Foreword

The financial collapse that began in the US in 1929 and the ensuing Great Depression to which it contributed, convinced the government, the public and much of the business class that a lightly regulated financial system free to pursue the parochial interests of its practitioners would inevitably lead to financial crises, some of which could create serious economic distress. In the case of the 1930s, the collapse threatened the economic and political viability of the country. The public blamed the Depression on greedy and powerful financial forces, perhaps to an unwarranted degree. Fear of the dangers of an unleashed financial system led to the adoption in the 1930s and 1940s of the strongest system of financial regulation the country ever experienced.

In the so-called ‘Golden Age of Modern Capitalism’ which lasted from about 1950 through the early 1970s, the appropriate role for the financial sector was thought to be as the ‘servant’ of the real sector rather than its pre-1930s role as its ‘master.’ This servant role was assured by strong financial regulation. Under government guidance, financial markets provided low-cost funds for business investment and for home building as well as a secure haven for household savings. And regulation minimized the likelihood of speculative financial booms and crises – while about 9000 banks failed in the 1930s, there were virtually no bank failures in these decades. The positive role played by the financial system was thought to have made a strong contribution to the best economic performance in US history in this era.

A series of events that took place after the late 1960s gravely weakened the Golden Age financial regime. These include the breakdown of the Bretton Woods fixed exchange rate system in the early 1970s, two bursts of inflation triggered by oil price shocks in the mid- and late-1970s that wreaked havoc on a regulatory system unprepared to deal with high inflation, and the Latin American debt crisis that threatened the solvency of large US money center banks in the 1980s. The stress these developments placed on the regulatory system, combined with an incessant demand for regulatory relief by increasingly politically influential financial interests, and an erosion of belief in the efficacy of regulation by those charged with enforcing the rules, eventually led to its dismantling. The new approach to regulation was based on the belief that free financial markets with only the
lightest touch of regulatory restraint will produce optimal outcomes. Alan Greenspan, considered the ‘wisest’ of financial market observers and, as Chairman of the Federal Reserve Board of Governors, the top regulator of US financial markets from 1987 through 2005, said recently that he ‘didn’t get involved in regulatory matters in part because his laissez-faire philosophy was often at odds with the goals of the laws Congress had tasked the Fed with enforcing’ (Wall Street Journal, ‘Did Greenspan add to subprime woes?’, 9 June 2007).

As the Golden Age financial regulation system was unraveling, financial markets grew at astonishing speed. The rapid increase in pension funds and institutional investors, coupled with recycled petro dollars and, after 1980, rising capital inflows to the US, provided vast supplies of funds to financial markets. Meanwhile, the demand for credit was fed by rising government budget deficits, an increased demand for home mortgages, the hostile takeover movement of the 1980s (followed after 2001 by the boom in private equity leveraged buyouts), and by the credit needs of financial institutions themselves in a process known as ‘financial deepening.’ Credit market debt grew from about 150 percent of GDP in the period from 1960 to 1980 to more than 300 percent by 2003. Total financial assets had been less than 500 percent of GDP from 1960 to 1980, but were over 900 percent by 2003. Released from their regulatory chains, financial markets did what they always seem to do when left to themselves: they exploded in size and became more volatile.

In the first decade or so after the demise of the Golden Age, US financial market growth took place in an environment in which the rules of the game set by regulators were changing dramatically and market conditions were volatile. It is thus not surprising that the overall profitability of the financial sector was itself volatile and disappointing in the 1980s. Financial sector profits cycled around 1.5 percent of GDP from 1960 to the late 1970s, but fell to below 1 percent in the mid-1980s. They began to rise rapidly in the early 1990s and by the early 2000s were over 3 percent of GDP. Thus, since the early 1990s the US has had a lightly regulated but very profitable financial system growing at rates far beyond those of the real sector. The gross value added of financial corporations rose from about 6 percent of nonfinancial corporate gross value added in the 1960s to 16 percent in the early 2000s. The current conventional wisdom is that financial markets should be the mechanism that decides how to allocate real resources to their most efficient uses – the brain of the system and once again the ‘master’ of the real sector.

Of course the US economy was not the only one to experience a ‘free market’ financial transformation; the US quickly began exporting the new model around the world. Indeed, the deregulation of domestic financial
systems and the deconstruction of barriers to the cross-border movement of money was a central mechanism in the process that spread neoliberalism around the world. It was the collapse of the US banking system in the early 1980s that led to the imposition of ‘Washington Consensus’ restructuring policies across much of Latin America. Many ‘developing’ countries, under pressure from Western governments, multinational banks and international financial institutions, loosened controls over inward capital flows. A rush of hot money often flowed into these countries, causing speculative bubbles. When these bubbles burst, money flowed out again, causing currency and financial crises. The G-8 countries, the IMF and the World Bank would then offer foreign currency loans needed to overcome the crisis, but only if affected governments agreed to more fully open their economies to foreign capital, impose restrictive macro policy and adopt ‘structural adjustment’ to convert the economy to a neoliberal model. Demands to allow foreign financial institutions untrammeled access to the domestic economy were usually the most vigorously pursued. Thus, the dramatic increase in the size and influence of global financial markets has been coterminous with and constitutive of the spread of neoliberalism across the globe. It is hard to analyse one in isolation from the other.

Eventually, most countries adopted lightly regulated, globally integrated financial markets. These markets eventually became more powerful in their effects on economic activity than at any time since J.P. Morgan’s ‘Money Trust’ dominated the US economy in the decades before the Great Depression. Since the distribution of ownership of financial wealth among households is now so concentrated, the average returns to financial wealth have been so high, and compensation for top executives has reached gargantuan levels, income and wealth inequality has skyrocketed everywhere. Financial asset price volatility has increased, making financial investment by ordinary families riskier just when the decline of traditional pension plans makes them more dependent on financial assets to fund their retirements. Financial innovations such as derivatives have raised qualitatively the complexity and non-transparency of financial markets even as they have become more powerful and moved beyond effective government control.

With this brief description of the evolution of financial markets, we can assess the contributions to our understanding of the complex effects of finance on economic activity contained in Özgür Orhangazi’s book *Financialization and the US Economy*. This book should be of interest to the general reader, who simply wants to learn more about the causes and effects of the transformation of financial markets, and it contains important new empirical evidence about the effects of financial change on nonfinancial corporate behavior that should be of interest to academic scholars working in this area as well as government and business leaders
concerned about the future of the US economy and the well-being of the majority of Americans.

The general reader will find the first five chapters quite informative. In the opening chapter, Orhangazi discusses ‘financialization,’ a term meant to capture the complex set of relations between financial markets and other aspects of the economy. There are many definitions of this elastic term in the literature. Consider one: ‘the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economy’ – a complex concept indeed. He accepts a broad definition of financialization at ‘the general level’ to guide his review of the literature, but when he moves to statistical hypothesis testing in the latter part of the book, he defines financialization more narrowly as ‘changes in the relationship between the nonfinancial corporate sector and financial markets.’ The second chapter documents empirically the rapid growth of financial markets, financial firms and financial assets relative to the rest of the economy. The third chapter presents an overview of the evolution of the US financial system from the rise of what is often called ‘Finance Capital’ around the turn of the last century to the current period. In the section on Morgan’s ‘Money Trust,’ Orhangazi astutely notes one important difference between the relation of financial to nonfinancial sectors of the economy then and now. Then, the most powerful bankers held direct control over many of the most important firms and industries in the country and cooperated to bring order and rationality to industries previously wracked by destructive competition, cutthroat pricing and chronic excess capacity. Today, powerful financial institutions have neither the means nor the desire to impose rationality on the economic system as a whole. Rather, they pursue their individual interests via speculation and risk-taking, capitalizing on information asymmetries (sellers of complex financial products always know more than buyers about these products), and through constant innovation that creates niche markets with high but temporary profit margins as it feeds market volatility.

Chapter 4 contains an insightful review of the literature on financialization. Orhangazi organizes the abundance of articles and books on this diverse subject into three categories: first, literature that sees the current dominance of finance as one phase of a repeating long wave in the history of capitalism; second, works that understand the rise of finance in the past 30 years as tightly connected to, and an integral part of, the rise of the global neoliberal order; third, writings which focus on the effects of financial markets on the governance and performance of nonfinancial firms in the current era – his own area of specialization. This review is especially useful because it critically evaluates as well as summarizes arguments put forth by various authors.
The last section of Chapter 4 provides a point of entry into the last three substantive chapters of the book, which will be of special interest to those already familiar with these issues. The focus of these chapters is the impact of today’s financial markets on the capital investment decisions of non-financial corporations in the US. In the Golden Age, it is argued, the US relied on the dominant real-sector ‘managerial firm’ to guide the economy over time. These firms made strategic decisions, including those affecting capital investment, based on their projected impact on the long-term growth and prosperity of the enterprise, and funded most investment projects with ‘patient’ sources of finance – mostly internal funds. Firms could also sell long-term bonds at modest real rates of interest. Equity holders typically held their shares for long periods, leaving management free of short-term stock market pressure. Real sector firms guided the economy; financial markets assisted in their efforts. Capital investment grew rapidly, helping sustain equally rapid productivity growth.

Everything in this picture changed dramatically in the past three decades. Average real interest rates have been much higher than before. Both the planning horizon and the objectives of managers of large nonfinancial firms have changed. The hostile takeover movement of the 1980s punished managers whose companies had low stock prices; they thus either had to raise their stock price in the short run by actions detrimental to the firm’s long-term health (such as borrowing to pay dividends or finance stock buybacks) or lose control of their companies to outsiders. In the 1990s, these firms began to compensate their most important executives with lavish stock options to harmonize their personal incentives with the objective of their institutional investors – to maximize stock price gains in the short run. In the present decade, both of these forces are at work: private equity funds threaten to take over firms with low stock prices while corporate executives’ compensation is based largely on stock options. Moreover, as Orhangazi demonstrates, companies now disgorge a much higher percent of their cash flow back to financial markets in the form of stock buybacks and interest and dividend payments than they did in the Golden Age. While they can always go back to the market to try and re-borrow these funds, this process of ‘impatient finance’ creates uncertainty about the cost and availability of investment funding and, again, induces a shorter planning horizon. Finally, through much of the new era, the rate of return that could be earned by nonfinancial corporations through investment in financial assets and/or in financial subsidiaries exceeded the rate of return on capital investment. This induced firms to substitute financial for real investment. All these factors – short planning horizons, expensive and uncertain access to external funds, pursuit of short-term stock price gains rather than long-term growth, and attractive alternatives to capital investment offered in
financial markets – are believed to have exerted downward pressure on capital spending.

All these assertions receive empirical support in the financialization literature through the use of institutional analysis, case studies and the examination of the movement of relevant variables over time. The conclusion that the rate of growth of investment in the neoliberal era is slower than it was in the Golden Age is also evident in the data. Unfortunately, very few scholars have attempted to formally test the effects of these changes on investment spending using up-to-date statistical techniques. However, in Chapter 6, Orhangazi uses time series regression methods to test two key ‘financialization’ hypotheses using aggregate data for US nonfinancial corporations: that payments to financial markets restrict capital investment because external funds are either more expensive than internal funds or have quantity constraints; and that profits from financial investments lower capital investment even though they expand internal funds because they signal the superiority of financial investment opportunities. He finds that, ceteris paribus, capital investment spending is reduced as payments to financial markets increase and as profits from financial investment rise. In mainstream economic theory, an increase in either these variables should not restrict investment. However, while both variables have the posited sign, the coefficient on the financial payments variable is statistically significant only at the 10 percent level, while the coefficient on the financial profits variable is not statistically significant.

Orhangazi is aware that econometric tests on aggregations of disparate firms can lead to both misleading results as well as low coefficient estimation precision. An aggregate regression might conclude, for example, that financial payments have no effect on investment only because half the firms in the sample react positively and significantly to an increase in this variable while the other half responds negatively. Each effect cancels the other, leading the researcher unaware of the importance of financialization on key economic sectors and thus unable to investigate why some firms are adversely affected by financial markets while others are not. To overcome this problem, in Chapter 7 he analyses the effects of his two ‘financialization’ variables on capital investment spending from 1973–2003 using panel data taken from Standard and Poor’s Compustat firm data set. With this micro data, he tests his hypotheses using all the nonfinancial firms in the set, but he also runs separate regressions on firms of different size and firms in different industries. The use of micro data allows Orhangazi to test a much richer set of hypotheses than is possible under the restrictions of macro data sets. To take two important examples, he finds that the financial payments variable has negative and statistically significant coefficients in almost all regressions, and that the financial profits variable has negative
and significant coefficients for larger firms – which are precisely the firms for which we would expect impediments to investment spending from the ‘financialization’ pressures described above to be most severe.

As far as I know, this is the first study to subject important hypotheses about the effects of financialization on corporate investment to econometric testing using a micro data set. It thus provides the most convincing statistical evidence yet that modern financial markets constrain rather than facilitate robust capital investment. The combination of this empirical contribution and the insightful review of and commentary on the financialization literature in the early chapters makes this book well worth reading.

15 June 2007

James Crotty
Sheridan Scholar and Professor of Economics
University of Massachusetts Amherst