1. Introduction

In 2008/09 the world economy was hit by a decline in real gross domestic product (GDP), which had not been seen for generations. The so-called 'Great Recession' started with the collapse of the subprime mortgage market in the US in summer 2007, and it gained momentum with the breakdown of Lehman Brothers in September 2008. Under the conditions of deregulated and liberalized international financial markets, the financial and real crises rapidly spread all over the world and reached another climax with the euro crisis which started in 2010. Although some countries quickly recovered from the recession of 2008/09, others did not. The world economy in late 2011 is still suffering from this deep crisis and, moreover, is threatened by another slowdown in growth and increasing fiscal and financial uncertainty, according to the latest outlook of the IMF (2011).

The world economy is hence far from having overcome the causes of the crisis, which in our view are rooted in the long-run developments since the early 1980s. It is by now widely accepted that the financial crisis has been caused by liberalized financial markets, wrong incentives, personal greed, fraud, naive beliefs, and herding behaviour of economic actors.[1] However, several authors have made clear that this is only part of the story and that the severity of the financial and economic crises can only be understood if the changes in income distribution over the last decades and the emerging global imbalances are taken into account.[2] We subscribe to this perspective and we hold that the following medium- to long-run developments since the early 1980s, in particular in the advanced capitalist economies but also affecting the emerging market economies, have been responsible for the crisis: inefficient regulation of financial markets, increasing inequality in the distribution of income, and rising imbalances at the global (and at the Euro area) level. These developments have been dominated by the policies aimed at deregulation of labour markets, reduction of government intervention into the market economy and of government demand management, redistribution of income from (lower) wages to profits and top management salaries, and deregulation and liberalization of national and international financial markets. In what follows, we will call this broad policy stance 'neo-liberalism', describing the policies implemented – to different degrees in different capitalist economies – since the early 1980s.

'Financialization' or 'finance-dominated capitalism' – we use these terms interchangeably – is interrelated and overlaps with neo-liberalism, but is not identical with it.[3] Epstein (2005, p. 3) has presented a widely accepted definition, arguing that '[. . .] financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'. The instabilities and crises the world economy is presently facing can therefore be understood as a crisis of neo-liberalism and finance-dominated capitalism.

The detailed features of financialization or finance-dominated capitalism have been described and analysed extensively and in detail by several authors.[4] This book does not aim to add to these descriptive studies and analyses. We rather attempt to develop a macroeconomic perspective on finance-dominated capitalism and its crisis. In the present book we will argue that from a macroeconomic point of view financialization has affected long-run economic developments through the following three channels:

1. With regard to distribution, financialization has been conducive to a rising gross profit share, including retained profits, dividends and interest payments, and thus a falling labour income share, on the one hand, and to increasing inequality of wages and top management salaries, on the other. The major reasons for this have been falling bargaining power of trade unions, rising profit claims imposed in particular by increasingly powerful rentiers, and a change in the sectoral composition of the economy in favour of the financial corporate sector.
2. Regarding investment in capital stock, financialization has been characterized by increasing shareholder power vis-à-vis management and workers, an increasing rate of return on equity and bonds held by rentiers, and an alignment of management with shareholder interests through short-run performance related pay schemes, bonuses, stock option programmes, and so on. On the one hand, this has imposed short-termism on management and has caused decreasing managements' animal spirits with respect to real investment in capital stock and long-run growth of the firm. On the other hand, it has drained internal means of finance for real investment purposes from the corporations, through increasing dividend payments and share buybacks in order to boost stock prices and thus shareholder value. These 'preference' and 'internal means of finance' channels have each had partially negative effects on firms' real investment in capital stock and hence on long-run growth of the economy to the extent that productivity growth is capital embodied.

3. Regarding consumption, financialization has generated increasing potential for wealth-based and debt-financed consumption, thus creating the potential to compensate for the depressing demand effects of financialization, which were imposed on the economy via redistribution and the impact on real investment. Stock market and housing price booms have each increased notional wealth against which households were willing to borrow. Changing financial norms, new financial instruments (credit card debt, home equity lending), deterioration of creditworthiness standards, triggered by securitization of mortgage debt and 'originate and distribute' strategies of commercial banks, made increasing credit available to low income, low wealth households, in particular. This allowed for consumption to rise faster than median income and thus to stabilise aggregate demand. But it also generated increasing debt–income ratios of private households and thus increasing financial fragility.

Against the background of these basic macroeconomic tendencies of finance-dominated capitalism, rising current account imbalances at the global, but also at the European level, have developed and contributed to the severity of the Great Recession and to the euro crisis. Some countries relied on debt-led soaring private consumption demand as the main driver of aggregate demand and GDP growth, generating and accepting concomitant rising deficits in their trade and current account balances. Other countries focussed on mercantilist export-led strategies as an alternative to generating demand, in the face of redistribution at the expense of (low) labour incomes, stagnating consumption demand and weak real investment, and have hence accumulated increasing surpluses in their trade and current account balances.

In this book we will develop and analyse the basic macroeconomic features and tendencies of financialization and their contributions to the crisis of finance-dominated capitalism. In Chapter 2, three dimensions of re-distribution – functional distribution, personal distribution and the development of top incomes – taking place in the course of financialization and neo-liberalism since the early 1980s, will be outlined and examined for the major Euro area countries, Austria, Belgium, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain; Sweden and the UK as EU countries outside the Euro area; and the US, Japan and China. In examining the effects of financialization on distribution we focus on the determinants of functional income distribution, because we consider the development of functional income distribution as the key to changes in personal distribution and to the understanding of the macroeconomic effects of distributional changes. We will identify the potential channels through which financialization and neo-liberalism have affected the share of direct labour in national income in the negative. Three channels are of particular interest here: first, the change in the sectoral composition of the economy in favour of the high profit share financial corporations and at the expense of the non-financial corporate sector and the government sector; second, the rise in overhead costs, in particular top management salaries and interest payments, and the increase in profit claims imposed on the corporate sector by shareholders; third, the weakening of bargaining power of workers and trade unions triggered by shareholder value orientation and short-termism of management, increasing relevance of the financial sector with weak trade unions, the threat-effect of liberalization and globalization of finance and trade, deregulation of the labour market, and downsizing of the government sector and abandoning government demand management policies.

Chapter 3 will deal with the effects of financialization on investment in real capital stock. We will start with a detailed examination of the effects of financialization and increasing shareholder power on corporate investment in capital stock, supplying theoretical and empirical evidence for the 'preference' and 'internal means of finance' channels. In order to derive the macroeconomic results, we will integrate the effects of financialization on distribution discussed in Chapter 2 and also briefly consider some effects of financialization on consumption without, however, dealing explicitly with household debt, which is discussed in Chapter 5. We will summarise the macroeconomic results of increasing financialization and shareholder power as they have been derived in the previous literature, before integrating some main channels of influence of financialization into a simple analytical Kaleckian stock-flow consistent model. This will enable us to outline the short- and medium-run effects with respect to the rates of capacity utilization, profits and capital accumulation, as well as to stability of the financial structure of the corporate sector. We will show that, depending on the constellation of parameters, our model gives rise to three different macroeconomic regimes in the face of rising shareholder power: 'finance-led growth', 'profits without investment' and 'contractive' regimes may emerge. We will show that only the 'finance-led growth' regime yields a medium-run stable financial structure of the corporate sector, whereas the other two regimes are prone to financial instability.

In Chapter 4 we will focus on the long-run effects of financialization on capital accumulation and productivity growth – and hence on potential growth. On the one hand, the early orthodox proponents of shareholder value orientation have argued that increasing shareholder power would induce managers to make more efficient use of the funds at their disposal and thus reduce the inefficiencies inherent in the 'principal-agent' conflict of modern corporations (Jensen/Meckling 1976). This should have a positive effect on productivity growth and the growth potential of the economy. On the other hand, to the extent that financialization, increasing shareholder power and rising shareholder value orientation of management causes a policy of 'downsize and distribute' (Lazonick/O'Sullivan 2000), in order to satisfy shareholders' demand for distributed profits and high stock and share prices, low capital stock growth will have negative effects on productivity growth and thus on long-run potential growth of the economy. We will address these potentially contradicting effects of financialization on capital accumulation and productivity growth in a simple Kaleckian distribution and growth model for a closed private economy with endogenously determined productivity growth. We will show that depressed capital accumulation caused by financialization and increasing shareholder power is also very likely to feed back negatively on productivity growth and hence on long-run potential growth of the economy.

Chapter 5 will explicitly address the effects of finance-dominated capitalism on private household consumption and indebtedness. We will examine in this chapter whether an economic boom based on debt-financed consumption and thus increasing household debt is necessarily bound to collapse for systemic reasons related to stock-flow or stock-stock dynamics. We will specify the conditions under which household debt–income or debt–capital ratios become unstable, triggering increasing financial fragility and finally financial crisis. These issues will be addressed in a simple Kaleckian distribution and growth model, in which we allow for debt-financed consumption of workers' households, along with redistribution at the expense of labour income and weakened animal spirits of the firm sector with respect to real investment, each caused by finance-dominated capitalism and neo-liberalism. We will show that increasing lending to private households will not necessarily trigger an unstable process of increasing debt–income or debt–capital ratios. However, such a process may arise, if lending to workers exceeds some threshold, and/or animal spirits of the firm with respect to investment in capital stock decline, and/or the rate of interest rises by too much such that it exceeds the endogenously determined rate of profit.

In Chapter 6 we will focus on the global imbalances which have arisen, in particular in the latter period of finance-dominated capitalism, and which have contributed to the severity of the recent crises. It will be argued that, against the background of partially depressing effects of finance-dominated capitalism via redistribution of income and via investment in capital stock, some countries have relied on debt-led soaring consumption demand as the main driver of aggregate demand and gross domestic product (GDP) growth, whereas others have focussed on mercantilist export-led strategies as an alternative to generating demand. We will examine the set of countries introduced in Chapter 2, derive an *ex post* typology along the lines mentioned above, and discuss the related global current imbalances.

The economic policy conclusions from our analysis of the macroeconomic channels of transmission of financialization and of the recent crisis can be found in Chapter 7. We will argue that a medium- to long-run sustainable recovery strategy for major parts of the world economy can neither follow the 'debt-led consumption boom' type nor the 'export-led mercantilist' type. We will rather make the case for an income- or wage-led recovery strategy embedded in a Global Keynesian New Deal, which tackles the main causes of the recent crisis, that is, inefficient regulation of financial markets, increasing inequality in the distribution of income and rising imbalances at the global (and at the Euro area) level. In particular, we will elaborate on the three main pillars of the policy package of a Global Keynesian New Deal: first, the re-regulation of the financial sector in order to prevent future financial excesses and financial crises; second, the re-orientation of macroeconomic policies, in particular in the current account surplus countries; and third, the re-construction of international macroeconomic policy co-ordination and a new world financial order.

In Chapter 8 we will turn to the euro crisis as the latest fallout of the crisis of finance-dominated capitalism. We will analyse the institutional and economic policy deficiencies of the Euro area and the European Union, which are at the roots of the euro crisis that started in 2010: the lack of an explicit guarantee of public debt of member countries by the European Central Bank, the exclusions of fiscal transfers among Euro area member countries, in principle, and the current account imbalances which have built up in the Euro area since 1999. Against the background of this analysis, we will describe some key ingredients of an alternative macroeconomic policy model for Europe based on Keynesian and Post-Keynesian principles. We will argue that stabilizing wage and expansive fiscal policies will have major roles to play in order to cope with the current account imbalances and to initiate recovery for the Euro area as a whole. We will derive a criterion for acceptable current account deficits for macroeconomic policy coordination within the Euro area. Finally, we will argue that the European Union and the Euro area will have to develop institutions and policies which, on the one hand, guarantee public debt of all the member countries, and which, on the other hand, provide the stable financing of acceptable current account deficits and thus a stable transfer of current account surpluses of the mature more slowly growing countries to the more rapidly growing and catching-up member countries. In Chapter 9 we will finally summarize our main findings and conclude.

NOTES

1. See, in particular, the overview in Akerlof/Shiller (2009, pp. 29–40, 149–56), but also Baker (2009).
2. On global imbalances and unequal distribution as causes for the present crisis, on top of the widely accepted inefficient regulation of the financial sector, see for example, with different emphasis, Bibow (2008), Horn et al. (2009), Fitoussi/Stiglitz (2009), Sapir (2009), Stockhammer (2010a, 2010b), UNCTAD (2009), and Wade (2009). In particular, see the early pre-crisis analysis by van Treeck et al. (2007) focussing on the effects of financialization on distribution, aggregate demand, global imbalances and the resulting potential for instability. For a review of the changes in world wide financial markets and related imbalances which fed the financial crisis see, for example, Guttmann (2009).
3. See Stockhammer (2010a, 2010b) for a similar distinction and Palma (2009) for a more extensive discussion of the relationship between neo-liberalism and the present crisis.
4. See, for example, Krippner (2005), Palley (2008), and the contributions in Epstein (2005) for a detailed treatment of the development of financialization in the US, van Treeck (2009b) and van Treeck et al. (2007) for a more detailed comparison of the macroeconomics of financialization in the US and Germany, and Stockhammer (2008) for the development in Europe.