1. Introduction

WHAT IS FINANCIALIZATION?

Profound transformations have taken place both in the US and in the global economy in the last decades. One salient feature of this era has been the dramatic changes that have taken place in the realm of finance. Both the size and importance of financial transactions have been growing continuously. Financial markets and agents have acquired an increasingly prominent position in the economy. The size and profitability of the financial sector have increased. Incomes derived from financial sources as opposed to nonfinancial sources have grown, while total debt in the economy has skyrocketed. The engagement of nonfinancial corporations (NFCs) in financial businesses has increased, as have their investments in financial assets and financial subsidiaries. At the same time, the involvement of financial markets and institutions in the decision-making processes of the NFCs has also increased, leading them to allocate a larger share of their funds to financial markets. In short, ‘[i]t is difficult to escape the impression that we live in a world of finance’ (Krippner 2005: 173).

Various aspects of these transformations, in relation both to domestic economies and to the international financial system, have attracted the attention of economists as well as scholars from other disciplines. Some have labeled all or parts of these transformations as ‘financialization.’ The concept has been used to designate diverse phenomena, including the globalization of financial markets, the rise of financial investments and incomes derived from these investments, the rise of the ‘shareholder value’ movement and related changes in corporate governance theories and practices.

Financialization has evolved into a concept similar to ‘globalization:’ a widely used term without a clear, agreed-upon definition. The precise form and usage of the term have been ambiguous. As a result, there now exist various definitions and uses of the term, as reflected in a recent volume on financialization (Epstein 2005), which brings together a diverse set of articles on various dimensions of financialization. In the introduction, Epstein (2005) acknowledges this situation and chooses to define financialization very broadly as ‘the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’ (p. 3). Given the vagueness and ambiguity of
the term, I need to define what I mean by financialization for the purposes of this book. However, before attempting to provide a definition of my own, there is merit in briefly looking at different definitions used in the literature in order to show the broad and diverse ways in which the concept of financialization has been used.

For example, Dore (2002), whose focus has been institutional changes in the last decades, provides a broad definition of the concept, a definition at least as broad as Epstein’s 2005 one:

> the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketed securities, and particularly of equities, among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles. (pp. 116–17)

The definitions of financialization used in newspaper columns, where the term has also become fashionable in the last few years, generally display a similar broadness and elusiveness. For example, Kevin Philips – whose use of the term in various places popularized it – defines financialization in the *New York Times* as follows: ‘The process of money movement, securities management, corporate reorganization, securitization of assets, derivatives trading and other forms of financial packaging are steadily replacing the act of making, growing, and transporting things’ (‘The cycles of financial scandal,’ 17 July 2002).

He adds, in *The Nation*:

> the financialization of America since the 1980s – by which I mean the shift of onetime savings deposits into mutual funds, the focus on financial instruments, the gianitization of the financial industry and the galloping preoccupation of corporate CEOs with stock options instead of production lines – has been a major force of economic polarization. (‘Dynasties!’, 8 July 2002)

To cite another example from the popular uses of the concept, British journalist Eamonn Fingleton labels the same process ‘financialism’ and defines it as ‘the increasing tendency by the financial sector to invent gratuitous work for itself that does nothing to address society’s real needs but simply creates jobs for financial professionals’ (Fingleton 1999, quoted in Phillips 2006).

Wade (2005) provides a more elaborated definition of financialization based on three developments:

> Financialization refers to the growing dominance of the financial economy over the real economy, as seen in (a) the tightening institutional interlock and
normative congruence around the interests of wealth holders, (b) the rapid redistribution of national income towards capital-owners and away from labor (dependent on wages and salaries), and (c) the rapid redistribution of national income towards the richest 10%, and 1% of households. (Wade 2005: 4)

In Wade’s definition, ‘institutional interlock’ can be seen as the key feature of financialization, as

other economic institutions – such as corporations, households, and the pension industry – come to organize themselves around financial markets. It has occurred by the stock market becoming the economy’s pivotal institution. In the corporate sector institutional interlock with finance comes through the transformation of managers’ financial incentives and their perceptions of their responsibilities. Their remuneration increasingly takes the form of stock options rather than salaries; and at senior levels they are recruited from the external labor market rather than promoted from within. Both things together promote the notion that maximization of shareholder value is their sole legitimate objective. They raise or lower budgets, buy or sell bits of companies, with the objective of raising the share prices, not only because they gain directly from stock options but also because the higher share price reduces the chances of hostile take-over – and their ouster. (Wade 2005: 9)

For Duménil and Lévy (2004b), financialization designates the structural change in the post-1980 era characterized by ‘the growth of financial enterprises, the rising involvement of nonfinancial enterprises in financial operations, the holding of large portfolios of shares and other securities by households, and so on’ (p. 82). Stockhammer (2004), who acknowledges the vagueness of the concept, narrows the definition and uses the concept particularly in relation to the NFCs: ‘financialization will be defined as the engagement of nonfinancial businesses in financial markets’ (p. 721). Following Arrighi (1994), who is one of the first authors to use the term though without a clear definition, Krippner (2005) employs a relatively narrow definition, too: ‘I define financialization as a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production’ (p. 174).

Not only have the definitions of financialization been numerous and/or unclear, but the composition of the set of works that employ the concept of financialization has also been quite diverse. For example, Randy Martin, a professor of art and public policy, uses the concept in analysing the effects of the increase in the influence of financial calculations and judgments on everyday life in his book Financialization of Daily Life (2002).¹

For the purposes of this study, I use the term at two levels: one broad and another more specific that is better suited for analytical use. At the general level, financialization refers to an increase in the size and significance of financial markets, transactions, and institutions. At a narrower level, I use
financialization to designate changes in the relationship between the non-financial corporate sector and financial markets. These latter changes include, first, an increase in financial investments and hence financial incomes of the NFCs; and second, an increase in financial market pressure on the management of NFCs. This increase in pressure, which is revealed through governance debates revolving around ‘shareholder value,’ results in an increasing transfer of resources from NFCs to financial markets in the forms of interest payments, dividend payments and stock buybacks. While I discuss how to develop an understanding of the financialization process in the first part of this book, I will be using the more general definition; and in the second part, when I analyse the impact of financialization on the nonfinancial corporate sectors’ rate of capital accumulation I will be referring to the second and narrower level of this definition. But before then, let me briefly discuss the major questions raised about financialization.

ISSUES AROUND FINANCIALIZATION

In general, financialization is associated with a rise in the share of national income accruing to the holders of financial assets and a concomitant decline in the share of labor, an increase in financial instability, slower growth and dimmer prospects for economic prosperity. Some of the effects of financialization – along with the trends toward globalization and neoliberalism that accompanied it – have been highly detrimental to a significant percentage of people around the globe. Accordingly, finding ways to mitigate the deleterious effects of financialization has been a central concern. Most of the literature, hence, has been concerned with negative effects of financialization, as we will see in the following chapters. However, before moving onto that, outlining the main issues around financialization would be useful to contextualize this book.

As revealed by the discussion of the various definitions of the term financialization, there is indeed quite a wide range of issues addressed in relation to this concept. No matter how the term is defined, however, the first step is to determine a measure of financialization (Krippner 2005; Crotty 2005). As Krippner (2005) notes, before any discussion of financialization and its impacts on the rest of the economy, ‘we ought to first determine whether it is in fact accurate to characterize the US economy as having been “financialized”’ (p. 174). She then provides a detailed presentation of the financialization of the American economy through a careful study of various macro data sources. Crotty (2005), in a broad discussion of financialization as one of the important components of the global neoliberal regime, documents various aspects of financialization for the US...
nonfinancial corporate sector, while Duménil and Lévy (2005) undertake a similar endeavor for both the US and France. These works unveil three important phenomena: NFCs have been increasing their financial investments relative to their real investments; they are earning a larger share of their profits from financial operations; and NFCs are discharging higher proportions of their earnings to the financial markets in the forms of interest payments, dividends and stock buybacks.

While documenting financialization has been an important research area, others, at least as important, are the analyses of the origins and underlying dynamics of it. The central question posed in these studies can be stated thus: why did financialization begin around the early 1980s? While mainstream economic theory has been mostly silent as to the origins of financialization, several heterodox scholars, including Arrighi (1994, 2003 and 2005), Arrighi and Silver (1999), Harvey (2003), Sweezy (1997) and Amin (1996, 2003), provide answers to this fundamental question. Arrighi’s approach, in particular, has attracted much attention. While most of these analyses locate the origin of financialization in the accumulation crisis faced in the 1970s, there are other contributions arguing that the roots of financialization are to be found in changes in financial markets caused by deregulation and liberalization. Duménil and Lévy (2005) focus on a third set of explanations; they emphasize the role of politics and class dynamics in the financialization process.

The macroeconomic dynamics of financialization in the US economy is a third topic of discussion. In particular, Boyer (2000), Aglietta (2000) and Aglietta and Breton (2001) provide attempts to understand these dynamics. Stockhammer (2004), who confirms some trends associated with financialization, analyses their effects on the capital accumulation of NFCs in the US.

Fourth, the changes that have taken place in corporate governance and their implications for corporate performance constitute a lively terrain of debate. The rise of the ‘shareholder value’ movement, the alignment of managerial and shareholder interests and their consequences are discussed by many including Lazonick and O’Sullivan (2000), Froud et al. (2000), Feng et al. (2001), Bivens and Weller (2004), Henwood (1997 and 2003), Morin (2000) and Jürgens et al. (2000). Moreover, Soederberg (2003), Singh (2003) and Glen et al. (2000) discuss the implications of the promotion of US style corporate governance in ‘developing’ countries.

Fifth, the era of financialization has been characterized by rising income inequality and a decline in the conditions of labor. This has attracted interest in explorations of changes in income distribution. Epstein and Jayadev (2005) document the fact that in a large sample of Organisation for Economic Co-operation and Development (OECD) member countries, the
share of national income going to ‘rentiers’ (financial institutions and holders of financial assets) rose in the 1980s and 1990s. Duménil and Lévy (2004c) thoroughly examine the changes in income distribution due to financialization. Lazonick and O’Sullivan (2000) document the effects of financialization on labor through corporate downsizing and higher financial payments.

A distinct but related debate is that of comparing financial systems. The US system in which financial markets are central has been compared with the German-type systems in which banks occupy a central place. Although the term financialization is not used in this debate, comparison between bank-based and market-based financial systems is the focus (for overviews of this debate, see Mayer 1988; Schaberg 1999; Ndikumana 2005).

Last but not least, changes in international financial relations are another topic of discussion. The explosion of international financial transactions, changes in the international monetary system and the burgeoning of financial crises in ‘developing countries’ are widely discussed (see, for example, Babb 2005; Akyüz and Boratav 2005; O’Connell 2005; Crotty and Lee 2005). Blecker (2005) shows the implications of financialization for international trade and finance theories. Many call attention to the unsustainability of financialization at the international level, while various works discuss international financial crises (see, for example, D’Arista 2005; Grabel 2005; Felix 2005).

OUTLINE OF THE BOOK

I hope to contribute to the literature on financialization in three ways with this book. First, I outline a framework through which we can understand the factors that led to the financialization of the US economy by providing stylized facts on financialization within a historical context and critically reviewing different perspectives on financialization. Second, I analyse the macroeconomic impacts of financialization on the investment behavior of the nonfinancial corporate sector. After developing a theoretical framework that highlights potential negative impacts of financialization on the capital accumulation process, I analyse aggregate US data to test the theoretical hypotheses. Third, using a data set for large US nonfinancial corporations, I analyse the impacts of financialization on firm behavior. This firm level exercise not only helps to overcome the problems associated with aggregate time-series analysis but also allows me to analyse diverse effects of financialization on different types of firms.

The rest of the book is organized as follows. In the first part of the book, composed of Chapters 2, 3 and 4, I outline a framework for understanding
financialization. I begin in Chapter 2 with an empirical documentation of
the financialization trends of the post-1980 era in comparison with the
earlier ‘Golden Age’ period. Simple time-series descriptions are useful in
concretizing the phenomena at the center of the financialization literature.
The following chapter provides a historical context to interpret the
financial expansion of recent decades. Starting with the ‘finance capital’ era
of the late 19th and early 20th centuries, I discuss the changing role of
finance within the economy throughout the 20th century. Chapter 4 pro-
vides a critical overview of the financialization literature. While discussing
various strengths and weaknesses of the main works in this literature and
highlighting the contributions of different perspectives, this chapter aims
to improve our understanding of financialization by presenting it as part of
a historical and contradictory process and concludes with a general frame-
work to help that.

In the next part of the book, I explore further the relationship between
the financial and nonfinancial sectors of the economy. Here I focus on the
potential impacts of financialization on the investment behavior of NFCs.
Chapter 5 develops a theoretical framework that analyses effects of
financialization on capital accumulation. In this chapter, I first discuss the
changing flow of funds between financial markets and NFCs and then I
seek to explore the effects of increased financialization on the real invest-
ment decisions of NFCs. Specifically, I outline two channels that have
been developed in the theoretical literature. First, I ask whether increased
financial investment and increased financial profit opportunities crowd out
real investment by changing the incentives of the NFC managers and
directing funds away from real investment. Second, I examine whether
increased payments to financial markets impede real investment by decreas-
ing available internal funds, shortening the planning horizon of the NFC
management and increasing uncertainty.

Hence, this chapter and the following chapters, which provide empirical
support for the theoretical approach developed in this chapter, contribute
to the debates around the effects of financialization on the capital accumu-
lation process. There has been much discussion on the relation between
financialization and real capital accumulation. For example, Crotty (2005)
describes a form of financialization in which NFCs have started to increase
their investment in financial assets, bought or expanded financial subsi-
diaries and shortened their planning horizons. Duménil and Lévy (2004a)
draw attention to the fact that interest and dividend payments to financial
markets have been on the rise and they argue that NFCs are therefore left
with smaller amounts of funds for real investment. Aglietta and Breton
(2001) make the same point and argue that an active market for corporate
control pushes firms to boost their share prices through dividend payouts
or stock buybacks and, as a consequence, the share of earnings devoted to financing growth is reduced. Stockhammer (2004) attempts to empirically trace the link between financialization and capital accumulation at the macroeconomic level and argues that investment in financial assets by NFCs indicates a change in management objectives towards adopting ‘rentier preferences.’

Using aggregate data for the US, I provide an analysis of the effects of financialization on real investments of NFCs in Chapter 6. The data suggest that there has been a sharp increase in financial investments undertaken by the nonfinancial sector after 1980, as well as an unambiguous increase in the payments made to the financial sector. I then provide econometric evidence that the increase in financial investments and in financial payments made to financial markets has had negative effects on the aggregate capital accumulation behavior of the nonfinancial corporate sector. In Chapter 7, I seek to empirically explore the relationship between financialization in the US economy and real investment at the firm level. Using data from a sample of NFCs from 1973 to 2003, I find a negative relationship between investment and financialization at the firm level. While this result reinforces the results of the earlier analysis, it also provides insights into across-firm characteristics of financialization.

Finally, in the last chapter, I bring together conclusions of the analyses carried out in the previous chapters and outline further areas of research that would contribute to a complete understanding of financialization and its implications.

NOTE

1. There is even an ‘International Working Group on Financialization’ in formation which is ‘interested in financialization and all the issues around relations between the capital market, firms and households’ (see www.iwgf.org).