Introduction

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This book explores and reviews the literature on the long-run transition towards finance-dominated capitalism, and the implications for macro-economic and financial stability and, in particular, for the recent global financial and economic crises. In our view, the recent crises indicate the demise of finance-dominated capitalism. This does not mean that the dominance of finance will necessarily disappear – quite the opposite, in fact, as it seems presently. But, against the background of the analyses presented in this book, it is difficult to imagine that finance-dominated capitalism in the future will be able to generate sustainable high growth rates in the mature capitalist economies.

The advanced capitalist economies have gone through two distinct regimes or stages of development since the end of the Second World War. The ‘golden age’ period of the 1950s and 1960s was characterized by relatively high growth rates, low unemployment and low inflation. It was based on a ‘social bargain’ or ‘social compromise’ between capital and labour, increasingly involving government activities. (Nearly) full employment was attained by Keynesian macroeconomic policies and supported by a strong welfare state in most of the advanced economies. The erosion of the ‘golden age’ period culminated in the ‘stagflation’ of the 1970s, which triggered a neo-liberal economic reaction. Policy responses focused on the deregulation of markets, and of labour and financial markets particularly, on the one hand, and on achieving price stability instead of full employment, on the other hand. This neo-liberal ‘counter-revolution’ has provided the conditions for the emergence of ‘financialization’ or ‘finance-dominated capitalism’ since the early 1980s, starting in the USA and the UK and spreading over the developed and, subsequently, also the developing capitalist world. This stage of development has been characterized by the expansion of financial markets, the introduction of new financial instruments, and the increasing dominance of financial motives in economic activity. Over the last 30 or so years, finance has come to dominate industry, and non-financial corporations have been increasingly engaged in financial as opposed to productive activities. Alignment of manage-

ment with shareholder interests reflected the shifting focus towards pursuing short-term ‘shareholder value’ maximization instead of the long-run growth objectives of the firm. What followed was a period of distinctly lower rates of capital accumulation in advanced capitalist economies, accompanied by rising inequality of incomes and wealth, and redistribution in favour of capital and at the expense of labour. In order to sustain consumption or to follow rising consumption norms by higher income groups, in some countries households relied increasingly on credit to finance their consumption expenditures, creating the problems of private household over-indebtedness in these countries. In other countries, weak investment and weak income-financed consumption demand was (partly) compensated for by rising net exports and current account surpluses, contributing to regional and global imbalances and to the latent over-indebtedness of the counterpart current account deficit countries.

Against this background the subprime crisis that broke out in the United States in 2007 could subsequently turn into the global financial and economic crises, the most severe crisis of global capitalism since the Great Depression. Seven years later, the world economy is still suffering from the consequences. In our view the general causes of the global financial and economic crises can be found in the problems, inconsistencies and contradictions of finance-dominated capitalism.

Our book will therefore firstly provide an overview of the transition towards finance-dominated capitalism as described in different strands of the literature. The long-run tendencies of financialization and its consequences are then analysed from a macroeconomic perspective. Subsequently, theories of financial crisis as well as important past crises are reviewed. From Chapter 5 onwards, the book deals explicitly with the recent global financial and economic crises. There has been a wide range of specific causes advanced in the literature for the generation and transmission of the 2007–09 crisis. Chapter 5 gives an overview of five important factors, and Chapters 6–10 explore some of the key factors that are said to have contributed to the crisis in more detail. These are, respectively, redistribution of income, international imbalances, deregulation, securitization and contagion, and the failures in risk management. A sixth factor, overly lax monetary policies of the US Federal Reserve since the early 2000s, is already addressed more extensively in Chapter 5.

The book begins in Chapter 1 with a survey of some of the important literature on financial, economic and social systems, with an eye towards explaining the tendencies towards financialization. This introductory chapter by Eckhard Hein, Nina Dodig and Natalia Budyldina serves as a background for understanding the rise of finance-dominated capitalism following the end of the ‘golden age’ of capitalism. The authors focus on

three important strands of the literature: the French Regulation School, the US-based Social Structures of Accumulation approach, and the contributions by several post-Keynesian authors, with a focus on the long-run views contained in Hyman Minsky's work, in particular. In their comparative assessment of these approaches, Hein, Dodig and Budyldina adopt the following four steps procedure. First, they sketch the basic structure of the approaches in order to single out how each of them views the interaction between social institutions and the economy, as well as the related dynamics regarding the development of the institutional structure and the associated stages or regimes of economic development. Second, they describe how these approaches view the structural breaks or the regime shifts in the long-run development of modern capitalism, which has triggered or at least has contributed to the emergence of a type of capitalism dominated by finance (financialization). Third, they outline how these different approaches view the main characteristics and features of financialization. Finally, they deal with the respective views on the consequences of financialization for long-run economic and social development, including the crisis of this stage of development.

In Chapter 2, Eckhard Hein and Nina Dodig review the empirical and theoretical literature on the effects of changes in the relationship between the financial sector and the non-financial sector of the economy associated with financialization on distribution, growth, instability and crises. The authors take a macroeconomic perspective and examine four channels of transmission of financialization to the macroeconomy: first, the effect on income distribution; second, the effects on investment in the capital stock; third, the effects on household debt and consumption; and, fourth, the effects on net exports and current account balances. For each of these channels Hein and Dodig briefly review some empirical and econometric literature supporting the presumed channels, and some theoretical and modelling literature examining the macroeconomic effects via these channels, and finally they present small Kaleckian models demonstrating the most important macroeconomic effects. The authors show that, against the background of redistribution of income at the expense of the labour income share and depressed investment in the capital stock, each a major feature of financialization, short- to medium-run dynamic 'profits without investment' regimes may emerge. These can be driven by flourishing debt-financed consumption demand or by rising export surpluses, compensating for low or falling investment in the capital stock. However, each type of these regimes, the 'debt-led consumption boom' type and the 'export-led mercantilist' type, contains internal contradictions: Rising household debt in the first regime and rising foreign debt of the counterpart current account deficit countries in the second regime may ultimately undermine

the sustainability of these regimes and lead to financial and economic crises.

Chapter 3 by Daniel Detzer and Hansjörg Herr provides a review of the relevant contributions of different schools of economic thought to the theories of crises as cumulative processes. Detzer and Herr first examine the approaches that regard financial crises as a disturbing factor of a generally stable real economy. Contributions by Wicksell, Hayek, Schumpeter and Fisher, and the early writings by Keynes belong to this group. Thereafter, Detzer and Herr review those approaches in which the dichotomy between the monetary and the real sphere is lifted. Here, the later works by Keynes and the contributions by Minsky are particularly important. Finally, the authors take a closer look at behavioural finance approaches. Having reviewed the different approaches, Detzer and Herr assess the similarities amongst them and examine whether those approaches could be fruitfully combined. Based on this, they develop their own theoretical framework, methodologically based on a Wicksellian cumulative process, however, overcoming the neoclassical dichotomy. The chapter ends with some policy recommendations based on this theoretical framework.

In Chapter 4, Nina Dodig and Hansjörg Herr analyse several severe financial crises observed in the history of capitalism which led to a longer period of stagnation or low growth. Comparative case studies of the Great Depression, the Latin American debt crisis of the 1980s and the Japanese crisis of the 1990s and 2000s are presented. The following questions are asked: What triggered major financial crises? Which factors intensified financial crises? And, most importantly, which factors contributed most to preventing a rapid return to prosperity? The aim of the authors is thus to identify the stylized facts of previous crises, in terms both of the causes of the crises and of the difficulties in recovering from such crises. Their main conclusions are that stagnation after major financial crises becomes likely when the balance sheets of economic units are not quickly cleaned, when the nominal wage anchor breaks, and when there is no sizable and long-lasting stimulus by the state. Finally, Dodig and Herr draw tentative conclusions for the recent financial crisis and the Great Recession.

The remaining chapters of the book deal with the 2007–09 financial and economic crises by addressing the specific factors which have contributed to originating or transmitting the crises. In Chapter 5, Trevor Evans provides an overview of these factors. After briefly outlining the background to the 2007–08 international financial crisis, Evans then goes on to examine five of the main approaches that have been put forward to explain the crisis: the widespread presence of perverse incentives, the over-expansionary monetary policy of the US Federal Reserve, the impact of global imbalances and a so-called ‘savings glut’ in developing countries,

the extensive deregulation of the financial system since the 1970s, and the attempt to generate an increasing return on the, in the recent decades vastly expanded, amount of financial capital and the associated pressure on wages. The chapter concludes with a brief note on the policy implications which follow from each of these explanations.

In Chapter 6, Jo Michell focuses on the relationship between changes in the distribution of income and the financial and economic crisis. According to Michell, the most widespread explanation for worsening inequality – technological change – is not convincing. He argues instead that the trends are better explained by the weakening of organized labour and the reduction of social protection that have taken place at the same time as the deregulation of trade and financial markets. The economic links between increasing inequality and rising household debt levels involve both household-level consumption behaviour and the macroeconomic effects of rising inequality. At the household level, Michell argues that rising debt levels were not the outcome of insurance against income volatility but were instead the result both of poor households being driven into debt by falling incomes and of imitative behaviour in which households attempted to emulate the ‘conspicuous consumption’ of households at the top of the distribution. At the macroeconomic level, inequality led to stagnationary tendencies, which were overcome by rising indebtedness and international imbalances.

Chapter 7 by Carlos A. Carrasco and Felipe Serrano surveys and analyses the economic literature on global and European imbalances and their connection with the global financial crisis. In the years preceding the crisis, there was increased attention paid to the existence of enormous current account imbalances among large economies worldwide. Research and policy papers can be divided into two positions regarding these imbalances. Some authors viewed global imbalances as part of a new equilibrium in the international financial system, while others urged policy intervention to reduce these imbalances. The Great Recession revived the debate over global imbalances and their influence on the gestation of the crisis. However, more recent work has clarified the relationship between the crisis and global imbalances, emphasizing the roots of the crisis in financial liberalization and the fragility of the international financial system. From this perspective, the authors highlight the need for deeper analysis of gross capital flows and the need to monitor credit levels as measures to prevent future financial crises.

Chapter 8 by Özgür Orhangazi deals with financial deregulation and its role in setting the conditions for the 2007–08 financial crisis. In the run-up to the crisis, deregulation created an environment in which mortgage lending expanded and speculation in other financial markets was

heightened, even though riskiness was steadily increasing. Orhangazi first briefly reviews the history of regulation and deregulation in the USA and then discusses the channels through which financial deregulation contributed to the 2007–08 financial crisis. The author also reviews policy suggestions of those who see financial deregulation as the main contributor to the financial crisis and provides a critical assessment of these, while broadly situating financial deregulation within the context of the broader changes in capitalism since the early 1980s.

In Chapter 9, Giampaolo Gabbi, Alesia Kalbaska and Alessandro Vercelli explain the recent financial crisis and the subsequent Great Recession from the point of view of incentives that have changed as a consequence of securitization and contagion processes. The authors provide a critical analysis of the basic principles of the asymmetric information approach and its two branches that take different views on the evolution of banking and the role of securitization in it. The first focuses on the impact of securitization on the traditional model of commercial banking, whereas the latter sees the role of securitization in the emergence of a parallel banking system (shadow banking). This divergence between the two approaches leads to different policy implications that can be drawn from the analysis of the crisis, advocating, respectively, the elimination (or heavy mitigation) of securitization and shadow banking, or the strict regulation of shadow banking and all the credit transfer processes.

In Chapter 10, the final chapter, Sérgio Lagoa, Emanuel Leão and Ricardo Barradas discuss the role of risk management in the context of the subprime financial crisis. The reasons for the failure of financial institutions to manage risk appropriately are striking, since this is supposedly one of their main roles in the economy. The authors contrast the mainstream view, which argues that risk management will become more efficient with the expansion of finance and will ensure diversification and control of risk, with the financialization literature, which emphasizes that risk management by financial corporations will not be socially efficient in a context of deregulated markets and will ultimately lead to an increase of aggregate risk and crises. To assess the validity of such a claim, the authors review the literature on risk management during the subprime crisis, and identify failures that fall into three categories: technique and methodology, corporate governance and strategy, and regulation and external factors. Following the same categories they review potential remedies presented in the literature to the identified problems. The authors' conclusion is that the failures in risk management should be interpreted in light of the financialization perspective, which is therefore a valuable approach when addressing regulatory changes in the financial system.