Financial Globalization Can Wreck Societies And The World Economy: An Interview With Political Economist Gerald Epstein

Prof.dr. Gerald Epstein

Since the outbreak of the 'global financial crisis' of 2008, there has been an explosion of interest in finance capital and on the so-called 'financialization' of the economy. Yet, there is no general consensus among scholars either on the causes behind the rise of finance capital or on the actual impact of 'financialization' on the economy and society. One of the leading scholars in the field of political economy interested in the 'financialization' of the economy and on the links between neoliberalism, globalization and 'financialization' is Gerald Epstein, Professor of Economics and Co-Director of the Political Economy Research Institute (PERI) at the University of Massachusetts at Amherst. In the interview below, Professor Epstein addresses several issues related to 'financialization', including it's macroeconomics and impact on the world economy, as well as it's links to instability and capitalist crises.

J. Polychroniou and Marcus Rolle: Professor Epstein, an increasing number of scholars have been turning their attention since the outbreak of the 'global financial crisis' of 2008 to the role of the finance sector in advanced capitalist economies. Can you give us a sense of how we should proceed to understand 'financialization', and address the question on whether it represents a distinct

'phase' in the evolution of capitalism?

Gerald Epstein: 'Financialization' is the latest, and probably most widely used term by analysts trying to 'name' and understand the contemporary rise of finance and its powerful role. The term had been developed long before the crisis of 2008 but, understandably, since the crisis hit, it has become even more popular. This vast and rapidly expanding literature on financialization has a number of important strands. Some of the literature focuses on clarifying the definition of financialization, and assessing whether it is a dominant cause of the ills confronting capitalism or is just a symptom of other, deeper causes; some asks whether financialization is a new 'phase: of capitalist development, perhaps a new 'mode of accumulation', or considers whether it is just one among a number of important developments along with 'neo-liberalism', 'digitization' and 'globalization' that are arising in the contemporary world; other literature is focused on less theoretical and more empirical matters, trying to measure the nature and extent of financialization, however defined, and to describe its institutional and economic dimensions; and still other work is focused on attempting to analyze theoretically and empirically the impact of financialization on important phenomena such as financial crises, productive investment, productivity growth, wages and income distribution; and finally, other parts of the literature are more policy-oriented, trying to grapple with policies and structural changes than can improve the role that finance plays in the economy. There are still many conundrums and open questions about 'financialization' which means it will remain a fruitful area for multi-disciplinary research and an important arena for political battles and structural reform for the foreseeable future.

As discussed by Malcolm Sawyer, the term financialization goes back at least to the 1990's and probably was originated by Republican political operative and iconoclastic writer Kevin Phillips, who first used the term in his book *Boiling Point* (New York: Random House, 1993) and, a year later, used the term extensively in his *Arrogant Capital* in a chapter entitled the "Financialization of America". Phillips defined *financialization as* "a prolonged split between the divergent real and financial economies (New York: Little, Brown and Co., 1994). (Sawyer, 2013, pp. 5-6).

Scholars have adopted the term, but have proposed numerous other definitions. Sociologist, Greta Krippner, for one, gives an excellent discussion of the history of the term and the pros and cons of various definitions. As she summarizes the

discussion, some writers use the term 'financialization' to mean the ascendancy of "shareholder value" as a mode of corporate governance; some use it to refer to the growing dominance of capital market financial systems over bank-based financial systems; some follow Hilferding's lead and use the term financialization to refer to the increasing political and economic power of a particular class segment, the rentier class; for some financialization represents the explosion of financial trading with myriad new financial instruments; finally, for Krippner herself, the term refers to a "pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production". (Greta Krippner, 'Thought Financialization of the American Economy,' Socio-Economic Review 3 (2), 2005, p. 174).

I have defined the term quite broadly and generally as: "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies." (Gerald Epstein, ed., Financialization and the World Economy. Northampton, MA: Edward Elgar Publishers, 2005). This definition focuses on financialization as a process, and is quite agnostic on the issue of whether it constitutes a new mode of accumulation or broadly characterizes an entire new phase of capitalism. Broad definitions like mine have the advantage of incorporating many features, but have the disadvantage, perhaps, of lacking specificity.

Other analysts have used variations on the term financialization to refer to more or less the same set of phenomena. Tom Palley has used the term 'neo-liberal financializaton' in his writings to emphasize the importance of neo-liberalism as part and parcel of the rise of financialization (Palley, 2013a, p. 8) Eckhard Hein and Tom Palley have not referred to financialization but to 'finance-dominated capitalism'.

Another important debate is on the periodization of 'financialization'. Is it only a recent phenomenon, say, important since the 1980's? Or does it go back at least 5000 years, as Malcolm Sawyer has suggested? If it goes back a long time, does it come in waves, perhaps linked with broader waves of production, commerce and technology or is it a relatively independent process driven by government policy such as the degree of financial regulation or liberalization? Giovanni Arrighi famously argued that over the course of capitalist history, financialization tends to become a dominant force when the productive economy is in decline, and when the dominant global power (or "hegemon") is in retreat. Think, for example the

early 20th century when Great Britain was losing power relative to Germany and the US, and the UK economy was stagnating. This was a period also of a great increase in financial speculation and instability.

In this way of thinking, financialization represents a new phase of capitalism, perhaps one that signals a decline in the power of the hegemonic country, in this case, the United States.

I hesitate to make such a sweeping claim. I think it is clear that financialization is a highly important phenomenon that is having big impacts on our economy. Does it define our epoch? This is a crowded stage. Financialization can cause massive problems but, unlike climate change, it is not likely to destroy the planet.

Polychroniou and Rolle: To what extent can we speak of the macroeconomics of financialization? In other words, how does financialization impact on investment, consumption, and distribution?

Gerald Epstein: There has been important research on the macroeconomics of financialization. Eckhard Hein and Til Van Treeck from Berlin, Tom Palley of the US and Englebert Stockhammer from the UK have been among the forerunners in this research area. These researchers identify three key channels through which financialization can affect macro variables and outcomes: 1) The objectives of firms and the restrictions that finance places on firm behavior; 2) New opportunities for households' wealth-based and debt-financed consumption; and 3) The distribution of income and wealth between capital and labour, on the one hand, and between management and workers on the other hand.

The net effect of these factors can mean that financialization can lead to economic expansion or stagnation dependeing on the relative size of these factors. But it almost always increases inequality. In addition, it almost always leads to financial instability and even crises.

Empricial work has looked at more specific impacts. Much of the macroeconomic literature on financialization concerns, of course, the impact of financialization on crucial macroeconomic outcomes such as economic growth, investment, productivity growth, employment, stability and income distribution. Stockhammer pioneered the theoretical analysis of the impact of financialized manager motives on investment. He showed that finance oriented management might choose to

undertake lower investment levels than managers with less financialized orientations. Ozghu Orhangazi used firm level data to study the impact of financialisation on real capital accumulation in the United States. He used data from a sample of non-financial corporations from 1973 to 2003, and finds a negative relationship between real investment and financialisation.

Leila Davis provided further evidence of negative impact of financialization on real investment. Her results are consistent with the concerns expressed by heterodox analysts and others that financialization will tend to reduce real investment.

An increasing chorus of analysts have expressed concerns that 'short-termism' associated with financialization may be coming at the expense of investments in human capital, research and development, employment and productivity growth. In a set of surveys of corporate managers, economists have shown that many chief financial officers are willing to sacrifice longer term investments in research and development and hold on to value employees in order to meet short-term earnings per share targets. Other empirical studies show that managers are willing to trade-off investments and employment for stock repurchases that allow them to meet earnings per share forecasts. Eileen Appelbaum and Rosemary Batt find in a survey of econometric studies of private equity firms find that especially large firms that use financial engineering to extract value from target companies, have a negative impact on investment, employment and research and development in these companies. In short, there is significant empirical evidence that 'short-termism' and other aspects of financial orientation have negative impacts on workers well-being, productivity and longer-term growth.

This raises the issue of the over-all impact of financialization on income distribution. There has been some empirical work to look at the impact of financialization on income and wealth distribution. Descriptive analysis in the U.S. indicates that the top earners, the 1% or even .01% of the income distribution get the bulk of their incomes from CEO pay or from finance.

There has also been interesting research on the relationship between financialization and economic growth. As the massive recession stemming from the great financial crisis makes clear, there is no linear relationship between the size and complexity of financial markets and economic growth. Several econometric studies have suggested an inverted U shaped relationship between

the size of the financial sector and economic growth. A larger financial sector raises the rate of economic growth up to a point, but when the financial sector gets too large relative to the size of the economy, economic growth begins to decline. To the extent that this relationship is true, economists are still searching for the explanation. One argument is that as the financial sector increases in size, because of its relatively high pay levels, it pulls talented and highly educated employees away from other sectors that might contribute more to economic growth and productivity. As a University Professor teaching economics since the 1980's, I can verify that many of my undergraduate students had the dream of going to work on Wall Street. Perhaps some of them could have contributed more elsewhere.

Adding up all these factors in the case of the United States, Juan Montecino and I estimated that, at the margin, the US financial sector in its current configuration has had a net *negative* on the US economy. We estimate that it has cost the US economy as much as $22 trillion over a thirty year period. (See, The Roosevelt Institute *Overcharged: The High Cost of High Finance* .

Polychroniou and Rolle: Neoliberalism, globalization and 'financialization' have shaped much of the world economy since the early 1980s. Is 'financialization' directly linked to globalization?

Gerald Epstein: Yes, definitely. In fact, modern globalization has, as one of its key components, a massive amount and increase in the level of financial transactions of all kinds. To take one stark measure, according to the Bank for International Settlements (BIS), there were $5.1 TRILLION in foreign exchange trades PER DAY in 2016, compared with only $80 BILLION of trades in goods and services per day. In short, there are more than $6 of foreign exchange trading for every $1 of foreign trade. What's being done with all this foreign exchange trading? Presumably the buying and selling for foreign financial assets and liabilities — much of this for speculation. The interconnection financialization and globalization in this sense is so intertwined that for years, mainstream economists and some policy makers have been referring to the current era in financial economic relations as one of "financial globalization" – even before the term 'financialization' became popular. Another clear sign of the global nature of 'financialization' comes from the international nature of financial crises in recent decades, the most recent one being the great financial crisis of 2008. In this case, European banks in particular were greatly implicated in the deals that led up to

the crisis, and a number of them are still paying the price.

However, it is not just the international banks that are involved in global aspects of financialization. Much of global investment by multinational corporations (MNC's) have highly financialized components to them. The New School's Will Milberg and his co-author, Debora Winkler, have written a terrific book called "Outsourcing Economics" that describes the financial activities of MNC's. They argue that these financial activities can sometimes support real investment that creates jobs and enhances productivity, but that much of it can also be engaged in other, less productive activities, such as tax evasion through the purchasing of financial assets or other financial dealings, and also various forms of financial speculation. *Citizens for Tax Justice* and authors like Nicholas Shaxson in *Treasure Islands; Uncovering the Damage of Offshore Banking and Tax Havens*, and James Henry who has written widely on global aspects of the financial underground.

Polychroniou and Rolle: According to the literature, there have been numerous financial crises from the late 1970s onwards, more than any other time in the history of capitalism, with the financial crisis of 2008 having by far the most destabilizing effects. In your view, what makes financialization such a destabilizing force?

Gerald Epstein: For centuries, finance and banking have been associated with financial crises, both domestic and international. The late, great economic historian Charles Kindleberger wrote in his famous book *Manias, Panics and Crashes*, that international financial crises are a "hardy perennial". Going back to the 16th century, Kindleberger estimated that a financial crisis happened someplace in the world once every 7 years on average.

Finance is inherently de-stabilizing because it is based on a promise about the future that can be reneged on, or just plain mis-calculated, since, as Keynes reminded us, the future is highly uncertain. And finance can easily lead to a whole chain of fragile interconnections through the economy which can come down like a house of cards. Now this would not matter much if finance wasn't important to the operations of modern economies, but it is. And this is especially true of "financialized economies"....in financialized economies, finance has become more and more central to the operations of the economy....finance has insinuated itself into almost every nook and cranny, and so, when something goes wrong, the

vulnerability can spread and wreck havoc. And I am not talking only about instability and crises, but also about destructive aspects of the everyday operations of the economy.

Interestingly, economists Carmen Reinhart and Kenneth Rogoff showed in their book *This Time is Different: Eight Centuries of Financial Folly,* this cycle was interrupted in the first 35 years or so after the Second World War, when there were virtually no financial crisis anywhere in the world. Why was this the case? The reason was that private finance, and especially global private finance, played a relatively small role in the period 1945-1980. This is because public finance was so important, because financial regulations were so stringent, and also because private finance had crashed so badly in the 1930's and it took decades for it to recover.

The financial de-regulation pushed by the bankers and their allies in the decades following the second world war eventually succeded and for the last several decades we have been back in the world of the "hardy perennial" financial crisis.

Polychroniou and Rolle: Is a return to the era of industrial capitalism as a means of countering the destructive effects of financialization a realistic policy that progressives should embrace?

Gerald Epstein: I think the impulse to bring finance under social control and reduce its role and destructive economic and political behaviors is absolutely correct and must be accomplished if we are going to make significant progress on reigning in financial instability and other destructive financial practices. To do this we need to not only re-regulate finance, but also need to develop and spread more public options in finance, what I have called 'finance without financiers' – more 'stakeholder financial institutions' — banks, savings institutions, insurance providers that are controlled by stakeholders and not shareholders.

Now that doesn't necessarily mean that these set of financial initiatives ought to be accompanied by more 'industrial' activities as our salvation. This is a very complex question that I cannot pretend to answer, especially in a short interview. But suffice it to point out the obvious problem that we are faced with an existential threat of climate change. This means that our economic alternatives must confront this problem. As my colleague Robert Pollin and his colleagues have shown, a significant push in the US and elsewhere toward the production of

renewable energy and energy conservation can have many collorary benefits, including job creation and reduction in income inequality. It is these initiatives that a reformed and revitalized finance can help to promote and that we should focus on, especially in the US and other rich countries.

Polychroniou and Rolle: Quite a few people argue that another financial crisis will surely erupt in the near future, especially with Donald Trump advocating deregulation. In this context, what signs in the economy should we be looking for in order to predict the next financial crisis?

Gerald Epstein: While it is true that no two financial crises are ever exactly the same, and that massive crises like the one we had in the 1930's and then again in 2007-2008 are infrequent, there are, nonetheless a few common signs to watch out for:

First, massive increases in private debt in relation to the size of the economy. High levels and large increases in 'leverage' as this debt ratio is called, has been shown to be one clear sign of financial vulnerability.

Second, big asset bubbles, such as we saw in the housing market in 2004-2007, or that we saw in the U.S. stock market in the 1920's, or in tulips in Amsterdam in the 17th century – these can be very dangerous because they are usually fed by massive increases in debt – the first point above – which leads to dangerous interconnections and the building of a financial house of cards.

Finally, complacency. The idea that 'this time is different' — the idea, that is, that we have reached a 'new age' such that bubbles and massive increases in private debt aren't dangerous this time because of some new invention or strategy….these self-delusional ideas are always present in the build up to crisis, and are always wrong.