



The processes of financialisation and economic performance

Malcolm Sawyer¹

University of Leeds

July 2016

Abstract: The paper considers the relationships between financialisation and economic performance. Financialisation is a persistent feature of industrialised capitalism, the nature of which differs over time and space. The present era of financialisation (since circa 1980) has been a world-wide phenomenon proceeding from different starting points and developing at different speeds, and can be viewed through the lens of variegated financialisation. The major features of the present era of financialisation are outlined. The increased scale of the financial sector leads to the issue of the relationship between financialisation and economic performance, and whether the additional resources used in the financial sector has been socially beneficial. The paper is completed by some brief remarks on the possibilities of de-financialisation.

Key words: financialisation, economic performance, financial sector

Journal of Economic Literature classification: G01, G20, E42

Economics Division
Leeds University Business School
University of Leeds,
Leeds LS2 9JT
UK

Email: m.c.sawyer@lubs.leeds.ac.uk

¹ This paper draws on the results of research undertaken within the project Financialisation, Economy, Society and Sustainable Development (FESSUD), which received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800, and for which I am the principal investigator. The views expressed in this paper are mine, and do not reflect the views of the partners within the FESSUD project nor of the European Commission. Information on FESSUD and for the working papers arising from the project, consult www.fessud.eu.



1. Introduction

The purpose of this paper is to consider the relationships between financialisation and economic performance. In order to do that we begin with some remarks on the general nature of financialisation, which is viewed as a persistent feature of industrialised capitalism. The nature of financialisation differs over time and space. The waves of financialisation have involved different characteristics including the nature of the relationships between the financial and real sectors. The differences of the processes of financialisation can be viewed through the lens of variegated financialisation. In section 3 the features of the present era of financialisation (since circa 1980) are outlined. These features have included the global nature of financialisation with virtually all countries involved, albeit that the rapid growth of their financial sector in some countries started later than in others (e.g. the former COMECON countries for obvious reasons). The increased scale of the financial sector leads to the issue of the relationship between financialisation and economic performance, and whether the additional resources used in the financial sector has been socially beneficial. This is examined in section 4. Section 5 is a brief enquiry into possibilities for de-financialisation.

2. The nature of financialisation

The term 'financialisation' has been variously defined and conceptualised, and synonyms such as financialised capitalism have been used. The general notion of financialisation is here viewed in terms of the growth of the financial sector: '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 2005, p.3). However, it is necessary to extend that notion in two ways. The first is to recognize that financialisation involves political and social dominance of the financial sector as well as the economy, and the second is to explore the forms which the growth of the financial sector takes in a specific time and place.

Financialisation (in the sense of growth of the financial sector) has been a long-standing feature of capitalist economies. Money (in the sense of that which is used as a means of payment) is a credit/debt relationship. However money is viewed as having developed, it facilitated trade and exchange and acts as a financial asset. Money



generally, but not universally, took a physical form which enabled a form of record keeping in an age when most were illiterate. But the physical form should not be interpreted in terms of commodity money in the sense that it is the value of the commodity, e.g. gold which gives money value. It is rather that money should also be viewed as a credit/debt relationship. Banks developed in 14th century Italy. Banks were engaged in the provision of finance for trade (often international) in 'mercantile capitalism'. Minsky argued that modern capitalism had developed out of 'mercantile capitalism' (in which banks merely provide finance for trade). The greatly increased financial requirements of industrial capitalism, to finance fixed capital with a much longer period of turnover or return, gave rise to 'financial capitalism'. The mercantile capitalism and financial capitalism were two periods identified by Minsky (1988;1993) relating particularly to American capitalism and the relationships between the real and the financial sectors. Minsky (1988, 1993) continued to identify two further stages: managerial, and money manager, and in each stage the relationship between finance and the real economy differ in significant ways. As Whalen (2012, p.257) expressed it, 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?".

The financial crisis of 1929 on Wall Street, and the banking crises of the early 1930s through Europe and the USA involved a period of what may be termed de-financialisation as the financial sector was much diminished in economic and political importance. Managerial capitalism was emerging, as reflected in the publication of Berle and Means (1932) with the idea that control of large corporations was passing from owners and shareholders to managers, and that managers would pursue objectives of size and growth. 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.



In each of these eras the scale of the financial sector grew (and the 1930s and 1940s representing a break in the onward march of finance). But it is not merely the growth of the financial sector which is involved. The financial sector can be viewed as a conduit through which funds flow from savers ('surplus units') to investors ('deficit units'). As such the efficiency with which those processes are fulfilled becomes a question of interest, and how well or badly different types of financial sector (e.g. debates between bank-based and market-based financial systems) perform that function.

Vercelli (2014) focused on two periods of acceleration of the long-term processes of financialisation. "The First financialisation occurred in the second half of the 19th century and lasted until the beginning of the Great Depression, while the Second financialisation started after the end of the Bretton Woods period (1971) and is going on unchallenged notwithstanding the crisis" (p. 25). Two observations can be made on this periodisation. The first is to be mindful of the geographic scope of financialisation. In the first period much attention is placed on the financial sectors of the USA, and a range of European countries (notably UK and Germany), though there were some global aspects in that portfolio investments were made by those industrialised countries in other countries. But the financial sectors of those other countries were not on the scale of the industrialised countries. The second is how the period of the 1950s and 1960s (the 'golden age of capitalism') is to be represented in that it also often involved (in the industrialised economies) growth of the financial sector, albeit within a framework of controls and regulation with those controls and regulations gradually being reduced. The 1950s and 1960s for the industrialised countries can be seen as a recovery from the de-financialisation of the inter-war period.

The focus of attention in this paper is financialisation in the present era which is dated from circa 1980. In the next section the features of financialisation in that era are considered, and that is followed by the effects of financialisation on economic performance.

3. The period since circa 1980.

The era since circa 1980 has been variously identified as a neo-liberal era (and related with the coming to power of Thatcher and Reagan in UK, USA respectively and the policy directions which they sought to follow), an era of globalisation (with the growth



of international trade, foreign direct investment and capital flows) and one of financialisation. The three are not mutually exclusive and indeed are more likely three mutually reinforcing phenomenon. Our attention here is on the financialisation.

Financialisation has not been limited to the industrialised countries of North America, Europe and elsewhere. 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 and it is those countries to which our discussion below relates. Bonizzi (2013) 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.

Ashman and Fine (2013) provide a brief summary of the main features of the era of financialisation since circa 1980. We use that structure as our starting point and add to it.

The first feature identified is the rapid expansion of financial institutions and financial markets. As noted above, 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. Bank deposits (as included in M2 measure of money) averaged 85.3 per cent in 1990, rising through 90.0, 102.6, 120.7 and then 126.1 per cent in 1995, 2000, 2005 and 2010 respectively². The volumes of trading and the turnover of financial assets have also grown rapidly. For a range of industrialised countries (14 European, plus USA, Canada, New Zealand and Australia) the median ratio of stock market capitalisation to GDP rose from 31.9 per cent in 1990 to 35.3 per cent

² Calculations refer to 28 countries, mainly Western European and also USA, Canada, Japan, Australia and New Zealand.



in 1995, then 97.1 per cent in 2000, 84 per cent in 2005, before falling back under the impact of the stock market crashes following the financial crisis to 70.5 per cent in 2010³. 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. The figures in Figure 1 illustrate the simultaneous growth of financial assets and liabilities within the Euroarea for the whole economy (and hence including households) and for non-financial corporations.

Financial institutions have often been a mixture of privately owned (and presumed to be profit maximising), mutual and co-operative owned and State owned. Mutual, co-operative and State-owned can often be viewed as 'double bottom line institutions' (DBLI) in that they have in general to at least break even (and hence some notion of profitability observed) and to pursue a range of social objectives such as provision of funds for groups excluded on groups of gender, ethnicity, for environmental projects etc.. A feature of the present era of financialisation has often been the decline of mutual and co-operative ownership and the involvement of State ownership.

The structure of the banking sector in particular has tended to change in the directions of becoming more concentrated (though some, such as the UK were already highly concentrated), less regionalised as regional banking gave way to national banking and more internationalised.

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. Many others, particularly drawing on the work of Minsky, have pointed to the de-stabilising effects particularly in the form of unsustainable credit booms.

³ Figures and subsequent ones in this paragraph calculated from Financial Development and Structure Dataset <http://www.worldbank.org/en/publication/gfdr/data/financial-structure-database>.



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 pursuit of shareholder value has been widely adopted through the interests of financial institutions. Van der Zwan (2014) views the pursuit of shareholder value as one of the three key characteristics of financialisation. There are implications, generally adverse, for the levels of investment and innovation by corporations from the pressures for the pursuit of short-term profits and dividends (as discussed below).

Fifth, the present era of financialisation is strongly associated with market mechanisms, neo-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. Globalisation and financialisation have interacted in that the financial sector grows to facilitate international trade and foreign direct investment. Global financial markets and linkages between national financial markets intensify.

The period of financialisation has also been associated with generally rising inequality over the past three decades. This has been well documented, in for example, OECD (2011). 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 been seen adding 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. Figure 2 illustrates the position for the G7 countries in respect of household liabilities relative to nominal disposable income. Although there are substantial differences in their starting levels all shown a trend rise which is particularly pronounced in themed 2000s. Alongside rising household debt has gone rising household financial assets and net worth.

An interesting question here is the underlying forces promoting that rise in consumer debt. In the build-up to the financial crisis, and particularly relating to the United State, rising inequality and stagnating real wages have been seen as a force pushing particularly low income households into acquiring debt as a means of maintaining living standards and enabling home ownership. Rising household debt requires an increased willingness of banks and other financial institutions to lend to households *and* an increased willingness of households to acquire debt. 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. van der Zwan (2014) lists as the third characteristic of financialisation, the ‘financialisation of the everyday. This includes ‘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 ... exercised through individuals’ own interactions with new financial technologies and systems of financial knowledge. 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.’ The trends 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 rise in



household borrowing and debt is another sign of the increased involvement of households with the financial sector.

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. These are general features of financialisation, but the growth of financial sectors has been pervasive across the world. The specific forms they take varies from country to country, and the timing of these developments similarly varies. The term 'variegated financialisation' can be used to signify the pervasive but differentiated forms of financialisation.⁴

4. Financialisation, growth and crisis

The intention of this section is to provide an overview of the empirical work, which bears on the question of the relationship between financialisation and economic performance. This includes the growth of the financial sector and growth, the occurrence and costs of financial crisis, financial liberalisation and growth, pursuit of shareholder value and investment, and financialisation and inequality.

a. Finance and 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

⁴ See Brown, Spencer and Veronese Passarella (2015) for some evidence on the spread of the financial sector and the differences across countries leading into notions of variegated financialisation. See also Ferreiro and Gómez (2016).

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 system and long-run 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).

Arestis, Chortareas, and Magkonis (2014) in their conducted a meta-analysis of the empirical evidence on the effects of financial development on growth concluded “the results suggest the existence of a statistically significant and economically meaningful positive genuine effect from financial development to economic growth” (pp. 557-9).

However, a host of studies have been published in the past five to ten years suggesting that the relationship between size of the financial sector (including financial deepening) and economic development (particularly economic growth) has weakened, and evidence of a non-linear inverted U-shaped relationship emerging with most developed countries now lying on the negative sloped portion of the relationship. As these studies using econometric analysis and require a substantial number of observation points, it is often the case that these results pertain to a period of the past three decades or so.

Rousseau and Wachtel (2011) argue that “we show that it [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” (p. 276). Arcand, Berkes, and Panizza (2012) “use different



empirical approaches to show that there can indeed be ‘too much’ finance. In particular, our results suggest that finance starts having a negative effect on output growth when credit to the private sector reaches 100% of GDP.” (p. 1). Cecchetti and Kharroubi, (2012)⁵ 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). Sahay et alia (2015) use a broad, measure of financial development, and find that the effect of financial development on growth is inverted U-shaped, with the effects weakening at the higher levels of financial development, coming from financial deepening rather than from greater access or higher efficiency. The weakening effect is viewed as impacting on total factor productivity rather than on the accumulation of capital. When the pace of financial development is relatively rapid then financial deepening can lead to economic and financial instability.

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.

The particularly significant view to arise from the recent literature is that the previous findings of positive relationships between financial development and more generally the size of financial sector with economic growth has weakened and often turned negative. As such these more recent findings feed into the idea that the financial sector may have become too large.

3.2 Finance 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

⁵ 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, Beck, Degryse and Kneer (2013).



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. It is significant that banking crises do not only lead to falls in output (and thereby rises in unemployment) but also that that lost output is not fully recovered.

3.3 Financial liberalisation and growth

A feature of the present 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.



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).

5. The need for de-financialisation

‘In the era of modern finance, a century-long near-stable ratio of credit to GDP gave way to increasing financialization and surging leverage in advanced economies in the last forty years. This “financial hockey stick” coincides with shifts in foundational macroeconomic relationships beyond the widely-noted return of macroeconomic fragility and crisis risk. Leverage is correlated with central business cycle moments. We document an extensive set of such moments based on a decade-long international and historical data collection effort. More financialized economies exhibit somewhat less real volatility but lower growth, more tail risk, and tighter real-real and real financial correlations. International real and financial cycles also cohere more strongly.’ (Jorda, Schularick, and Taylor, 2016, p.1).

This echoes with remarks made above on financial instabilities and financial crises, and their associations with the present era of financialisation. Further, the empirical work to which reference was made in the previous section suggests that the scale of



the financial sector has a negative rather than positive effect on economic growth. This accords with the general idea that the financial sector has become 'too big' (Epstein and Crotty, 2013, for example). The notion of being 'too big' means that the financial sector is proving a drag on the development of the real sector.

The idea that the financial sector is in some sense too large and does not focus on its key roles is not a new one, though it is one that has frequently been dismissed by economists and politicians (not to mention by the financial sector itself). Tobin (1984) voiced sceptical views of the efficiency of our vast system of financial markets and institutions, which as he noted "run against current tides—not only the general enthusiasm for deregulation and unfettered competition but my profession's intellectual admiration for the efficiency of financial markets" (p.2). He doubted the value of "throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to the social productivity" (p. 14). A more recent statement of this view is the 'financial system costs the economy on a daily basis by attracting too many talented workers, distorting incentives to engage in long-term investments, making poor strategic decisions in managing firms it controls, and other problems associated with allocation of credit, capital and talent.' (Epstein and Montecino, 2016). Stiglitz (1994) argued "that much of the rationale for liberalizing financial markets is based neither on a sound economic understanding of how these markets work nor on the potential scope for government intervention." (p.22). He argued that financial innovations often contribute little to the achievement of economic efficiency, and may well be welfare-decreasing. Overall he postulates that "Improvements in secondary markets do not necessarily enhance the ability of the economy either to mobilize savings or to allocate capital" (p. 22). Zingales (2015) poses the question in the title of his paper which formed the basis of presidential address to the American Finance Association of 'does finance benefit society'. "While there is no doubt that a developed economy needs a sophisticated financial sector, at the current state of knowledge there is no theoretical reason or empirical evidence to support the notion that all the growth of the financial sector in the last forty years has been beneficial to society" (p.3). He continues by arguing that there is both theory and empirical evidence that a component of that growth has been pure rent seeking, and



that a task of academics is to use research and teaching to reduce the rent-seeking dimension of finance.

Epstein and Montecino (2016) examine the costs of the financial sector to American households in terms of three components: (1) rents, or excess profits; (2) misallocation costs, or the price of diverting resources away from non-financial activities; and (3) the costs of the 2008 financial crisis.

The rents obtained by the financial sector comes 'through a variety of mechanisms including anticompetitive practices, the marketing of excessively complex and risky products, government subsidies such as financial bailouts, and even fraudulent activities, bankers receive excess pay and profits for the services' and they estimate the total cost of financial rents as in the range of \$3.6 trillion–\$4.2 trillion between 1990 and 2005. Mis-selling, antic-competitive and fraudulent activities in the financial sector impose their costs. Dzimwasha (2015) indicates that the 20 largest global banks paid \$235billion in fines for a range of mis-selling in the seven years following the 2008 financial crisis. Zingales (2015) reports that fines paid by financial institutions to US regulatory agencies amounted to \$138.59 billion over period 2010-2014. Fines imposed in the UK by Financial Services Authority and its successor Financial Conduct Authority amounted to just under £3.5 billion during the years 2009 to 2015.⁶ Robert Jenkins provides a listing the 'misdeeds' of banks at <http://www.finance-watch.org/hot-topics/blog/1186-jenkins-bank-misdeeds>. He gives over 50 proven cases and 25 currently under investigation. These range from mis-selling (e.g. of payment protection insurance, interest rate swaps), manipulation of markets (e.g. precious metals markets, US Treasury Market auction/client sales, energy markets), aiding and abetting tax evasion and money laundering for violent drug cartels, collusion with Greek authorities to mislead EU policy makers on meeting Euro criteria, etc.

Misallocation costs, echoing Tobin's remarks, comes from speculative finance which 'harms the economy on a daily basis ...by growing too large, utilizing too many skilled and productive workers, imposing short-term orientations on businesses, and starving some businesses and households of needed credit. We estimate that the cost of misallocating human and financial resources amounted to \$2.6 trillion–\$3.9 trillion between 1990 and 2005. Malkeil (2013, p.97) argues that neither the argument that

⁶ Calculated from <http://www.fsa.gov.uk/about/press/facts/fines> and <http://www.fca.org.uk/firms/being-regulated/enforcement/fines/2015-fines>.



the increase in fees reflected increasing returns for investors from active management nor if it was necessary to improve the efficiency of the market for investors who availed themselves of low-cost passive (index) funds is supported by the data. 'Thus, the increase in fees is likely to represent a deadweight loss for investors. Indeed, perhaps the greatest inefficiency in the stock market is in "the market" for investment advice.' For the costs of the financial crisis, Epstein and Montecino (2016) use the estimates from the Dallas Federal Reserve (Atkinson, Luttrell, and Rosenblum, 2013, Luttrell, Atkinson, and Rosenblum, 2013). 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. These estimates relate to the US and the recent financial crisis: in the section above costs of other financial crises have been indicated.

Epstein and Montecino (2016) overall place the total costs imposed on society as between \$12.9 trillion and \$22.7 trillion in the period 1990 and 2023, which represents between 66 per cent and 133 per cent of one year's US GDP.

There is much strength in the argument that as far as most industrialised nations are concerned the financial sector has become 'too big', and as the growth and scale of the financial sector is part of financialisation, the policy conclusion would be the need for de-financialisation. In calling for de-financialisation, it has to be recognized that financialisation also involves the political power of the financial sector, and that any moves in the direction of de-financialisation will be fiercely resisted.

The view of a 'too big' financial sector involves a number of strands of argument, and the moves towards de-financialisation in the general social interest would need to be multi-dimensional.

First, the manner in which the financial sector has grown has not been conducive for investment and savings, though a key role of the financial sector is viewed as providing financial assets for households to hold their savings, to act as intermediaries between savers and investors, and to allocate and monitor funds for investment. Indeed, the basis of the financial development encourages economic growth was the encouragement of savings and of the allocation of funds for investment purposes. The ways in which the financial sector has grown in the past three decades have tended to be away from the fulfilment of those roles, and into the direction of development and trade in financial assets and derivatives. I have argued elsewhere (Sawyer, 2016) for



policies to aid the establishment of a more diverse set of financial institutions including local and regional banks, mutual and co-operative organisations, micro-credit and micro-finance and State development banks which would be more focused on the savings-investment links and would be capable of being closer to their customers and allocating funds in a more social desirable direction.

Second, the growth of financial markets and speculation have diverted resources into what are essentially zero-sum games. A financial transactions tax (on a wide range of financial transactions) would aid the discouragement of trading in existing assets. There is also a case for a broader ranging view of taxation of the financial sector which is in general undertaxed through financial activities tax.

Third, the rush to financial liberalisation and the failures of the regulatory systems were important contributors to the occurrence of financial crises (and thereby to the major costs of recession which financial crises involve). It has to be recognized that any financial system will eventually involve instability and crisis. Minsky's 'financial instability' hypothesis reflects views that a capitalist economy is inherently cyclical generating by forces within the system, rather than by 'shocks'. Further, 'market forces are destabilizing and must be constrained to create stability. However, there is no permanent solution to the problem of cycles because "stability is destabilizing"' (Wray, 2016, p.72). 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 'near-term receipts are insufficient to cover even interest payments' (Wray, 2016, p.79). Regulatory reforms have their role to play in aiding a less crisis-prone financial system. But the problems of regulatory capture loom large.

6. Concluding comments

This paper has put the case that the financialisation of the present era has in general been detrimental for economic performance. It has pointed to the costs which the financial system imposes on society. It has argued the need for de-financialisation, and sketched some ways for seeking to do so, though in the full recognition that the political power of the financial sector will limit the changes of achieving any significant de-financialisation.

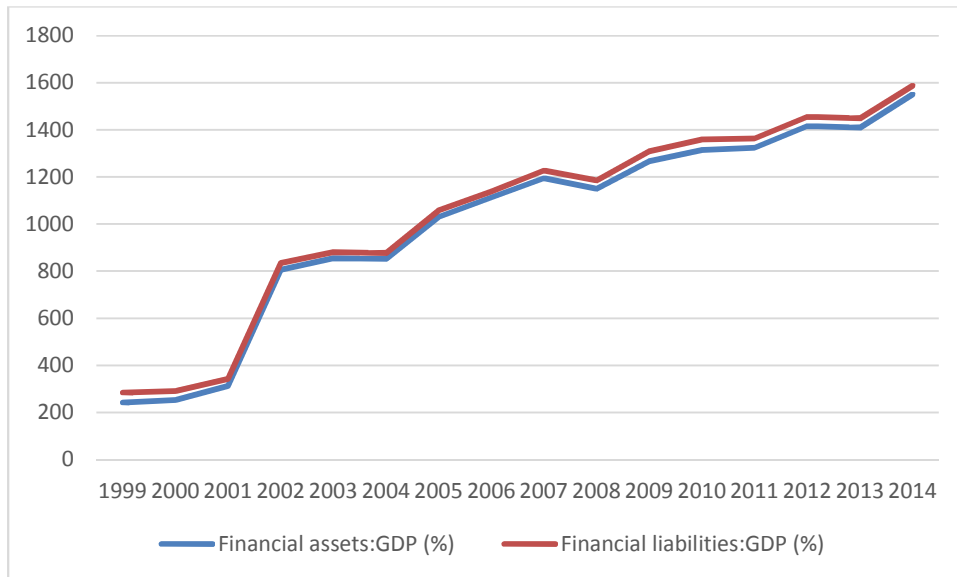
References

- Aghion, P. Howitt, P. and D. Mayer-Foulkes, (2005), 'The Effect of Financial Development on Convergence: Theory and Evidence', *Quarterly Journal of Economics*, Vol. 120, pp. 173–222.
- Arcand, J-L, Berkes, E. and Panizza, U. (2012), 'Too much finance?', *IMF Working Paper* Wp/12/161.
- Arestis, P. (2016), 'Financial Liberalization, the Finance-Growth Nexus, Financial Crises and Policy Implications', in P. Arestis and M. Sawyer (eds.), *Financial Liberalisation: Past, Present and Future*, Annual Edition of *International Papers in Political Economy*, Houndmills, Basingstoke: Palgrave Macmillan.
- Arestis, P., Chortareas, G, and Magkonis, G. (2015), 'The financial development and growth nexus: a meta-analysis', *Journal of Economic Surveys* vol. 29(3), pp.549-565.
- Ashman, S. and Fine, B. (2013), 'Neo-liberalism, varieties of capitalism, and the shifting contours of Africa's financial system', *Transformation: critical perspectives on Southern Africa*, no. 81/82, pp.144-178.
- Atkinson, T., Luttrell, D. and Rosenblum, H. (2013), 'How bad was it? The costs and consequences of the 2007-09 financial crisis', *Federal Reserve Bank of Dallas, Staff Papers* no. 20 July
- Barajas, A., Beck, T., Dabla-Norris, E. and Reza Yousefi, S. (2013), 'Too cold, too hot, or just right? assessing financial sector development across the globe', *IMF Working Papers*, WP/13/81.
- Barajas, A., Chami, R. and Reza Yousefi, S. (2012), 'The finance and growth nexus re-examined: do all countries benefit equally?' unpublished IMF Working Paper (Washington: International Monetary Fund).
- Beck, T., Degryse, H. and C. Kneer, (2013), 'Is More Finance Better? Disentangling Intermediation and Size Effects of Financial Systems', *Journal of Financial Stability*, 10 (2014) 50– 64.
- Berle, A.A. and Means, G.C. (1932), *The modern corporation and private property*, New York : Macmillan,
- Bonizzi, B. (2014), 'Financialisation in Developing and Emerging Countries: A Survey', *International Journal of Political Economy*, vol. 42, no. 4, Winter 2013–14, pp. 83–107.

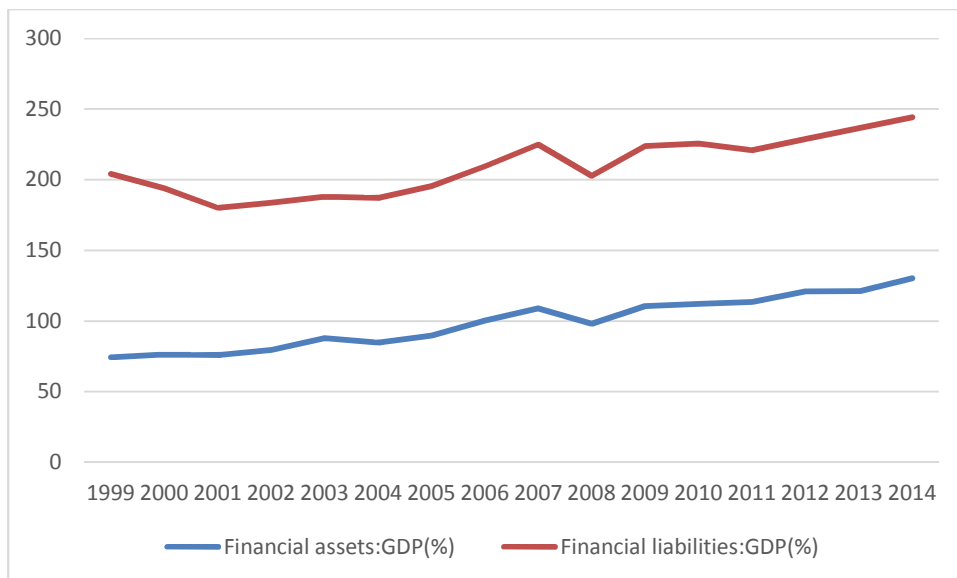
- Brown, A., Spencer, D. and Veronese Passarella, M (2015), 'The nature and variegation of financialisation: a cross-country comparison' *FESSUD Working Paper*, 127 (available from fessud.eu)
- Bumann, S., Hermes, N., Lensink, R. (2012), *Financial liberalisation and economic growth: a meta-analysis. Technical Report* London: EPPI-Centre, Social Science Research Unit, Institute of Education, University of London.
- Cecchetti, S.G., and E. Kharroubi. (2012), 'Reassessing the Impact of Finance on Growth', *BIS Working Papers*, No. 381.
- Cournède, B., Denk, O., and Hoeller, P. (2015), 'Finance and inclusive growth', *OECD Economic Policy Paper*, no.14.
- Dabla-Norris, E. and Srivisal, N. (2013), 'Revisiting the link between finance and macroeconomic volatility', *IMF Working Papers*, WP/13/29.
- Epstein, G. (2005), 'Introduction: Financialization and the World Economy.' In G. Epstein, (ed.), *Financialization and the World Economy*. Cheltenham and Northampton: Edward Elgar.
- Epstein, G. and J. Crotty. (2013), 'How Big Is Too Big? On the Social Efficiency of the Financial Sector in the United States', *PERI Working Paper* 313.
- Epstein, G. and Montecino, J.A, (2016), 'Overcharged: the high cost of high finance', Roosevelt Institute, available at <http://www.peri.umass.edu/236/hash/fd100f263f6805db4562d7816b225e5f/publication/711/>
- Ferreiro, J. and Gómez, C. (2016), 'Financialisation and Financial Balance Sheets of Economic Sectors in the Eurozone' in P. Arestis and M. Sawyer (eds.), *Financial Liberalisation: Past, Present and Future*, Annual Edition of *International Papers in Political Economy*, Houndmills, Basingstoke: Palgrave Macmillan.
- Greenwood, R. and Scharfstein, D. (2013), 'The growth of finance', *Journal of Economic Perspectives*, 27(2), Spring 2013, pp. 3–28 doi=10.1257/jep.27.2.3
- Hein, E. (2012) *The Macroeconomics of Finance-dominated Capitalism – and Its Crisis* Cheltenham: Edward Elgar.
- Jorda, O., Schularick, M and A.M. Taylor (2016), 'Macrofinancial history and the new business cycle facts', *NBER Macroeconomic Annual Conference*, 2016
- Laeven, L., and Valencia, F. (2013), 'Systemic banking crises database', *IMF Economic Review*, vol. 61, pp.225-270 doi:10.1057/imfer.2013.12.

- Lazonick, W. and O'Sullivan, M. (2000), 'Maximizing shareholder value: a new ideology for corporate governance', *Economy and Society*, 29:1, 13-35.
- Levine, R. (2005), 'Finance and Growth: Theory and Evidence' in Philippe Aghion and Steven N. Durlauf (eds.) *Handbook of Economic Growth*, Amsterdam: Elsevier: 866-934.
- Luttrell, D., Atkinson, T. and Rosenblum, H. (2013), 'Assessing the costs and consequences of the 2007-2009 financial crisis and its aftermath', *Federal Reserve Bank of Dallas, Economic Letter*, vol.8 no. 7 September
- Malkiel, Burton G.. 2013. "Asset Management Fees and the Growth of Finance." *Journal of Economic Perspectives*, 27(2): 97-108. DOI: 10.1257/jep.27.2.97
- McKinnon, R.I. (1973), *Money and capital in economic development*, Washington : Brookings Institution.
- Minsky, H.P. (1993), 'Community Development Banks: an idea in search of substance', *Challenge*, March/April 1993.
- Minsky, Hyman P. (1988), 'Schumpeter: Finance and Evolution', *Hyman P. Minsky Archive*. Paper 314. http://digitalcommons.bard.edu/hm_archive/314
- OECD (2011), *Growing Income Inequality in OECD Countries: What Drives it and How Can Policy Tackle it?*, Paris: Organization for Economic Co-operation and Development.
- Philippon, T. and Reshef, A. (2012), 'Wages and human capital in the U.S> finance industry: 1909-2006', *The Quarterly Journal of Economics*, vol. 127(4), pp. 1551-1609
- Rioja, Felix, and Valev, N. (2004), 'Finance and the Sources of Growth at Various Stages of Economic Development' *Economic Inquiry Journal*, Vol. 42, pp. 127–140.
- Rioja, Felix, and Valev, N. (2005), 'Does One Size Fit All? A Reexamination of the Finance and Growth Relationship', *Journal of Development Economics*, Vol. 74, pp. 429–447.
- Rousseau, P.L. and Wachtel, P. (2011), 'What is happening to the impact of financial deepening on economic growth?', *Economic Inquiry* Vol. 49, No. 1, pp. 276–288.
- Sahay, R. et alia, (2015), 'Rethinking financial deepening: stability and growth in emerging markets', *IMF Staff Discussion Note* 1508.
- Sawyer, M. (2016), 'Confronting financialisation' in in P. Arestis and M. Sawyer (eds.), *Financial Liberalisation: Past, Present and Future*, Annual Edition of *International Papers in Political Economy*, Houndmills, Basingstoke: Palgrave Macmillan

- Shaw, E. S. (1973). *Financial deepening in economic development* New York : Oxford University Press.
- Stiglitz, J. and Greenwald, B. (2003), *Towards a New Paradigm in Monetary Economics*, Cambridge University Press.
- Stiglitz, J.E. (1994), *The Role of the State in Financial Markets*, in M. Bruno and B Pleskovic (Eds.), *Proceedings of the World Bank Annual Conference on Development Economics 1993*, Supplement to The World Bank Economic Review and The World Bank Research Observer, pp. 19-52; ;
<http://documents.worldbank.org/curated/en/1994/03/9314597/>
- Tobin J. (1984), 'On the efficiency of the financial system', *Lloyds Bank Review*, July
- van der Zwan, N. (2014), 'State of the Art: making sense of financialisation', *Socio-Economic Review* (2014) 12, 99–129.
- Van Treeck, T. (2009) 'The Political Economy Debate on 'Financialisation' – a Macroeconomic Perspective', *Review of International Political Economy*, 16, 907–944.
- Vercelli, A. (2014) 'Financialisation in a long-run perspective: an evolutionary approach', *International Journal of Political Economy*, 42(4).
- Whalen, C.J. (2012), 'Money Manager Capitalism' in *The Handbook of Critical Issues in Finance* edited by Jan Toporowski and Jo Michell, Aldershot: Edward Elgar, pp. 257-261
- Wray, L. R. (2016), *Why Minsky Matters: An Introduction to the Work of a Maverick Economist*, Princeton: Princeton University Press
- Zingales, L. (2015), 'Does Finance benefit society?', Prepared for the 2015 AFA Presidential Address, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2585194



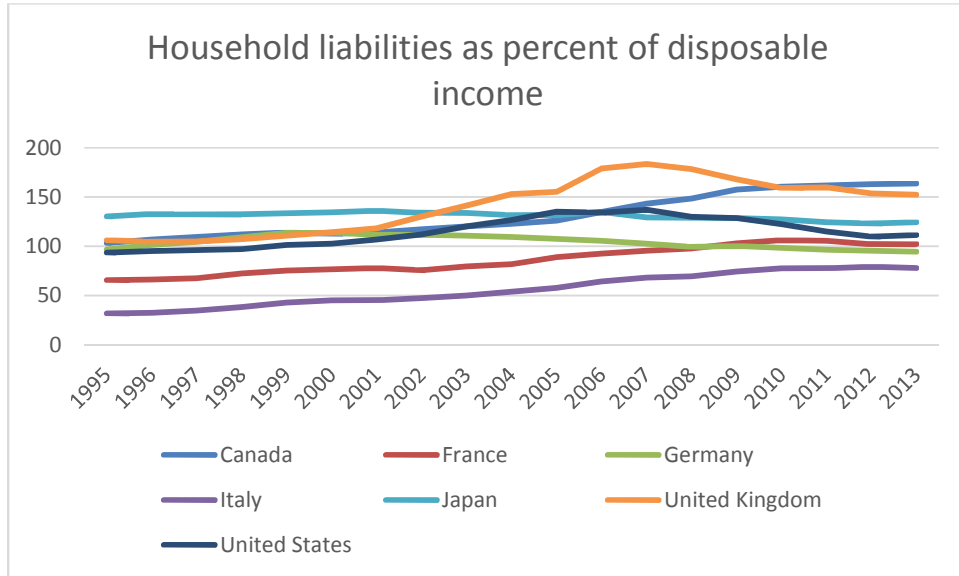
Total economy



Non-financial corporations

Figure 1: Financial assets and liabilities for euroarea countries

Source: based on statistics given in Ferreiro et alai (2016) Table 1



Source: OECD Economic Outlook, Annex Tables various issues