<td>0.07</td>
<td>20.90</td>
<td>20.10</td>
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<td>0.01</td>
<td>1.11</td>
<td>0.80</td>
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<td>0.47</td>
<td>8.69</td>
<td>4.44</td>
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<td>-0.93;0.20</td>
<td>33.40</td>
<td>33.20</td>
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<tr>
<td>Lithuania</td>
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<td>0.30</td>
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<td>Netherlands</td>
<td>0.28</td>
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<td>Poland</td>
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<td>n.a.</td>
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</tr>
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Source: Key figures from European Association of Co-operative Banking
http://v3.globalcube.net/clients/eacb/content/medias/key_figures/2014_key_statistics_financial_indicators.jpg
Where two or more figures given in column 2, the rates of return refer to sub-sectors.
Market share figures are combined from sub-sector figures where required
Figure 1. Total Private European and U.S. Securitization Issuance (In billions of U.S. dollars)

Sources: Association for Financial Markets in Europe; Bloomberg; IMF staff calculations; and the Securities Industry and Financial Markets Association.
Note: Figures for 2014 are annualized based on data to September.
1 European securitization includes asset-backed securities (ABS), collateralized debt obligations, mortgage-backed securities, small and medium enterprise securitizations, public finance initiatives, and wholesale business securitizations.
2 U.S. securitization includes ABS, commercial mortgage-backed securities, and residential mortgage-backed securities.

Source: Segoviano, Jones, Lindner, and Blankenheim (2015)
Chart 9 Shadow bank liabilities versus traditional bank liabilities in the US

Source: Flow of Funds Accounts of the United States compiled on the basis of the definitions from Pozsar et al., (2010).

Source: Bakk-Simon et alia (2012)
Bibliography


This project is funded by the European Union under the 7th Research Framework programme (theme SSH) Grant Agreement nr 266800
Table 2.1 Size of banking and stock market by country

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Source: Financial Development and Structure Dataset (compiled by Aslı Demirgüç-Kunt, Martin Čihák, Erik Feyen, Thorsten Beck, Ross Levine)
Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'
Chapter 6. Financialisation, Society and Social Well-being

6.1 Introduction

This chapter brings together the research of FESSUD which relates to the financialisation of everyday life and of society. In the FESSUD Description of Work (and seen again in Chapter 1), the FESSUD project spoke in terms of examining the effects of financialisation on society, social life and well-being. The ways in which the financial sector has expanded its activities into society stand as an outstanding feature of the present era of financialisation. The ‘financialisation of the everyday’ has been identified by van der Zwan (2014) as one of the major approaches to the study of financialisation. This approach ‘appreciates the diverse ways in which finance is grounded in practices of everyday life. These studies have interrogated projects and schemes aimed at incorporating low-income and middle-class households in financial markets through participation in pension plans, home mortgages and other mass-marketed financial products. Finance has become a decentralized form of power in this body of work, exercise through individuals’ own interactions with new financial technologies and systems of financial knowledge.’ (p.102)

This chapter is structured in the following way. Section 6.2 discusses financialisation and material culture. The rise of household debt has often been viewed as a characteristic of financialisation processes of the past few decades, and involved in the generation of financial crises. One of the aspects of financialisation has been seen as the dramatic rise of household debt, and that rise in debt particularly in terms of sub-prime mortgages in the USA seen as at least a contributory cause of the financial crisis. Section 6.3 reviews the work of FESSUD in respect of household debt, its growth and relationship with inequality. The following two sections report on empirical work conducted within FESSUD on the financial sector and well-being. Section 6.4 reports on the conclusions from participatory research across nine countries. Section 6.5 draws on the findings of the FESSUD Finance and Well-being Survey conducted across five countries was designed to assess the impact of financialisation and of the financial crisis on well-being. Section 6.6 provides a policy report on social impact of the financial crises with particular reference to Portugal and the UK. The central topic of section
6.7 is financialisation and pensions. The systems of provision approach is applied to housing and water, drawing on case studies undertaken within FESSUD. In section 6.9 there is an overarching policy report on financialisation and well-being.

6.2 Financialisation and Material Culture

Fine (2013) argues that the impact of financialisation on households can be felt in terms of the broader provision of services and welfare in the lives of people, as well as in the culture it produces. In particular, Fine observes that finance has made its presence more intensive in areas where it had already operated, and financial operations have extended into fields related with social reproduction, such as housing and pensions where it had often not operated. In doing so, finance has been promoting the privatisation and commodification of such fields, downgrading citizens to consumers, and promoting the idea of individual responsibility.

Fine (2013) suggests the following themes (‘10Cs’) for the investigations of financialisation and culture.

’Constructed – to what extent are households directly or indirectly impacted upon, and conscious of, structures, agents, relations and processes of financialisation as opposed to being merely the customers of financial products (and which of these)

Construed—whilst embroiled within financialisation in particularly ways, to what extent is it close in this sense but equally extremely distant in terms of the knowing of finance in the broadest sense of more or less informed understandings of the financial system and its workings and implications.

Commodified – to what extent has financialisation been a consequence of changing forms and levels of provision which are themselves linked to broader shifts in economy and society

Conforming – this might revolve around financial literacy and the ways in which it both conveys and conceals knowledge of the financial systems and both misinterprets the nature of the material culture of financialisation and potentially reinforces the ‘deviancy’ it is intended to temper (not least by intensifying competitive pressures around credit markets for those with limited access
Contextual—this might tease out differentiated responses to financialisation according to circumstances of the household

Contradictory—explore attitudes to saving and spending

Closed—powerlessness

Contested—democratisation of finance as mythology of market

Collective—consumer, citizen, organisations and national responsibilities.

Chaotic—all of the above but possibly learning to highlight these on the ground’

[Fine, 2013, pp. 33-34]

A reflection of the material culture of financialisation and the downgrading of citizens to consumers can be seen in financial education initiatives (Santos, 2013; Gabor, 2013). As pointed out by Santos, despite their apparent neutral and de-politicised appearance, such initiatives function as part of the wider neoliberal strategy that aims to transform values, perceptions and attitudes towards a direction favourable to market expansion. Taking the reconfiguration of the welfare state as their starting point, financial education initiatives promote the idea of individual responsibility in engagement with finance. In that way, such initiatives help to shift attention away from systemic failures and towards individual wrong doings. While financial education initiatives were at the forefront of the agenda prior to the crisis in the name of financial inclusion (for discussion see Gabor, 2013), Santos observes that they have also been an integral part of the post-crisis political discourse that seeks to promote finance as the solution to the problems it itself created.

Santos (2013) considers arguments advanced by national and international agencies committed to advancing financial education programmes. ‘[T]his commitment is symptomatic of financialised contemporary capitalist societies that have promoted the steady integration of individuals and household into financial markets.’ The manner of many welfare state reforms promoting more private provision are requiring individuals to be responsible for their future financial positions, expanding the demands for financial products and services. ‘Financial education agenda is instrumental to this endeavour, exposing the dominance of neo-liberal ideology with its emphasis on the promotion of the self-reliant
individual ... Financial education is thus an important element in the analysis of the material culture of financialisation and how these interact with experiences of financialisation.’ (Abstract)

Another dimension of the material culture of financialisation relates with the role of the media. The issue is examined in detail by Happer (2013) who shows that mainstream media have been systematically operating in a way that favours the market and corporate interests. Effectively this has implied the shaping of sympathetic attitudes towards particular directions, and the limitation of the space for discussion of alternative narratives and solutions. Particularly in the case of finance and the discussion of the financial crisis, Happer asserts that such influence has been masked by the limited immediate experience of the public with ‘high’ finance, and the consequent treatment of financiers as the ‘experts’.

Gabor (2013) explored the scholarship and policy discourses around financial exclusion. It first maps the theoretical journey of the concept, from deeply political origins in the work of economic geographers to a depoliticized, methodologically individualist re-framing in policy discourses pre-crisis. This mainstreaming wrote off the spatial, social or institutional dimensions to exclusion, presenting it as a combination of market and individual failures resolvable through state intervention and financial literacy campaigns. The crisis then generated a new wave of critical readings of the financial inclusion agenda that departs from treating households as (future) consumers of financial services. One strand draws on Foucauldian ideas about the production and governance of financial subjectivities. This overlaps with the approach of the FESSUD project towards the material culture of financialisation in relationship to broader historical changes in systems of provision. In this approach, the relevant question is how subjects (households) engage with, and resist, financialisation both through material practices and ideas/meanings that shape subjectivities.

6.3 Financialisation and household debt

The general rise of household debt (relative to household income and GDP) has been a widespread phenomenon during the present era of financialisation. Santos and Teles, (2013,
p. 16) note that much of the accounts of household debt has been based on USA and UK. In general, though, ‘at a lesser pace and scale, other countries have undergone processes of financialisation, which have also involved individuals and households’. Although from different starting points, proceeding at different speeds, and interacting with what appear to be different attitudes to debt, the rise of household debt has been near universal. Its role in contributing to ‘boom and bust’ and instability is much debated, as is its role in the generation of the 2007/09 financial crisis (in conjunction with rising inequality and securitisation of loans) as discussed in Chapter 2.

Karacimen (2013) finds that a key argument in the financialisation literature ‘is how developments in the financial sector created room for the expansion of consumer credits and paved the way for integrating individuals into finance through changes in their saving and borrowing patterns. … [I]n the age of financialisation banks turned towards individual income as a source of profit … as a part of their business diversification. … There have been several reasons for the changes in the banking sector activities …. Apart from structural reasons such as the changing financing behaviour of corporations, innovations in the financial markets in the last few decades have been key to integrating broader segments of the society into the financial system. Together with developments in the new information technology and advances in risk management techniques, it has become easier for banks to obtain information about a greater number of prospective borrowers. Similarly, the increasing use of securitization, especially in advanced countries, has enabled banks to generate further liquidity and provided means for extending consumer credit to larger numbers. With securitization banks regularly bundled the debt from credit users and sold it to investors in the securitisation market … As asset-backed securitization provided cheaper source of funding, it has become an important element of the extension of credit to broader segments of society.’

Karacimen (2013) argues that the current rise in consumer credit and household debt is historically unique. ‘An accurate understanding of the phenomenon necessitates including a multidimensional analysis of the many transformations that capitalism has been undergoing
such as transformations in the welfare systems, changes in labour markets and developments in the financial sector’ (p.2).

The US subprime crisis illustrated the involvement of households with the financial system. ‘Although this new engagement of households with the financial sector has been explained by an array of both demand and supply factors (e.g. new norms of consumption and technological innovation), social constraints have been pointed to as primary causes by the burgeoning financialisation literature. .... This literature has related rising levels of household debt to stagnant income, rising inequality and the retrenchment of the welfare state. Faced with new consumption norms and real income stagnation, low and medium-income households incurred in rising levels of debt, it has been argued, in order to keep up with consumer demand emerging in an increasingly unequal society marked by the growing privatisation of public provision, promoting the expansion of finance into new areas of provision.’ (Santos and Teles, 2013, p.15). However, Santos and Teles (2013) argue the ’role of social constraints in the analysis of household financialisation is not limited to debt incurred by vulnerable households. .... Diverse social standings imply different, but inter-connected, relations – in terms of access, types of assets and liabilities, and costs and returns – with the financial sector’ (p.15) with richer households tending to hold riskier financial assets and greater access to debt through growing financial wealth. The growing involvement of households with financial institutions means those institutions acquiring considerable information of households financial position (e.g. ownership of financial assets) as well as past credit history, stimulating the segmentation of particular financial markets ... tailored for different household financial standings. ‘This suggests that besides the mere intensification of households’ financial dealings, more qualitative transformations may have also been occurring and reflected in the diversification of market segments’ (p.15).

The examination of aggregate data is useful for identifying the wide trends that have been taking place across countries. In this direction, Santos and Teles (2013) examine sixteen EU countries, which are grouped based ‘on Bruno Amable’s (2003) taxonomy of financial systems for Europe, which draws on the classic bank-based versus market-based dichotomy. Based
on a large number of financial indicators and the identification of three relevant factorial axes – the size of the economy, the presence of foreign banks, the bank balance sheet structure or ownership – Amable grouped four different clusters of countries, one market-based and three bank-based, concluding that a slow convergence to the more liberal market-based model was taking place. For the purposes of the analysis, three different groups of EU countries were composed:

1) The *Early Financialisers* comprises the UK, the Netherlands, Ireland, Denmark and Sweden. It gathers countries (UK, NL) that qualify as market-based systems as put forward by Amable in that they ‘are characterized by the importance of institutional investors and particularly pension funds, the importance of the stock market indicated by a high capitalization relative to GNP, a well-developed venture-capital system, high mergers and acquisitions activity, and a low concentration of ownership’ (Amable 2003: 145, 149). They also include bank-based systems (IE, DK, SE) that have more developed capital markets, where ‘banks have a somewhat “passive” role: bonds and securities represent a large part of the banks’ assets and the debt/GNP ratio is significantly lower than in other countries’ (Amable 2003: 149). The rates of household participation in debt and financial asset markets are high.

2) The *EMU core* corresponds to the bank-based ideal type, being composed of the Economic and Monetary Union members, including the main continental European economies – Germany, France and Italy – and the peripheral ones – Portugal, Greece and Spain. They are deemed to have ‘a high credit/GDP ratio as well as an important share of insurance companies among institutional investors [...] showing] little mergers and acquisitions activity, weak development of accounting standards, and a lagging venture-capital sector. Ownership is concentrated and the State plays a relatively important role in the control of some large corporation’ (Amable 2003: 149). The level of participation of households in financial markets is close to the Euro Area average.

3) The group of the *Latecomers* is composed by Eastern European countries – Bulgaria, Hungary, Poland, Romania and Slovakia – that have engaged in processes of financial
liberalisation and privatisation at a later stage, after the collapse of their planned economies. They also share a strong foreign banking presence that is characteristic of Amable’s third cluster. Household engagement with the financial system is relatively low.’ (Santos and Teles, 2013)

Santos and Teles identify two key patterns of household indebtedness: one marked by the prevalence of mortgage debt and one related by the rise of consumer credit. The former is found to be more relevant for the description of the experiences of the early financializers, while the latter is associated with the latecomers as well as certain peripheral countries of the EU.

Santos and Teles (2013) find ‘a shared trend of growth in both household debt and financial wealth, denoting common institutional changes that have equally affected households across Europe’ with a few exceptions. ‘Thus, financialisation understood in terms of increasing household engagement with financial markets, both in terms of rising financial liabilities and assets relative to disposable income, is a common trend across Europe, notwithstanding different scales and paces among the EU countries. Housing loans are the largest category of debt of growing importance. ‘[C]onsumer credit, despite its relatively low weight in disposable income in most countries, has registered a more varied evolution. It has generally grown in all countries, but at very different paces - rising faster in the Latecomers group made up of Eastern European countries and in Greece, declining or stabilizing among the Early financialisers and the EMU core countries. There is thus some convergence across Europe, where countries with low levels of household indebtedness, the Latecomers, became increasingly involved with finance, especially due to the evolution of consumer credit that became relatively more prevalent’. ‘Total household debt seems to bear a close relation with household financial asset holdings, hinting that the general engagement of household with financial sector is generally made on both sides of the balance sheet.’ Pension and life insurance funds have become important financial assets held by households, indicating the pressures towards private pension provision. There is though no generalised direct
engagement of households with financial markets, the other side of the coin of more ownership of equity by financial corporations. Inequality and stagnant wages have been identified as the main driving forces that pushed households into financial markets, particularly into debt markets. These pressures as a significant factor in the generation of the financial crisis have been examined in Chapter 3 (see Karacimen, 2013 for discussion on USA, and critique of arguments as applied to European countries). However, Santos and Teles (2013, p.55) find that ‘the analysis of various measures of income inequality and of the evolution of wage income in Europe does not provide strong support for the hypothesis that higher inequality is associated with higher household indebtedness. At the aggregate level, at least, the extraordinary involvement of the generality of European households in financial markets over the last two decades is not clearly matched by a sharp intensification of inequality. Not only do EU countries have very different levels of inequality, but they have also followed different trajectories in recent years. Thus, in some countries a reduction of inequality has actually been compatible with growing household indebtedness. ... Moreover, cross-country differences in terms of inequality are not matched by different stages of household financialisation, as might be expected.’

Santos and Teles (2013) acknowledge that, as argued in ILO (2013) and elsewhere, financialisation may contribute to declining wage share in income, ‘the claim that the deterioration of living and working conditions has been a primary cause of households’ engagement with finance to fill the gap between income and extant or new norms of consumption is a far more intricate issue. ... This suggests that the engagement of households with finance also seems to be related to the development of the financial sectors in each country – thus accounting for the strong relation between financial liabilities and assets – and the forms and organization of provision of specific goods – such as housing (as a source of liabilities) and pensions (as a source of assets).’ (pp.59-60)

Santos and Teles (2013) do not find support at the country level for the hypothesis that high inequality is a driving force leading to households’ reliance on debt. ‘Countries with comparable values for the Gini coefficient present disparate household financial situations,
both in terms of indebtedness and financial wealth and countries with similar household financial situations experience different values of inequality of income.

“These results suggest that as participation rates in debt markets increase, they increase for all income groups, though at a faster pace for higher income groups, resulting in unequal levels of participation. It also shows that participation rates differ in the various debt markets, within and among countries. The relative position of the various countries, in turn, suggests that the different rates of participation may reflect the relative state of development of the national financial systems as well as that of the socioeconomic standing of the country” (p.72).

6.4 Financial sector and well-being – a participatory reflection

A research task within FESSUD set out to bring forward the perspectives of representatives of different vulnerable groups on the financial system through a research process inspired from participative research practice led by different civil society organisations across Europe. The main motivation of this research was to elicit the perspectives of these groups on the financial system and the reforms that these envisage to better tailor the financial sector to their needs. It aimed to understand how different financial subjects are involved with the financial system and to shed light on social exclusion phenomena produced or reinforced through financial inclusion or exclusion. This research was carried out in nine countries, and involved workshops involving different types of vulnerable groups in each country (for details see Tancau and Gabor, 2016).

Policy concerns with financial inclusion have flourished since the global financial crisis. This is somewhat paradoxical, given that the crisis started as a crisis of subprime mortgages, powered by private finance seeking to extend the frontiers of risk and include the very poor, on terms highly vulnerable to circumstances outside their control. This participative research project aims to contribute towards a nuanced portrayal of the financialisation of everyday life by examining how representatives of marginalised groups manage, negotiate and resist such processes.

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8 This section is a shortened version of Chapter 11 of Tancau and Gabor (2016).
The research goes beyond the ‘citizen as investor’ lens typically adopted in the financialisation literature. Indeed, accounts of the financialisation of everyday life ask how low and middle class households participate in financial markets through pension plans, consumer credit or mortgages.

The financial inclusion literature portrays the knowledge/inclusion nexus differently across social classes. There is little if any concern with the super-rich, who do not need not learn much, since they can pay for the knowledge of asset managers, who arbitrage (tax) rules through offshore jurisdictions. For the middle classes, learning about finance means learning about individual portfolio management decisions, in the hope of mitigating future risks as the state and employers retreated from social obligations for retirement, health and education. The poor need to learn how to overcome their fears of finance, recognize predatory lending practices and generally accept the financialisation of social relationships.

Since the financial crisis, there have been significant efforts to ‘cleanse’ financial inclusion from its subprime, overindebtedness echoes and render it as a desirable goal. The World Bank together with the Alliance for Financial Inclusion, supported by fintech companies and their philanthropic arms, have used the theoretical insights of behavioural economics to argue that ultimately, overindebtedness is a mark of individual, behavioural shortcomings rather than structural dynamics in the financial sector linked to a relentless expansion of risk frontiers.

This action-based research project sought to open up questions and ideas that alert civil society organisations and the disadvantaged groups they work with to the systemic issues that underpin celebratory narratives of financial inclusion. It sought to encourage a critical reflection that positions disadvantaged groups, those at the margins of finance and at the frontiers of risk production, as legitimate participants in on-going conversations about finance and financial reform. In so doing, the participatory approach stresses the potential for outlining a politics of the possible that is not dictated and narrated from positions of structural power.

The participatory exercise was guided by two critical questions:
1. What would inclusion look like if it happened on the terms of the economically disadvantaged?
2. What reforms do the disadvantaged regard as crucial to achieve inclusion on their own terms?

These two broad questions were broken down into several sub-questions. How do disadvantaged groups experience finance across time, space and place? How do they perform their role as financial subjects, expected to simultaneously embrace financial markets as the post welfare-state answer to future uncertainties and to recognize the threats it poses to individual engagement? How are vulnerabilities shaped by engagement or lack of engagement with the financial system? What meanings do they attribute to a sense of autonomy from (within) finance? What negotiation and resistance processes do they engage in?

Several key themes emerge from the nine country reports produced by civil society organisations. First, participants pointed to banks as primary nodes of connection to the financial sector, highlighting the mediating role that the (welfare) state plays in that relationship. Thus, welfare states often create relationships between the poor and banks through social service payments, but (choose to) exercise little influence on the terms of that relationship. Where participants viewed a positive contribution that private finance could make, it was in allowing them to fulfil the aspirations created by the asset-based welfare regime, whereby financial security is guaranteed by access to the housing market. Whereas the mainstream financial inclusion discourse encourages financial service providers to embrace new technologies (mobile banking) and products, participants stressed the preference for traditional relationship banking that would allow greater flexibility for financial service providers to account for their (changing) individual circumstances. Second, few participants saw fulfilment of the promises that financial inclusion would benefit the poor by boosting shared prosperity. Rather, the participatory exercise created the space for participants to stress over and over again their deep mistrust in financial institutions, and the unequal power relationships that render their financial life deeply precarious.
Participants called for financial services to be tailored to the individual circumstances of the socially disadvantaged, and for the state to become the primary provider of such services. The FESSUD participatory consultation suggests that placing such faith in the promise of market mechanisms, albeit mediated by digital technologies, may be misplaced. Participants from disadvantaged groups, those targeted through financial inclusions agenda, report few positive experiences with technology-intensive banking. Rather, their vision of an inclusive banking sector is a vision of relationship banking and of a careful state involvement to protect them from what they continue to perceive as predatory and discriminatory banking practices. It is important to stress that the findings of the participatory process bear lessons for broader efforts in international development to accelerate financial inclusion as the new pathway to development (Gabor and Brooks 2016). The experience of countries in Europe that have achieved the goal of financial inclusion, often by employing the apparatus of the welfare state, do not bode well for a development paradigm that stresses financial education as the method to improve the poor’s resilience to financial shocks and that attributed crises and failures of financial inclusion to consumer fallibility. The formerly ‘unbanked’, those at the bottom of the income distribution, experience financial subjectivities of a precarious nature that often translate into anxiety and the erosion of wellbeing. They conceive of the state – in its capacity of both regulator and provider of financial services – as the single most important solution to redressing the power imbalances in their daily engagement with finance. The research exercise brought forward the direct experiences and views of different vulnerable groups and, despite the different political and economic contexts, there are shocking similarities in the way the financial system impacts people’s lives in the nine different countries. All reports communicate both about the distrust of citizens in the finance system and the changes needed in the way financial institutions are governed, structured and regulated. People preferred financial institutions that they would feel more in control of and which would be trust-worthier, so that the negative effects on the emotional well-being stemming from the engagement with different representatives of the financial system would be minimised.
Representatives of vulnerable groups are very critical of financial inclusion due to its negative effects on their material and emotional well-being; the way the current system operates and includes them generates fears their not being able to pay back a loan, of falling prey to a scam, or of being treated disrespectfully. The mere interaction with representatives of banks – seen by them as the main public interface of the financial system – provokes the feeling that they are not being listened to, that their personal circumstances and difficulties are not understood and cared about, that they are exploited or that they constantly have to be on their guard as they cannot trust financial institutions they are constrained to deal with and, finally, the feeling that they are excluded and marginalized because of their social and economic status or because of their identity.

All reports talk about the shift “from welfare to debtfare,” a decisive structural feature of the current situation, which – due to the very structure of finance and the negative effects of dealing with it (stress in managing repayments, fear not to be able to stay on top of one’s debt, repossessions, etc., shown by the national reports) negatively impacts on peoples’ well-being.

At the same time the reports also show that vulnerable groups understand that some of the problems generated by the financial system cannot be addressed through reforms of the financial system, but would require both different welfare policies and economic policies and holding the state accountable to fulfil its duties and grants citizens their rights.

Despite the negative dimensions of their daily life realities, the reports also show that vulnerable people are far from being passive and are constantly seeking ways to prepare and cope with the daily risks that surround them, for instance by building assertive local action groups or organisations that can press for public policies that reduce risk. It also shows their individual resilience built up through daily processes of negotiation and resistance to pressure. When it comes to holding accountable the right actors for achieving the needed changes and transformations, vulnerable people are well aware that governments should be more protective of the citizens and guarantee them access to their rights.
6.5 Financialisation and Well-being

6.5.1 Finance and Well-being survey

The FESSUD Finance and Well-being Survey was designed to assess the impact of financialisation and of the financial crisis on well-being. Considering its broader aims, the survey objectives are:

1. To characterise individual and household relationships with finance;
2. To investigate the uses and reasons given for the take up of debt;
3. To probe individual assessments of household relations with finance;
4. To probe individual assessments of the impact of the financial crisis on various domains of household life;
5. To measure the distribution of the effects of financialisation and of the financial crisis across different socioeconomic groups;
6. To assess the extent to which the effects of financialisation and of the financial crisis are attenuated by different social institutional settings.
7. To undertake this in a comparative setting of different countries by both extent of financialisation and its national context.

The FESSUD Finance and Well-being Survey consisted of telephone interviews (fixed line and mobile phone), carried out in November December 2014 with nationally random samples of households in five countries: Germany, Poland, Portugal, Sweden and the UK that were selected to be representative of different types of financial system and welfare regime in the EU. For each household, one resident (aged 18 or older) responsible for financial decisions living in the five countries that took part in the study was interviewed. The sample size in the countries ranged from 1300 for Portugal and 1501 for Poland and Sweden, bringing the total sample to 7009.

The key findings were:

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9 Much of this section comes from the executive summary of Santos, Lopes and Costa (2016) with minor amendments.
Notwithstanding almost universal engagement with the financial sector through current bank accounts, individual and household relationships with finance vary in the five countries of the study.

The UK, the Swedish and the German households are significantly more financialised than the Portuguese and the Polish households when considering household financial wealth, both in terms of the composition of financial assets and the total amount of these assets.

The Portuguese, the Swedish, and the UK households are significantly more financialised than the German and the Polish households when considering household debt, namely their participation in mortgage markets and, thus, the total amount of debt held by households.

Participation in mortgage markets is positively associated with income, being more frequent amongst the higher income quintiles.

Having a mortgage is mainly associated with the start of an independent and autonomous life, but financial considerations are also relevant as housing loans are also conceived as an investment decision. Satisfaction with accommodation is higher among owners, irrespective of having a mortgage or not.

Personal loans are relatively more uniformly distributed across and within countries than mortgages. Easy access is the main reason presented for having this type of debt. Contracting a personal loan is associated with insufficient income, being used by at least a third of households with such debt to cover unexpected expenses and/or current living expenses. This pattern is observed especially in the UK and Portugal.

Respondents evaluate positively their dealings with finance; especially in the UK and Sweden. Positive assessments are associated with higher levels of household debt and of financial wealth.

The impact of the economic crisis on the household is perceived to have been particularly negative by the Portuguese respondents and perceived as almost non-
existent by the Swedish, with the Polish, British and German respondents standing somewhere in between these two extremes.

- Considering the period of the last 5 years, more than 40% of respondents in all countries declare that their households had to manage a lower household income, with the percentage of households significantly higher in Poland and Portugal.
- More than 50% of respondents who are employees in all countries declare that they had to work more intensively at work during the same period, with this percentage significantly higher in the UK and Portugal.
- More than 15% of respondents in all countries report experiencing a decrease in the overall control over one’s life over the past 5 years, with the percentage of respondents higher in the UK and Poland.
- The unemployed stand out as the socioeconomic group that has been most severely hit by the crisis, reporting the lowest levels of life satisfaction, even in the countries less affected by the crisis and associated with more robust Welfare States. In all countries, employment promotion measures is the public service with which respondents are most dissatisfied.

Focusing on five countries that represent different types of financial system and welfare regime in the EU, the survey findings show how and the extent to which household engagements with finance is differentiated across and within countries, and thereby suggestive of underlying mechanisms of inequality production and reproduction. Consistent with country-level data, household engagements with the financial sector are both more widespread and diversified in developed countries with more advanced financial systems, such as the UK and Sweden, where a high level of household debt is associated with a high level of financial wealth, indicating that engagement with the financial sector is generally made on both sides of the household balance sheet.

The Portuguese case, by contrast, shows that, while households have also had an intense relationship with finance, this has been especially through the mortgage markets, also favouring the accumulation of wealth of the better off. However, financial vulnerability is a
more widespread phenomenon and corresponding overall dissatisfaction with finance is high. In this respect, Portugal is aligned with Poland, even though Polish households have a relatively low intensity of involvement with finance. In Germany, households stand somewhere in between these two poles, in terms of household financial dealings, overall financial situation and respondents’ satisfaction with finance.

In all countries, household participation in debt and financial asset markets is highly differentiated, both in extent and content, across socioeconomic strata. High-income households tend to have substantially higher rates of participation in financial markets, both as borrowers and holders of financial assets. They tend to have higher rates of participation in mortgage markets, and to hold a higher fraction of financial assets, such as shares, bonds and voluntary private pension plans. In contrast, low-income households tend to contract debt with higher interest rates for the purchase of consumer goods, having less means to deal with liquidity or solvency problems, thereby being more vulnerable to personal and social contingencies that compromise use of their wage income.

Taken together, these results indicate that financialisation amplifies extant inequality, as manifest in the different rates of participation in debt and financial assets markets which are unfavourable to the least well-off. Household debt is concentrated in higher-income households and tends to be a means through which this socioeconomic stratum strengthens its relative advantage, reproducing and consolidating corresponding inequalities. By benefiting higher-income households, finance promotes and reinforces (private and commodified) forms of provision that are increasingly detrimental to the most vulnerable segments of the population.

Countries with lower levels of socioeconomic development that have followed such unequal financialisation paths, such as Portugal and Poland, have become more exposed to financial and economic crises, with more detrimental and widespread effects on individual and household wellbeing. The continued effects of the crisis is creating further pressures on welfare reform suggesting further divergence on the horizon amongst EU countries.
Finally, the survey brings to the fore the centrality of work. Not only unemployment is a crucial vehicle of transmission of the effects of financial and economic crises on individual and household material and subjective well-being, even in the least exposed countries, but also the financial and economic meltdown has detrimental impacts on workers through reductions of wage income, growing job insecurity, and increased work intensity. These transformations then impact on the material culture of financialisation to the extent that transformations in the labour markets and in systems of provision produce changes in people’s perceptions about what they can expect from collective forms of social provision and the role finance can play to fill in the gaps.

6.5.2 Financialisation and work

Betzelt, Lopes and Santos (2016) examine the finance-work nexus in the five countries where the FESSUD Finance and Well-Being Survey was conducted. Drawing on sociological and economic literature that address the relation between finance and work, a set of hypotheses are formulated and tested to explore, at the micro level, the way in which finance may have impacted on well-being through its effects on labour relations. It concludes that the financial crises of 2007-09 have accentuated social inequality, having had a more negative impact on low-income groups and younger workers with more precarious labour contracts. But contrary to what could have been expected, in Germany and Poland (where household involvement with finance is lower than in the UK, Sweden and Portugal) the relation of households with finance and workers’ position in labour markets revealed to be more detrimental to the low income groups. In these two countries, the claim that the relation of households with financial systems has been pushed by structural circumstances finds empirical support since the low- and medium-income households have got into debt in order to provide for basic living expenses and have experienced deteriorating working conditions. On the contrary, in Sweden, Portugal and the UK a more even distribution of the impacts of the GFC and financialisation was found, as measured by the reduction of household income and the use of loans to cover basic living expenses. But different factors may account for this. In Portugal, the more even distribution of these impacts might be explained by the more
severe and widespread impact of the crisis across the socioeconomic spectrum. In Sweden, the very mild impact of the crisis on the country, its relatively low levels of inequality and more robust welfare system might instead explain the more uniform distribution. And in the UK, the even distribution of the GFC impacts might instead be explained by the more widespread and uniform role of finance in peoples’ everyday lives across the social strata and for various purposes.

Notwithstanding country differences, living conditions have worsened after the financial crises of 2007-09 for a significant number of households, as reflected in respondents’ reports of declining household income, recourse to debt to cover living expenses and deteriorated employment relations. As the finance-work nexus has been more detrimental to the low-income and non-standard workers in Germany and Poland, the paper concludes that the impacts of financialisation on well-being cannot be simply read off from the sizes of national financial systems or the extent of household engagements with finance. It needs to take also into account the more intermediate effects of finance on well-being through labour market segmentation. The micro-level analysis of finance-work relations has thus brought to the fore detrimental impacts of finance that do not emerge in macro-level analysis.

6.5.3 Economic and social well-being in Poland

Dymarski (2016) brings together data from various sources to shed light on the recent evolution of economic and social well-being in Poland. Acknowledging methodological difficulties inherent to comparisons from different statistical sources (e.g. the use of different survey methods, samples, measurement and scalar scales, etc.) that jeopardise straightforward comparisons, the paper examines discrepancies between the generally positive macroeconomic evolution of the country based on aggregate variables, such as economic growth, unemployment rate and income distribution, and the generally negative individual perceptions of the impact of the crisis on the country and on the household in Poland. Various tentative explanations are put forward, one of these attributes the discrepancy to weak social protection of the most vulnerable and insufficient dispersion of economic growth into widely distributed social benefits.
Santos et al. (2013) contrast the impact of financialisation and the crisis upon the material and non-material well-being of the households of eighteen EU countries. In terms of material measurement they find that although the households in all countries have experienced drops in their disposable incomes and rising unemployment rates, the impact of the crisis has been felt more acutely across the southern and eastern parts of the continent. To explain such results, the authors highlight the importance of institutions and the levels of welfare provision in each country. Regarding subjective well-being, it appears that with the exception of the most extreme cases of deterioration of living standards (Greece and Ireland), subjective well-being measures do not follow as closely as expected the development of material economic conditions. As pointed out by the authors this is because subjective evidence involves a bias arising from the fact that in face of worsening living conditions, households might be applying a downward adjustment to their norms and expectations (the issue is discussed at more length in Boffo et al., 2013). In that regard, improving or static subjective well-being scores might not necessarily provide an accurate portrait of the actual conditions of life.

6.6 Policy report on social impact of the financial crises

Barker, Brown and Spencer (2016) assess the impacts of the 2007-09 financial crises, the subsequent recession and austerity programmes on social well-being via an analysis of five key domains—healthcare, housing, social security, education and work—areas which have traditionally constituted key aspects or concerns of the welfare state. This was undertaken through case studies of two countries, namely Portugal and the United Kingdom. A subjective approach to well-being was rejected, primarily on the grounds that people’s assessment of their own well-being tends to adapt to changing circumstances, in favour of an objective approach, looking at changes in a range of key indicators relating to the above domains, e.g. health outcomes, unemployment rates and homelessness figures. The general finding is that

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10 This section draws heavily on Barker, Brown and Spencer (2016) Conclusion. The supporting evidence for the conclusions drawn in this section is given that paper.
the financial crises and austerity have had serious negative impacts on social well-being across the selected domains.

Amongst the key findings are that health needs are going unmet, with evidence of patients in Portugal having less time and money to access health services and pay for medication, and waiting times for treatments rising in the UK. There are indications of worsening mental health outcomes in both countries through the crisis and period of austerity, with some austerity measures even linked to an increase in suicides. Housing is becoming more difficult for many people to access, with the state withdrawing traditional supports for homeownership in Portugal, and mortgage deposits having increased enormously in the UK. There is also evidence that both the post-crisis recession and austerity measures have led to a rise in homelessness in the UK. In the realm of social security, there have been major reductions to pensions in Portugal, while reforms to the UK pension system since 2010 are set to make future pensioners worse off. Research draws a link between a rise in deaths among elderly people and cuts to Pension Credit in the UK.

Young people have also suffered greatly in the crisis and ensuing period of austerity, with major cuts to education funding in Portugal leading to increases in class sizes, reductions in the range of subjects taught and in the special help available to disabled children. In the UK, education at primary and secondary levels have been better protected against spending cuts. However, massive increases in student loans particularly for higher education are seeing young people beginning their working lives under a huge personal debt burden. In the sphere of work, so crucial to mental and physical health as well as the maintenance of income, huge numbers of jobs have been lost in both countries, with the effect of the crisis on the private sector being followed by large cuts in public sector employment. Youth unemployment has been a particular blight in Portugal. In the UK, while the private sector has produced more jobs than have been shed in the public sector, many of these jobs are low paid and low skill. As Steve Coulter (2016) writes of the UK, ‘Good headline GDP and employment data obscure an underlying picture of a low-wage, labour-intensive economy falling steadily behind its competitors.’ It also obscures a picture of worse pay and working conditions for workers.
As Stuckler and Basu (2014) write, at its worst, austerity kills. While this represents austerity’s most profound ability to damage social well-being, this lethal potential should not detract from its myriad subtler, but still profound, harms. The financial crises and austerity have caused widespread unemployment, stymied educational opportunities and put commonly shared life goals such as homeownership beyond the reach of many people. Those that have managed to stay in work or have found new jobs during this period have often seen their pay and conditions worsen. The serious negative effects of these changes on people’s hopes, aspirations and general morale must not be underestimated. Of particular concern are the effects on young people, who will have to live with the consequences of the crisis and austerity longest. Not only is their early development being stifled through cuts to education, but job prospects in adulthood are increasingly uncertain. Very real limitations are being placed on young people’s ability realise their potential.

6.7 Financialisation and pensions

Private pension provision (rather than state provision) has become a major area of people’s lives where they engage directly or indirectly with the financial sector and where their financial well-being (in old age) depends on the performance of the financial sector. The increasing involvement (which varies substantially between countries and between social classes) of people with the financial sector with regard to pensions is a clear example of the financialisation of the everyday.

Despite the exposure of private pension schemes to the financial turmoil, the current crisis has presented itself as an opportunity to bring this agenda further forward. The trend towards the privatisation of social protection systems, enhancing individual responsibility through growing access to financial markets, must then be assessed against the background of greater levels of unemployment and increasingly precarious employment relations with the likely result of greater inequality and social vulnerability across Europe.

Churchill (2013) and Saritas (2013) discuss the trends and evolution of pension policies in the EU over the last three decades. As Churchill points out, while the overall trend has been a fall in the generosity of the state and a parallel growth of private pension funds, the
institutional characteristics of each country play an important role too. In that regard, Churchill finds that the UK is one of the countries where the public provision of pensions has been most substantially suppressed. In addition, many continental countries such as Germany have imposed more restricting parameters into their benefit formulas and have introduced private funded pension schemes in order to recover the ground lost by state provision. Peripheral countries have also followed a similar trend, especially since the outset of the crisis. Two noteworthy exceptions appear to be Netherlands and France where a relatively more generous pension system has been maintained. Overall, the rise of private pension funds means that households have become more involved in financial activities, and in that sense have further exposed themselves to the risks and systemic fragilities of finance [also see Saritas, 2013].

Bayliss, Churchill, Fine and Robertson (2013)\textsuperscript{11} reviews a case study on pensions to consider relationships between financialisation and well-being. The case study discusses the growth in the use of private pension funds to finance income in retirement, as well as other measures that result in a tightening of the link between the contributions made over working life and the pension benefits received in retirement. These measures have introduced new uncertainties into the system of retirement income provision, and have reduced the sense of social responsibility for wellbeing in old age across the European Union. These changes are seemingly having an impact on the confidence felt by individuals over their old age across member states. In addition, they are leading to a growth in the “pension gap”: the difference in provision for men as opposed to women. This is emerging as a new political problem for member states, and as such is already leading to new “counter” reforms such as larger basic pensions and changes to reduce gender inequalities during working age.

Rodrigues, Santos and Teles (2016) contribute to the literature on the financialisation of pensions by examining the transformations occurring in Portugal. While the country followed similar processes to those of core EU countries, leading to an increasingly integrated

\textsuperscript{11} The following paragraphs use the paper mentioned with minor amendments. Bayliss et alia (2013) also discuss housing, health and water.
financial sector in the international arena, this integration was mainly led by the banking sector rather than by capital markets, and from a subaltern position within the Economic and Monetary Union. This has had reflections on the relatively reduced role of private retirement-income products in the country. Nonetheless, the Portuguese pension system was equally subject to reform aiming at reducing its weight in public expenditure. The result was a reduction in coverage and benefit without achieving an equivalent match in supplementary private forms of pension provision, having particularly detrimental impacts on those with unstable labour market careers. The Portuguese case thus accounts for both the differentiated and uneven nature of financialisation in that the financialisation of the country in general and of pensions in particular have contributed to deteriorate a most critical domain of social provision promoting financial markets increasingly dominated by foreign capital.

Churchill (2016) discusses the “neoliberal” pension reform across the European Union since the beginning of the millennium, which has been based upon misguided trust in the efficiency of capital markets and misplaced concerns regarding the debt levels and expenditure of states. It argues that the economic benefits predicted by the champions of the reforms have failed to materialise. A predictable if undesired consequence has been the growth in the discrepancy between male and female post-retirement outcomes. Given that this is largely a consequence of gendered labour market participation rates, policy options to counter this direction of travel include enhancing childcare provision. It is defended that this option, alongside others, should be promoted with the same vigour as the original pension reform, if the EU wants to show that it is serious about its long-term commitment to gender equality. According to macroeconomic logics that depart from the pre-crisis orthodoxy, this alternative policy route could itself lead to the boost to economic prosperity that the original pension reform failed to inspire.

6.8 Systems of provision: housing and water

12 This section draws very heavily on the contribution of SOAS to D8.28.
The case studies around housing and water have, unsurprisingly, displayed significant presence of the state, financialisation and neoliberalism. Taking financialisation as starting point, its scale and scope, its incidence, and its form and content are highly differentiated, not least because of divergence across the case studies in how it is situated in relation to the neoliberal state.

Neoliberalism has been associated with a shift in the way in which households associate with basic service provision with a greater emphasis on individual responsibility. Increasing individualism of the population is linked with the inroads being made by private financial capital. But this is uneven and can be related in part to variegation in the nature and impact of financialisation. Furthermore, the case studies show considerable diversity in the material cultures of financialisation across sectors and locations, as explored in our analysis of what has been termed the 10Cs (as outlined in section 6.2).

There are common trends that can be identified from the case studies, apart from the growing inequality and variegated vulnerabilities already suggested. These include: the growing presence of finance in daily life but also the corresponding restructuring of the forms, location, balance and substance of policymaking.

This section considers the state’s changing role in the provision of basic services and how this has been shaped by the advance of financialised neoliberalism to varying degrees across the case study countries. Economic and social reproduction – as evidenced by housing and water – have been transformed over the past 30 years. The case studies corroborate the view that the defining feature of this transformation is the intensive and extensive accumulation of interest bearing capital supported by the state under the ideological veil of non-intervention. For example, housing policy has been dominated by an increased emphasis on private home ownership, and states have played a key role in this. State activities in support of owner occupation range from creating legal and regulatory frameworks for primary and secondary mortgage markets to subsidising mortgages and building houses to be mortgaged. In water, privatisation has been heavily promoted if not necessarily fully achieved across the case studies considered. Even with state ownership, the case studies show a shift
in policy with a greater emphasis on both commodity form and commodity calculation, if not full commodification of water. The overall picture then is one of heavy state activity couched in terms of pro-market rhetoric with non-commodified forms of provision prohibited. The state has sold off housing in some countries (particularly in UK and Poland) but this was more significant because these had a more substantial state housing sector than the other countries. House building has become increasingly concentrated in the private sector with some provision for self-build significant, notably in Poland.

The second phase of “re-rolling” out of institutions in which the neoliberal state becomes more firmly established with market-oriented modes of governance took different forms in the case studies. The state continues to retain significant control, if not as a direct provider of services, in shaping policy and discourses along neoliberal lines. Both water and housing have seen the sectors governed by a commitment to market reforms which is not to say that the state does not intervene but that this is governed by a presumption against state provision and, where possible, subsidy.

In the housing case studies, the state has been behind a process of commodification with provision increasingly governed by a commitment to market forms. This is not to say that states have not intervened, only that their interventions are constrained by a presumption against state provision and in favour of what are, at times for some, elusive access through market forms. All of the case studies show a strong trend for an increase in owner occupation, and this is promoted by the state as the tenure of choice. This is also associated with a preference for private capital involvement in the building, financing and allocation of housing, if unevenly so in practice. In the UK, two key government actions have shaped the housing market: the discounted sale of local government-owned property to sitting tenants and the reform of the mortgage market. The result has been a vast increase in the amount of credit chasing residential land and the housing situated on it.

In the case-study countries there has been a greater emphasis on land allocation according to its highest value in monetary terms. This, in turn, has meant that housing has acquired an identity as a financial asset as well as a role as a form of shelter with the asset value
increasingly taking priority. In housing, state finance is used to promote specific outcomes, particularly owner occupation. For example, in all of the case studies, the state created a regulatory environment that allowed mortgage lending to take place. Across sectors and case studies, the state operates at different levels, as regulator, provider and financier. In addition the rolling out of the neoliberal state has had divergent impacts on local government. A common theme in some of the case studies was the delegation of responsibilities to the local level while at the same time, resources with which to provide services were diminished.

State policies directed at creating markets are also engaging with finance to varying degrees and forging a path for greater involvement of the financial sector in the provision of these services. In housing, the promotion of owner occupation leads to a greater reliance on mortgage finance which leads to a greater claim of finance on incomes. In water the state has opened the way for greater involvement of the financial sector, largely through privatisation.

At one level, a mortgage is a simple credit relation between borrower and lender. But it becomes embroiled in financialisation once the mortgage obligation is sold on as part of some other asset which becomes routinized under neoliberalism. In water, similarly, infrastructure has, for decades, been financed by the issuing of bonds. In South Africa and Turkey, regional and local Estate entities continue to raise finance for water investment from international borrowing and public water utilities use derivatives to hedge against changes in interest rates and currency fluctuations. What is different with financialisation is the scale and scope of use of financial mechanisms and innovations, rather than increasing productive efficiency, to increase shareholder returns.

In housing, financialisation has been most widespread in the expansion of mortgage lending which has brought households into the realm of financial markets with a corresponding expansion of secondary mortgage markets. Underpinning this has been the rise of owner-occupation as the favoured tenure form as this usually requires a mortgage. The expansion
of home ownership both supports and is supported by greater availability of mortgage finance in the case studies.

The state has provided more direct support with subsidies for home ownership but this does not necessarily lead to financialisation. In Poland, the privatisation of housing did not initially transform new provision of housing into commodities as policy was more oriented around the heavily discounted transfer of existing stock to households and not motivated by profit. In addition, the country did not initially see the take-off of mortgage-backed buying and selling of houses. The development of secondary housing markets in Poland has been impeded by the poor quality of the privatised housing stock. In South Africa, the expansion of the housing stock was based on giving ownership rights to the poor black population with subsidised finance. However, despite the expansion of owner occupation this has not spurred on financialisation due in part to the exclusion of low-income households from mortgage markets even where they have become owner-occupiers.

Despite an apparent stepping back of the state, the cases clearly show that the state shapes resource transfers to finance and sets the conditions for the transformation of commodity forms and revenues into capital. However, the outcomes have been diverse. The case studies show that financialisation has expanded but that this has been highly variegated and is most prominent in the UK in both housing and water. Elsewhere expansion of commodity form and calculation have stopped short of full commodification in water. In housing, financialisation is associated with the expansion of home ownership although, while necessary, this is not a sufficient condition as the case of South Africa demonstrates.

Our research suggests that financialisation, where has been observed, is indicative of an expansion of fictitious capital, arguably at the expense of the real economy. This has been a feature of finance in general, resulting from a growth in the influence of finance over the control of resource allocation – including the flows of money, credit, and foreign exchange and the level and composition of output, employment, investment and trade and the financing of the state by money capital embodied in an array of more or less esoteric financial assets.
The financial assets become intrinsically speculative and unmoored from the imperatives of production.

Typically, literatures on finance, incorporating financialisation or otherwise, have increasingly acknowledged the dysfunctions attached to its disproportionate expansion, pinpointing numbers of mechanisms and impacts (from short-termism to speculation both at the expense of long-run investment). What has proven more difficult to pin down is the corresponding increase in the power and control of finance in and of itself and as a broader reflection of its location within the neoliberal era. The same applies to the related but separate ways in which financial interests have overcome or suppressed resistance to, and conflicts over, its exercise of power and control although, as can be seen, there is a burgeoning literature on the financialisation of everyday life.

The difficulties in pinning down the power and (social) control of finance derives precisely from the abstract and general nature of these concepts but that, in practice – across structures, processes, relations and agencies – they are exercised in distinct and differentiated if mutually supportive and conditioning ways. What, after all, is the power of money? In short, the (nature of the) power of finance in housing markets differs from that in the corridors of government as in, for example, the formulation and implementation of macroeconomic policy. Thus, power and control need to be specified concretely and contextually even if the analytical frameworks previously summarised above provide a starting point for doing so.

With the power of financialisation itself, two very different aspects are striking. The first is the extent to which the financial system is out of control, as evidenced by the financial crisis of 2007-09, and the aftermath. This is not to say that the financial system has been without regulation, even if this had in some respects been relaxed (or outflanked by shadow banking), nor that it has been without substantial promotion and support.

In some respects, the well-observed failure to reregulate, let alone transform rather than reform, the financial system is a reflection of the range of channels through which finance exercises its power within the neoliberal context. Here, we would point to shifts not only in
the balances of power but also the location, the forms and the consolidation of that power, i.e. where power is exercised, through what mechanisms and how these are concentrated, respectively. For the balance of power, the neoliberal period has witnessed the weakening of the organisation and presence of labour and other progressive movements, with a corresponding reduction in policy influence and representation. For the location of power, there has been increasing centralisation to national, or even supra-national, government especially when it comes to allocation of resources (even if it is typical of neoliberalism for it decentralise responsibility for service delivery without necessarily the capabilities to deliver). And, within governments, financial interests and control have been increasingly embedded within institutions and institutionalised structures that are generally conceived as imposing financial imperatives and eroding alternative forms of democratic participation.

There is a growing literature that suggests that finance cannot be controlled. At the time of the financial crisis, the financial sector was far from unregulated. The financial crisis was not the result of slack regulation but came about because finance is unknowable. There was extensive regulation and there has since been state bailout funding. This is not what one would expect from a supposedly laissez-faire system.

In the water sector in England and Wales, the case study shows how regulation became denser and increasingly burdensome requiring the submission of ever greater volumes of data raising concerns that the wood would be lost for the trees. There has now been a shift to 'light touch' regulation. This takes a different approach. It has emerged that simply pressing companies to disclose more details about their operations does not improve regulation. The process is more complex and relations between the state and the regulated are more challenging. In England and Wales the shift to light touch regulation means that company directors have to sign off to say that they have complied with regulation. This is instead of submitting vast amounts of data to the regulator. Now adherence to regulation relies on the reputational impact of directors.

But still there are substantial elements of sector provision that are outside the scope of regulation. In England and Wales, it is just the water utility that is subject to regulation while
a world of financial innovation has evolved around the regulated companies. Financial extraction is largely achieved through dividends and corporate transfers but these are outside the scope of the regulator and considered to be ‘market outcomes’. The regulator freely admits that it is in no better position to judge these factors than credit ratings agencies which play an important role in the regulatory process.

The changing role of the state from a provider to a facilitator of markets hinges on the state’s ability to regulate the market process. But regulation raises significant challenges, particularly the issue of information asymmetry but this is all the more pronounced with the interventions of finance. Furthermore, where there is a reliance on private investment, policy needs to be mindful of the needs and wants of investors.

In housing, shelter needs are subordinated to land valorisation. In the context of increased capital mobility, rents can be drawn from the global application of finance rather than determined by local factors. States and local governments now compete to attract capital through urban place-making and the development of ‘post-industrial’ central business districts, which segregate urban space to the exclusion of the poor. As stated in D8.26: “The growing integration of land and real estate markets, with land treated more and more like a financial asset, further feeds the extent to which land use is governed by the pursuit of ground rent. Rent appropriation and the imperative to assign land to its most valuable uses should, therefore, be viewed as a response to the globalisation of capital and the rebalancing of the economy towards the financial sector” (Robertson 2015). Similarly in the supply of water, provision that was once organised on a local level is now subsumed into the investment portfolio of global conglomerates.

The case studies provided a significant insight into the changes taking place in economic and social reproduction around the neoliberalisation of housing and water. These were not all connected with financialisation and some aspects of provision were entirely within the state sector. However, even here there is substantial evidence of a shift in the way in which households relate to the provision of basic services with increasing responsibility assigned to the individual and a reduction of collective provision.
Variegated vulnerabilities are indicative of the complex ways in which households are attached to financialisation, state provision and state support. At one extreme, with privatised provision, well-being is differentiated by access to income and credit. At the other extreme, it depends upon what, how and to whom the state continues to provide, at least to those who are marginalised from access to private or privatised provision and, thereby, dependent upon the state. As suggested previously, the latter tends to involve commodity forms and calculation rather than commodities, although neoliberalism tends to press for conversion of one to the other in a journey from commodity calculation through commodity form to commodities. However, this is far from unilinear as, for example, promotion of financialisation of provision for the included (private pensions for example) can itself consolidate exclusion of others, giving rise to residualised provision, in part as social policy.

Housing and water are core elements in economic and social reproduction, and neoliberalism has led to the proliferation of financial relationships and institutions in daily life. Commodification via privatisation connects some households to the world’s financial capitals. In all the case studies there is a section of the population whose wealth is tied up in their housing. As a result of the shift towards treating housing as an asset, housing has been subject to heightened international investment in both mortgages and their derivatives and in real estate directly embroiling housing and housing-related debt in global financial networks.

In water the connections with global finance are more opaque. The links are most pronounced in England and Wales particularly in companies owned by the financial sector that have securitised income from water bills for decades into the future. But, even where privatisation has led to a takeover by a publicly listed company, these are often owned by financial institutional investors and some are headquartered overseas with Asian companies featuring prominently as stakeholders in water companies in Portugal and South Africa. Consumers are largely unaware that the payment of a water bill brings them into contact with global finance.
Households are clearly (if unwittingly) significant players in the world of finance as it was the non-payment of housing costs that was the proximate cause for the financial crises of 2007-09. Households are the source of the income streams for securitised financial products and these have a distinctive risk profile in financial markets.

While privatisation and financialisation are associated with exploitation and extraction, exclusion from these can also be a source of even greater deprivation. Financialisation does not just oppress the most deprived. Access to a mortgage is not just subprime exploitation but also provides access to capital gains and housing wealth, with these patterns of wealth allocation dictated by finance. Becoming embroiled in networks of global capital clearly raises challenges for households and also affects and effects distributional outcomes in income and provision, with considerable ambiguities around the incidence of advantages and disadvantages of being included, or excluded, from such financial chains. In South Africa, poor black households have been persistently excluded from mortgage markets but heavily incorporated into the most severe forms of consumer credit.

With the household as asset class, there is an associated shift in the culture of responsibility to the individual. According to Bryan and Rafferty (2014), emergent social relations from the household as an asset class requires another form of subjectivity, (p.409), “a culture of financial calculation that becomes absorbed as part of the daily norms and dispositions of social being” and later “the presumption of rights of access to housing, education and healthcare are being replaced by the acceptance of individual financial participation and calculation. The project of subjectivity in these emergent social relations points to a discourse of subordination to the individualism and discipline implicit in financial calculation.”

The case studies added weight to the shift in attitudes to the household with greater individual responsibility for provision associated with neoliberal reforms including those that stopped short of privatisation and financialisation.
In housing the shift to greater owner occupation has meant reconstituting individuals and entrepreneurially self-reliant saver investors. Individuals are responsible for their own housing with the risk of eviction if they do not keep up with mortgage payments. Yet inevitably there are those that fail to fit into the market mould and the neoliberal model faces considerable challenges in coping with the hard to employ, house, educate, provide for in old age, raise out of poverty, provide for healthcare etc. The case studies show an increasingly residual approach to social policy meaning that the state provides a basic level of support to the most disadvantaged but does not step in to address wider issues of inequality that are emerging from the neoliberal structures of provision. Given the emphasis on the entrepreneurial individual at the expense of collective regimes, social policy was found not to target, let alone capture, any kind of redistribution but instead to be narrowly focused on alleviating the harshest conditions imposed by neoliberal regimes.

In the provision for water, the increasing emphasis on cost-recovery pricing has led to water bills that are unaffordable for many, most notably in England and Wales and South Africa. The social cost when this individualism and residualism goes wrong is potentially devastating. Households can be disconnected for non-payment of their water bills (except in England and Wales), evicted for non-payment of housing costs and, in South Africa, the two sectors overlap and households can face eviction for non-payment of their water bills. Sector reforms have created structures that are unaffordable for many. Yet these continue with a discourse of “market outcomes”. Nowhere does social policy extend to inclusive and redistributive housing policy. State support is the exception and couched in narratives of personal responsibility.

6.9 Policy report on financialisation and well-being

Deliverable D5.08 (Policy Report on Financialisation and Well-Being), reflects on the work produced for WP5, and draws policy suggestions to address the inequities and uncertainties generated by financialisation processes. The summary report on the impacts of

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13 This section draws heavily on the Preface to D5.08.
financialisation and of the financial crisis on household well-being (as discussed above) underlined rising inequality and insecurity in people’s everyday lives. This deliverable initiates discussion on how relevant areas of provision can be definancialised to combat inequities and uncertainties generated by financialisation.

6.9.1 Financialisation and housing
Robertson (2014a) examines the link between financialisation and housing. Pointing out at the cross-county cultural and institutional heterogeneity, the author asserts that while in certain northern European countries, such as the UK and the Netherlands, the rise of home-ownership has been indeed complemented by a corresponding increase in mortgage debt, this is not a result that can be blindly generalized. Indicatively, Robertson argues that in a number of southern European countries the rise in home ownership is better explained by means of the cultural particularities of those societies, rather than by means of mortgage lending, given the limited role of the latter there. In addition, Robertson finds that mortgage borrowing is more prevalent among higher-income households. In that sense, rather than engaging into the hypothesis that sees an element of exploitation in the relationship between households and finance, Robertson asserts that mortgage finance has actually reproduced and consolidated existing inequalities.

In ’Definancialising well-being: the case of housing’, Santos and Robertson (2016) initiate discussion on how relevant areas of provision can be definancialised by examining the housing system of provision. Housing has been a most critical conduit through which households have increasingly engaged with the financial sector and thereby contributed to finance’s expansion into adjacent domains of economic and social life. As analysis of the impact of financialisation and financial crisis required examining the ways in which finance interacts with the entire chain of production that forms a given system of provision, which is commodity-specific and is shaped by multiple factors, they argue, the examination of the definancialisation of housing likewise demands investigating the structures, agents, relations and processes that form a given housing system of provision in its social, political, geographical and historical context. A first step in this direction is attempted, mobilising,
without being comprehensive, what has been learned about the embroilments of finance with the UK and the Portuguese housing systems of provision, and ongoing policy discussions in these two countries. As tension escalates in the face of mounting evidence of the failures of financialised housing systems, prospects for the de-financialisation of housing become more likely.

*Health Policy*, by Kate Bayliss, considers policy implications from the effects of the financial crisis of 2007-09 on health services, drawing on surveys and focus groups conducted for FESSUD Work Package 5 in Poland, Greece, Romania, Portugal, Belgium and Sweden and a study on health financialisation in England. Overall, the effects of the financial crisis depend on the underlying system of health provision. The evidence from WP5 indicates that the financial crisis has had an adverse impact on access to health care. In a number of locations surveyed, basic services became less affordable following the financial crisis and this was particularly significant for those outside the formal financial sector who lacked insurance or where access was linked to employment status. In England, in contrast, health services are almost all financed through general taxation and so households did not suffer immediate effects. However, this was the trigger for government spending cuts which have curtailed budget allocations to health services since 2010 resulting in historically unprecedented financial deficits for many health providers. This has been the backdrop to substantial sector reforms including a much greater role for the private sector. For policy, the tax-funded model provides greater equity in health service provision and insulates households from the effects of the financial crisis. However this model is at risk due to pressures for more market-oriented approaches including commercialization, competition and privatization.

*Water Policy*, by Kate Bayliss, draws on three case studies in England and Wales (EW), South Africa and Portugal to demonstrate that water policy is on a similar trajectory in each of these locations. The provision of water is increasingly presented as a market activity, with water treated as a commodity and the supply of water, as a business. Privatisation has been pursued to varying degrees and, where this has not been achieved, state water companies are encouraged to operate in a similar fashion to private companies. There are a number of
limitations with this approach. Policies such as ‘full cost recovery’ in practice require value judgments as it is far from clear, for example, what costs should be recovered or from whom. Democratic accountability can suffer where water is privatized, particularly where companies are owned offshore by financial investors. Privatisation and financialisation put upward pressure on prices and social equity may be adversely affected. An alternative policy approach would focus on public provision of water so that providers are accountable to the electorate in a transparent manner with any surplus reinvested in operations. It is not enough, however, just for public provision of water. Policy reorientation is required so that water is recognized as a social good requiring universal access rather than a market commodity.

*Definancialising well-being: a marginalised groups’ perspective*, by Daniela Gabor and Maria Magdalena Tancau, brings forward the views of the marginalized on the financial system and gives an account the experiences they have when engaging with finance. Three main elements characterise the relationship of the marginalised with finance a) financial inclusion always happens on banks’ terms, b) participation in finance is described more as a disempowering rather than empowering experience but despite the first two c) the socially excluded are not powerless victims of the financial system and its manifestations but agents of change who understand how the system works and are capable to negotiate and resist financialisation and to initiate change. In line with the above, the policy recommendations emerging form participative research with marginalised groups go beyond reforms of the financial sector and propose measures and changes that would enable people experiencing exclusion and marginalisation to enjoy more dignity and well-being in relation to the financial sector and in society in general and have access to the necessary material resources in order to lead a good and fulfilling life.

**6.10 Concluding comments**

This chapter has clearly set the many ways in which there has been and continues to ‘financialisation of the everyday’. This financialisation of the everyday ranges from our immediate engagement with the financial sector as savers and debtors through to reliance
on the financial sector for housing finance and pension provision. The case studies and research have examined the effects which financialisation has on society—often in an adverse direction.
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Chapter 7 Financialisation and the environment

7.1 Introduction

The WP7 has investigated the relationship between finance and sustainability seen mainly from the point of view of environmental sustainability. It is difficult, and possibly misleading, to separate finance from the other economic aspects of development and to sever environmental sustainability from the other dimensions of sustainability. Consequently, in the WP7 deliverables finance and environmental sustainability play the main role without losing sight of the economy at large and of the other dimensions of sustainability.

This chapter summarises the main methodological and substantive issues that emerged from the work carried out on financialisation and sustainable development. Within Work Package 7 (on Finance, Environment and Sustainability) the focus was mainly on the unsustainability of the existing energy system, the need of a rapid transition to a low carbon economy, and the financialisation of built environments.

This report focuses first on a few crucial methodological issues discussed within WP 7 (section 7.2). Section 7.3 discusses the unsustainability of the existing energy system based on the prevailing use of carbon fuels, focusing on the urgency of a rapid transition to a low carbon economy. Section 7.4 analyses which role financial instruments may play to promote and facilitate the transition towards a low carbon economy. Section 7.5 investigates the implications for sustainability of the growing trade of energy derivatives. Section 7.6 examines the implications of the disembodiment of money from the impacts on sustainability of the “real” economy of socio-ecological flows of matter and energy. Section 7.7 summarises research into relations between financialisation of built environments and urban sustainability. Section 7.8 discusses the growing problems affecting environmental policy in a financialised economy. Section 7.9 draws the main policy implications deriving from the preceding analysis. Section 7.10 concludes.

7.2 Methodological issues

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1 This chapter is essentially the deliverable D7.25 except for material on financialisation which is contained in Chapter 1.
In this work package, the dialogue between different disciplines has been favoured by the adherence of WP7 research to a variegated but broadly convergent methodological orientation. A few crucial methodological principles that have inspired the work done can be mentioned and discussed: a particular attention for disequilibrium dynamics, long period trajectories, structural change, irreversibility of time, radical uncertainty and co-evolution of the biosphere and the human activity within it.

The first methodological principle to be emphasized is the need to escape from the strictures of equilibrium positions and trajectories. It is well known that the standard approach of macroeconomics focuses on market-clearing equilibrium positions (cf. discussion in Chapter 2). This approach diverts attention from all the problems that may jeopardize sustainability: economic and financial fluctuations, unemployment, inflation, stagflation, financial bubbles, crises, great crises. In this view, the apparent disturbances of otherwise smooth market processes are necessarily exogenous and do not affect the actual sustainability of market processes. However, the sustainability of a system crucially depends on the expected impact of endogenous disequilibrium processes that may trigger a cumulative divergence from a sustainable equilibrium trajectory. The sustainability of development at the global level may thus be only assessed by investigating the complex dynamics of the system describing the co-evolutionary interactions between economic activity and the biosphere (see in particular Clark and Hermele 2014, and Vercelli 2014d).

The second methodological principle to be emphasized is the need of framing any argument about the sustainability of development within a long-run time horizon. This is necessary because the concept of sustainable development refers to long-period features of the development process such as the equity of intergenerational distribution, the quantity and quality of social and natural capital, the preservation of the fundamental equilibria of the biosphere (ibidem). On the contrary, the process of financialisation has progressively shifted the focus of economic decisions towards the short period. In the view of many practitioners and observers the growing liquidity and mobility of assets seems to justify the assimilation of most economic decisions to the paradigmatic choice of an optimal portfolio of assets.
taking into account exclusively the short-term profitability of each asset. The growing importance in finance of computerized high-frequency trading has further strengthened the orientation of decision makers and researchers to an ever shorter period. This orientation to the short period reflected by much of standard economics raises serious problems for its application to the sustainability issues studied by FESSUD. Unfortunately, also the (meagre) section of mainstream economics studying the long period, as for example long-period growth theory, is hardly applicable to sustainability issues because structural change is usually ignored or strongly played down. The standard approach sees sustainable growth as mere “steady state growth” and ignores most environmental and social constraints.

The work of Work Package adopted instead a structural approach suitable to an in-depth long-term analysis of sustainability. In this view, sustainability is not a steady state within a given structure as in standard growth theory but sustainable structural change, namely a process of co-evolution complying with the requisites of sustainability, such as intergenerational equity, emphasised by the Bruntland Report (WCED, 1987), or the preservation of natural capital that is one of its pre-requisites. This co-evolutionary conceptual framework acts as a powerful methodological bridge between economics and finance on one side and natural sciences on the other side since the latter typically study the biosphere from an evolutionary point of view (Kallis and Norgaard 2010; Weisz and Clark 2011; Clark and Clark 2012; Clark 2013).

A thorough investigation of the nexus between financialisation and sustainability has also to take account of the radical uncertainty and the irreversibility of the effects of economic activity on the biosphere. The standard model of mainstream macroeconomics, ultimately based on general equilibrium theory, assumes the complete reversibility of time. This implies the irrelevance of current mistakes for long-term sustainability in the sense that, whenever policy makers discover a mistake – even a huge one impairing the sustainability of development – this can be easily and quickly remedied and its consequences undone at no cost. Unfortunately, in the real world this is not the case. Environmental deterioration cannot
be undone (as in the case of a loss of biodiversity) or can be undone only at high cost (as in the case of climate change) with a considerable and sometimes catastrophic delay.

The problem of irreversibility is made even more significant by the fact that the consequences of human activity on the biosphere are subject to radical uncertainty that cannot be taken into account through standard probabilistic methods, nor insured by applying the standard principles of commercial insurance. It is a standard result of decision theory that, under irreversibility and radical uncertainty, the conservation of options ultimately linked to the conservation of natural capital has significant value in itself. This suggests a policy based on a strong version of the precautionary principle (see, for example, Vercelli, 1998).

Another concept that plays a crucial role in the analysis of the substantive themes is the divisive scarcity concept. Scarcity in standard economics is not an objective concept as it depends on the tastes of economic agents and the short-term availability of resources. The latter depends on the system of prices and may be easily modified by the interplay of demand and supply. In this view, scarcity is substantially endogenous, although it is conceded that natural constraints may affect economic scarcity in the short period. The scarcity of natural resources is conceived as relative to their demand while both demand and supply crucially depend on the system of prices. In this view, the insufficient supply of a certain natural resource, as compared to its demand, would bring about an increase of its price and this would deflect demand towards substitutes. In the case of oil, demand would be deflected towards coal or natural gas, whose price however is strictly correlated with that of oil, and eventually towards renewable energy sources whose price is much less correlated with that of fossil fuels. In addition, the higher price of oil would encourage a series of decentralised actions contributing to increase the supply of oil and/or to reduce its price: new prospections, increased production through more expensive techniques, technological progress aiming to increase energy efficiency, and so on.

All these actions are believed to succeed in general to quickly re-equilibrate demand and supply and to stabilize price along a smooth long-term trajectory based on market fundamentals. In this view, scarcity of natural resources is not worrying except when it is
policy-induced for short-term purposes, as in the case of the two oil shocks of the 1970s. According to the point of view of natural scientists, instead, the flexibility of supply obtained through the price system may be successful only in the short period but certain crucial natural constraints cannot be constantly shifted or permanently removed. For example, the quantity of fossil fuels retrievable from the earth is given. No doubt, technical progress may increase the quantity of fossil fuels that may be retrieved at acceptable costs, but the natural constraint may only be shifted forward to a limited extent.

The conflict between these two conceptions of scarcity is particularly visible as regards the issue of peak oil. Most mainstream economists deny the existence of a peak in the world oil production at least in the near future. Experts with natural science background disagree on the estimate of the year in which the production of cheap conventional oil will peak but agree on the prediction that we are not far from it. The committee appointed by the US Energy Department found in their final report (often called “Hirsch report”) that most estimates agree on the proximity of a peak of world oil production (Hirsch et al., 2005). In any case, taking into account the strong uncertainty on the time profile of oil production and the costly and time-consuming irreversibility of its effects on the economy, it is rational to take decisions on the likely hypothesis that the peak of oil production is not too far ahead. Premature mitigation efforts may be costly but the cost of late mitigation would be much more damaging. Therefore, the Hirsch report maintained that according to standard risk management principles it is rational to start immediately a serious and systematic mitigation policy. A generalization of this argument may be found also in the Stern Review in reference to climate change policy (2006). As for the effects on climate change of the growing use of fossil fuels, the uncertainty of the effects is much stronger and the irreversibility much more intense. We have thus to act immediately with great determination to try to avoid catastrophic effects before the end of this century.

7.3 The energy system and the transition to a low carbon economy

Since the Industrial Revolution, the process of financialisation has progressively expanded into many fields of human life, including labour, money and land that so far had been kept,
at least in part, outside the market logic, as emphasized in particular by Polanyi (1944). Subsequently, the logic of market has progressively extended its reach from agricultural and manufactured products to land, built environment and the biosphere in general. The long-term process of financialisation has progressively transformed nature from an end in itself to a mere instrument.

The process of financialisation captured long ago the vital activity of energy production, distribution and consumption (henceforth referred to as “energy system”). The Second Financialisation (cf. Chapter 1) strengthened the link between energy and finance by making energy resources object also of systematic financial speculation. The energy system is nowadays a crucial field of interaction between nature (environment) and finance. This was crystal-clear during the recent Financial Crisis (2007-09) and the subsequent great recession. The subprime crisis was triggered by the interaction between, on one side, the housing bubble increasing the financial vulnerability of economic units, and, on the other side, the spike in the price of oil, soon reflected in the price of food, because of the scarcity of environmental resources (see Vercelli, 2014b and 2016). Central banks reacted to the cost inflation triggered by the sudden increase in oil and food prices by increasing the discount rate. This policy move raised to a certain extent the entire structure of interest rates including those relevant for mortgage rates. The ensuing increase in mortgage delinquency and foreclosure rates determined a spike in the supply of houses and a consequent precipitous fall of house and mortgage-based securities prices starting the propagation of the financial crisis to other economic sectors and countries, eventually determining what came to be called Great Recession. In particular, the crisis had an impact on action on climate change:

“On a positive side the crisis has triggered a theoretical and policy debate about Green Growth, one element of which is the idea of green stimulus that has seen its first implementation in 2009. On a negative side ... climate action has taken a serious blow due primarily to a shift in public concern and political will. The lost political time was not made up by a fall in GHGs due to lower economic activity partly because of a shift to coal. Though
crises are often opportunities and can be a symptom of underlying socio-technical transitions, unlike past transitions a transition to sustainable energy systems must be a largely policy driven transition. Unlike past transitions, the time frame available is much shorter. Given the centrality of policy guidance in this transition, the greatest damage associated with the Great Recession seems to come from the shifting government priorities” (Papandreou, 2015).

In addition, the Fukushima accident, which occurred in March 2011, had a significant impact on the process of convergence towards a sustainable development trajectory:

“The Fukushima accident made evident, and further worsened, the shortcomings of the existing energy system based on fossil sources. In particular, it reduced significantly the current and prospective contribution of nuclear energy to the global supply of energy aggravating for a foreseeable future a trend characterized, according to many experts, by structural excess demand of energy. This effect is likely to last in the longer period since, in the absence of a major technological breakthrough; a new “nuclear renaissance” such as that started in the late 2000s seems unlikely in the near future. In any case, the necessary upgrading of safety standards in nuclear reactors and the downsizing of their contribution to energy generation has been, and will continue to be in the foreseeable future, a significant factor of cost inflation that interacts with the ongoing recession jeopardizing a durable escape from it. (Vercelli, 2014f)

More specifically, it has to be acknowledged that the accident revealed a series of failures in the design of the Fukushima plant (unable to withstand the consequences of an earthquake such as that occurred in March 2011 and the ensuing tsunami). In addition, it revealed a short-sighted management of the crisis (late decision of using sea water to cool down the reactors), poor regulation (also due to regulatory capture), late and contradictory reactions of policy authorities. It is argued that a common root in all these shortcomings may be “found in the intrinsic instability of the nuclear energy generation process due to the critical dynamic nature of the nuclear chain reaction underlying the production of energy. The structural instability of the process implies strong risks that can be only partially mitigated with
precautionary measures. This casts serious doubts on the viability of nuclear energy as cheap, clean and secure source of energy able to contribute to the mitigation of global warming. In any case, the cost of nuclear energy is due to increase significantly in consequence of the new security measures that will have to be taken after the Fukushima accident. Only a significant, but at the moment unexpected, technological breakthrough could re-launch the perspectives of nuclear energy in the next two decades or so.” (Vercelli, 2014c and f)

Whatever has been the impact of the crisis and the Fukushima accident, the transition from the current energy system towards a low carbon economy will crucially depend on the evolution of energy prices that are strictly related to macroeconomic fluctuations:

“When taking a very long run perspective the key message is that energy prices have shown a steady decline, but that the price rise after 2005 may be ushering in a new era of higher prices. Oil price has a central role in the energy markets ... From the first major oil shocks in early 1970 oil prices have been closely linked to the macroeconomic recessions.” (Ruzzenenti and Papandreou, 2015).

Some useful lessons may be learned from the history of oil prices:

“(1) with low energy/oil prices it will be more difficult to garner support for a low carbon transition, (2) high fossil fuel prices can make climate policy easier to pursue but without strong climate policies in place they may not be a boon to a low carbon energy transition as high oil prices can just as easily induce new exploration and development of oil fields or technologies, (3) there remains controversy about the likely trajectory of future fossil fuels though the ‘conventional’ wisdom expects a higher plateau, (4) modelling fossil fuel prices remains a daunting challenge but is an important part of forming an effective climate policy along with understanding the interaction of a carbon price (and other mitigation policies) with fossil fuel prices. Ultimately, we need a better understanding of the way that policy and system change affect the price of energy services rather than energy prices. When energy services associated with low carbon become cheaper or more attractive than their high
carbon counterpart we will have forged the road to a low carbon economy.” (Papandreou, 2014a).

7.4 Low carbon transition and the role of financial instruments

A specific policy issue investigated has focused on finance for sustainability, and particularly on the extent to which, and the ways in which, new financial instruments could better support the transition to a low carbon economy. This work has been based on the premise that the impacts of finance are inherently ambiguous and highly contingent and that any form of finance cannot be easily separated from the contexts and conditions that co-evolve with its deployment and governance. Of course finance and financialisation, and the associated modes of governance, can choose to fund unsustainable activities and fail to invest in sustainable activities. Some of the causal factors and processes that underpin the unsustainability of financial systems are systemic and structural. Without wishing to downplay the critical importance of these factors in any way, the research has sought to focus on potential solutions. In particular, a research line explored some of the ways in which new modes of finance and governance could better support sustainability, especially by intensifying and accelerating low carbon transitions (see in particular deliverables Gouldson (2014) and D7.15).

This line of research began with an evaluation of the scale of challenge and an assessment of the size of the climate finance gap – that is the difference between the levels of low carbon investment that are needed to avoid dangerous climate change and the levels of low carbon investment that have actually been made in recent years. It is acknowledged that there is a compelling global economic case for climate action (Stern, 2007). However, it also recognised that an effective response still requires enormous levels of investment and that the general, long term, social case for action on climate change does not always translate into a specific, short term, private case for investment, and that the availability of public funds is frequently constrained in contexts of austerity. These factors have led to levels of financing for low carbon developments that are much lower than many estimates suggest are necessary. The IPCC (2014) estimated that global investment in climate mitigation and
adaptation was in the range of USD 343 to 385 billion per year in the period between 2009 and 2012, and Buchner (2013) suggested that global climate finance flows have plateaued at USD 359 billion. Both of these estimates equate to roughly 0.5% of global GDP; approximately one third of the upper end of the investment needs as estimated by McKinsey (2010), GEA (2012), WEF (2013), McCullum et al (2013) and IEA (2013a), and one quarter of the upper end of the investment needs as set out in the Stern Review [Stern 2007].

As well as acknowledging the scale and importance of the climate finance gap, WP7 research has stressed that the need for an effective response to under-investment in climate mitigation is pressing. As the years pass, decisions are being made that are locking the world into high carbon development paths for years to come, whilst at the same time long lived emissions continue to accumulate in the atmosphere and the opportunity to make investments that will help to avoid dangerous climate change diminishes. Indeed, the IEA (2013a, p.3) reported that ‘the goal of limiting warming to 2°C is becoming more difficult and more costly with each year that passes’. To avoid dangerous levels of climate change, we have to limit GHGs atmospheric emissions to no more than 450ppm, a level that is associated with a good chance of avoiding dangerous climate change (IPCC, 2014). The IEA (2013a, p.3) finds that ‘almost four-fifths of the CO2 emissions allowable by 2035 are already locked-in by existing power plants, factories, buildings, etc. If action to reduce CO2 emissions is not taken before 2017, all the allowable CO2 emissions would be locked-in by energy infrastructure existing at that time.’

Given the scale of the climate finance gap and the need for urgent action on climate change, it is important to identify and evaluate the potential contribution of innovative financing arrangements with the potential to reduce the cost and enhance the impact of low carbon investments. An interesting case study is the potential contribution of revolving funds where the savings from investments in energy efficiency and other forms of low carbon development are captured and reinvested either to reduce the need for new finance or to increase the impact of available finance.
Although revolving funds have been proposed by agencies such as the International Energy Agency and the European Commission, there has never been a formal academic evaluation of the potential contribution of such funds. This lack of academic analysis is not unusual – indeed the IPCC (2014) notes that the scientific literature on investment and finance to address climate change is still very limited and that knowledge gaps are substantial.

To make the discussion less abstract and more practicable, we focus on the role that revolving funds could play in promoting energy efficiency in buildings. Globally, over one-third of all final energy and half of electricity are consumed in buildings that are therefore responsible for approximately one-third of global carbon emissions (IEA, 2013b). Energy use in buildings is therefore of critical importance, and many reports highlight the presence of cost-effective opportunities to improve their energy efficiency (IPCC, 2014). However, the IPCC (2014) noted that many, potentially attractive, energy efficiency investments do not meet the short-term financial return criteria of businesses, investors, and individuals. As a result, the IEA (2013b) predicted that without a concerted push from policy, two-thirds of the economically viable potential to improve energy efficiency in buildings will remain unexploited by 2035.

The reasons for this inertia relate to the presence of strong barriers to change. The IPCC (2014) cited imperfect information, split incentives, lack of awareness, transaction costs, and inadequate access to finance, industry fragmentation, the need for new delivery mechanisms and the absence of pipelines of bankable energy efficiency projects as significant barriers. Focusing specifically on the financial barriers, the IEA (2013a) highlighted the importance of up-front costs, levels of risk, issues with interest and discount rates and the inadequacy of traditional financing mechanisms for energy-efficient projects. New forms of policy support, new institutional arrangements, new forms of finance, and new business models are therefore required if the energy efficiency opportunities in buildings are to be exploited (DECC, 2012a; GEA, 2012; IEA, 2013a; IPCC, 2014).

The scale of the challenge is formidable – the IEA (2013b) estimated that over the next four decades USD 31 trillion would be required to promote energy efficiency in buildings at a rate
that gives the world a good chance of limiting the temperature increases associated with climate change to 2°C. Whilst the IEA (2013a) suggests that ‘it is widely recognised that mobilising huge investment into energy efficiency is essential’ it also argues that ‘offering advantageous financing mechanisms is likely to require public funds and these may be harder to justify with tighter public budgets’ and that as a result mobilising private as well as public sector financing will be essential. In 2008, the IEA argued that one way of doing this might be to establish revolving funds for building refurbishment.

These issues are particularly relevant in Europe. The European Commission has set a target of reducing energy consumption by 20% by 2020, with performance assessed relative to business as usual projections that include assessments of background trends in energy use and energy efficiency (EU, 2012). It has also recognised that €100 billion a year will be needed to reach this target, and it has set aside €27 billion to support the transition to a low carbon economy through the European Structural and Innovation Funds and €265 million for a European Energy Efficiency Fund. It has also recently established the Energy Efficiency Financial Institutions Group to find new ways of overcoming barriers and scaling up investment in support the search for new ways of supporting energy efficiency investments, particularly in buildings renovation (EEFIG, 2015). In each of these areas, there is a pressing need not only to make more funds available for energy efficiency and low carbon transitions, but also to significantly enhance understanding of the ways in which those funds could be most effectively and efficiently deployed.

The European buildings sector is a central part of the wider drive to improve energy efficiency. Energy use in buildings accounted for 34% of total final energy demand in Europe in 2007, with the residential sector accounting for 23% and the commercial sector 11% (GEA, 2012). The European Commission (2011, p.8) stated that ‘In Europe, the built environment provides low-cost and short-term opportunities to reduce emissions, first and foremost through improvement of the energy performance of buildings … emissions in this area could be reduced by around 90% by 2050’. It also stated that the buildings sector provides the second largest untapped and cost-effective potential for energy savings after the energy
sector itself (EC, 2011). Like many other agencies and policy makers, the EC recognised the importance of finance and investment if the transition to more energy efficient buildings is to be made. There is recognition that there needs to be a marked improvement in financial incentive structures and that 'Innovative programs will be needed to eliminate information barriers, reduce transaction costs and mobilise investment capital' and that smart financing schemes are needed that can leverage private sector investments (ECF, 2013 p16). Indeed, the European Union has stated that ‘Public finance through innovative financing instruments, such as revolving funds, preferential interest rates, guarantee schemes, risk-sharing facilities and blending mechanisms can mobilise and steer the required private finance’ (EC 2013, p.11).

Given the broader context as discussed above, our work has explored the case for the creation of revolving funds that could be used to increase levels and enhance the performance of investments in energy efficient and low carbon buildings in the UK. Based on the development of a model designed to explore and illuminate the workings of a revolving fund, we considered the impacts that such a fund could have on the financing of a large-scale energy efficiency programme for the domestic sector in the UK. The results of the first stage of this research are published in Gouldson et al (2015).

The model was applied using realistic data on the costs and benefits of domestic sector retrofit drawn from a large-scale ex-post evaluation of the actual impacts of domestic sector retrofit activities (see Webber et al, 2015). The results show that the total funding required to fully deploying a range of energy efficiency and low carbon measures across the UK housing stock would be £33.7 billion. Obviously, this is a very substantial level of investment, but critically the results suggest that while £24.8 billion of this total would need to come from new capital, £8.9 billion could come from recycled investment based on savings that were recovered and reinvested. The results show that recycled investment could therefore make up 26.4% of the total investment needs over the lifetime of the fund.

In the context of a neoliberal government that is actively pursuing an austerity agenda, the prospects for large-scale public sector investment in such a fund seem increasingly remote.
However, our results also show that an ambitious domestic sector retrofit programme could essentially pay for itself, albeit with significant upfront investment requirements and over an extended period of time. This finding could be of great significance as it suggests that ambitious action on climate change, and very high levels of investment in low carbon transitions, need not be funded by the state. Ambitious action is therefore possible even in contexts of austerity. However, it is recognised that the state probably needs to play an active enabling role, especially through policies designed to reduce risk and uncertainty in low carbon transitions.

As well as exploring the different roles that government could play in enabling significant levels of investment in low carbon transitions, this research has also considered the relative merits of different forms of private and civic action. In particular, it has examined the pros and cons of private, neo-liberal and civic, community-based, modes of finance and governance for low carbon transitions. WP7 research worked out a comparative evaluation of the characteristics and outcomes of different applications of the revolving fund concept. In one instance, this investigation evaluated the outcomes of a private profit-driven scheme that has ready access to finance but invests only in commercially attractive low carbon measures. In another, it considered the outcomes of a civic not-for-profit scheme that has more limited access to capital but that invests in all viable low carbon measures. This investigation also considered the outcomes of a publically funded scheme that also invests in all socially beneficial low carbon options. The empirical case again relates to the retrofit and energy efficiency up-grade of the domestic building stock in the UK.

The results of this investigation show that a public or civic scheme could have substantially greater impacts than a private scheme. Specifically, the research finds that a public or civic schemes generates approximately 4.7 times as much investment and 2.3 times as much carbon savings as the private scheme. Crucially, if a private profit-driven scheme was adopted first to exploit all of the cost-effective opportunities, the prospects for a further private or even a public or civic scheme to step in to invest in the less cost-effective measures that were left unexploited by the initial private scheme would be low. This is because the
opportunities to cross-subsidise investments in the less cost-effective options with the returns from the more cost-effective options would have been removed. The early emergence of private profit-driven schemes could therefore be seen as a form of ‘asset stripping’ that will make longer-term transitions or deeper levels of decarbonisation harder to achieve.

This investigation also argues that private schemes are likely to generate a series of negative social and behavioural spillovers that make collective action on climate change and on other issues less likely in the future, whilst civic schemes could generate positive spillovers and enhanced levels of social capital that do the opposite. We therefore call for greater support for civic investment, perhaps in the form of mutually owned, community based investment funds, and we highlight the opportunity for policy makers to put as much effort into the development of public-civic partnerships in the coming years as have put into the deployment of public-private partnerships in recent decades.

Summing up, innovative financing arrangements such as revolving funds—which capture and reinvest a share of the savings from low carbon investment—could enable very significant levels of low carbon investment. Indeed, FESSUD research shows that an extensive domestic sector retrofit scheme could be made essentially cost-neutral through the use of a revolving fund, albeit with significant up-front investments that would only pay for themselves over an extended period of time as energy savings come through. This research has also shown that the up-front investment costs of such a scheme could be significantly reduced through the creation of a revolving fund. Such a retrofit scheme could also generate wider social, economic and environmental benefits by tackling fuel poverty, improving energy security and reducing carbon emissions.

7.5. The growing diffusion of energy derivative contracts: implications for sustainability and regulation

Along with the new financial instruments supporting the transition to a low carbon economy, in the deliverable D7.12 (Gabbi, 2016) research has explored the impact on sustainability of energy derivative contracts and the way they are traded. This critical analysis has been
carried on in the light of the usual behaviour of agents (producers, merchants, processors, and end users on one side, money managers and financial traders on the other side). Moreover, this investigation has focused on the shortcomings of the current regulation principles, the impact of commoditization and financialisation of energy in terms of price volatility correlations. In the ensuing deliverable D7.13 (Gabbi, 2015) a re-regulatory framework aimed at stabilizing the markets is suggested.

The starting point of the analysis is the observation that the commoditization of energy resources (considered as a component of financialisation) has dramatically affected the energy market. Commodities markets have had massive economic impact on nations and people. Unusual disruptions caused by weather or natural disasters can not only be an impulse increasing price volatility, but can also cause regional food shortages. The increasing use of financial contracts, particularly derivative contracts, on energy resources has similar consequences.

Recently, a large stream of literature has been produced to evaluate the co-movements among commodity prices and derivatives. Ghosh, Heintz, and Pollin (2011) demonstrate that the use of futures contracts and spot commodity prices had a large impact. They also conclude that regulators should design a set of rules “to enact and enforce policies capable of effectively dampening excessive speculative trading on the commodities markets for food”.

Pradhananga (2015) shows that as financialisation of the commodities futures market proceeded and more traders entered the futures market, market liquidity increased. Much of the rise in liquidity was due to increasing investment in commodity indices, which meant that futures and OTC contracts of unrelated commodities are considered as a portfolio asset. This increase in liquidity across different commodity markets, lead to synchronized change and positive correlation in commodity prices. Pradhananga (2015) provides thus strong empirical evidence that the financialisation of the commodities market led to the recent rise in co-movement of (unrelated) commodity prices.
A significant factor to underline is the microstructure of agents trading commodity (and energy) derivatives. After the crisis, producers, merchants, processors, and end users were net short in futures positions on U.S. exchanges. This is consistent with the purpose to edge a position that is structurally long for their storage of commodities. On the other side, most index funds are ‘long only’ funds whose value increases only when the prices of the underlying commodities rise. Investors in such instruments expect commodity prices to rise; money is lost if the values of the underlying commodities in the index decrease. Many of the managers of index-style investments do not trade the individual components of an index on a daily basis; instead, they buy and hold these investments over periods of months or years, rolling contracts forward to avoid physical delivery.

During the financial crisis of 2007-09, markets experienced a dramatic increase in the correlation between crude oil and other commodities as demand decreased for raw materials. Both before and after the world economic slowdown, there were observable increases in the correlations between commodity prices.

Energy derivatives do follow the same pricing assumptions applied to plain vanilla derivative contracts, which is the non-arbitrage opportunities, based on the efficient market hypothesis. The real world experiences many factors deviating from rational expectations, such as: mismatch in asset/hedge maturities: long maturity of assets vs. short maturity of hedges; mismatch in granularity: fine (daily, hourly) granularity of assets vs. coarse granularity of hedges; mismatch in underlying commodity, ‘dirty’ hedges; violation of normality hypothesis; fat tails. Moreover, there are many liquidity constraints: for example, price and execution time may depend on the volume, while distributions are hard to calibrate because of biases due to liquidity constraints. Therefore, different hedging strategies may produce different option values. The most important issue appears to be the unpredictable volatility, which seems to be affected by the diffusion of energy financial contracts. Unlike cash flows of financial products, the cash flows of energy assets are determined by complex operating strategies: dispatch strategy for power plants or injection/withdrawal strategy for gas storage. Therefore, hedges are ‘dirty’ and result in residual cash-flow variance.
Other determinants contribute to explain why volatility on energy has not reduced with the large use of derivative contracts. First, there is a need to match instantaneous demand with instantaneous generation because it is not possible to store electricity in any significant quantity; second, the demand and supply are inelastic. This is why energy prices are characterized by extremely high volatility, seasonal jumps and daily effect. Therefore, the time horizon of such instruments must be short.
Summing up, the usual belief that the rise of derivatives usage reduced the price volatility of energy resources has to be rejected. On the contrary, the financialisation of the commodity and energy markets appears to be highly correlated with a jump in volatilities, as previously explained.
The growth of innovative products written on energy commodities, along with the role of financial players, shows how these markets have been highly financialized.
The pricing of energy contracts is usually based on the absence of arbitrage opportunities that require perfectly efficient markets, but the empirical evidence demonstrates that most of these assumptions are inconsistent. Hedging is concretely difficult to execute because of the volatility jumps in most liberalized markets (especially for the electricity exposures).
Because of the stochastic dynamics assumptions and the physical and geopolitical elements, which affect energy prices, the time horizon of speculators (and hedgers) necessarily must be very short.
Current regulation is designed to promote a process towards the realization of the theoretical assumptions of efficient markets. This sort of regulation, for all the reasons previously explained, is unable to constrain destabilizing speculation. Therefore, regulation should be re-designed to avoid this sort of speculation. The concrete solution can be found along the following guidelines:

1. Banning any naked position;
2. Imposing a clearing scheme for all the OTC contracts;
3. Forcing clearing houses to get physical collateralization from clearing members (and the same for the non-clearing members involved in the trade);
4. Authorizing to become market makers only the players able to guarantee the maintenance of bid-ask spreads within a regulatory level. This means a liquidity buffer requirements calibrated on the minimum volume of their cumulated trade. Their exposures could remain naked within a pre-determined period of time, after which a physical energy position to hedge the derivative exposure must be taken;

5. Regulators are expected to monitor the volatility prices and to use “non-conventional” tools to suspend derivative trades and provide penalties to non-compliant agents.

7.6. Disembedment of money from the “real” economy of socio-ecological flows of matter and energy

A troubling aspect of financialisation identified in previous research is the historical process of separation between finance and the real economy. One task of our research has been to grasp these processes and how they are understood in different approaches and schools of economic theory. A first step in this analysis deals with currencies as such. Commodity currencies have commonly been juxtaposed with fiat money, implying a development from primitive forms of money that required anchoring in a commodity to gain acceptance, to more sophisticated monetary regimes based on confidence and trust. Hermele (2014) suggests that the idea of a gradual replacement of the former by the latter is an ahistorical construct: commodity and fiat monies have replaced each other over the millennia, and the latest craze for commodity currency was as recent as the 1920s when many European currencies were based on gold. Properly understood, money is a social relationship, whereby the anchoring of money in commodities over the centuries may be seen either as strengthening the social contract between the regent and the people, or as undermining it by reducing the space of politics at the expense of automatic regulators. With the break-through of democracy in the early 20th century, the benefits of automaticity were increasingly questioned and finally abandoned in the 1930s.

The Bretton Woods regime, although based on dollar-gold convertibility, is from this perspective seen not as a commodity currency system but rather as one where politics took the lead over market forces. The demise of this era is often explained by the US misusing its
de facto international currency monopoly. However, the crucial shift was rather the advent of neoliberal political domination which once again disembedded markets from politics, tying the hands of politics and thus of democracy.

The main deficiency of the current international monetary order, in this perspective, does not reside in the absence of a suitable anchor, such as gold, but in the disembedding of market forces, including rules governing the world’s major currencies. Just as the embedding of post-World War 2 markets grew out of the dismal economic, social, political and military experiences of the interwar years, so too, a re-embedding of markets may ensue from the economic, social and political turmoil following the financial crisis of 2008. This analysis suggests that it is the political embedding of markets that policies should focus on, not the binding of currencies to a commodity anchor.

A second step in grasping the historical processes of disembedding finance from the real economy is to review various perspectives in economic theory. Hermele (2015) critically reviews Classical, Marxist, Neo-classical, Neo-Schumpeterian and Ecological perspectives on relations between the real economy and the financial economy. Following a key distinction made by ecological economists, three levels of the economy are highlighted: the financial, the real – where production of goods and services take place – and the ‘real-real’ – where the physical pre-conditions for the other two are situated. The analysis suggests that the three sectors cannot be understood in isolation from each other, and that some of the recipes for a resumption of healthy relations between finance and the real economy forget to anchor this vision in a clear understanding of the limits to growth analysed by ecological economists. Attempts to strengthen the real economy for the most part lack an understanding of one of the salient traits of the real world: its materiality, its physicality, its ‘real-realness’. Thus, an old contradiction intensifies between economists who realize that the economy is an open subsystem of the natural world, and those who prefer to visualize the economy as an entity with no other limits than those imposed by “bad” policies. The physical limits of the real economy remain a fact of the real and real-real economy that most economists have hardly begun to grapple with. The analysis suggests that bringing finance into relations with the real
economy that are beneficial for society requires attendance to the ecological dimension of the real-real economy, which is the very basis for economic activities and human welfare. Finally, this task addresses the issues surrounding experiences with, and potentials of, redesigning money as a means to bring finance more clearly into the service of society and aligned with sustainability. To this end, Hornborg (2015) draws on research in semiotics and ecological economics to analyse ways in which money can be ‘domesticated’. The phenomenon of money is, he suggests, recursively intertwined with central features of the human condition, from modes of cognition, religion, and morality to power, exploitation, warfare, and the nation state. The emergence of economics has reflected and reinforced historical processes of commercialization and monetization. The challenge for an economics concerned with sustainability ought to be how to respond to the problems posed by Nicholas Georgescu-Roegen (1971) in his observations concerning the biophysical limits to economic growth.

General-purpose money makes all values commensurable, regardless of whether they pertain to the reproduction of human organisms, communities, ecosystems, or the world-system. A way of curbing the destructive social and ecological consequences of financialisation might be to more clearly distinguish local values (such as those concerned with food, shelter, energy, community, and place) from the values pertaining to global communication. General-purpose money is a peculiar kind of sign, impossible to classify as belonging to one of C. S. Peirce’s three general categories of signs: index, icon, or symbol (Peirce was founder of semiotics as a formal branch of philosophy).

Since the marginalist revolution, mainstream economics has detached itself from two closely related concerns: namely, with the material substance and with the morality of trade. Heterodox arguments appealing to moral norms such as ‘justice’ and ‘equality’ are based on real asymmetries in the flows of embodied biophysical resources, whether labour time, hectares of land, tons of materials, or Joules of energy. The general historical trend toward a transition from metal through paper to electronic money has entailed a progressive separation of finance and monetary flows from ‘real’ flows of matter and energy. Economics
thus needs to investigate the possible connections between financial crises and the declining ‘net energy’ or EROI (Energy Return On energy Investment) in modern production processes.

7.7 Financialisation of Built Environments and Urban Sustainability

Built environments in Europe account for eighty to ninety percent of capital formation (stock, fixed) and about sixty percent of capital investments (flow, circulation) with the credit system functioning as essential mediating link between fixed and circulating capital (Sotelo and McGreal 2013). Clark and Hermele (2014) provides an overview of research into financialisation of the environment while Clark, Larsen and Lund Hansen (2015) reviews financialisation of the built environments. The literature suggests similar structures and mechanisms underlying financialisation of both natural and built environments, and that these processes are associated with rent seeking in its broadest sense and the rise to ascendancy (again) of a rentier economy. This involves the disembedding of finance from the real economy and its natural preconditions (Hermele 2014, Hermele 2015, Hornborg 2015), facilitated by rapid proliferation of innovative financial derivative markets, instruments and ‘vehicles’ (Harvey 2010).

The research on the financialisation of built environments highlights the characteristics of financialisation as a profoundly spatial process, forging social relations that form conditions for urban governance, social geographic change and urban sustainability. Work Package 7 research furthermore underscores how financialisation of built environments is enmeshed with related processes of commodification, privatisation, rent seeking and accumulation by dispossession (Harvey 2014). Land rent and the creation and capture of rent gaps – gaps between potential land rents and actually capitalized land rents – are emphasised as central to understanding financialisation of built environments (Clark et al 2015).

Where land (in its broadest sense, as space, environment, urban or rural) is commodified, privatised and opened up to rent seeking, tensions between potential and actual uses of land manifest in the exchange values of potential and actual land rents, forcefully directing flows of capital into built environments. This is also the case in societies with relatively large public sectors and welfare state institutions. Finance capital’s constant seeking of rent in
'investment' opportunities has pushed political reforms to privatise and commodify spheres of urban commons built up and institutionalised over centuries. Exchange value considerations become the primary drivers of urban policy and development of built environments. By turning built environments into vast sources of unearned income (Sayer 2015), primarily interest and land rent, financialisation has turned the production, exchange and consumption of built environments into systems that create, reproduce and intensify inequalities.

Built environments have become machines for syphoning value from the real and real-real economies into financial wealth. The research suggests that unless the singular power of finance capital and landed developer interests is kept in check, any successes of urban politics, be they environmental, cultural, social or economic, will be valorised and captured by finance and real estate capital through the mechanisms of property markets. Sustainability thus becomes vulnerable to financial exploitation and an instrument of financial speculation, exacerbating asset bubbles. A policy implication of this research is that land and built environments need to be brought into the sphere of public property and urban commons, where use value driven investment decisions can be democratically anchored (Khan and Clark 2016).

FESSUD research into these issues includes case studies of financialisation of built environments in Ankara (Topal et al 2015), Stockholm and Copenhagen (Lund Hansen et al 2015), with special focus on housing, and how financialisation relates with shifts in urban governance and changing social geographies. These studies show that across different political, cultural and geo-historical contexts, financialisation of housing is associated with neoliberalisation of urban politics, social exclusion and displacement, and growing inequalities.

Grydehøj et al. (2015) brings together the three case studies in a comparative analysis of processes of financialisation of built environments in Copenhagen, Stockholm, and Ankara, with emphasis on entrepreneurial urban governance, housing policies and the sphere of cooperative housing. The motivation for focusing specifically on forms of cooperative housing
is that cooperative housing represents a particularly interesting segment because of its position between the market and the state. Entrepreneurial urban governance is especially relevant to recent developments in these case cities, as the shift from managerialism to entrepreneurialism has involved privatisation and marketization of housing, opening up this major sector of built environments to the penetration of financial interests and decision-making.

In all three cases, post-war national governments assumed expanding responsibilities for the welfare of citizens, especially in the sphere of housing. Legislation and support to cooperative housing associations were implemented as means of rapidly expanding the urban housing stock. In Copenhagen and Stockholm the challenge lay in creating a new kind of affordable housing for a new and well organised urban working class. Ankara also lacked affordable housing, explosive growth finding a measure of relief in the proliferation of squatter settlements. Despite Western-style city plans, the relative lack of legal and administrative control over land use in and around Ankara permitted the informal spread of low-income housing in a manner that was not possible in the Scandinavian capitals.

Another common aspect of all three cases is that legal constructs and programmes designed to provide affordable housing came under pressure to be reformed along lines rendering them vulnerable to financialisation. Legal changes in the Danish and Swedish cooperative tenure were clearly aimed to open this sector of the housing market for the flow of credit and financial investment. The historically rooted use-value oriented ideals of cooperative housing, which had been maintained by a legal framework friendly to associational property ownership, was displaced in order to install a new order of exchange-value orientation. Also in Ankara, policies geared to support forms of cooperative housing have fallen by the wayside, as housing subsidies have been channelled to private companies producing housing and amenities for high-income residents. These shifts in housing policy are associated with a broader shift in urban politics from urban managerialism to urban entrepreneurialism. The branding and selling of cities under the discipline of urban competitiveness; the ‘need’ to attract capital investment and the ‘creative class’; municipal sell-outs and privatisation of
services, institutions and built environments: this has been the context within which financialisation of built environments in Stockholm, Copenhagen and Ankara has played out, and in which changes in cooperative housing have played an important role.

Beyond these case studies, empirical analysis of cities across Europe (and globally) suggest that financialisation of built environments can be conceptualized as a generic process encompassing many variegated sets of institutional arrangements and social relations (Farahani and Clark 2016; Clark 2015). The contingencies surrounding and forming the process give rise to different political, social and environmental impacts which do not fit easily into the categories of ideal types, and yet cannot be adequately understood as unconnected to related processes extending across geopolitical scales.

The political impacts of financialisation of housing are enmeshed with variegated neoliberalisation, manifesting in multifarious transformations toward entrepreneurial forms of urban governance. Cities are commodified, branded, and strapped to the dictates of inter-urban competition: attract capital and “the creative class”, or suffer the consequences. Urban politics is furthermore impacted by growing inequalities associated with financialisation, as consolidations of economic power appropriate and subsume processes of democratic decision making.

The social geographic impacts of financialisation of housing – social polarization, with growing homelessness, slum formation and ‘urban decay’ at one end, and intensifying gentrification and absentee ownership of extravagant housing at the other end – are intertwined with the political impacts, which reinforce financialisation of housing as part and parcel of entrepreneurial urban governance. Housing is increasingly considered a pure financial asset, and decisions over housing production and distribution are made in terms of its exchange value rather than its use value. Decisions to ‘invest’ in housing become investor-oriented, geared to secure increasing exchange values for rentiers, rather than object-oriented, geared to the use values and basic needs of people associated with social reproduction.
The impacts of financialisation of housing on urban sustainability are the least researched and most difficult to pin down, not least due to the elusiveness and co-opted character of sustainability. Financing investments in ‘green’ and ‘sustainable’ built environments is an important element of the larger sphere of environmental politics, not least climate change and carbon politics. But while there have been significant achievements and valuable measures taken in this direction, there is an urgent need to further develop and utilize these achievements (Gouldson 2014; Gouldson et al 2015). There is also much evidence of greenwashing both existing built environments and new investments, without substantial basis for the claims: narratives of branding green and sustainable cities are widely used to “sustainability-enhance” investment vehicles and their underlying real estate values. Though difficult to answer unequivocally, it is important to ask: who is served by the increasing aestheticisation of “green” values (Grydehøj 2016), and what are the actual environmental impacts of green flagship urban developments, including the faraway sources of commodity chains and material flows making the lifestyles in these places possible (Anderberg and Clark 2013; Clark and Hermele 2014)?

7.8 The environmental policy in a financialised economy: viability, alternative approaches, and the case study of the EU-ETS.

The work of WP7 confirms that there is a significant convergence on the main features of a much-needed sustainable model of development. Significant examples of a broad agreement between experts of different disciplines and policy makers of many countries may be found in recent documents approved by the UN Assembly (see for example United Nations, 2012; UNFCC, 2015). What is still missing is a sufficiently wide and firm commitment on the actual implementation of a concrete path of transition from the current model of development to a sustainable trajectory. This involves difficult choices of priorities, weights, instruments that have huge differential implications for different interests and preferences, and are thus bound to be highly conflictual.

When environmental policy started to be systematically adopted in the 1970s, it relied mainly on “command and control” instruments. Their efficacy has been increasingly questioned in
the 1980s and 1990s when the confidence in free markets progressively surged to new heights. In consequence of this change of attitude, environmental policies shifted towards market-based instruments, such as environmental taxes and tradable permits, believed to be in principle more efficient and less distortionary instruments. Economic theory argued that these instruments are consistent with free market principles as they internalise the negative externalities that otherwise would jeopardize the correct functioning of free markets (Pigou, 1920), and play the crucial role of completing them (Coase, 1960).

In recent years, however, market-based instruments showed unexpected weak points. First, it is difficult to identify and measure the externalities that these instruments are supposed to internalise. In addition, environmental taxes, believed by many environmental economists to be in principle the most efficient instrument (Nordhaus, 2007), cannot be easily implemented also because of the strong anti-tax attitude of most citizens. In many countries, early attempts of introducing carbon taxes to reduce the emissions of GHGs have been abandoned in favour of a system of tradable permits affecting directly only one section of decision makers in commerce and industry. Their influential opposition, however, has often impaired the correct implementation of the tradable permits schemes.

A case in point is the European Emission Trading System (EU ETS) that represents the cornerstone of the European Union’s policy to combat climate change. This scheme adopted in 2005 has so far been the most ambitious and comprehensive plan of this kind. However, it is argued that:

“Despite being a prototype for other countries, the EU experience has shown a mixed skylight, characterized by flashing lights and dark shadows. While the emission reduction target for 2020 (-20%) has already been achieved by the EU, the estimated emissions reductions are likely to depend mainly on the worldwide economic recession that has significantly reduced industrial production (and consequently the resulting GHG emissions) rather than on carbon markets that have proved to be highly volatile” (Borghesi and Montini, 2016a).
Notwithstanding the serious shortcomings observed in the EU application of tradable permits, similar schemes have been recently adopted in many other world areas (namely the Regional Greenhouse Gas Initiative [RGGI], the Californian Cap and Trade System, the Australian Carbon Pricing Mechanism [CPM], and the Quebec Cap and Trade System [see Borghesi et al., 2016]). Many other emission trading systems, moreover, are rapidly emerging in further world areas, such as Japan, South Korea, Kazakhstan, Switzerland, New Zealand, Mexico, and so on (Newell et al., 2013). Between 2013 and 2014, also China started implementing seven pilot projects in selected cities or provinces (Beijing, Tianjin, Shanghai, Chongqing, Guangdong, Hubei, Shenzhen) with the goal of developing a nation-wide ETS in the future. The new ETSs that are rapidly spreading at the world level take account of the shortcomings of the EU-ETS introducing productive innovations. This creative process of imitation could possibly transform the EU from forerunner to follower in the ETS context, unless the EU will introduce similar innovations to improve the performance of the EU-ETS scheme (see Borghesi and Montini, 2016a and 2016b; see also Borghesi et al., 2016).

The crucial problem, however, is so far unsolved. To reduce GHGs emissions in a really effective way, a tradable permits scheme should be as global and homogeneous as possible. As the deliverable D7.09 maintains, there are three possible options: “(i) a worldwide ETS; (ii) a global network of regional/domestic ETS regimes; (iii) a linkage scheme between interacting regional/domestic ETS blocks.” (Borghesi and Montini, 2016b; see also Borghesi et al., 2016). Unfortunately, none of these options seems now politically viable.

In recent years, the viability of environmental policy itself has been increasingly questioned based on general theoretical and empirical arguments (Vercelli, 2016). Two of these arguments have been considered in the WP7 deliverables in some detail: the Jevons paradox (recently generalised under the name of “rebound effect”), and the Sinn paradox (also called “green paradox”).

Jevons, one of the most famous economists of his time, as early as in 1866, argued that “It is a confusion of ideas to suppose that the economical use of fuel is equivalent to diminished consumption. The very contrary is the truth.” (Jevons, 1866). This argument has been
recently developed and generalised under the name of “rebound effect”. An increase of efficiency in the use of energy, and/or a reduction of its relative price, bring about an increase in the consumption of energy. This argument is usually presented as a reason against environmental policies at least in the field of energy efficiency and climate change control (claiming that, for example, an increase in the fuel-efficiency of cars encourages indulgence towards a greater displacement or more driving or higher speed). The empirical evidence however does not corroborate the Jevons paradox as the rebound effect is generally found to be significantly less than 100%, not more as implied by the Jevons paradox. In addition, the downward influence of growing fuel efficiency may be easily offset by apt measures such as a tax that keeps constant the cost of fuel.

Basosi and Ruzzenenti (2014) investigates the rebound effect in the European freight sector finding that, by using the standard econometric methodology, the rebound effect has a value of about 40% globally and 38% on cross-border trade. These results do not confirm the futility of the policies of internalisation of carbon externalities pursued in the EU, but confirm their weakness. However, by using a different innovative methodology based on network analysis, the cross-border rebound effect almost disappears.

Sinn has recently generalised the argument based on the rebound effect to criticise the environmental policies pursued in recent decades, in particular in Europe. He argued that energy demand reduction strategies, such as those pursued by the EU in recent years, “simply depress the world price of carbon and induce the environmental sinners to consume what the Kyoto countries have economized on. Even worse, if suppliers feel threatened by a gradual greening of economic policies in the Kyoto countries that would damage their future prices, they will extract their stocks more rapidly, thus accelerating global warming.” (Sinn, 2008, p.360).

This “green paradox”, as Sinn himself called it, casts serious doubts on the efficacy of green policies, at least in their usual demand-side approach. These policies based on incentives to energy saving and efficiency risk to be “self-defeating” (Papandreou, 2015). The green paradox, however, does not deny the possibility of a more efficient environmental policy, if it
is designed by taking into account all the economic fundamentals including, as Sinn himself emphasizes, the supply conditions neglected or underplayed by the existing policy strategy. Borghesi, S. and Montini, (2015) investigate the effectiveness of environmental policy in reference to the EU-ETS system: “While the specific effect of the EU-ETS on GHG emissions can be hard to disentangle, its impact on EI [eco-innovation] and thus on the firms’ capacity to abate pollution can be the object of a more direct investigation, both on the theoretical and on the empirical side. Carbon pricing can persuade the most virtuous firms to invest in new technologies, with a twofold goal: firstly, to avoid purchasing costly tradable permits; secondly, to sell, and thus monetize, the available permits in excess. Furthermore, innovative firms can gain early mover advantages from being at the forefront in the cap and trade market. This can allow them to acquire a dominant position, derived from the capacity to anticipate competitors in the implementation of environmentally friendly innovations (eco-innovations). The incentive to invest in low-carbon technologies, however, is diminished if the carbon price is low or extremely volatile. In the former case, this is because a low carbon price leads firms to keep using the old, polluting technologies and buy pollution permits rather than shift to new environmentally friendly technologies. In the latter case, it is because high price volatility generates uncertainty about the actual profitability in investing in the new technologies, and about the expected advantages of eco-innovations.” (see also Borghesi et al 2016, p.79). Analysing latest European Union Allowance (EUA) unit price trend, it is possible to understand how European firms currently are not stimulated to invest in eco-innovation (EI) due to low carbon price values and high price volatility. The EU could upgrade and fine-tune its ETS setting both a EUA price floor and a EUA price ceiling to combat the negative effects produced by price volatility and to better support the introduction on large scale of EI. As Borghesi et al. (2016, p.80) point out “Mixed evidence and no unanimous consensus emerges from the literature that is still in its early stages of development as it generally focuses on the early phases of the EU-ETS due to a time lag in the data availability. In the near future, it will certainly be possible to derive more precise and robust indications from the empirical
analysis as the EU-ETS experience goes on and longer time series of data become available for more refined analyses. In general, however, the main conclusion that can be drawn so far is that the EU-ETS had at most a very weak impact on EI.”

7.9 Finance and sustainability: issues, open problems and policy recommendations

Taking account of the shortcomings of market-based instruments as experienced in their recent concrete application, many papers of WP7 argue that the ideal policy mix of environmental policy should resume a more systematic use of command-and-control instruments (see in particular Clark and Hermele, 2014). For example, with regard to financialisation of built environments, a crucial policy implication of WP7 research is that land and built environments need to be brought into the sphere of urban commons, where use-value driven investment decisions can be democratically anchored (Clark et al 2015; Lund Hansen et al 2015; Topal et al 2015; Grydehøj et al 2015; Khan and Clark 2016). Social and environmental sustainability can be strengthened by securing the right to housing and the right to the city, which in turn requires bringing urban land, built environments and financial institutions engaged in financing production of built environments under public ownership, or at least under significantly stronger public control and regulation (see D7.24). This is not to say that policy makers should forsake market-based instruments. However, the latter should be better coordinated with the instruments and constraints of direct regulation. A case in point is the EU-ETS system discussed in the preceding section. Two main policy recommendations clearly emerge from the analyses performed in the deliverables D7.08-D7.10. In the first place, the EU ETS needs to be reformed by introducing a price collar, namely, both a price floor and a price ceiling that limit the high variability that has been observed over the initial phases. This reform seems particularly important since empirical evidence shows that presence of a price floor contributed to prevent carbon price from collapsing in the other ETSs in which this mechanism was introduced (Borghesi et al., 2016). This suggestion is an example of how the use of market-based instruments can be coordinated with measures of direct regulation to increase the effectiveness of environmental policy.
More in general, the EU should rethink its environmental policy strategy. The latter has been mainly (if not exclusively) based on the EU ETS as its crucial cornerstone. However, this is probably not the right way to go as the incentive that such a system provides to eco-innovation appears to be rather weak. This does not mean that the EU ETS should be forsaken, but its role should be deeply revised, abandoning the wrong illusion that its application may automatically drive the European system along a sustainable path.

Within a more comprehensive policy framework, which is the contribution that finance may offer to increase the environmental sustainability of development? Policy makers may adopt, or encourage the adoption, of new financial instruments, but their efficacy is always constrained by quite strict conditions. In section 7.4, for example, we have seen that an extensive retrofit scheme can be made essentially cost-neutral over time through the creation of a revolving fund, albeit with significant up-front investments that would only pay for themselves over an extended period of time. The initial investment requirements could be significantly reduced through the creation of such a fund, while the savings realized would be sufficient to fund significant incentives schemes to encourage participation. Innovative financing arrangements such as revolving funds could therefore enable states with limited capacity (see Gouldson, 2014).

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This is not to say that policy makers should forsake market-based instruments. However, they should be better coordinated with the instruments and constraints of direct regulation. A case in point is the EU-ETS system. Two main policy recommendations clearly emerge from the analyses performed in the deliverables D7.08-D7.10. In the first place, the EU ETS needs to be reformed by introducing a price collar, namely, both a price floor and a price ceiling that limit the high variability that has been observed over the initial phases. This reform seems particularly important since empirical evidence shows that presence of a price
floor contributed to prevent carbon price from collapsing in the other ETSs in which this mechanism was introduced (Borghesi et al., 2016). In this sense the EU ETS, which was originally seen as a prototype for its followers, might have now to learn from them.

More in general, the EU should rethink its environmental policy strategy. The latter has been mainly (if not exclusively) based on the EU ETS as its crucial cornerstone. However, this is probably not the right way to go as the incentive that such a system provides to EI appears to be rather weak. This does not mean that the EU ETS should be forsaken, but its role should be deeply revised, abandoning the wrong illusion that its application may automatically drive the European system along a sustainable path.

Many obstacles slow down the necessary rapid transition from the current unsustainable energy system based on the use of fossil fuels to a new sustainable energy system based on renewable energy sources. Some of these obstacles are related to the diffusion of financial derivatives written on energy underlying assets (see section 7.5). Their pricing models assume the non-arbitrage hypothesis, although the empirical evidence shows significant deviations from the standard assumptions, such as the mismatch in asset/hedge maturities, and the violation of normality hypothesis. Moreover, the unpredictable volatility of energy prices in liberalized markets shows that it is hard to calibrate hedging in the medium-long run. The deliverables D7.12 and D7.13 argue that it is necessary to re-design the regulation of energy derivatives banning naked positions; imposing a clearing scheme for all the OTC contracts; requiring clearing houses to get physical collateralization from clearing members; authorizing to become market makers only the players able to guarantee the maintenance of bid-ask spreads within a regulatory level. The new regulatory framework should also attribute to regulators and supervisors non-conventional tools to suspend derivative trades and provide penalties to non-compliant agents (see section 7.5).

This confirms that policy makers should act consistently to shift the bulk of financial flows from speculation to a renewed role of support of the real economy to accelerate the transition to a sustainable development trajectory. In particular, policy makers should take urgent steps to close the climate finance gap. Although the required levels of investment are
very significant, the costs of not making these investments are likely to be much greater. The flows of finance into climate mitigation and adaptation are approximately one-third of the level needed to avoid dangerous levels of climate change. In the existing scenario, even profitable low carbon investment opportunities are systematically overlooked. In the buildings sector, for example, the IEA forecasts that, without extra policy support, two-thirds of the economically viable potential to improve energy efficiency in buildings will remain unexploited by 2035.

The IPCC (2014) cited imperfect information, split incentives, lack of awareness, high transaction costs, inadequate access to finance, industry fragmentation, the need for new delivery mechanisms and the absence of pipelines of bankable energy efficiency projects as significant barriers to low carbon investment. Focusing specifically on the financial barriers, the IEA (2013a) highlighted the importance of up-front costs, levels of risk, issues with interest and discount rates and the inadequacy of traditional financing mechanisms for energy-efficient projects as barriers to change. New forms of policy support, new institutional arrangements, new forms of finance, and new business models are therefore required if the energy efficiency opportunities in buildings are to be exploited.

Innovative financing arrangements such as revolving funds could enable major public interest programmes to be undertaken in ways that both significantly reduce the need for new public investment and that even render substantial programmes cost-neutral over time. In particular, revolving funds could enable states with limited capacities and resources to act in contexts and on issues where action might otherwise be impossible, particularly in an era of austerity.

Other monetary and financial innovations may contribute to accelerate the transition to a sustainable development trajectory. For example, the deliverable D7.18 authors argues that electronic money opens new possibilities to design currencies that promote equality, democracy, and sustainability, while insulating people’s basic material needs from the vicissitudes of financial speculation. The shortcomings of earlier experiments with alternative currencies provide a foundation for designing a complementary currency system.
that is fair, widely utilized, government-regulated, easily administrated, and efficient. It is conceivable that national authorities could issue a complementary currency, which can only be used to purchase locally produced goods and services, and to distribute it as a basic income to all citizens (Hornborg 2015, 2016).

Notwithstanding these and other interesting and constructive examples, the main contribution of finance to environmental sustainability is still that of providing an adequate support to the huge investments necessary to converge towards a more sustainable development trajectory. As Vercelli argues, “The transition to a sustainable model of development crucially depends on the quantity and quality of investment and this in turn crucially depends on the adequate support of the financial system. In order to use investment as a concrete lever to push towards sustainability the existing trajectory of the economic system we have to grasp the nexus between the existing development trajectory and the ongoing technological trajectory. The understanding of this nexus provides valuable insights on the requirements of a financial system able to support a sustainable model of development and a rapid transition to it.” (Vercelli, 2014e).

The financial system should support in particular the so-called eco-innovations referring to any product, process or organizational innovation that is more environmental friendly than relevant alternatives. The most relevant investment, strategic investment, produces all its benefits only in the very long period. In addition, its benefits are typically public goods that private investors may only partially appropriate. The expectations of the costs and benefits produced by the process of strategic investment typically extend along many decades and are subject to strong, even radical, uncertainty. In consequence of the process of financialisation, private investors take decisions within a progressively shorter time horizon and are strongly uncertainty averse (see Vercelli, 2016). This explains why “from the development of aviation, nuclear energy, computers, the Internet, biotechnology, and today’s development in green technology, it is, and has been, the State – not the private sector – that has kick-started and developed the engine of growth” (Mazzucato 2013, 13).
It is well known that financial markets are reluctant to finance innovation investment, the more so the more radical is the departure from existing routines. This is because the expected returns on innovative investment are not only risky but also very uncertain in the sense of Knight and Keynes. This has a series of consequences that discourage innovative investment. First, credit ratings focus on the financial performance of the firm rather than on its industrial performance: “in some cases it is the most “productive” firms that have the worst credit ratings, perhaps due to their greater spending on long-run growth investments” (Demirel and Mazzucato 2014, 51). In addition, the widespread practice of stock ‘buybacks’ in the interest of shareholders and top managers (particularly if the latter are endowed of generous stock options) has been found to be detrimental to R&D spending. The recent crisis increased the bias against innovative investment as the enhanced uncertainty aversion of lenders produced an increase in the cost of credit that hit the innovative firms more than the non-innovative ones (ibidem). Finally, the kind of strategic innovative investment that may accelerate the transition towards sustainable development has a long-run time horizon as its most significant returns are destined to emerge much beyond the short-term horizon of finance. This makes this sort of strategic investment unsuitable for private investment.

There is only one possible way out from this problem. The government as representative of the long-term interests of all the citizens has to play the role of catalyser for the strategic innovation necessary for a new sustainable trajectory. Contrary to some well-publicised myths, this is what happened in the past: “for example, the infrastructure of the ICT revolution, laying the basis for the Internet, was lavishly funded by the State from its beginning stages until it was installed and fully functional and could be turned over for commercial use” (Perez 2013, xxii).

The Government either has to intervene by investing directly in the strategic sectors to enhance sustainability, or by financing the relevant private investment, or by providing incentives and insurance for private investors and lenders able to correct the distortions mentioned above. These different channels of intervention do not exclude each other and are
likely to have synergic effects. In the US, for example, the state played a crucial role in all the most significant innovations since World War II through specific agencies and initiatives. A significant recent example is the policy recently pursued in Germany to develop solar PV that made it the world leader in this field: “by revising its feed-in tariffs (FIT) policy in 2000 to provide better pricing for solar PV . . . Germany made solar PV competitive with traditional power sources and even wind energy. At the same time, Germany also established a ‘100,000 roofs’ programme to encourage residential and commercial investment in the technology . . . . Germany grew its solar PV capacity from just 62 MWs in 2000 to over 24,000 MWs by 2011. This is similar to completing 24 nuclear power plants in about 10 years” (Mazzucato 2014, 156).

Public finance has thus a crucial role to play in the field of strategic investment for sustainability. Investing in strategic technology implies uncertain returns and unavoidable mistakes. It is thus encouraging to see that the public banks providing patient capital show often very good results even in the light of mere standard accounting. The BNDES, for example, has been earning record-level returns: the return on equity (ROE) in 2010 has reached the remarkable rate of 21.2% allowing not only the refinancing of strategic investment but also much needed investment in health and education (Mazzucato, 2014, 5). Analogously, the Chinese development bank catalysing the country’s investment in the green economy obtained excellent results (ibidem). Similarly, in 2012 the Kreditanstalt für Wiederaufbau (KfW), the German state investment bank, reported $3 billion in profits.

The intervention of the state as catalyser of the investment necessary to implement the transition to a sustainable development trajectory is thus not necessarily inconsistent with the public debt problems haunting many countries.

7.9 Concluding remarks

Financialisation poses new challenges for achieving ecological, social and economic sustainability, regardless of whether we consider it a novel or a recurrent phase of capitalist development. Two basic paradigms on the issue under discussion, each of which has many variants, may be distinguished. According to the viewpoint of mainstream economics,
financialisation is a physiological process contributing to the welfare of economic agents provided that it is introduced, promoted and self-regulated by the market. In this view, sustainability (conceived as mere “steady growth” of GDP) is guaranteed by market-led technological progress. This view is criticised by various heterodox streams. Typically, they distinguish sharply two different aspects of finance, a physiological one of support to the real economy and a pathological one of self-referential speculation. Our work confirms that the increasingly strict link between financialisation and issues of sustainability has far-reaching implications. Its causes and consequences may be understood only by taking a long-period evolutionary approach.

The results of WP7 deliverables converge to show that the process of financialisation, as occurred in the last three decades, has seriously jeopardized sustainability. Actually, the second financialisation started in the early 1980s has significantly altered the balance between physiological and pathological functions of finance in favour of the second. Sustainability may thus be reached only within a model of development radically different from the existing one. In particular, sustainable growth cannot be recovered within a business-as-usual perspective, as many current policies seem to believe.

Summing up the view emerging from our research, financialisation as a variegated and evolutionary process has clear implications for the sustainability of development. Sustainability, in all its definitions, is about the compliance of the process of development with well-defined economic, social, and environmental constraints. For example, according to the well-known definition suggested in the Bruntland report (WCED, 1987), development is sustainable if “meets the needs of current generations without compromising the ability of future generations to meet their own needs”. A vast literature has clarified that sustainability in this sense is attainable only under a set of binding economic, social and environmental constraints. Therefore, the compatibility between financialisation, which is about the relaxation of constraints to economic decisions, and sustainability that is about compliance with crucial constraints, is in principle problematic.
This does not imply, however, that the conflict between finance and sustainability is necessarily insurmountable. Finance could, and should, give a fundamental contribution to a rapid transition towards a trajectory of sustainable development and provide the necessary funding for its deployment by making possible the massive investments necessary to reach these goals. This requires, however, a radical reform of finance by constraining its growing self-referentiality and by channelling its activity instead at the service of the real economy in the direction of a new trajectory of development consistent with sustainability.
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Chapter 8 Regulation, de-regulation and financial liberalisation

8.1 Introduction
The chapter opens with the theme of the interactions of de-regulation, financial liberalisation and financial crisis, with an emphasis on the experiences of de-regulation during the era of financialisation and the links with the occurrence of financial crisis. In the following section (8.3), attention moves to the principles of regulation. There is coverage here of the general principles of regulation, the discussion of a Minskyan framework with its emphasis on the role of central banks in regulation, regulatory capture diminishing the effectiveness of regulation and then the forms which regulation may take. Section 8.4 is devoted to country specific experiences, covering European experiences and the United States.

8.2 De-regulation, financial liberalisation and financial crisis
Financialisation in the present era has been closely involved with financial liberalisation and de-regulation. The consequences of financial liberalisation for economic growth and financial stability have been reviewed in Sawyer (2015) and summarised in Chapter 1.

The era of financialisation has also been one of financial crises. Notermans (2013, pp.11/12) suggests that three conclusions can be drawn from the frequency of financial crises. First, financial instability is an inherent feature of the financial system, which stands in contrast to the mainstream theorising which suggests otherwise (cf. discussion in Chapter 2). Second, financial innovation including securitisation may have contributed to the severity of the financial crisis (particularly of 2007/09), though securitisation may be the expression of inherent instabilities of the financial system. Third, regulators of the financial system fail to draw appropriate lessons from previous crises which could aid prevention of repetition of crises.

De-regulation and liberalisation have been viewed as closely linked with the occurrence of financial crises in general, and the financial crises of 2007/09 in particular. Following the financial crises of 1929 to 1933, the regulatory responses in the United States included the passing of the Glass-Steagall Act, which many have seen as contributing to the absence of

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1 Arestis and Sawyer (2016) is a volume on financial liberalisation in which Arestis (2016) reviews the arguments on financial liberalisation. Evidence is also given in Sawyer (2015, 2016).
financial crises prior to the 1970s and whose repeal fed into the recent financial crises. "While the major objective of the Act may be seen as the prudential regulation of banks to ensure the value of public deposits in terms of Federal Reserve notes, it did this by restoring the separation of commercial and investment banking, limiting the activities of deposit-taking commercial banks to short-term commercial lending" (Kregel, 2014, pp.6/7). "The Securities Act of 1933 regulated the securities markets and Securities and Exchange Commission (SEC) was established to regulate secondary trading. The Commodity Exchange Act of 1936 regulated the exchanges for commodities and futures trading. Other pieces of regulation were established for different parts of the financial system. Savings and loans associations were to be overseen by the Federal Home Bank Loan created in 1933, and credit unions by the Bureau of Federal Credit Unions. The regulation of insurance companies was left up to individual states" (Orhangazi, 2013).

Orhangazi (2013) notes the argument that financial deregulation and lenient application of regulation created increasingly more liberalized financial markets which helped to create the conditions for the financial crises of 2007/09. "Financial deregulation and liberalization created an environment in which mortgage lending expanded and speculation in other financial markets were heightened even though riskiness was steadily increasing. The end result was the failure of mortgage firms, banks and a major insurance company, followed by the collapse of the market for short-term loans, which then first led to a liquidity crisis and then to insolvencies and a debt deflation, thereby sending the whole economy into a deep recession." (Orhangazi, 2013). Orhangazi (2013) specifically mentions four aspects of deregulation: (i) the end of the Bretton Woods fixed exchange regime and the ending of capital controls (from 1974 in the USA), (ii) abolition of limits on US interest rates in 1980, seen as precondition for introduction of sub-prime mortgages, (iii) elimination of wide range of restrictions on financial institutions from 1980s onwards, culminating in the final repeal in 1999 of the Glass-Steagall Act, with similar processes in UK and continental Europe, (iv) “the decision not to impose tighter regulations on the founding by banks of subsidiaries in such
areas as the Caribbean (for the US) or Ireland (for Europe); and of new forms of derivatives” [Orhangazi, 2013].

Orhangazi (2013) surveys the developments of the 1960s and 1970s which paved the way for financial liberalisation. These include accelerating inflation, financial innovations, changes in the needs of industrial capital, rise of financial power, rise of institutional investors. Financial deregulation and liberalization led to the rapid expansion of financial innovations including complex financial derivatives; rising securitization; the rise of a shadow banking system with much less regulation; increased risk taking by financial institutions; and flawed decisions based on flawed financial models. Orhangazi (2013) elaborates how these features all contributed to the increased fragility of the financial system. “[W]hile financial deregulation and liberalization prepared the conditions for the crisis, the proximate cause of the crisis was the decline in house prices, which had a large impact in the mortgage market. When housing prices began declining and adjustable mortgage rates were raised to higher levels, a number of borrowers began defaulting on their mortgage loans. Asset-backed securities linked to the mortgage market began losing value. As the mortgage-backed securities were spread across all financial institutions, the crisis spread to other assets based on short-term debt. Repo markets, asset-backed commercial paper markets, and money market mutual funds were at the center of this crisis.” Orhangazi (2013).

Notermans (2013) points to the widespread view that regulatory failure was a major cause of the financial crises. He then indicates that two variants can be distinguished, namely “the passive variant [that] regulation failed to adequately constrain an inherently unstable financial system”, and “the active variant [that] (changes in) an inappropriate regulatory framework provoked the crisis” (p.8). However, “both interpretations share the conclusion that ultimately it is the quality of public regulation and supervision that determines the degree of financial stability” (Notermans, 2013, p.8).

Orhangazi (2013) notes that “analyses that focus on financial market deregulation and liberalization as the causes of the crisis are based on the theoretical premise that left to their own workings financial markets are inherently unstable. Deregulation and liberalization
created an environment where financial fragility steadily increased and resulted in a deep financial crisis that sent the economy into a recession. Therefore, there is need for radical regulation”. In his view, two issues are raised by this approach. The first is that it focuses on financial factors as leading to the crisis, downplaying (or ignoring) problems in the non-financial real economy. The second is policy proposals on regulation and on downsizing the financial sector have to tackle the issue of power of the financial industry.

Although there is a wide agreement on the central role played by regulatory failure in the build-up to the 2007-09 financial crisis “there is no consensus on what this failure exactly consisted of, and accordingly, what appropriate remedies should look like. In a longer-term perspective, the argument that financial instability primarily reflects regulatory failure builds on the historical record which shows that crisis were very rare events indeed between the 1930s and 1970s when financial markets were tightly regulated”. It would then seem to be the case that “public authorities have both the knowledge and means to assure a large degree of financial stability but became increasingly unwilling to employ them since the 1970s. The exact content of regulatory failure in this this perspective can be summarised in one word: deregulation. Given the culture of greed that inevitably characterises financial markets, deregulatory measures such as the repeal of Glass-Steagall, the introduction of full capital account convertibility, the liberalisation of interest rates, the promotion of an unregulated shadow banking sector and of opaque derivative, the introduction of the EU single market caused the crisis. Yet, using a somewhat shorter historical perspective, some analysts come to the conclusion that deregulation cannot be the main cause of the current financial instability because it occurred well before 2004, when the bubble started to inflate. In this view changes in regulatory frameworks instead are the main cause of the current financial instability” (Notermans, 2013, pp.21/2) such as the switch from Basel I to Basel II. The rapid growth of what has become termed the shadow banking system (even if that lacks a precise definition) has been an element of the general processes of financialisation and has represented growth of the financial system with little regulation. In effect the degree of regulation of the financial sector diminishes with the growth of shadow banking. Notermans,
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(2013, p.22) indicates three main mechanisms characterising the growth of shadow-banking in the USA, namely Money Market Mutual Funds (MMFs) who attracted part of the deposit business from traditional banks, sale and repurchase agreements (REPOS), and securitisation involving such instruments as mortgage-backed securities (MBS), asset-backed commercial paper (ABCP) and collateralised debt obligations (CDOs).

Notermans (2013, p.28) notes that the is a degree of consensus that credit rating agencies in effect, whether by accident or design, worked to hide the exposure of financial institutions to risk. The rating of American MBSs “were based on two untenable assumptions, namely that housing prices would not decline in future and that no-documentation mortgages did not imply a significant deterioration of the quality of the borrower. The poor quality of ratings, in turn, was a major factor behind the lack of transparency that led financial regulators to underestimate the risks present in the system. Since ratings are a factor in determining capital adequacy ratios for banks, their widespread underestimation of risk will contribute to undercapitalisation and hence systemic risks. Moreover, existing microprudential regulation requires many institutional investors to only acquire highly rated assets” (Notermans, 2013, p.28).

“Inaccurate ratings are frequently seen to have been the outcome of a conflict of interest, errors in rating methods and intense competition. A conflict of interest arose because it was the institutions issuing securities that commissioned and paid for rating and the commission was proportional to the value of the issue, thus creating incentives for overrating.” (Notermans, 2013, p.28).

8.3 Principles of regulation

8.3.1 General principles of regulation

Although de-regulation and liberalisation in the financial sector have gone on alongside de-regulation (and privatisation) in the real sector, the purposes of regulation and de-regulation may be somewhat different in the two sectors. In the real sector, regulation has generally been conducted at the micro/industry level, and focused on forms of consumer protection – whether in the form of regulating prices, price-cost margins and profitability (to limit the
exploitation of market power), regulating with entry conditions and licensing or in terms of product specification. For the financial sector, regulation has taken the form of licensing financial institutions, control over interest rates, capital controls etc. It was against these types of controls that the financial repression literature was directed, and which helped to underpin the moves towards financial liberalisation (discussed in Chapter 2). Regulation governing who can operate as a bank or financial institution is a significant feature of financial regulation, and the relationships between the central bank and banks have roles to play (as discussed below with regard to ‘lender of last resort’). There are though other aspects to financial regulation, notably seeking to address issues of financial instability and crisis.

Regulation of financial markets can be viewed in terms of micro-prudential and macro-prudential aspects where the objective of the first is to limit the failures and bankruptcies of individual institutions, whereas macro-prudential seeks to limit the occurrence of major instabilities and financial crises. (Notermans, 2013, p.8). However, microprudential regulation does not take the interconnectedness between financial institutions sufficiently into consideration as a result of which the illiquidity or insolvency of one set of institutions may cause problems for another set of institution B. With substantial interlinkages, the probability of a significant number of institutions encountering problems simultaneously will be much larger than suggested when the likelihood of instability of individual institutions is treated as independent events. Hence capital adequacy ratios set on the basis of the probability of the price of an individual bank’s assets changing by a certain percentage over a given period of time may turn out to be grossly inadequate. In addressing and resolving a crisis “an exclusive focus on microprudential issues may be seriously counterproductive. To the extent that banks try to restore their capital ratio by means of reducing their asset base, microprudential regulation will impact a procyclical effect as lower market prices for assets will trigger moves to sell more of those assets” (p.10).

“The case for regulation can be made on several grounds. The first argument rests on the public good nature of financial stability” and as “will be undersupplied by the market
Therefore requiring interevention by the public authorities”(Notermans, 2013, p.15). “As far as financial stability has the nature of a public good there is the need that public authorities adopt measures to preserve and maintain it. In this sense, it is necessary that these authorities adopt a combination of microprudential and macroprudential policies. The microprudential policies try to reduce the probability of bankruptcies and idiosyncratic shocks. The objective of these policies would be the protection of the consumer of financial services (investors, depositors. On the contrary, macroprudential policies try to avoid the burst of financial crises, avoiding the negative macroeconomic impact resulting of the financial stability. Thus, if in microprudential policies risks are managed at an individual level, in macroprudential policies risks are managed at an aggregate level.” (Ferreiro, 2016, pp.18-9).

“A second strand of thought departs from the inevitable reflexivity of social systems. The basic intuition is that market actors react to the environment but the environment itself is the sum of the decisions by market actors. ... As a result, it is quite possible that beyond a given threshold market interactions will amplify instead of dampen volatility” (Notermans, 2013, p.16)

“[T]he correlation in strategies between financial institutions will then be high because all see the same opportunities and hence we see herding behaviour. Systemic risk would be enormous and not checked by market discipline” (Boot 2011). In more technical terms, if financial systems are potentially exposed to self-fulfilling prophecies, herding and contagion, the decisions of individual investors or the movement of individual assets can no longer be analysed as independent events based on a Gaussian probability distribution....Yet, that was the assumption underlying the risk management techniques that came to be employed in response to the 1987 US stock market crash and the 1998 failure of the Long Term Capital Management (LTCM) hedge fund.” (Notermans, 2013, p.17)

“[T]hose who emphasis moral hazard problems would primarily seek a solution to financial instability along the lines of designing regulations in such a way that market discipline can exert its maximum effect a substantial part of which would consist of the reduction of
information asymmetries through better disclosure and improving the quality of rankings issued by CRAs. If instead, financial stability is considered a public good, or if financial markets are characterised by pervasive reflexivity, herding and contagion rather than moral hazard is the main issue, meaning that little trust can be placed in market discipline and imposing external regulatory constraints on firm behaviour will be crucial. How pervasive this regulation will need to be, in turn, depends on the extent to which it is possible to effectively compartmentalise different sections of the financial markets. It compartmentalisation can be effective, institutions whose failure would have no systemic consequences, such as hedge funds, for example, could be left unregulated. If, however, contagion is inevitable, microprudential regulation will need to encompass all institutions.” [Notermans, 2013, p.18]

8.3.2 A Minskyan framework and central banking

Argitis (2015) drawing on the approach of Hyman Minsky and focuses on the role of central banks in addressing issues of financial instability and fragility (see Chapter 2 above, Toporowski (2012) and Hein, Dodig, and Budyldina, (2012), for further discussions on Minsky). Argitis (2015) argues that central to Minsky’s approach is the idea that central banks have to deal “with risky position making processes that trigger endogenous non-sustainable leverage and liability structures, which affect negatively the financial structure of the effective demand and the cohesion between the financial system and the macroeconomic system”. The financial sector is innovating and prone to financial fragility and instability. Financial instability is the process through which financial fragility impacts on the non-financial side of the economy. “Financial fragility results from the ‘natural’ propensity of economic units to make positions in order to make a profit. In complex position-making operations increase the likelihood of maturity mismatch between assets and liabilities on the balance sheets of firms and banks. This effect makes the asset and/or liability side of the balance sheet sensitive to changes in e.g. the interest rate, the income amortization rate, which affect the solvency and the liquidity of the organizations”. (Argitis, 2015, p.9)
In terms of approaches to regulation, Argitis indicates that Minsky proposed “that the central bank should be the institution that can guarantee the breadth, depth, and resiliency of a market by choosing the instruments to finance position takers in order to stabilize asset prices” in contrast to the frequent focus on price stability. “In such a case financial stability depends on central banks’ targeting the development of new or strengthened secondary markets or additional discount facilities. Therefore, secondary markets can stabilize the financial system when they provide the liquidity that transforms assets into a reliable source of cash whenever an economic unit has to finance or refinance a position. The central bank is the only institutional source of refinancing a position. The central bank is the only institutional source of refinancing that can be truly independent of changes in confidence of the financial markets” (Argitis, 2015, p.21).

Minsky viewed the central bank has having “the power to prevent financial and macroeconomic instability if it can create the monetary and financial conditions for higher investment in real assets and higher employment, which generate cash flows and income-based lending. Liquidity allocation that promotes asset creation and bubbles at the expense of investment and employment do not generate sustainable cash flows and motivates asset based lending which increases financial fragility and instability. In the discount window central banking, central banks can buy and sell private debt instruments and can protect and support particular types of assets and liabilities that create employment improving the domain of stability of the system. Open market operations have an indirect impact on asset prices and are effective to control un-borrowed reserves and the liquidity of the balance sheet. Minsky proposes an extended us of central bank’s discount mechanism that provide liquidity to support asset prices in conjunction with supervision of a reserve-creation ‘relationship’ between the banks and the central bank (Kregel, 1992). The reasoning is that financial fragility arises not only from the financial connections and interrelations between non-financial units and banks, but also from lending relationships between the banking system and the central bank” (Argitis, 2015, p.26).

8.3.3 Regulatory capture
The general idea of regulatory capture is that those with a substantial interest in the outcome of regulatory and policy decisions can be expected to concentrate their resources on attempts to influence the policy outcomes they prefer, while members of the public will only have a small stake in the outcomes (though collectively the benefits could be large) will not find it individually worthwhile to seek to influence policy (see, for example, Stigler 1971 for early expression of this idea).

Regulatory capture is often viewed as a serious issue, and not just in the context of the financial sector. It may though be intensified in the case of the financial sector where many have argued that the financial sector, notably in, but not limited to, the USA exerts considerable political influence. Indeed, the growing political power of the financial sector is one element of financialisation.

Six mechanisms through which regulatory capture may occur can be identified (Noteermans, 2013). These are:

1. Regulators will need a close knowledge of the regulated industry and often gain that through past workings with the industry itself, and have to work closely with regulated the industry;
2. Regulators may look forward to a lucrative career in the regulated industry which may compensate for their lower renumeration as a regulator.
3. Financial firms have substantial resources at their disposal for lobbying activities, and this increases their political power.
4. When regulation dampens down asset price booms, there can be resistance to regulation by those who benefit from such price booms.
5. Differences in regulatory frameworks may engender regulatory capture to the extent that the regulated industry is seen to be negatively affected by the current regulations.
6. “one channel of regulatory capture ... runs via the economics profession. Lucrative contracts with financial firms ... led academic economists to downplay or negate the risk fo financial instability while advocating reforms that are sensitive to the interests of the industry.”
The form that regulation has taken has varied widely over time and over different structures of the financial system. Regulations which exclude specific types of financial operations are subject to erosion by innovations that do not fit the exclusionary list precisely. The same is true of inclusive regulation which limits to a specific list of accepted activities. Similar problems arise in both rules-based regulatory systems and principles-based regulatory systems. The former, which promulgates specific rules to be applied by supervisors, may be subverted by innovations that fall outside the set of rules. The second, which is based on a set of principles to be applied, and thus designed to allow human cognition to identify and avoid the problems of the blind application of rules, leaves a degree of discretion in application by the supervisor which often leads to excessively lenient application of principles or to what has come to be called “regulatory capture” in which supervisor absorbs the objectives of the institutions to be regulated’ (p.6).

The history of financial systems shows that financial crises have accompanied the capitalist system since its early development. However, the increasing frequency and seriousness of financial crises in the last decades despite more extensive and pervasive regulation suggests that a rethinking of this approach is overdue and that more simplified regulations may be more effective than increasingly casuistic writing of regulation.

The recent crisis has spurred a wide revision of financial regulation, whose breadth might be perceived as a serious attempt to give it consistency and effectiveness. However, this re-regulation process has not been the result of a radical rethinking of the existing set of regulations or the overall approach to financial regulation. According to the G20, an international group that has taken the lead in proposing a new international regulatory structure, the crisis was the result of ‘excesses’ that were produced by specific lacunae in the previous regulatory framework. On this view, all that has to be done is to deal with specific areas.”

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2 This sub-section is a slight amended form of passages from Kregel and Tonoveronachi (2014a).
According to the *laissez faire* approach, the structure of the financial system endogenously adapts to the needs of the economy. Financial innovations, in both private institutions and financial products, are the main drivers of this adaptive efficiency. The 'efficient market hypothesis' presumes agents' best use of available information in allocating funds, independently of perfect information and complete markets. Arbitrage is the expression of competitive forces and the necessary condition for price discovery leading to equilibrium. This explains the focus on eliminating imperfections and barriers to the free movement of capital, i.e. on operational efficiency. Although the *laissez faire* equilibrium may not be optimal, public intervention is viewed with suspicion because it may introduce more distortions than it is designed to remove. Specific legal implications follow, generally tending to restrict the scope of public intervention and to tie the hands of politicians and bureaucrats with fixed rules. In any case, when specific public action is clearly directed at removing, or at least lessening single departures from optimal conditions, they are accepted without question. When public action takes a different direction, the onus of proof is shifted from the proponents of *laissez faire* to public authorities who must assess the net benefits to be produced from their action. This is a crucial passage, since to be effective it requires grounding the proof on objective or clearly verifiable quantification of the net benefit. It should be noted that the implementation of many of the mandated rules under Dodd-Frank have been suspended or delayed because the regulatory agencies have not been fully compliant in providing assessments of the costs and benefits of the proposed rules.

A relevant question for both approaches is whether regulation should concern institutions, products or functions. Adaptive approaches that leave financial structure endogenously determined by financial innovation are not consistent with direct regulation of specific institutions and products. If it did, it would support the creation of innovations for regulatory avoidance. An alternative is to follow the functional approach favoured, inter alia, by Merton and Bodie (1995). The authors make the case of banks using insured deposits to fund loans. They argue that the function carried out by banks in the payment system benefits from insured transactions deposits because monitoring costs are thus held at a minimum. On the
contrary, using insured deposits to fund loans produces moral hazard. Regulation should then distinguish two functions, obliging banks to fully collateralise insured deposits with Treasury bills and fund loans with capital and other forms of debt. This would not require a narrow bank structure and would permit other financial intermediaries, such as mutual funds, to accept insured deposits under the same regulatory conditions.

The major departure of current regulation from what mainstream principles should require concerns the failure to adopt the functionalist approach. Perhaps, as in the USA, this is the effect of having abandoned a structural approach based on institutional specialisation without considering what type of regulation was consistent with leaving financial structures free to adapt; or, as in Continental Europe, the legacy of bank-based systems. In any case, this has increased the regulatory failures coming from a partial analysis approach.

One of the foundations of the de-regulation of the last decades was to leave markets free to mould the structure of the financial system through innovations in products and institutions. More precisely, prudential regulation was intended to produce a set of incentives capable of keeping this dynamic process within an acceptable degree of stability, while not interfering with the gains in efficiency coming from competitive innovation. In the aftermath of the recent crisis the G20 decided to guide the re-regulation process; its guiding principle was that financial reforms should avoid ‘excesses’, but not impair private innovations.

8.4 Country Specific Experiences

8.4.1 European regulatory experiences

With reference to the single currency and the operations of the ECB that for a common interest rate policy to be effective in implementing the policy objective, and have similar impact on the member states adopting the single currency called the Euro, all member states would have to have similar financial performance and similar financial architecture to insure the efficient transition of single monetary policy actions implemented by the central bank into national financial conditions (p.5)

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3 This subsection is based on extracts from Kregel and Tonveronachi (2014b).
Because monetary policy is primarily transmitted through the impact of interest rates on the performance of the lending behavior of the private financial system, the decision to adopt a single currency also meant the creation of a common institutional structure for the financial systems of the member states. Indeed, the divergences in the institutional financial structure and monetary policy instruments and operating procedures used in the national banks of the component member states were as large, and in some cases even larger, that the differences in inflation performance or government fiscal policy stances.

Seven country studies were undertaken on the impact of implementation of EU directives on banking and finance on national regulatory systems. There were initial members of the EEC, France, Germany and Italy, and whose financial systems evolved within the full process of trade integration preceding the introduction of the move to a common monetary and financial structure. It includes a late adhesion country, Spain, exhibiting the problems of catching up of a country of similar size as the initial member states. Finally, it includes three even more recent members who were formerly planned economies from Eastern Europe, Estonia, Hungary and Slovenia, to give a flavour of the different problems faced by these countries adapting the entire structure of their economic and political systems in the process of homogenization of their financial services. The country studies were conducted in two periods – pre-2008 crisis and post-crisis.\(^4\) Table 8.1 provides an overview of the different evolutions of national regulatory system.

With open financial borders, the adoption of common rules and homogenous supervisory practices became an integral part of the objective of integration of the European financial markets.

While this process of convergence of financial structure was implicit in the movement to the integration into a single market via a common currency, it also took place within a global trend toward deregulation of financial institutions and the liberalisation of financial markets in the major financial centers of the developed world that commenced after the US...  

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\(^4\) The country studies were published as working papers and are listed at the end of the chapter.
suspended the Bretton Woods gold parity of the dollar in 1971. This approach implied an increasing emphasis on the role of market forces in the global distribution of financial assets and the regulation of financial institutions. Increased market competition was seen as a more effective means than government controls to improve efficiency, the allocation of financial resources, and the support of long-term real growth. Markets would be more efficient in providing the innovation of financial practices, products and institutions in support of financial and economic stability.

The enduring regulatory dispute between strict application of prudential rules versus discretionary interpretation of financial regulations by national supervisors was won by the latter and the new common European regulatory structure was influenced by and largely reflected this approach to place greater reliance on market discipline and what came to be known as “light touch” regulation.

The comparative analysis provided by the country studies raise questions on whether the past and more recent changes are contributing to increase the financial stability and efficiency of individual banks and national financial systems. The crisis has demonstrated the drawbacks of formulating the regulatory framework on standards borrowed from the ‘best’ industry practices from the large developed countries, originally developed exclusively for large global banks, but now applied to all financial institutions.

The complexity of supervisory tasks surpasses the ability and resources of even large, high income countries. The rejection of structural measures in favour of prudential regulation, based on market-based risk hedging, has been the result of the deregulation of financial systems and the isolation of financial policy from government fiscal policies driven by the presumed importance of central bank independence in implementing monetary policy with the sole objective of managing inflation. This has deprived single countries of tools capable of managing specific problems, particularly serious for economies undergoing structural adjustments in their political and economic systems. Especially for the members of the Eurozone, the disappearance of these degrees of freedom has come on top of losing control of monetary and fiscal policy to the ECB and the recent reforms of the Stability and Growth
Pact. The current push for EU peripheral countries to undertake more extensive structural changes within the given fiscal limits make them more cumbersome. With significant structural differences still characterising the EU economies, the benefits of a higher level of financial harmonisation and centralisation appears questionable, given that the main power of economic intervention to deal with specific problems remains at national level”.

However, given the preservation of national regulatory jurisprudence and supervisory jurisdictions, based on diverse national legal codes and practices meant that substantial discretion was left to individual member countries in the practical implementation of the common EU rules and principles. As a result the legal incorporation of the common financial market place was effectuated via the issuance of European Directives which in difference from Regulations are not introduced directly into member country jurisprudence, but have to be adapted and adopted with the agreement of national legislative bodies.

The regulation process promoted by the Single European Act has undoubtedly produced a convergence on rules, supervisory practices and, above all, on institutional and structural features for the seven countries represented in this report. As might have been expected, the changes were more marked for the formerly centrally planned economies. Since the Directives introduced were in large part consonant with a convergence towards international standards in all developed financial systems, the general framework, if not specific national features, would have been followed in many cases even in absence of the push towards unification of the financial systems in EU member states. The level playing field created by the introduction of the system of a single European passport has, however, produced a greater harmonisation than might have been reached otherwise.

The failure to introduce a common EU regulatory agency … meant that national authorities retained full discretionary powers in the interpretation and application of EU directive once incorporated in national legislation. The recent crisis has made evident the difficulties in this approach and has led to the support for tighter interpretation and application of existing regulation, as well as widening its application to encompass maximum harmonisation.
through a series of institutional reforms such as the European Supervisory Authorities, the Single Resolution Authority and a Single Supervisory Mechanism.

The seven country studies showcasing the process of introduction and implementation of EU financial regulation surveyed in this report demonstrate the diversity in financial structure and regulatory and supervisory frameworks at the beginning of the EEC and in particular at the beginning of the process of providing the level financial playing field initiated with the Single European Act. The countries chosen demonstrate a variety of different experiences encountered by countries starting from three very diverse initial conditions.

For all the countries surveyed, the introduction of Directives initiated shift in the domestic balance of power in favour of central banks and Regulatory agencies at the expenses of national parliaments and executive branches of governments. However, this shift was not peculiar to EU member states, reflecting a more general disengagement of government from direct economic responsibility due to the increasing dominance of political parties supporting greater market regulation on the one hand, and the increasing complexity of regulations which shifted decision-making from elected governance structures to technical experts at the national and in the case of the Basle Committee, international level.

The general areas covered for the period up to 2007 were: Liberalisation of capital movements; Cross-border competition and permitted activities; Capital requirements; Consolidated supervision; Supervision of financial groups and conglomerates; Large exposures; Investment services; Deposit guarantee schemes; Crisis management schemes; Accounting standards. The areas covered for 2008 to present were: Augmented capital requirements; Corporate governance; Deposit guarantee schemes.

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8.4.2 United States

Kregel (2014) presents the major changes in financial regulation in the United States with an extensive discussion of the most recent measures contained in or mandated by the Dodd-Frank Act, as well as providing historical background. It presents the most important changes in regulatory legislation proposed following the 2007/09 crisis intended to prevent a collapse of the financial system. It also considers some of the impacts of American legislation on the European Union countries.

The initial responses to the financial crisis was “based on the idea that it was unforeseeable ... [due] to a highly improbably “perfect storm” of factors unlikely to be repeated; once the damage has been brought under control by eliminating the “toxic” mortgage backed assets, the financial system would be restored to health.” (Kregel, 2014, p.14). There were urgent measures to restore liquidity and bank lending, notably the ‘troubled asset relief program’ (TARP) passed in 2008 aimed to remove toxic assets for banks’ balance sheets and provide new capital, actions of the Federal Reserve to extend lender of last resort activities, and engaging in ‘zero interest rate policy’ (ZIRP) and ‘quantitative easing’ (QE). Then, “the major

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5 The formal name is “An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”.
response has been that we cannot let ‘It’—another Great Depression—happen again. Many recognize that radical changes are required in the regulation governing the financial system to make sure that such widespread supports measures will never again be necessary to prevent the collapse of the financial system. Congress thus moved rapidly to write and approve a major overhaul of financial market regulations, with the rallying cry that the American taxpayer will never again be required to finance the bailout of Wall Street and Wall Street will never again bring about the collapse of Main Street” (Kregel, 2014, p.19).

The basic objective behind the financial sector reform bills was to “shield taxpayer from the costs of the failure of financial institutions. Protection of the taxpayer from having to finance financial sector bailouts has thus replaced the stability of the financial system at the centre of the reform process. This has meant that the major emphasis has been on the problem of dealing with banks that are too big or too interconnected to fail. In addition, the belief that much of the damage from the sale and securitisation of sub-prime mortgages was due to predatory and/or fraudulent practices of financial institutions has led to the proposals for protection of the taxpayer from predatory business practices in the form of a financial products safety commission. The presumption is that the business models and practices of the post-1999 financial system are basically sound if these prophylactic measures are introduced.” (Kregel, 2014, p.20)

“Thus, the basic theoretical argument that large, integrated financial institutions create synergy in providing a broad range of financial services and reduce risk by pooling is maintained by those who are most influential in “reform”, while the difficulties these institutions caused in the financial crisis will be managed by better regulation and provisions to ensure that if they do collapse, they will be allowed to fail without requiring support from public funds and without causing major damage to the real economy. The two major pillars of the reform package are regulations to better manage the risks undertaken by large “systemically significant” financial institutions, and the means to force them into bankruptcy liquidation without the need for anything but temporary public assistance. The problems faced in the last crisis are not seen to result from the size of multifunction institutions but
from the failure to allow them to fail without public assistance. This is seen as the result of the absence of a formal mechanism for bankruptcy that applies to all bank and nonbank financial institutions. Thus, the insured bank subsidiaries operating within bank holding companies are will be allowed to function more or less as before the crisis, with the exception of the Volcker controls on proprietary trading and clear rules on their rapid resolution or dissolution in the case of insolvency under the FDIC. Finally, the approach to reform continues to support the idea that markets provide efficient price discovery” (Kregel (2014) p.21) including prices of financial assets and executive compensation.p.21

The Dodd-Frank legislation faced two problems of implementation: the degree of detail covering virtually every aspect of the financial system, and excessive burdens planed on the regulatory agencies. (Kregel (2014) p.22). “The centerpiece of the Dodd-Frank legislation is the creation of the Financial Stability Oversight Council (FSOC). It has the objective of provide collective accountability for identifying risks and responding to emerging threats to financial stability.” (Kregel, 2014, p.23)

“Most of the regulatory actions in the Dodd-Frank Act call for measures to correct difficulties that have emerged from the multifunction banking that was permitted by the 1999 Gramm-Leach-Bliley Modernization of Financial Services Act.” (Kregel, 2014, p.24). However, “the major sections of the Act do little to reverse the trend toward larger and larger multifunction bank conglomerates. Indeed, it does not create any limits on their size, interconnectedness, or leverage” (Kregel, 2014, p.37).

8.4.3 UK
Montanaro (2014) provides a detailed overview of the main stages of the development of banking regulation in the UK in the past four decades. “Until the financial crisis, the superiority of light-touch, principles-based approach to financial regulation was claimed as key factor in the succes and international prestige of the British system. The association between light-touch regulation and the vulnerability of financial systems has now been largely accepted by the same British regulators.” (p.44). Shabani et alai (2014) view the growth and deregulation of banking as being promoted by government and others. A largely informal system of regulation and self-regulation was replaced from the 1970s onwards by
de-regulation (particularly of the financial markets including the ‘big bang’ changes to stock markets in 1986). In the 1980s and 1990s promotion of ‘light touch’ regulation and of competition between financial intermediaries which was deemed as sufficient to ensure efficiency of the financial system. In the aftermath of the financial crisis, following the Vickers Report, “the fragmentation of financial regulation and its separation from lender of last resort facilities has been reduced, with regulation being returned to the Bank of England. Capital and gearing requirements are being raised.”

8.4.4 Nordic countries
Montanaro (2014) further analyses the regulatory implications of financial crises in the Nordic countries (Finland, Norway and Sweden) in the 1990s. Montanaro (2014) queries whether the experience of previous crises left such long-lasting lessons to the Nordic countries, leaving them better equipped at a political and regulatory level to deal with financial crises of a systemic dimension. The three Nordic countries were hit relatively lightly during the recent crisis, though growth in Finland has been very slow as a result of deflationary fiscal policies. The question can then be asked whether the crises in these countries had a positive learning effect, and Montanaro responds that the answer is still more or less open. She argues that as a consequence of the crises of the early 1990s, “banking systems in the Nordic countries gradually became more concentrated and integrated, making problems of dealing with cross-border banks’ crisis the principal – and as yet unresolved—regulatory challenge for the Nordic countries” (pp.71/2)

8.4.5 European Union
Tonveronachi (2015) provides a detailed and critical discussion of international and European reforms for banking and finance taken after the financial crisis. Three avenues of reform are examined -- revision of the Basel framework, a novel mechanism of crisis resolution of systemically important banks (SIB) and the introduction of some structural measures. The analysis of Tonveronachi (2015) on these three elements singles out the tensions between the full restoration of global finance and the erection of national safeguards. He argues that "to a certain extent, the tendency is to allow for some national ring fence for retail banking and to protect the global nature of wholesale banking. ... National rules are becoming less
homogenous for the retail segment and the internationalisation of wholesale banking is increasingly entrusted to the recognition of equivalent results. The principle of home country control is thus weakened, especially where some sort of subsidiarisation gets a foothold. Moreover, the wider scope given to supervisors’ discretionary power increases the weight of principles with respect to rules.”

“The first response to the crisis by the authorities of the European Union was to build new institutions with the explicit mandate to increase the harmonisation of rules and supervisory practices among its member countries. The goal to build a single financial market was seen as requiring a highly levelled playing field and it was considered as a priority for opposing the fragmentation caused by the crisis acting on markers that had previously undergone a process of convergence not one of integration. Harder hit by the crisis due to its incomplete institutional design, the euro area has made a further step towards centralisation with the creation of the banking union. For the EU implementation of Basel III and of the resolution framework, the push towards greater harmonisation has meant to avoid some of the national discretion left by the two international standards and to introduce regional specificies; the banking union will further rein, although not completely, in national discretion.”

However, the EU was subject to centrifugal responses to the financial crisis. Several countries have legislated on a range of issues before and independently from the European Union and Tonveronachi (2015) gives structural reforms as an example. “[D]ifferent national lessons learnt from the crisis and the widening and deepening of regulation have sharpened national sensitivities, which have pushed in the opposite direction to enhanced harmonisation”. As the Basel III framework came into EU legislation in 2013 through the fourth Capital Requirements Directive and the Capital Requirements Regulation, the compromises between different views and interests meant significant margins of national discretion. “The directive on bank recovery and resolution is by definition a minimum standard, and variously customised national implementation will confront the more homogenous bloc of the banking union. The future outcome may be an increased polarisation between countries pertaining or not to the banking union. The future outcome may be an
increased polarisation between countries pertaining or not to the banking union and the continued use of intergovernmental agreements concerning a restricted number of EU countries instead of treaty reforms directed at higher political, economic and financial harmonisation for all. The increased harmonisation of some countries will probably confront a higher overall variability. In other terms, presently the EU is not capable of escaping from the regulatory fragmentation interesting the international arena.” (p.36)

Tonveronachi stresses the “weaknesses and fragilities of that [present] framework when the heterogeneous reality of the EU is taken into account”. The constraints on financial regulation come “from missing the international approach, which makes financial stability dependent on the financial morphology freely determined by financial markets, with the belief that the EU integration will come from the operation of private interests.” Tonveronachi proposes “a reform of the ECB operations that would create the single financial market, at least for the euro area” along with changes to fiscal rules (more generally discussed in chapter 9). “A radical reform of financial regulation is presented that would combine higher financial resilience with finance more closely serving national economies.”

Montanaro (2016a) views the global financial crises of 2007-09 as a “turning-point in the theoretical debate and in the policy preferences for architecture of financial supervision and the functions of central banks” “The new role of the central banks in safeguarding financial stability, and the crucial importance of macro-prudential policies are the main reasons why the architecture of supervision needed to be revised, both theoretically and by policy makers.” (Montanaro, 2016a). There is now broad consensus that “on the one hand, that monetary stability and financial stability are two sides of the same coin and, on the other, that there are underlying synergies and interactions between micro- and macro-supervision.” (Montanaro, 2016a)

“Central banks, as bankers of banks, have always had a very important role in banking supervision. Changes to the structures in financial systems have led to a blurring of the traditional differences between sectors in financial systems. The very specificity of banks requiring a special supervisory regime, especially because of the interactions between their
solvency, liquidity, and smooth-operation-of-payments system, has been partly allayed. With the wisdom of hindsight, this evolution should have implied that functions assigned to central banks in crisis prevention and management should have been extended over all intermediaries with systemic importance. The diminished importance of traditional commercial banking with financial systems contributed instead to call into question the central banks’ role in prudential supervision.” (Montanaro, 2016a).

“Theoretical consistency, however, is the only yardstick we can use to judge any solution. In this perspective, the central banks – in view of the crucial role they are inevitably called upon to play in financial crisis management—cannot fail to step up to take responsibility for crisis prevention, of which prudential supervision is such a vital part.”

Montanaro (2016b) discusses of the idea of a European banking union with identification of weaknesses and barriers in the current implementation of the project. “The EU’s institutional architecture for financial regulation, based upon the principles of decentralisation across countries, segmentation across sectors, and voluntary cooperation among national regulators was clearly unsuitable to deal with overall financial stability risks arising from the internationalisation and conglomeration of financial firms. Oppositions to a true European arrangement for burden-sharing, and potential distribution consequences in the event of a crisis of a cross border bank have been the main hurdle to centralisation at European-level supervision.” This paper aims to demonstrate that ... the banking union’s design is just a partial solution for financial stability problems arising from the fragmentation of the single market in the event of idiosyncratic or systemic banking crisis. The analysis performed on non-euro countries’ assessments of the pros and cons in joining the banking union clearly shows that until the fiscal responsibility for financial stability remains at the national level, the regulatory centralisation at the EU level cannot serve the traditional divide between home and host supervisors.”

“In the aftermath of 2008 financial crisis, the EU financial regulation architecture shifted from decentralisation and mutual recognition of home rules and supervisory practices to a progressive regulatory harmonisation. Strengthening cross-border cooperation between
supervisors and central banks, improving convergence in supervisory practices, reducing room for national discretions, were considered the main instruments to reconcile divergence between the European market dimension and the national and sectoral dimension of financial supervision.

“The banking union project is a radical break of the past approach based on a centralised regulation with decentralised supervision: it seems therefore inevitable that in this new institutional framework, the very existence and necessity of the European System of Financial Supervision inside the banking union, sooner or later, will have to be called into question. At the same time, it seems just as inevitable that the new responsibilities for financial stability assigned to the ECB cannot be limited to banks. The macro-prudential powers, which the ECB received with the start of the SSM are centred on the banking systems ... However, banks and non-banks financial firms, such as life insurance companies, brokers-dealers, investment funds, are closely linked through market-based financing. One reaction to the banking union could be the shifting of activities outside the banking sector. The idea that the perimeter of the ECB’s supervisory powers might be contained within the limits set out by the Treaty could be an illusion.”

8.5 Concluding Remarks

The policy attitudes and changes along with the ineffectiveness of implementation of the regulation of the financial sector have been seen as highly significant contributory factors to the occurrence of the 2007-09 financial crisis. The frequency of financial crises which has been observed raises important issues on the need for financial regulation and the difficulties of design and implementation. The final parts of the chapter have covered the ways in which a range of countries have evolved their regulations of the financial sector, and some of the challenges facing the European Union in that regard.
References


Country studies on regulatory systems


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Source: Kregel and Tonveronachi (2014b)
Chapter 9 Economic policies and developments in Europe.

9.1 Introduction

The financial crises of 2007/09 were soon accompanied by what became termed the euro crisis. Difficulties in the operations of the single currency of the Eurozone were apparent before the financial crisis, if not widely considered – including widening current account imbalances, associated capital account flows, some differences in inflation and competitiveness experiences and a general failure of member countries to observe the Stability and Growth Pact. The financial crisis and the following recession highlighted some of those issues, and the extent to which the euroarea had relied on large capital flows between member countries, which had also fed into credit booms. Much of the focus of the euro crisis centred on Greece, and more generally the GIIPS (Greece, Ireland, Italy, Portugal and Spain). Within the FESSUD project, there has not been a specific focus on the sovereign debt crises but rather on macroeconomic imbalances which paved the way for the so-called “debt crisis”. This chapter brings together aspects of the FESSUD work which has related to economic performance and macroeconomic policies within the Economic and Monetary Union (and to some degree of the European Union).

The European Central Bank (ECB) has been set up as an independent central bank (hence not subject to political control) and as any central bank faces a ‘one-size fits all’ problem which is intensified in the context of the euroarea. That problem is that a single policy instrument (the policy interest rate) is set to apply across (now) 18 national economies whatever the economic conditions applying in each country and whatever the responses of inflation, output at the national level to a change in interest rates. The ECB remains forbidden to directly monetise national deficits and debt. A number of papers within the FESSUD project have addressed the role of the ECB and the effects of its policies within the Economic and Monetary Union. The ECB as a major central bank and given its locus within the EU necessarily has effects on EU countries which are not members of the Eurozone. Some of the issues which arise are considered in section 9.2.
The philosophy of the Eurozone from Maastricht convergence criteria through Stability and Growth Pact and now the ‘fiscal compact’ and ‘excessive deficit procedure’ has involved limitations on national budget deficits and public debt, with in principle fines and censure for exceeding the limitations. In section 9.3, examine how fiscal policies and budget deficits have evolved in practice in the years since the financial crisis. It is well-known that the Eurozone was set up without little regard being paid to the patterns of current account deficits and surpluses, and hence also little regard to the corresponding capital account surpluses and deficits and the implications for the cross-border capital flows. As shown in Sawyer (2014), and elsewhere, the current account imbalances tended to widen in the decade leading up to the financial crisis; after there was considerable narrowing in that countries with large current account deficits suffered deflation thereby reducing their imports, and encountering difficulties in funding those deficits.

In section 9.4 consider the issue of convergence/divergence between member states. The operation of a currency union requires convergence with respect to inflation, interest rates and more generally return on financial assets. Without inflation convergence, there would be widening differences of price competitiveness. Without interest rate convergence, moving of borrowing and lending across national borders. The difference between nominal interest rate and rate of inflation, i.e. the real rate of interest is particularly relevant for the supposed effects off monetary and interest rate policy on inflation. Was there convergence?

Section 9.5 turns to some put forward some general policy proposals to address the euro crisis and divergence within the euroarea.

9.2 The Role of the ECB and its policies in EMU

It has long been recognized that the economies which came together to adopt the euro diverged in many respects, and that divergence would complicate the operations of the European Central Bank (ECB) which was commissioned to operate a single policy interest rate policy in pursuit of price stability (interpreted as annual inflation in the range of 0 to 2 per cent). The hope amongst proponents of the formation of the euro was for convergence of economic performance and structure between the economies involved which would facilitate
the operation of the Eurozone including by the ECB. Towards the end of this chapter the issue of convergence or divergence between Eurozone economies is directly addressed. However, this section begins with some of the issues surrounding a lack of convergence and the operations of monetary policy within EMU. This is followed by more general consideration of the transmission and effectiveness of ECB’s monetary policy.

The next sub-section sets out the intellectual framework (essentially that described as ‘new consensus in economics’) within which the ECB has operated. For the ECB (as for many central banks) the question has been raised, which became particularly pertinent with the onset of the financial crisis, on the relationship between price stability and financial stability. There had been a general presumption that price stability would underpin financial stability, but the events of 2008 disabused people of that idea. A further issue is inflation differentials between regions and nations which takes on greater significance for the ECB than for national central banks because of the history of differences in inflationary experience.

The third sub-section considers the responses of the ECB to the financial crisis and its aftermath.

9.2.1 Transmission and effectiveness of ECB’s Monetary Policy

The inherent difficulties of the operation of monetary policy in a single currency area (that is one covering more than one country) include note, with reference to the single currency and the operations of the ECB, that “for a common interest rate policy to be effective in implementing the policy objective, and have similar impact on the member states adopting the single currency called the Euro, all member states would have to have similar financial performance and similar financial architecture to insure the efficient transition of single monetary policy actions implemented by the central bank into national financial conditions” (Kregel and Tonveronachi, 2014b, p.5).

“Because monetary policy is primarily transmitted through the impact of interest rates on the performance of the lending behavior of the private financial system, the decision to adopt a single currency also meant the creation of a common institutional structure for the financial systems of the member states. Indeed, the divergences in the institutional financial structure and monetary policy instruments and operating procedures used in the national
banks of the component member states were as large, and in some cases even larger, that the differences in inflation performance or government fiscal policy stances.” (Kregel and Tonveronachi, 2014b, p.6)

A preliminary conclusion of Veronese Passarella (2013) was “that what ECB’s reports regarded as a process of (nominal) convergence, and hence of increasing integration of Eurozone’s economies, has rather turned into process of real divergence (and hence disintegration) due mainly to national differential in both unit labour costs of production and income growth rates”. From a critical survey of the ECB’s official documents, it is shown “that the most part of ECB’s official releases and working papers are characterized by a number of theoretical biases which prevented the ECB to regard the post-Lehman financial turmoil as the other side of a structural crisis of the euroarea (and not just a temporary deviation from the ‘natural equilibrium’ path of some European economies triggered by the burst of US asset bubbles and fuelled by fiscal indiscipline and profligacy).” Passarella argues that the increases in current and capital account imbalances following the introduction of the single currency was regarded as the appropriate workings of market forces, as capital moved between countries from low-return investments to high-return investment in the peripheral countries. “[C]ross-border capital flows were regarded as the proof that the process of European financial integration was improving, also driving the process of ‘levelling’ of economic fundamentals of European economies” (Veronese Passarella, 2013). However, “increasing foreign investments are not always a positive phenomenon for weakest economies. On the contrary, the inflow of capitals in EU peripheral countries ended up financing domestic asset price bubbles, rather than productive investment, and, along with the rigid one target (price stability) one instrument (nominal interest rate) policy of the ECB, contributed to push real divergences among Euro area countries to unsustainable levels.”

The single market and currency fostered the cross-border expansion of banks, and alongside rising financialisation and the processes of financial innovation gave rise to fragile financial structures “mainly due to the lack of two stabilizing mechanisms: an European-level lender
of last resort and a common European fiscal policy. Thus, “the inconsistency between structural heterogeneities across member states and international capital mobility through cross-border banking were destined to give rise to an uneven distribution of costs and advantages of the European project of financial integration” (Montanaro, 2015, p 10, quoted in Ferreiro, 2016).

Creel et alia (2014b) assess the transmission of the monetary policies of the ECB over the period June 2007 to December 2012 covering the financial crisis in the four largest economies of the Eurozone where both ‘conventional’ and ‘unconventional’ policies are examined in terms of transmission to interest rates and money market lending volumes, sovereign bonds (6 month, 5 year and 10 years bonds), loans to non-financial corporations, loans to households and deposits. “The main result is that only the pass-through from the ECB rate to interest rates has been really effective ... while the transmission mechanism of the ECB rate to volumes and of QE [quantitative easing] to interest rates and volumes has been null; or uneven over this sample. One argument to explain the differentiated pass-through of ECB monetary policies is that the successful pass-through from the ECB rate to interest rates, which materialized as a huge decrease in interest rates during the sample period, had a negative effect on the supply side of loans, and offset itself its positive effects on lending volumes. Exceptions to this appear on markets where very specific actions have been taken by the ECB, namely sovereign-bond markets at 5-year horizon in southern countries.” (pp.24-25)

Hubert and Viennot (2013) focus on the monetary transmission mechanisms in France over the period 1999 to 2012 through the interest rate and the bank lending channels. Their analysis of the interest rate channel in France ‘has shown that it [pass-through] was quite high and significant for money market rates, government debt rates and lending rates to non-financial corporations and that it has almost doubled since the crisis” (p.38). The bank lending channel “appears to be far less important that the interest rate channel but still significant for loan supply to households. This supply has experienced a drop since the crisis.
As for interest rates, the effect of a shift in the ECB rate could be either immediate or delayed” (pp.38-9).

“All in all, if the interest rate channel is effective, the bank lending channel seems not to be: the banks have indeed lowered their loan supply until mid-2012. This conclusion supports the hypothesis that banks reconstituted their capital ratio and reduced access to credit. The fact that there exists a significant pass-through only to interest rates (and not to volumes) may also explain the recent ECB policy of quantitative easing. This non-conventional monetary policy instrument, which consists in the ECB balance sheet expansion through the acquisition of assets (debt securities, bonds or riskier assets like agency debt, asset-backed securities or mortgage-backed securities) in order to increase the banking sector’s reserves and thus the impact of the monetary policy on the real economy in a low interest rate environment, has been indeed used recently by the central bank in order to try to escape a European liquidity trap and to counter speculation in bond markets that finance sovereign debts.” (Hubert and Viennot (2013), p.39)

Hubert (2015) examines econometrically the impact of ECB’s inflation projections on private inflation forecasts. This paper aims at establishing empirically whether the quarterly inflation projections made by the ECB influence private inflation forecasts and whether they may be considered as an enhanced means of implementing policy decisions by facilitating private agents’ information processing. Evidence is produced that ECB inflation projections do influence private inflation expectations positively, and convey signals about future ECB rate movements. The paper suggests that ECB projections enable private agents to correctly interpret and predict policy decisions.

9.2.2 Price and financial stability

Arestis (2014) considers the intellectual framework within which the ECB has operated. The ECB was established, along the model of the Bundesbank, as an independent (of political influence or control) central bank with the key objective of ‘price stability’ which become interpreted as a rate of inflation in the range 0 to 2 per cent per annum. The ECB should also in principle support other economic policies of the European Union. It became seen as a
leading example of inflation targeting – independent central bank with low inflation as its objective to be addressed through interest rate policy. The European Central Bank argued that “price stability is the best – and, ultimately, the only -- contribution that a credible monetary policy can make to economic growth, job creation and social cohesion. This reflects the fact that a policy-maker who controls only one instrument cannot meet, and be held accountable for the fulfilment of, more than one objective. The pursuit of additional objectives would risk overburdening monetary policy, and would ultimately result in higher inflation and higher unemployment. Over the longer term, monetary policy can only influence the price level in the economy; it cannot exert a lasting impact on economic activity. This general principle is referred to as the ‘long-run neutrality of money’” (ECB, 2008, p.34)

Arestis shows how the ‘new consensus in macroeconomics’ can be viewed as the intellectual framework within which the ECB operates. Prior to the financial crisis, the adoption of inflation targeting and more generally adherence to the ideas of the ‘new consensus in macroeconomics’ were seen to have brought ‘the great moderation’ (Bernanke). However, a range of problems arise of which [three] are mentioned here. The first is that NCM incorporates (particularly in Taylor rule) the notion of the ‘natural rate of interest’, which can be seen as the real rate of interest (based on the nominal rate of interest set by the central bank) at which the rate of inflation would be constant and also which corresponds to the Wicksellian natural rate at which savings and investment intentions would be in balance. The concept of the ‘natural rate’ is flawed in that it is embedded in a specific theoretical framework which may be an inappropriate one. Within the context of a single currency, even if the ‘natural rate’ exists, it is likely to differ between countries, and the central bank is only able to set a single nominal interest rate, albeit one that translates into different real rates of interest, dependent on local inflation rates.

The second, a reflection of the ‘one size fits all’ problem, is that the ECB can only address the average rate of inflation across the Eurozone, and cannot address differences in inflationary experiences between countries. Those inflationary differences when they persist are also important for the evolution of relative competitiveness between countries. As
Veronese Passarella (2013) shows while there has been a convergence of nominal interest rates between Eurozone member countries (which is to be expected from the single central bank setting a single policy interest rate) there was not a convergence of real interest rates as inflation differences persisted. Those inflation rate differences were considerably smaller than prior to the formation of the euro, but nevertheless has significant implications for the Eurozone. A country with a relatively high rate of inflation will experience a relatively low real rate of interest (and perhaps negative). There is then the perverse result that a country with high inflation has low real rate of interest, whereas the NCM and inflation targeting approaches would require a country with high inflation to have a high real rate of interest.

“Moreover ... under the hypothetical condition that the ECB responded to the economic conditions of the individual EMU members, the target interest rates for most member states, except Germany, would have been quite different from those predicted by the area-wide data. Therefore, the ECB policy best fits the economic conditions of only certain member states. Because economic conditions of the EMU members have been quite unsynchronized, the ECB policy actions, which might be adequate for the EMU as a whole, have been too loose for faster growing member states such as Greece, Portugal and Ireland, but too tight for slower growth member states, such as France” (Jurek and Marszalek, 2015, p.19)

The third is that the ECB is focused on low inflation, and operates with the view that inflation depends on inflation expectations and output gap, and the policy instrument of the rate of interest (the ‘Taylor rule’). This framework suffers from difficulties when inflation above (below) target arises alongside negative (positive) output gap as the economic data points in different directions. Further, price stability is treated as consistent with financial stability. In the case of the ECB and the euroarea, the member countries experienced very considerably different experiences with growth of credit (often associated with conditions in construction and the housing market). There were simply no policy arrangements and instruments which were to hand to address these differences.

It is evident that the objective of the ECB as with many other central banks has been that of low inflation. It has been long discussed as to how inflation targeting (often expressed as
price stability) relates to financial stability. As Montanaro (2016a) argues, behind this working of central banks, one can find the ‘prevailing belief that financial markets were naturally efficient and resilient, the pre-crisis consensus was that a low and stable inflation, together with “light touch” micro-prudential supervision, was also the best way to deliver financial stability” (p. 4). According to this view, “monetary policy should not react to asset prices bubbles, except to the extent that they affect price stability, and should only intervene after the bubble had burst” touch” micro-prudential supervision, was also the best way to deliver financial stability’ (Montanaro, 2016a, p. 4).

Blot et alia (2014a) note a ‘conventional wisdom’ that “a monetary regime that produced aggregate price stability will, as a by-product, tends to promote stability of the financial system” (Borio and Lowe, 2002, p.27). This conventional wisdom can be found in Schwartz (1995) who emphasizes both a micro and a macro channel in the link between inflation and asset prices. On the micro wide, she relates price instability to inflation distortion, growing uncertainty, shortened investment horizons, and governments’ nominal gains. All these dimensions produce financial instability. On the macro side, she discusses the impact of price instability on the value of collateral and on financial risk. Then, inflation would encourage speculative investment leading to financial instability” (Blot et alia, 2014a, p. 4).

Blot et alia (2014a) “investigate evidence on the link between the level and conditional variances of price and financial instability from 1993 for the US and 1999 for the Euronoe to 2012, which covers stable and volatile periods and allows us to assess the effect of changing economic conditions on the empirical relevance of the conventional wisdom” (p.5). Their paper uses three methodologies of correlation coefficient, VAR and DCC-GARCH to investigate the relationship between level and conditional variances of price and financial stability. They find that “none of the three empirical methodologies shows a continuous positive link between financial and price stability. Moreover, a negative link sometimes appears in the data” (p.20). Noting that financial instability can develop in a low inflation environment, they argue that “financial stability should certainty be addressed independently from the objective of price stability” (p.20). Financial stability requires instruments of macro
and micro prudential regulation to foster financial stability which cannot rest on the use of the policy interest rate of the central bank.

Arestis (2014, p.18) argues that “the sole emphasis [of central bank policy] on price stability cannot be justified. History is replete with examples of relevant episodes when price stability has been achieved only to witness macroeconomic instability subsequently. These examples (see Angeriz and Arestis, 2007, for example) clearly demonstrate that price stability was followed by unsatisfactory economic performance. The price stability of the 2000s [even though inflation was not completely within the 2 per cent target] and the ‘great moderation’ or the NICE (Non-inflationary Consistently Expansionary) period, which was claimed for that period, contained within it the seeds of a financial crisis which became apparent from August 2007 onwards).”

“However, the financial crisis that burst in 2007 has proved that price stability is not a guarantee for financial stability and that ... there is a twofold causation relationship, and, thus, the shocks arisen at the financial sector can have an impact on real economic activity. Hence, the need for central banks to supervise the normal working of financial markets, as this a necessary condition for the real stability and include financial stability as a key objective of any strategy of monetary policy.” (Ferreiro, 2016)

“In this sense, a vicious circle was generated between monetary policy and financial markets. Monetary policy, by focusing on price stability, would have contributed to the build-up of large financial imbalances and to an excessive size of financial sector and financial balance sheets, thus leading to a more fragile financial system. On its behalf, the changes in the size and operation of the financial markets and institutions would have contributed to reduce the effectiveness of the conventional transmission channels (among others, interest rate and credit channels) of monetary policy.” (Ferreiro, 2016)

Jurek and Marszalek (2015) draw attention to the weakened relationship between an independent central bank and the fiscal authorities (which of course in the EMU are the national authorities). The “potential lack of coordination will probably result in a suboptimal economic performance” (p.23). The problems may come from a combination of causes such
as different objectives pursued by fiscal and monetary authorities, different views on effects of fiscal and monetary policy (coming from adherence to different economic theories), and different economic forecasts. “As a result, coordination is weak, and none of the policymakers achieve their target.” (Jurek and Marszalek [2015, p.23])

In a world of multiple objectives (including employment and financial stability), there is also a need for multiple instruments operated by different authorities, not central bank only. This in turn requires policy co-ordination, particularly if the ECB is to stand ready to operate as lender of last resort or as a buyer (of government bonds) of last resort. A closing of monetary policy, fiscal policy and surveillance over the financial system is necessary, as combining monetary and prudential instruments appears to be the main challenge. The new formal breakdown of responsibilities is necessary, as well as re-evaluation of the ECB functions. (Jurek and Marszalek, 2015, P.13)

“Therefore, perhaps formal reformulation (or supplement) of the ECB statutory goal, especially leading to including – at least partially – above-mentioned suggestions also would be helpful for better consistency of the policy mix within euro zone. It is not, however, only the case of change in numerical inflation target, but rather more thorough change in the overall philosophy of the ECB policy. The goal should by no means reflect complexity of the post crisis reality and take into account that the problem of ‘monetary disorder’ is not only the problem of unstable prices.” Jurek and Marszalek (2015, p.30)

“But the monetary policy strategy must be amended at the level of the tools used by central banks. Since the onset of the financial crisis, and with the burst of the Great Recession, most central banks have abandoned the common practices based on the setting of official short-term policy interest rates and the provision of very short-term liquidity to banks embarking on the implementation of unconventional monetary policy measures (see on this respect, Creel, Hubert and Viennot, 2014b; Rodriguez and Carrasco, 2014; Serrano and Altuzarra, 2015).” (Ferreiro, 2016)

9.2.3 Nature and evolution of ECB policies since the financial crisis
Rodriguez and Carrasco (2014) note the unchanging nature of the ECB’s institutional arrangements after the financial crisis. However, “since the outbreak of the financial crisis, ECB and other major central banks have implements measures beyond their standard toolkit. For instance, ECB has introduced full-allotment loans with fixed rates, an expansion of the list of assets eligible as collateral, longer-term liquidity provisions in the euro and other currencies, changed the required reserve ratio, implemented outright purchase of specific securities, modified interest rate corridors, and introduced new communication tools.” (p.5)

Rodriguez and Carrasco (2014) identify four phases of ECB policies¹.

“Phase 1: From the start of the global financial crisis in September 2008 (Lehman collapse) to April 2010

In this Phase 1, ECB measures were targeted at enhanced credit support (ECB, 2010). In the autumn of 2008, “the ECB decided to move to a fixed rate system with full allotment tenders. This move was intended to reassure market participants that, if banks faced unforeseen liquidity shortages, they could refinance through the ECB at a known rate for a known period, for as much as they needed. This has made ECB money and bank reserves mostly endogenously determined since October 2008” (Rodriguez and Carrasco, 2014, p.9). The ECB cut the main refinancing operations (MRO) rate from 4.25 to 1.99 over this period, and reduced the interest rate corridor from 200 basis points (bp) to 100 bp until January 2009, then increasing corridor width to 200 bp until April 2009, and then reduced to 150 bp in May 2009.”

The ECB “changed the loan conditions by implementing three and six-month full allotment Long-Term Refinancing Operations (LTROs) in November 2008 (300 billion of euros) plus 12-months LTROs in June 2009 (442 million euros). It lowered the rating threshold for collateral and agreed currency swaps with major CBs (central banks), including the FED, the BoE (Bank of England), the Swiss National Bank, and the Bank of Japan. Finally, the ECB introduced the Covered Bond Purchase Programme 1 (CBPP1) to promote the ongoing decline in money

¹ Arestis (2014), Veronese Passarella (2013) also have a chronology of ECB policy actions.
market rates, to ease funding conditions for credit institutions and enterprises, to encourage credit institutions to maintain their lending to clients, and to improve market liquidity in important segments of the private debt securities market.” (Rodriguez and Carrasco, 2014, p.9)

The liquidity injected during the acute banking crisis meant an increase in the balance sheet of the ECB of around 30 per cent in less than a year, which can be compared with a more usual increase of around 4 per cent per annum.

“Phase II: From the start of the euro area sovereign debt crisis in May 2010 (Greek crisis) to August 2011”

This phase covers the first stage of the sovereign debt crises. Throughout this phase the “ECB was reluctant to act as a lender of last resort for sovereigns where, in less than a year (May 2010 to March 2011), Greece, Ireland, and Portugal were bailed out.” (Rodriguez and Carrasco (2014) p.10) The Securities Markets Programme (SMP) was initiated and reached 100 billion euros in August 2011, and fully sterilised through fixed term deposits, but then not renewed. The ECB balance sheet did not increase significantly. The ECB raised interest rates in response to a perceived threat to price stability, from 1 per cent to 1.25 in April 2011, and then to 1.5 per cent in July 2011.

“Phase III: Re-intensification of the euro area sovereign debt crisis coupled with increase banking sector strain from August 2011 to May 2013”

“at the start of this phase and after the re-intensification of both crises [financial and sovereign debt], the ECB decided on an extension of the maturities of LTROs, there was no alternative for the ECB than providing unlimited funding to the banking system; in August 2012 the ECB declared that the non-standard measures will be there as long as necessary” (p.11). In July 2011, the ECB cut the MRO interest rate to 0.75 per cent, and reactivated the SMP eventually leading purchase of sovereign bonds of stressed countries of 220 billion euros in February 2012. “It also implements Covered Bond Purchase Programme 2 (CBPP2), which reached a high of 16 billion euros”. The “most significant measure was the announcement in September 2012 of the so-called Outright Monetary Transactions (OMT)
programme” (p.11). Two Very Long-Term Refinancing Operations (VLTROs) were undertaken in December 2011 with 489 billion euros and in February 2012 with 529 billion euros. The ECB also reduced reserve requirements for 2 per cent to 1 per cent in mid-2012. “The sum of all these measures led to a peak in the balance sheet of close to 3 trillion euros and of nearly 800 billion euro in excess liquidity close” (p.11)

“Phase IV: From June 2013 to May 2014”“ Back to normal times? Deflationary risk says not really”

“The main characteristic of this phase was the sharp decrease in the size of the balance sheet and of excess reserves, which is explained by the early repayment of the 1-trillion VLTROs”. Money market interest rates were significantly volatile. “The response of the ECB to this situation and to the overall assessment of inflationary outlook was to cut the MRO rate by 25 bp to 0.25% in November 2013.”

“The ECB pumped limited liquidity into commercial banks in 2007 after the August of the same year emergence of the crisis. Nonetheless, the ECB raised its rate of interest twice before it started reducing it from 4.25 percent in September 2008 (after the Lehman Brothers collapse on 15 September 2008) to an all-time low of 0.25 per cent in November 2013. In May 2009 the ECB enhanced credit support to euro area banks at very low interest rates through the introduction of the Long-Term Refinancing Operations (LTROs). Sovereign debt is used through this scheme as collateral on the loans provided. LTRO is designed to provide longer-term liquidity than the standard Main Refinancing Operations (MROs, whose maturity is one week—liquidity could also be accessed through the Emergency Liquidity Assistance (ELA) scheme, which is a very temporary measure designed to help banks during periods of crisis. Initially LTROs were offered monthly and typically repaid in three months, six months or one year. In December 2011, however, the ECB offered a three-year type of LTROs, which had a significantly immediate higher demand than previous operations. From December 2011 to February 2012 the ECB provided euros 1 trillion to the euro area banks” (Arestis, 2014, pp.24/5)
Dodig and Herr (2015) argue that “The ECB did not take over the function of a lender of last resort for the governments early enough.... It acted only in a phase of great instability of capital markets in the EMU. The ECB’s purchase of government bonds from crisis countries began in 2011 via the Securities Markets Program. However, bonds were purchased on secondary markets only and it was announced that this would be limited in volume and in time. It was essentially a half-hearted attempt by the ECB to solve the sovereign debt crisis” (pp.25-6).

Changes occurred in July 2012 when Mario Draghi, President of the ECB, declared he would do “whatever it takes” (Draghi, 2012) to save the euro. “The ECB finally stated that it would purchase unlimited amounts of national debt on secondary markets – however, provided that the countries in question agree to reform programs negotiated with the Troika. EMU capital market calmed down after this promise” (Dodig and Herr, 2015, p.26)

“Monetary transfers between EMU banks are carried out via the Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET 2) ... With the outbreak of the sovereign debt crisis, capital flows to crisis countries stopped and capital flight from crisis countries to stable countries in the EMU started. The boom phase of capital inflows, which financed the high current account deficits, turned into a bust phase with net capital outflows. As Spanish or Greek banks were cut off from the EMU money market, the only possibility left for these banks was to ask for refinancing from their national central banks. The national branches of the ECB refinanced their banking systems without limit as part of their lender of last resort function for national central banks. To legally allow the refinancing, the quality of collateral for the refinancing process was reduced in such a way that banks in crises countries always had sufficient collateral for open market operations.” (Dodig and Herr, 2015, pp.26/7)

“ECB measures cannot be framed under the traditional definitions of QE [Quantitative Easing] because Outright Monetary Transactions [OMT] have not been implemented and SMP [Security Markets Programme] has been fully sterilised. Instead, expansion in the ECB balance sheet came primarily from increases in the extraordinary longer maturity loans with
broadly accepted collateral. Thus, ECB measures are not QE in the traditional sense, even when, in a broader definition, these measures can be framed as QE.” (Rodriguez and Carrasco, 2014, p.7).

“Since the outbreak of the financial crisis, the ECB has taken many unusual measures, but most likely too little, too late. With the benefit of hindsight, its strategy can be considered backward looking in times when principal actors should be more proactive and take larger risks to counteract such negative scenarios. The ECB has acted as a lender of last resort to the banking system, providing banks with ample liquidity and avoiding the collapse of the system; yet it did so hesitantly until the end of 2011, four years after the outbreak of the financial crisis, when the 1 trillion VLTROs were placed and ECB state that non-standard measures will be available as long as necessary. Simultaneously, the FED and the BoE had already embarked on QE long before.” (Rodriguez and Carrasco, 2014, p.17)

"Why so late and too little? Because the ECB has too tight a straitjacket and a narrow mandate: price stability. Until this is amended and the ECB becomes a real CB [central bank], all the blame is not attributable to the ECB alone, but to politics as well. This means a change in the legal framework of the ECB to include not only its function as a lender of last resort, but a triple mandate: price stability, maximum employment, and banking supervision and regulation …” Rodriguez and Carrasco (2014, p.17)

This is echoed by Arestis (2014, p.31) who argues for a different monetary policy. “Reformulation of the objectives of the ECB to include high and sustainable levels of employment and economic growth, in addition to price stability... The ECB must be made accountable to the European Parliament; the ECB statutes should be changed so that it can clearly be involved in the co-ordination of fiscal and monetary policies. Ultimately ECB should be ready to take instructions from other European bodies, such as the ECOFIN. ... Furthermore, and perhaps most importantly, the ECB should undertake explicitly and fully the role of lender of last resort, and should be responsible for the stability of the EMU financial system. In this respect, the ECB should be responsible for all deposit insurance”
9.2.4 Influences of the ECB and EMU in the broader region

Benlialper and Comert (2015) indicate that the Central Bank of the Republic of Turkey (CBRT) has a new monetary policy framework which has put more emphasis on financial stability concerns. However, the “key variables the Bank [CBRT] wants to influence within the new framework are very sensitive to developments especially in financial flows” which are strongly affected by external factors such as global risk perception. The paper finds that the CBRT’s interest rate in strongly influenced by Fed and ECB rates, even though it operates within a flexible exchange rate.

Voyvoda and Yeldan (2015) study fiscal policy in post-1980 Turkey. They argue that “The distinguishing feature of the series of AKP governments over the post 2003 period was that they had deliberately adopted the mission of executing the neo-liberal project under the discourse of ”strong government” without confronting any stong popular opposition... On the macro-economic policy side, a significant shift towards ”speculative-led growth” has been realized, where “macroeconomics” has become almost synonymous with ”monetary policy” (at the expense of fiscal policy). Furthermore, monetary policy has often taken the exclusive form of inflation targeting.... All these changes can be placed within the concept of financialization, i.e. an overall ascendance of finance over the real economy, industry in particular” (emphasis in original).

“An overall comparison of the aggregate level of fiscal stimuli across Turkey and other G20 emerging market economies [in response of global financial crisis] reveal that the size of the Turkish packages had been relatively small. Part of this problem stems from the fact that the Turkish fiscal balances were relatively more fragile at the onset of the crisis.... A comparison of the Turkish fiscal stimuli as estimated by the IMF staff reveals that Turkish fiscal stimulus measures had fared significantly dismal as compared to the global average of the emerging market economies.”

“The fiscal performance of the Turkish economy over the last two decades varied. The 1990s had been a period of acute deterioration of the public sector balances with increased indebtedness and the rising interest burden. A series of failing attempts on broadening the tax base and to curtail public expenditures led to the eruption of the 2001 crisis, during when
Turkey was following an IMF-led adjustment programme. The post-crisis era witnessed a significant narrowing of the fiscal budget deficits, especially with respect to the central government administration.”

“Given the acuteness of the perceived dilemmas on disinflation and fiscal credibility, the resolution of the current impasse will surely necessitate a more tolerant view over the programmed targets (on both inflation and the primary surplus ratio) as well as a coherent and a mutually supportive macro policy design. Furthermore, there is a clear case for the acute need to design viable policies to diminish the exposure of the domestic economy [in particular of the financial markets] to short term, speculative foreign capital. This, in turn, may necessitate implementation of capital management techniques to gear inflows towards longer maturities and imposition of a financial tax to raise fiscal revenues.”

Juuse and Kattel (2015) consider the implications of two major changes in the ownership of the banking systems in the new member states of the EU on macroeconomic and financial stability. The major changes are on the one hand the demise of state-owned banking system, and on the other hand a system of foreign owned banks. “When drawing conclusions on the effects of different ownership structure, one has to bear in mind that in the case of CEECs [Central and Eastern European Countries], specific historical context needs to be acknowledged, as several problems and obstacles in achieving the macroeconomic stability with the state-ownership in the banking sector were related to the transition process from socialist production regime to the introduction of market economy institutions.” (pp.54-5).

However, in the 2000s, “the activities of foreign-owned banks took place in the context of increasing global liquidity and asset prices boom that was taking place in the Western world. Hence, ownership as such had not mattered so much for the macro-economic stability in the CEECs, but rather internal developments, that is, transition to market economy with associated challenges in the 1990s that rendered these economies unstable, and external factors, such as international capital flows in the 2000s that incurred imbalances through the activities of the banking sector” (p.55).
Juuse and Kattel find that “foreign ownership in the banking sector has increased vulnerability to internal and external imbalances” in the Baltic States with their implementation of neo-liberal market economies. “In such a liberalized and deregulated macro-economic environment, excesses in housing demand and certain economic activities have been fuelled by aggressive lending activity of foreign-owned credit institutions that resulted in overhating economy in terms of housing market and consumption boom. Visegrad countries, on the other hand, have managed to alleviate the negative effects of foreign ownership in the banking sector through macroprudential policies and strong industrial based as an export platform that have enabled government to manage exsdtrenal and internal imbalances.”

Overall, the ownership of the banking sector did not as such interact with macroeconomic stability. It was rather that “vulnerability of the CEECs has stemmed from the international specialization of these economies and their volatile export production, but also financial architecture, based on the common EU standards, and overall liberalization as well as deregulation tendencies, that is, deteriorating degree of monetary and fiscal sovereignty, that have rendered these economies vulnerable to potential capital flight due to increased dependence on foreign capital as a source of domestic demand financing.”

Gabor (2015) explores the ECB’s policies after the financial crisis in terms of effects of the Central and Eastern European Economies (CEEC). She notes that the banking system in the CEEC countries are dominated by Western European banks “whose asset and liability management made solvency a local problem and liquidity a regional (euro) issue”. Further, “an attitude of benign regulatory neglect towards cross-border banking practices coupled with an aggressive expansion strategy of Western European banks left countries in Eastern Europe highly vulnerable to the transmission of financial shocks via cross-border banking channels, without institutional mechanisms to manage cross-border banking fragilities.”

Then in the immediate aftermath of the financial crises of September/October 2008, the central banks of the CEEC faced a shortage of euros and Swiss francs “that confronted the ECB with the demands of its role as a systemic central bank for the region.” Gabor (2015)
argues that “at the height of the banking crisis, the ECB was only prepared to provide currency bridges to central banks that it perceived to be its peers .... The CEE crisis – and its socio-economic impact - would have looked differently had the ECB assumed the responsibilities of its systemic role.”

Gabor (2015) argues that the position of the ECB in respect of CEE countries was riddled with conflicts of interest. The systemic role of the euro in CEE countries, many on route to adopting the euro, would have required the ECB to provide temporary support for central banks when currency markets - dominated by financial institutions located in the Euro area – stopped working. Yet its participation in deciding bailout conditions, an overtly political role, constrained the extent to which it was willing to extend unconditional support, via swaps, to CEE central banks. While the ECB had no mandate to be either an official Troika negotiator or international lender of last resort via swaps, it choose to interpret the extensions of its mandate in such a way that it reinforced its institutional position in the bailout mechanisms, but at the expense of policy autonomy in CEE countries. The ECB took advantage of its privileges as currency issuer to help enforce Troika policies and preserve the cross-border banking model that it views essential to its broader political strategies of financial integration.”

“Euro area banks’ strategies in Eastern Europe were rendering the ECB a systemic central bank for the region. Yet the ECB refused to contemplate the financial stability implications of this systemic role beyond lip-service to international cooperation via BIS and other fora.”

“Yet the ECB – alongside Member States - encouraged European banks to expand, because of its explicit interest in accelerating financial integration, crucial for the effectiveness of monetary policy, particularly in light of the commitment of the New Member States to join the Economic and Monetary Union as soon as the convergence process allowed it. This drive for financial integration also fit well with the political consensus in old Member States that the aggressive cross-border expansion of the 'national champions' would help Europe ride the seemingly unstoppable wave of financial globalization”.
“The ECB proved more willing to coordinate with central banks in high-income countries where Euroarea banks had funding exposures (the US in particular), and Northern Europe where CEE foreign-owned banks were headquartered (Sweden, Denmark), than with CEE central banks.”

“Will this be an isolated episode in the complex, fraught politics of the EU and the ECB? At first sight, the answer appears to be yes. The Banking Union agenda promises to curtail the vulnerabilities of cross-border banking, and create mechanisms for managing the potential spillovers. It also invites CEE countries to opt in the plans, considering the important role that EMU-owned banks play in their banking systems. Yet on closer look, Banking Union opt-ins remain fraught with uncertainty. Many CEE countries are less enthusiastic about Euro adoption, and about opting into the Banking Union plans. Their reluctance stems from inadequate institutional design (decisions taken by ECB governing council where opt-in countries do not have access), and from inadequate liquidity backstops (the ECB’s emergency liquidity assistance on narrow terms). Opt-in countries would have to handle supervisory failures by the ECB on their own.” (Gabor, 2015).

9.3 Fiscal policies in EMU
A particular feature of the EU is that there are agreements to constrain the operation of national fiscal policies as mentioned in the introduction. The Stability and Growth Pact of the Economic and Monetary Union allows a role for the automatic stabilisers, though subject to constraints of budget balanced over the cycle (now structural budget balance) and an upper limit of 3 per cent of GDP on budget deficit. The question which Ferreiro et alia (2015) address the what impact these rules have on national fiscal policy, and whether in practice fiscal policies in the EU since the financial crisis have been pro- or counter-cyclical.

Serrano and Altuzarra (2015) survey economic policies pursued after the financial crisis. They identify three broad phases. In the first, there were strategies of expansionary monetary and fiscal policies. In the second, starting in 2010, there was a start on the withdrawal of the fiscal stimuli, with the maintenance of an aggressive monetary policy to stimulate private credit through expansion of money supply (e.g. quantitative easing). The third phase was viewed (from 2014) as characterised by an end of demand stimulation policies and stress on
structural adjustment and supply side policies (the adoption of the ‘fiscal compact’ by the countries of EMU being the major example). At the time of their writing the start of the withdrawal of quantitative easing by the Fed was scheduled for late 2014 which did not come to pass.

They argue that emerging markets showed greater resilience than advanced economies in the crisis for two basic reasons. The first is that for advanced economies there was an endogenous shock by excessive debt, whereas for emerging economies the financial crisis was an external shock from the advanced economies coming through financial and trade channels. In the GFC, emerging markets had no banking crises. The emerging markets were able to implement countercyclical policies. They argue that “the experience of past crises had shown the risks associated with excessive dependence on external financial resources and the constraint for conducting countercyclical policies stemming from neither having the exchange rate as a tool to cushion the external effects of the crisis nor sufficient fiscal space.” The authors point to the difficulties of the Eurozone in addressing the GFC. They point to the interactions of the GFC and the sovereign debt crisis in Greece and other southern European countries. They also note that “the process of European monetary integration is unique in the history of monetary unions since it rests on a centralized monetary policy and a decentralized fiscal policy, although subject to certain restrictions in the form of fiscal targets (limits on deficit and public debt)” (p.37).

“The implementation of monetary policy by the ECB has faced serious challenges to stimulate credit in the area. The fiscal adjustment policies and the absence of community fiscal mechanisms, moreover, has forced countries that have been most badly affects by the debt crisis to make strong fiscal adjustments which have aggravated their already difficult economic situation.” (p.37).

Ferreiro et al. (2015) analyse the fiscal policies in the EU since the crisis, most notably whether they have been pro- or counter-cyclical, with separate analysis of two periods, one going from 2009 to 2010 and one thereafter and comparison between EMU and non-EMU countries.
The question posed is whether the implementation of a countercyclical fiscal policy has been a widespread phenomenon since the eurozone’s creation (as a virtual currency) in 1999. The analysis of fiscal policy is undertaken with examination to two sub-periods, before (1999 to 2007) and after (2008 to 2013) the global financial crisis. This enables an examination of whether there has been a shift in the stance of fiscal policies of the European Union during the financial crisis. Countries are also divided into Eurozone countries and non-Eurozone countries. This division enables an examination of whether the fiscal rules operating in the Eurozone impacted on the members of the Eurozone.

The stance of fiscal policy is measured in terms of changes in the primary cyclically adjusted budget balance (PCABB) of general national governments in the European Union (with data obtained from Eurostat database). An improvement in the PCABB is identified with a restrictive fiscal policy and tightening of the budget position, and a worsening in the PCABB identified with an expansionary fiscal policy. The output gap (the difference between actual GDP and potential GDP) is used to signify of a downturn (negative output gap) or expansion (positive output gap): output gap data provided by AMECO database. The operation of the automatic stabilisers of fiscal policy would mean that the actual budget balance would move further into deficit with an economic downturn as tax revenues fall and elements of social assistance rise; and deficit would fall or surplus rise with economic upturn. The use of the PCABB abstracts from such cyclical movements in the budget position, and could be viewed in terms of the operation of discretionary fiscal policy in the face of economic fluctuations.

Fiscal policy is defined here as procyclical when an expansionary fiscal policy is implemented during a period of expansion and when a restrictive fiscal policy is implemented during a recession. A countercyclical fiscal policy would arise when expansionary fiscal policy is implemented during a recession and when a restrictive fiscal policy is implements during an expansion.

The figures in Table 9.1 clearly show that countercyclical fiscal policies dominated up to the financial crisis, whether in terms of countries implementing expansionary fiscal policies during recessions or restrictive fiscal policies during expansions. However, a large number
of countries implemented expansionary fiscal policies in the years 2006 to 2008, that is just before the financial crisis and as it began. Since 2011, most countries have been adopting restrictive fiscal policies even during an economic downturn.

Table 9.1 near here

Focusing on more recent years the differences between the two groups of countries since 2011 can be noted. In the case of the Eurozone in the years 2011, 2012, and 2013 there was a recession in 14, 16 and 16 countries, respectively. Out of these countries, the percentage adopting a procyclical restrictive fiscal policy was 86 per cent, 69 per cent and 88 per cent in 2011, 2012, and 2013 respectively. The situation in the non-Eurozone countries was, however, substantially different. In the years 2011, 2012, and 2013, 10, 11, and 10 countries respectively experienced a recession. During those three years, the percentage number of countries implementing a procyclical fiscal policy was much lower than that of the Eurozone—80 per cent, 55 per cent and 30 per cent respectively.

The existence of a clear tendency towards implementing procyclical fiscal policies (which does not happen in the EU member states outside the Eurozone) indicates a failure of the design of fiscal policy in the Eurozone which makes it difficult for fiscal policies to work along the lines of ‘functional finance’ – that is the use of discretionary as well as non-discretionary fiscal policies to address economic downturns (with appropriate reversal during economic upswings). Such a policy would exhibit counter cyclical polices with budget deficits rising in response to economic slowdowns. This failure inhibits the recovery of economies.

9.4 Convergence and divergence in EU

Since the establishment of the Euro, the process of financial integration in the Euro Area has led to a convergence in member states’ nominal interest rates and an increase in the volume of cross-border intra-Eurozone capital flows (Veronese Passarella, 2014; Sawyer, 2014; Carrasco and Peinado, 2014). Contrary however to European policy makers’ expectation that nominal convergence would lead to real integration between European economies (for a discussion of the perception of the ECB see Veronese Passarella, 2013), and in face of pre-existing national differentials in key economic variables (such as unit labour costs, income growth rates, productivity growth, etc.), financial integration did not manage to deliver a
convergence in real terms. Rather it created and consolidated current and financial account imbalances, with increasing capital flows moving from core countries such as Germany to peripheral ones such as Greece and Spain. As documented by Veronese Passarella (2013), prior to the crisis such imbalances were treated by the ECB as a sign of the proper working of market forces, whereby capital inflows from the core were taken as a key driver for levelling the economic fundamentals of European economies. Post-crisis on the other hand, the ECB has pointed out domestic weaknesses and misaligned national policies as the key cause of such imbalances, rather than acknowledging the structural shortcomings of the financial integration process, as unfolded up to the crisis.

Carrasco and Peinado (2014) undertake an empirical analysis of the origins of European imbalances; convergence/divergence analysis of key macro indicators such as real effective exchange rate, inflation, industrial production and interest rates.

The global pattern of current account imbalances is illustrated in Figure 9.1. It can be readily seen that the Eurozone as a whole was in small surplus with respect to the current account during the 2000s, with a rising surplus after the financial crisis into the 2010s. The patterns of inflation are also indicated in Figure 9.1 where there is an indication of the differences between countries.

Figure 9.1 near here.

“The global financial crisis and the European sovereign debt crisis have demonstrated the unsustainability of macroeconomic imbalances among European Union member states and, particularly, Eurozone countries.” Carrasco and Peinado (2014) identify four factors from the literature which may contribute to imbalances. “The first factor relates to the process of economic and financial integration in the Eurozone. In this regard, external imbalances are consequence of a real convergence process in which EMU countries with relatively low levels of development are converging towards highly developed countries” (p.6).

The second factor refers to the diverging trends in price and non-price competitiveness. “The diverging trends in competitiveness within the Eurozone are related to three interconnected
characteristics of the Eurozone: significant differences in economic structures, different economic strategies and current economic policy design of the EMU.” (p.9).

The third factor pushing the development of external imbalances comes from demographic differences in population structure and dependency ratios. Countries with a relatively young population may be characterised by relatively high savings ratio as the young save for their pensions. Countries with relatively old and retired population may have lower savings ratio as the pensioners are running down their savings. Link savings with external balance. “However, in the case of the Eurozone, this factor has not been deeply explored in the economic literature” (p.9).

The fourth factor suggested is a form of the twin deficits perspective from the connections between the current account position and the budget position. The national accounts relationship of (Private savings minus private investment) plus (Tax revenues minus government expenditure: budget surplus) plus (Imports minus exports and net income: current account deficit) = zero indicates that for a given private savings/investment balance there would be a position in which a lower budget surplus (higher budget deficit) would be associated with a larger current account deficit. However, the “evidence from EMU countries does not present a common pattern: for some countries, fiscal positions have contributed to current account imbalances, while this relationship does not exist for others.” (p.9).

Carrasco and Peinado (2014) argue with many others that the removal of exchange rate risk with the formation of the euro “incentivized capital flows from the core countries to periphery countries in the Eurozone in a search for higher marginal returns due to the expected process of real convergence and, to some extent, the overestimation of future growth in the peripheral economies. Those capital flows exerted downward pressure on nominal interest rates and encouraged the creation of a debt-led consumption bubble in the periphery countries. In addition these capital flows contributed to the development of a bubble in the residential investment sector while exerting demand-side pressures on prices and wages in the southern countries. ...Moreover, the core countries of the Eurozone have been characterised by depressed domestic demand and growth in prices and wages below the
level of productivity growth, thereby securing gains in competitiveness relative to the countries of the periphery.” (p.10)

Carrasco and Peinado (2014) argue that the design of economic policies within the euroarea permitted the continuation of divergent trends of key macroeconomic indicators. They note in particular, the lack of convergence of business cycles among the countries of the euroarea and the ineffectiveness of the common monetary policy. Further “fiscal policy, framed within the limits of the SGP, has constrained the actions of national governments in the presence of external shocks, contributing to the exacerbation of the crisis and the deterioration of economic outlooks in the peripheral countries. Finally, wage and income policies have not been coordinated to correct macroeconomic imbalances without affecting inflation rates through controlling the divergent wage growth rates among Eurozone member countries” (p.10)

“In the case REER [real exchange rate], IP [industrial production], HICP [harmonised index of consumer prices] and IR [interest rate], the presence of a unit root would indicate divergent trends between the indicated country and the reference country [Germany], while in the case of CA [current account], the presence of a common unit root indicates the persistent absence of a balanced current account. The results … reveal a marked divergence in IP. In the case of REER, there is evidence of the presence of a common unit root for all the members of the panel, while for HICP and CA, there is evidence of individual unit roots. Finally, IR is the only variable exhibiting convergence. In summary, REER, IP, HICP and CA reveal evidence of diverging trends, while there has been convergence in interest rates.” (Carrasco and Peinado, 2014, p.12)

Carrasco and Peinado (2014) estimate equations on panel data relating current account positions with GDP growth differential, unit labour costs, old age dependency ratio and fiscal policy, of which the first two are statistically significant and the last two not. Plotting “the average current account in the period preceding the adoption of the Euro versus the average for the Euro period … a positive relationship between the average current account in both the pre- and post-Euro periods [is observed]”. (pp.16-7)
Dodig, Hein and Detzler (2015) argue that under financialisation, where there has been re-distribution of income away from labour and low income households, different demand and growth regimes may prevail. Three regimes are identified.

A debt-led private demand boom regime “is characterized by negative financial balances of the private household sectors, in some countries accelerated by corporate deficits and thus deficits of the private domestic sector as a whole, positive financial balances of the external sector, and hence, current account deficits, high growth contributions of private domestic demand, and negative growth contributions of the balance of goods and services” (p.7). After examination of the data, the authors place USA, UK, Spain, Estonia, Greece and South Africa in this group.

An export-led mercantilist regime “characterised by positive financial balances of the domestic sectors as a whole, and hence negative financial balances of the external sector, and thus, current account surpluses”. Growth is then mainly driven by rising net exports. This type of regime was found in Germany, Japan and Sweden in the sample of countries examined, and it could be anticipated that some other Northern European countries would come within this category.

The domestic demand-led regime “is characterized by positive financial balances of the private household sector as well as the external sector, and hence, current account deficits. ...[I]t is usually the government, and, to a certain degree, the corporate sector running deficits.” (p.8) There is a positive growth contribution from domestic demand, but without a dominance of private consumption”. The authors distinguish “low-growth mature economies driven by domestic demand, and high-growth catching-up domestic demand-led economies”. France, Hungary, Italy, Poland, Portugal and Turkey were assigned to this group.

The significance of this typology of regimes is (at least) twofold. The first relates to financial sustainability and crisis. The authors argue that the first two regimes identified “contain internal contradictions, with respect to foreign debt and with respect to foreign debt of the counterpart current account deficit countries, which may finally undermine the sustainability
of these regimes and lead to financial and economic crises.” (p.9). The unsustainable nature of rising household debt (and often its interconnections with inequality and with rising property prices) has been widely examined in the context of the global financial crisis [cross reference to other chapters]. The consequences of the capital flows (reflecting current account imbalances) have similarly been widely examined, notably within the euroarea. Dodig et al. further examine the recovery processes across the different regimes.

The second is of particular significance for the operations of the euroarea. The sectoral balances could be expected to differ substantially between the different regimes, which has implications for the government budget deficit. The relationship indicated above of (Private savings minus private investment) plus (Tax revenues minus government expenditure: budget surplus) plus (Imports minus exports and net income: current account deficit) = zero suggests that a common deficit target across euroarea member countries may be difficult to achieve.

Ferreiro, Gálvez, Gómez and González (2016) have shown that, since the creation of the European Monetary Union, the structural differences existing among the euro countries have not declined but they are even larger, a divergence process that has increased during the current Great Recession. “The existence of this process of rising divergence implies that the assumption that with the passage of time the nominal convergence that allowed the creation of the European Monetary Union would give rise to a real convergence process between the euro countries has not fulfilled. Furthermore, the macroeconomic policies in the Euro area, both the single monetary policy and the national fiscal policies, have not been able the appearance of these imbalances, thus leading to the necessary reconsideration of these policies.”

9.5 Some policy proposals

Hein and Detzer (2014), Hein (2015) advance policy and rules recommendations for Europe for addressing problems of differential inflation, divergence in competitiveness and current account imbalances all of which have undermined the operations of the single currency. They focus on monetary policy, wage and income policy, fiscal policy, and industrial restructuring. Their policy agenda includes:
“Incomes and wage policies should take over responsibility for nominal stabilisation, i.e. stabilising inflation at some target rate which contributes to maintaining a balanced current account, to the extent that exports and imports are sufficiently price-elastic. In order to contribute to rebalancing the current accounts, nominal wage growth in the current account surplus countries will have to exceed the benchmark of national long-run productivity growth plus the inflation target for an interim period, whereas nominal wage growth in the deficit countries will have to fall short of this benchmark during the adjustment process, however, without driving the economy towards deflation” (Hein, 2015, p. 27).

“In this sense, Hein (2015) points out that the re-regulation of the financial system requires of a set of measures aimed at guiding the financial sector to the real economic activity (real investment and growth of real GDP). Thus, measures are required which increase transparency in financial markets in order to reduce the problems of uncertainty, asymmetric information, moral hazard and fraud. Moreover, re-regulation should generate incentives for economic actors in the financial and non-financial sectors to focus on long-run growth rather than short-run profits (thus involving the reduction of securitization). Finally, measures directed at containing systemic instability, like credit controls, asset-based reserve requirements and counter-cyclical capital requirements for all financial intermediaries should be introduced, and a general financial transactions tax in order to slow down activity in the financial sector should be implemented.” (Ferreiro, 2016)

“Current account imbalances are only possible when corresponding capital flows exist. Current account deficits [in the Eurozone countries] could be easily financed by deficit countries as investors in surplus countries obviously expected that, within a monetary union, regional indebtedness would not pose a problem” (Dodig and Herr, 2015, p.3)

“The EU policy package to solve the sovereign debt crisis, increase the lost competitiveness of crisis countries and to stimulate growth, at least in the medium term, were:

- Fiscal consolidation with the aim of restoring investors’ confidence became paramount and various auserity measures were endorsed by and/or imposed upon debtor-deficit countries...
- Internal devaluation was considered the key point to restore competitiveness. This included nominal wage cuts as a key element ...
- Structural reforms like liberalisation, privatisation and deregulation should bring back long-term economic growth ... “ (Dodig and Herr, 2015)

“According to the official EU documents the external and internal balances of the EU economies—primarily abundant credit expansion and excessive debt accumulation, large and persistent current -- account deficits and surpluses and losses in competitiveness – were significant contributors to the recent crisis.” (Dodig and Herr, 2015, p.7)

The current account imbalances “High GDP growth in the deficit countries was to a large extent driven by real estate bubbles which were allowed to develop alongside credit driven consumption.” (p.7)

“When the Great Recession hit Europe all countries followed an expansionary fiscal policy. Fiscal stimulus, together with costly bailout-packages of banks and other financial Institutions, increased budget deficits considerably in 2009 and 2010. In early 2010 and later in all Southern European countries and Ireland interest rates for public debt started to increase to unsustainable levels. In addition, a general change in fiscal policy was introduced, led by Germany and the EU Commission. Budget consolidation, rather than fiscal stimulus, became the policy priority.” (Dodig and Herr, 2015, pp.28-9).

Hein and Detzer (2014) outline policy recommendations addressing the problems of inflation differences, divergence in competitiveness and the current account imbalances within the Eurozone. It is aimed, inter alia, to prevent the ‘export-led’ and debt-led consumption boom’ types of development. Those authors work within the framework of Thirlwall’s model of balance of payments constrained growth (e.g. Thirlwall 2002). They argue for the ECB to target low real interest rates (rather than fine tuning inflation targeting), with a focus on financial stability and acting as lender of last resort for both the banking system and for Eurozone member governments. With regard to the latter, the authors argue for the ECB to target country specific caps on government bond yields given by the long-run nominal GDP

2 They cite European Commission (2013, 2014).
growth rate of the respective country (and hence an interest rate along the lines of the ‘fair rate of interest’\(^3\)).

Wage policies could be developed to aid stabilizing income shares and contribute to achieving stable inflation rates. “Wage policies should also contribute to rebalancing price competitiveness within the Euro area, but we should not expect large effects on the prevailing current account imbalances”, as price elasticities of demand may be low and supply limitations on expansion of exports. ‘Functional finance fiscal policies’ are to be used to take up the excess of private saving over private investment at non-inflationary full employment output levels in each country. The implementation of such policies would come from coordination of government expenditure across countries (as a federal government budget appears political infeasible). It is also recognized that the catching up and convergence processes for living standards and employment will be associated with current account deficits in the less prosperous countries and surpluses in the more prosperous. “These should be accepted and taken into account when coordinating fiscal policies, provided that the periphery grows at a sustainably higher rate than the centre. For this purpose, industrial restructuring and catching up should prevent unsustainable credit-driven bubbles and consumption booms, improve existing industries and develop new export industries” so that the balance of payments growth rate of the periphery countries lifted.

“External help was organised by EMU surplus countries and the IMF and executed by the Troika. The Troika strategy consisted of ... fiscal austerity .... Internal devaluation .... Structural reforms.”

“In spite of fiscal austerity, budget deficits in the crisis countries could not be reduced as planned as fiscal austerity reduced the tax base via a shrinking GDP and increased the social costs of the crisis. Public debt in per cent of GDP increased in spite of austerity. In the end, only the late promise by the ECB in 2012 to guarantee for public debt ended the sovereign debt crisis—not austerity policy. The ECB could have given such a promise already in 2010.”

\(^3\) See, for example, Lavoie and Seccareccia (1999).
“The way the internal devaluation in current account deficit countries was enforced was a disaster as well.” (Dodig and Herr, 2015)

“Overall there were two fundamental misconceptions in the handling of the crisis in the EMU. Crisis countries were forced to follow an asymmetric adjustment process. Sharing the burden with current account surplus countries and countries with no refinancing problems would have been necessary to prevent the deep crisis in the EMU. The second fundamental mistake was to believe that fiscal consolidation may slightly reduce growth in the short-term but structural reforms will unfold market forces spontaneously and will lead to a recovery and full employment. ... There was no element of demand creation in the Troika’s recommendation”. (Dodig and Herr, 2015)

What was required was a symmetric approach. “This would have meant ... higher wage increases and fiscal stimulus after the Great Recession in surplus countries like Germany, as well as a European wide program of demand stimulation, for example in the framework of a green new deal, a cautious consolidation of public finances and no wage cuts in crises countries, and a guarantee of public debt in crisis countries at the beginning of the sovereign debt crisis.” (Dodig and Herr, 2015)

Tonveronachi (2016) draws attention to the inconsistencies between “the fiscal, monetary and financial regulatory framework and the construction of single market” and which cannot “be solved by reforming the EU treaties because there is no agreement on the new design”. Tonveronachi (2016) argues that in the political and institutional set up of the EU there are different parts are moving at different speeds, and at each stage the result is often not incomplete and incoherent. “This is particularly relevant when for some crucial aspect the degree of harmonisation among member countries is pushed to the limit, as for the subset of countries that share the same currency and same monetary policy while retaining a relevant part of fiscal sovereignty”. Insofar as national government deficits are constrained to zero, the euroarea (EA) would be close to the USA design (where States often have balanced (current) budget requirements) with “the crucial different that the EA does not have a central treasury with its discretionary policies on federal expenditure, taxes and debt. A
relevant inconsistency comes from the common central bank using a toolbox that is indistinguishable from that adopted by central banks of federal states.” It is argued that the existing EU and EA designs “are not consistent with the Union’s primary economic goal of creating a single internal market for capital, firms, goods, and services. More than that, the EU/EA construction suffers from relevant fragilities whose solution cannot be left to an undefined long period. The reform proposals currently under scrutiny are not capable of producing a long-term viable design.”

“The current and still evolving EU financial regulatory framework conveys the idiosyncratic features that characterize the peculiarity of the EU construction. The latter comes from pursuing the goal of the internal single financial market in a framework of a coalition of states, each retaining large doses of sovereignty.” (Tonveronachi, 2016, pp.5/6)

“The peculiarity of the EU design comes from attributing to liberalised markets the task of integrating and homogenizing such structurally diverse situations, with the EU and national authorities self-relegated to the role of producing and enforcing common rules. The bizarre and anti-historical idea was that economic integration would have paved the way to political integration, not the other way round. … The recent crisis has shown that markets may at best provide convergence but not integration, that convergence is fragile, that factors leading to divergence cause political de-integration and that market-friendly rules are among such factors. A reassertion of the political primacy in the public-private partnership is lone due, not in Europe.” (Tonveronachi, 2016, p.6)

“The necessary conditions for a genuine single market are single authorities and legislation on economic, financial, fiscal and social matters, which require a centralized nation state. A federal state leaves some discretion to adapt to local conditions.” (Tonveronachi, 2016, p. 7)

9.6 Concluding comments
The European Central Bank (ECB) has been set up as an independent central bank (hence not subject to political control) and as any central bank faces a ‘one-size fits all’ problem which is intensified in the context of the euroarea. It has been generally argued here that the ECB acted ‘too little too late’ in its response to the financial crisis. The focus on price stability
in its mandate means not only downplaying of any concern over the level of economy activity but also runs into the difficulty that price stability and financial stability may not be aligned.

In section 9.3, examine how fiscal policies and budget deficits have evolved in practice in the years since the financial crisis. It is well-known that the Eurozone was set up without little regard being paid to the patterns of current account deficits and surpluses, and hence also little regard to the corresponding capital account surpluses and deficits and the implications for the cross-border capital flows.

In section 9.4 consider the issue of convergence/divergence between member states, where significant divergences continue even following the formation of the currency union, and thereby raising issues for the operation of the currency union. Section 9.5 turns to some put forward some general policy proposals to address the euro crisis and divergences within the euroarea. These policy proposals would require a drastic rethink of the policy arrangements currently governing the euroarea.
References


Figure 1: Current Account (% of GDP) for selected countries and regions. Source: IM

Source: Carrasco and Peinado (2014)
Figure 2: Current Account (% of GDP) and Inflation Rates. Source: OECD Statistics

Source Carrasco and Peinado (2014)
Table 9.1 Number of EU countries adopting procyclical and countercyclical fiscal policies

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<tr>
<th>Year</th>
<th>Expansionary in Recessions (Countercyclical)</th>
<th>Expansionary in Booms (Procyclical)</th>
<th>Restrictive in Recessions (Procyclical)</th>
<th>Restrictive in Booms (Countercyclical)</th>
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<td>6 (35%)</td>
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<tr>
<td>2002</td>
<td>4 (24%)</td>
<td>5 (50%)</td>
<td>8 (47%)</td>
<td>3 (30%)</td>
</tr>
<tr>
<td>2003</td>
<td>7 (41%)</td>
<td>3 (30%)</td>
<td>4 (24%)</td>
<td>4 (40%)</td>
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<tr>
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<td>5 (29%)</td>
<td>1 (10%)</td>
<td>3 (18%)</td>
<td>3 (30%)</td>
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<tr>
<td>2005</td>
<td>1 (6%)</td>
<td>1 (10%)</td>
<td>5 (29%)</td>
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</tr>
<tr>
<td>2006</td>
<td>1 (6%)</td>
<td>0 (0%)</td>
<td>6 (35%)</td>
<td>8 (80%)</td>
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<tr>
<td>2007</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>12 (71%)</td>
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<tr>
<td>2008</td>
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<td>0 (0%)</td>
<td>13 (76%)</td>
<td>8 (80%)</td>
</tr>
<tr>
<td>2009</td>
<td>13 (76%)</td>
<td>6 (55%)</td>
<td>0 (0%)</td>
<td>2 (18%)</td>
</tr>
<tr>
<td>2010</td>
<td>8 (47%)</td>
<td>4 (36%)</td>
<td>0 (0%)</td>
<td>1 (9%)</td>
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<tr>
<td>2011</td>
<td>2 (12%)</td>
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<td>2 (12%)</td>
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<td>5 (29%)</td>
<td>5 (45%)</td>
<td>1 (6%)</td>
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<td>2013</td>
<td>2 (12%)</td>
<td>7 (64%)</td>
<td>0 (0%)</td>
<td>1 (9%)</td>
</tr>
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</table>

Source: Ferreiro, Galvez and Gonzalez (2015)
Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project.

The abstract of the project is:

‘The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?’
THE PARTNERS IN THE CONSORTIUM ARE:

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