RESEARCH HANDBOOK ON

Political Economy and Law

Edited by

Ugo Mattei • John D. Haskell

RESEARCH HANDBOOKS ON GLOBALISATION AND THE LAW

Research Handbook on Political Economy and Law

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RESEARCH HANDBOOKS ON GLOBALISATION AND THE LAW

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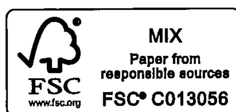

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9. Financialization and the nonfinancial corporate sector

Özgür Orhangazi

I. THE RISE OF FINANCIALIZATION

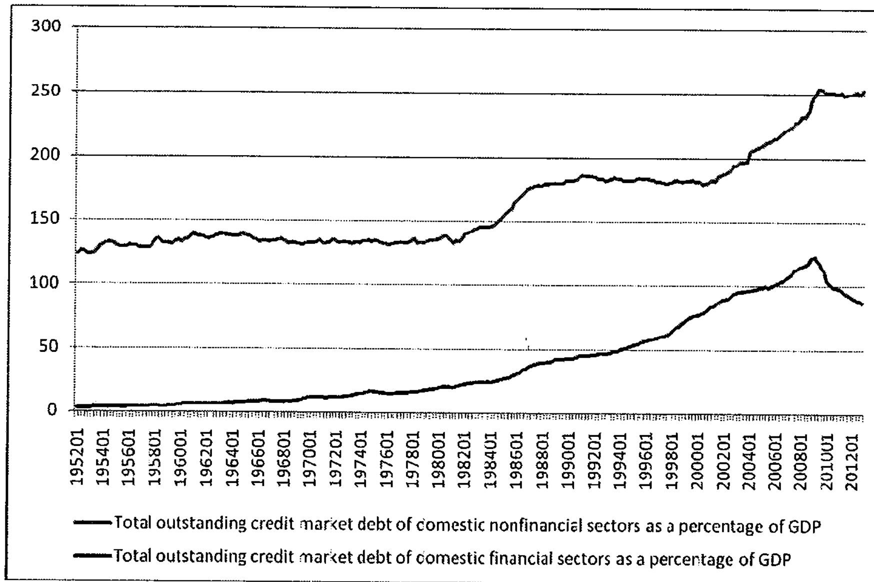
Financial activities include lending and borrowing activities and dealings in financial assets such as stocks, bonds, derivatives, foreign exchange and so on. Nonfinancial activities, on the other hand, consist of production and distribution of goods and services that are not directly related to financial activities. Finance moves purchasing power across different actors in the economy through credit or transfer of ownership rights to assets, which shifts wealth from one form to another and is expected to bring payments over time. In the post-1980s era, the size, importance and power of financial markets, transactions and institutions have greatly increased. Financial motives and financial elites have come to dominate the economy. These changes have been analyzed through the concept of financialization. Some have interpreted financialization as a shift from productive to financial activities, while others have stressed the dominance of finance in general over economic activities.[1] At the same time, scholars have pointed out that financialization involves changes in the relationship between the nonfinancial corporate sector and financial markets. On the one hand, nonfinancial corporations have begun acquiring more and more financial assets and deriving a larger share of their revenue from financial sources. On the other hand, the managers of nonfinancial corporations have come under increased pressure from financial markets to maximize short-run returns, which has led to increased payments to financial markets in the forms of interest payments, dividend payments and stock buybacks.[2]

The size of the financial sector with respect to GDP, financial incomes as a share of national incomes, financial corporations' profits with respect to nonfinancial corporations' profits, and total debt in the economy have all shown sharp increases in recent decades. For example, total global financial assets as a percentage of the world GDP have risen from 109 per cent in 1980 to 263 per cent in 1990, 310 per cent in 2000 and 355 per cent in 2007, just before the US financial crisis. Figures 9.1, 9.2 and 9.3 indicate this in terms of the increase in the size of finance in the US economy.

Figure 9.1 depicts total outstanding credit market debt as a percentage of GDP between 1952 and 2012. For both the nonfinancial and the financial sectors there was a significant increase after the 1980s. For the nonfinancial sector, the jump in credit market debt outstanding in the 2000s was due to an increase in mortgage debt. This is more clearly observed in Figure 9.2, which shows outstanding credit market debt of households and its two major components, mortgages and consumer credit. Figure 9.3

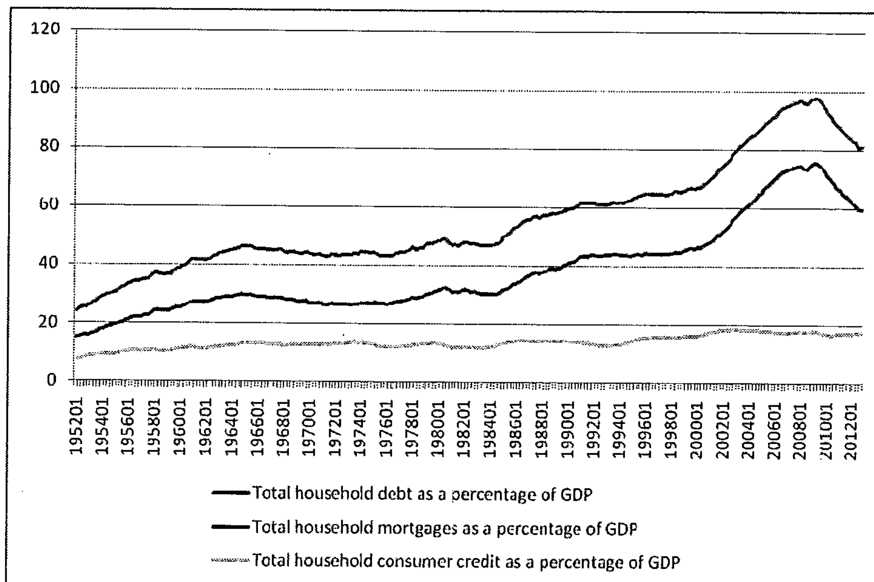
1 Gerald A. Epstein, *Financialization and the World Economy* (Edward Elgar 2005).
2 Özgür Orhangazi, *Financialization and the US Economy* (Edward Elgar 2008).

shows the income of finance, insurance and real estate (FIRE) as a percentage of national income between the years 1952 and 2011. This ratio too increased significantly in the post-1980s era.



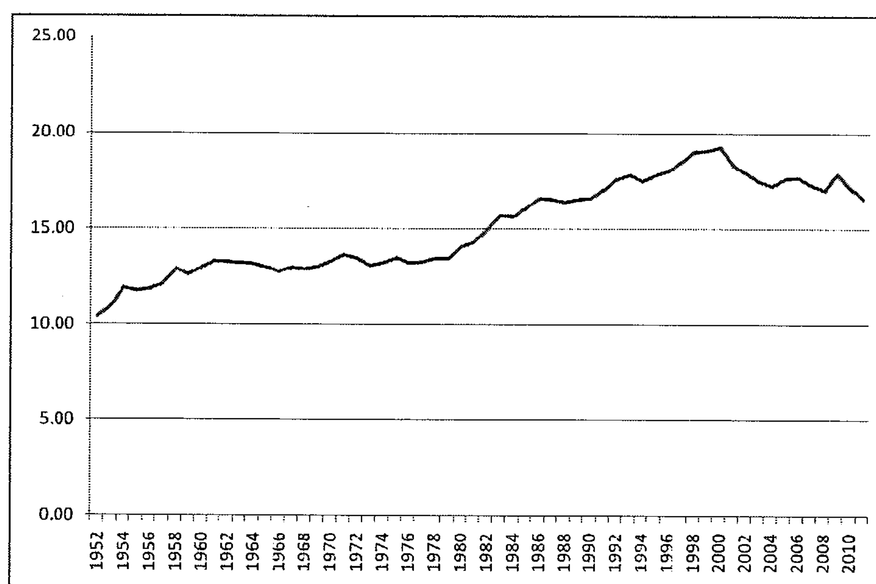
Source: Flow of Funds Accounts of the United States, Tables D.3 and F. 6.

Figure 9.1 Credit market debt outstanding by sector, 1952–2012



Source: Flow of Funds Accounts of the United States, Tables D.3 and F. 6.

Figure 9.2 Household credit market debt outstanding, 1952–2012



Note: FIRE income in BEA statistics is calculated using SIC for years prior to 1998 and NAICS thereafter. The relative decline after 1998 seems to be at least partly due to the switch to NAICS classification.

Source: Bureau of Economic Analysis, National Income and Production Accounts, Table 6.1.

Figure 9.3 FIRE income as a percentage of national income, 1952–2010

The rise of financialization is generally associated with the demise of the Keynesian accumulation regime of the 1970s and the subsequent rise of global free market neoliberalism. The financial systems of advanced capitalist economies were heavily regulated in the era following the Great Depression of the 1930s and the Second World War. These regulations had two major aims: ensuring the stability of the financial sector and promoting capital accumulation in the nonfinancial corporate sector. However, by the 1970s, the stagnating economy became characterized by declining profitability, high inflation and increased bankruptcies. This crisis gave way to two central dynamics that were to shape economies in the coming years: attempts to recover profitability and the expansion of finance in an increasingly deregulated/unregulated environment. The collapse of the Bretton-Woods international financial system and high rates of inflation led to a number of financial innovations that sought to tackle the increased levels of uncertainty and paved the way for decades of complicated financial innovations. In addition, the belief that free markets are preferable to regulated markets became dominant by early 1980s. The passage of two new laws, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982, marked the beginning of the deregulation of the US financial sector.

Financialization received support from mainstream economic and financial theory, which argued that expansion of financial markets enhances efficiency and allows better management of risk. Expanding financial markets and the broad range of financial assets expand the states of nature covered by financial instruments and hence increase

efficiency.[3] This allows financial markets to improve their pricing of future outcomes and in turn enables markets to better allocate resources across future economic conditions. At the same time, it also allows economic agents to put together investment portfolios that increase their returns and their risk coverage. Furthermore, an increase in the volume of financial trading creates more market liquidity and prevents financial market prices from being vulnerable to small disturbances or manipulations by market participants. Mainstream economic theory also dismissed the potential problem of financial speculation by arguing that speculation is stabilizing: market prices are determined according to economic fundamentals. If prices diverge from fundamentals, speculators drive prices back to the level determined by fundamentals through buying or selling.[4]

In fact, it is possible to identify a tendency within capitalism towards financialization. After corporate forms of organization appeared, the separation of ownership and management could then be seen as a first step in 'financialization' because, after the separation, the owner is not directly tied to productive capital. Rather, his relationship to productive capital is financialized, as the income generated by the productive capital appears to the capitalists only as a stream of financial payments.[5] The transformation of ownership of capital from direct ownership of enterprise to indirect ownership via financial securities allows capitalists to escape a major problem they face as individuals when their wealth is stuck in the form of an actual enterprise, which is always under threat of new technologies and the competition of new products.[6] While in the post-war era financialization was held under control within the regulated set up, by 1980 financial sector interests, together with other business interests that promoted deregulation, furthered policies that removed barriers in front of financial markets and allowed for their expansion. As the financial sector gained increased power, it became quite active in pushing for a more liberalized finance.

II. FINANCIALIZATION OF NONFINANCIAL CORPORATIONS

Standard economic theory views the financial sector as providing necessary services to support the activities of nonfinancial corporations, most significantly their investment in productive assets. However, in the era of financialization, the relationship between financial markets and nonfinancial corporations has changed significantly. On the one hand, there has been an increase in financial market pressure on nonfinancial corporations through changes in corporate governance, starting with the hostile takeover movement of the 1980s and proceeding to the so-called shareholder revolution

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[3] Keith Arrow and Gérard Debreu, 'Existence of an Equilibrium for a Competitive Economy' (1954) 22 Econometrica 265–290.

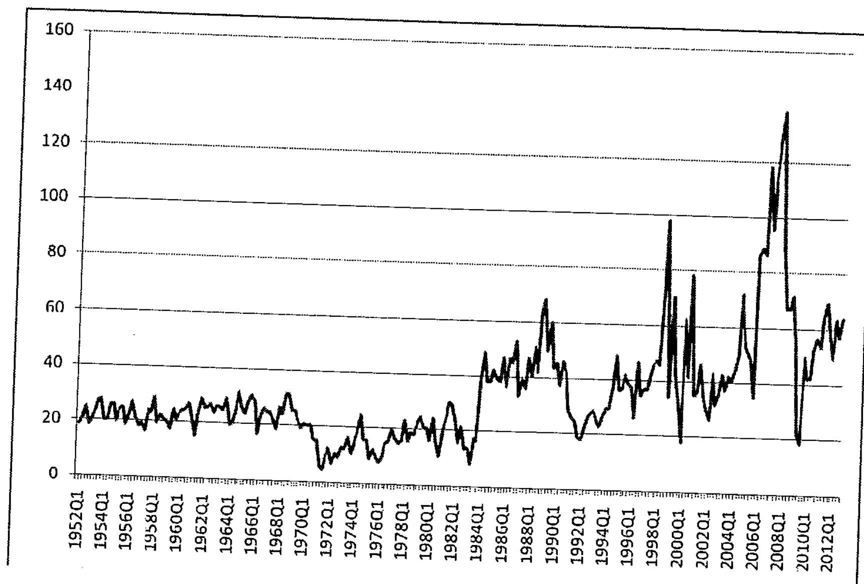
[4] Milton Friedman, 'The Case for Flexible Exchange Rates', in id. (ed), *Essays in Positive Economics* (Univ of Chicago P 1953) 157–203.

[5] Eric Pineault, 'Finance capital and the institutional foundations of capitalist finance: theoretical elements from Marx to Minsky' (unpublished paper, Ecole des Hautes Etudes en Sciences Sociales 2004).

[6] David Kotz, 'Neoliberalism and financialization' (conference in honour of Jane D'Arista, Massachusetts, May 2008).

of the 1990s. The same period has therefore witnessed an increasing transfer of earnings from nonfinancial corporations to financial markets in the forms of interest payments, dividend payments and stock buybacks. On the other hand, nonfinancial corporations themselves have been increasingly involved in financial activities and derived an increasing share of their income from these activities. These developments reflect a change in the objectives of top management, which includes an increasing propensity for short-termism in firm decision making.

Until the 1970s, nonfinancial corporations adopted a strategy of retaining and reinvesting earnings with an eye on long-term growth and profitability. Starting in the early 1980s, this was replaced with a strategy that focused on downsizing corporations' labour force and distributing an increasingly higher share of earnings to shareholders. This fundamental change in the strategy of nonfinancial corporations was a result of the worsening performance of corporations in the 1970s together with the increased power of institutional investors. The 1960s witnessed fast-paced corporate expansion through internal growth, as well as through mergers and acquisitions, to be followed by poor performance in the 1970s. As seen in Figure 9.4, the 1970s witnessed a significant decline in the profitability of the nonfinancial corporate sector.



Source: Flow of Funds Accounts of the United States, Table F.102.

Figure 9.4 Net dividend payments and stock buybacks of nonfinancial corporations as a percentage of total internal funds

The unstable macroeconomic environment of the 1970s and the intensification of international competition exacerbated this problem and major manufacturing corporations in the US began struggling with excessive centralization and innovative competition. The rise of institutional investors, such as those involved in pension funds, mutual funds and investment funds, as well as life insurance companies, contributed to the shift in the balance of power in corporations from managers to financial markets, and the hostile takeover movement of the 1980s caused significant changes in corporate governance. Increased control of stocks by institutional investors enabled the takeover

market that was advocated by agency theorists – as will be explained below – while giving more collective power to shareholders to influence returns as well as the market value of stocks. Financial market liberalization and deregulation increased financial investment opportunities and enabled the growth of institutional investors.

As nonfinancial corporations struggled with adverse economic developments and declining rates of profits in the 1970s, a group of American financial economists elaborated theories regarding corporate governance that were to be known as agency theories.[7] This approach became dominant by the 1980s and 'the idea that the market for corporate control was a useful tool for enforcing managerial efficiency appeared in the US Supreme Court decisions ... and the Economic Report of the President for 1985 ... signaling that the financial model had graduated from minority view to orthodoxy'.[8] Accordingly, a firm exists for the interests of its shareholders and the firm managers' task should be to maximize value for shareholders. However, a firm's managers might have different objectives than those of a firm's shareholders and creditors. Shareholders should exercise power in order to make sure that the managers maximize returns for them and to that end the interests of shareholders and managers should be aligned by introducing incentives for managers to maximize shareholder value. Hence, the agency theory rationalized the coming explosion in top management compensation and stock option grants. Stock option grants were thought to best align the interests of management with those of shareholders. The agency theory also supported an active takeover market, which would act as a threat to management when incentives were not sufficient to maximize shareholder value, and this has also been operational in rationalizing the takeover movement as well as private equity investment.

Consequently, the behaviour of nonfinancial corporations has increasingly been readjusted to the requirements of financial markets. Stock options have given managers motives to maximize stock prices in the short run, which, together with high executive pay, has clearly benefited top management. While this is a desired outcome from the agency theory perspective, it entails problems for nonfinancial corporations when financial markets are dominated by short-termist herd behaviour. It should be noted, however, that the focus on the short-term share price might have come before the long-term growth of firms.[9] Lazonick and O'Sullivan, for instance, argue that this transformation undermined the dynamism of the economy while at the same time narrowing the social base of prosperity.[10] Other scholars, such as Freud, Johal and Williams, have demonstrated that this corporate governance approach 'sets up a mechanical universe where following or breaking rules of corporate governance has predictable

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[7] See Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure' (1976) 3 J Finan Econ 11–25; Eugene Fama and Michael Jensen, 'Separation of Ownership and Control' (1983) 26 JL and Econ 301–325; Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims' (1983) 26 JL and Econ 327–349.

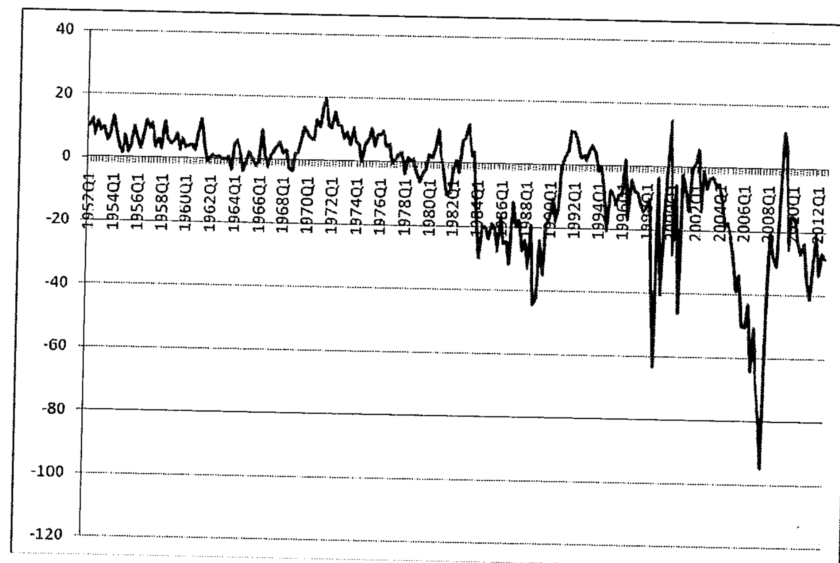
[8] Gerald Davis and Suzanne Stout, 'Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980–1990' (1992) 37(4) Administrative Science Q 605, 609.

[9] Lucian A. Bebchuk and Yaniv Grinstein, 'The Growth of Executive Pay' (2005) 21 Oxford Rev of Econ Policy 283–303.

[10] William Lazonick and Mary O'Sullivan, 'Maximizing Shareholder Value: A New Ideology for Corporate Governance' (2000) 29(1) Economy and Society 13–35.

results … [and] generally suppresses meso and macro analysis by constructing the economy as a bundle of corporations and the corporation as a bundle of investment projects'.[11] Orhangazi has also noted that 'agency theory is usually embedded in what would otherwise be a Walrasian general equilibrium model which has no contradictions or problems beyond principal–agent conflict. It trivializes the challenges faced by management – most of which have nothing to do with agency problems'.[12]

Figures 9.4, 9.5 and 9.6 show how these changes were reflected in balance sheets and income statements of nonfinancial corporations. Nonfinancial corporations began distributing a higher share of their cash flow to financial markets in the forms of dividend payments and stock buybacks, as could be observed previously in Figure 9.4, which shows net dividend payments plus stock buybacks as a percentage of nonfinancial corporations' total internal funds. In this era, the stock market has been an institution through which nonfinancial corporations not only did not raise funds for investment, but on the contrary, actually transferred earnings. Figures 9.5 and 9.6 demonstrate two ways this occurred: Figure 9.5 showing net new equity issuance as a percentage of total internal funds, and Figure 9.6 showing net borrowing through credit market instruments.

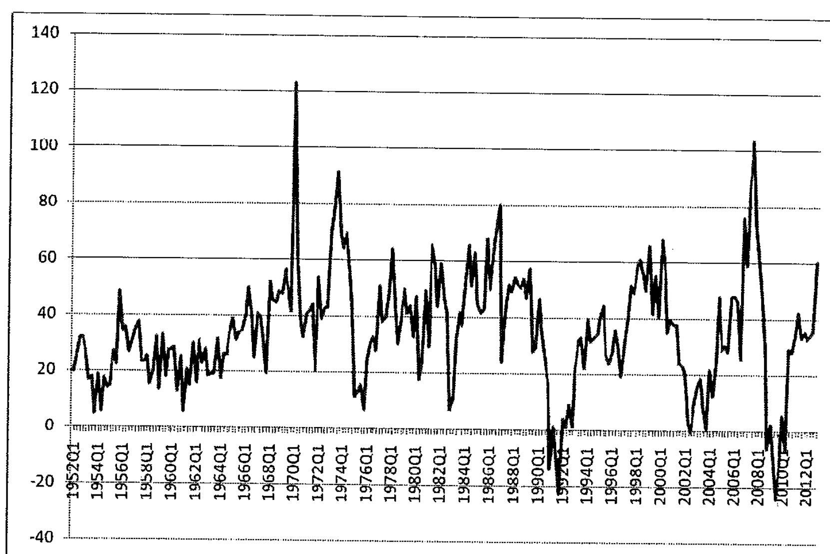


Source: Flow of Funds Accounts of the United States, Table F.102.

Figure 9.5 Net new equity issuance of nonfinancial corporations as a percentage of total internal funds

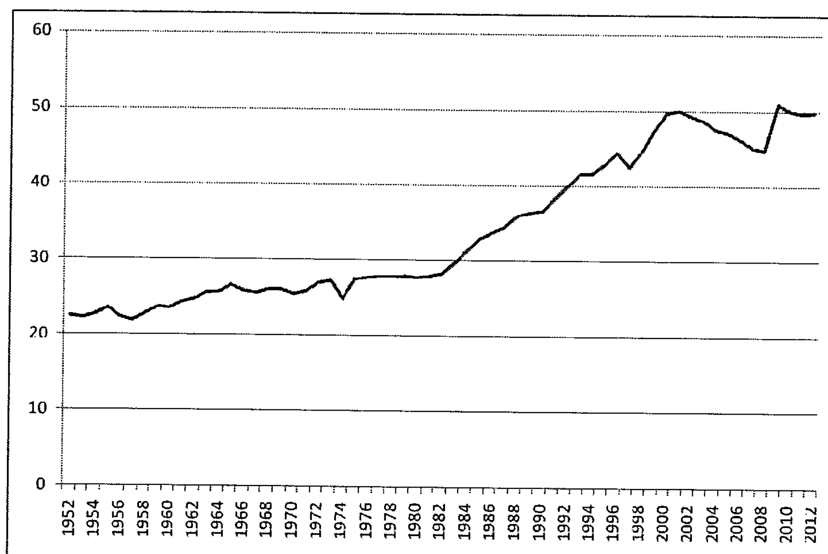
On the other side of the story, nonfinancial corporations themselves began acting like financial corporations. As they were squeezed by financial markets, they turned towards financial investments and operations to support their incomes. Figure 9.7 shows the

[11] Julie Froud, Sukhdev Johal, Karel Williams, 'Financialization and the Coupon Pool' (2002) 78 Capital and Class 123–124.
[12] Orhangazi (n 2).



Source: Flow of Funds Accounts of the United States, Table F.102.

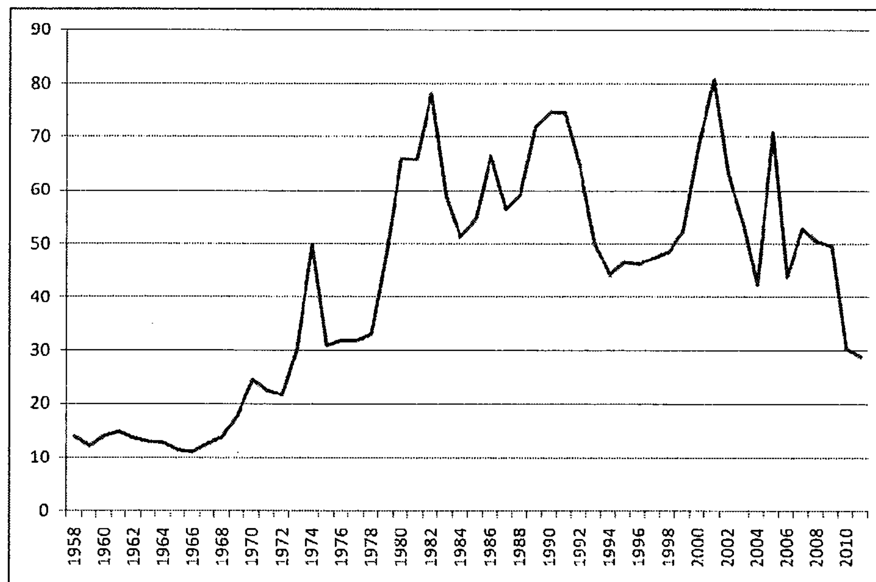
Figure 9.6 Net new borrowing of nonfinancial corporations as a percentage of total internal funds



Source: Flow of Funds Accounts of the United States, Table B.102.

Figure 9.7 Financial assets of nonfinancial corporations as a percentage of total assets

increase in their financial assets as a percentage of total assets and Figure 9.8 shows financial incomes as a percentage of internal funds.[13]



Source: Bureau of Economic Analysis, National Income and Production Accounts, Tables 6.16, 7.10 and 7.11.

Figure 9.8 Interest and dividend income of nonfinancial corporations as a percentage of total profits

III. FINANCIALIZATION, CAPITAL ACCUMULATION AND LABOUR

Financialization of nonfinancial corporations is often associated with lower investment in productive capacity. There are two channels through which financialization potentially had negative effects on the productive investments of nonfinancial corporations. First, availability of financial investment opportunities and nonfinancial corporations' increased involvement in acquisition of financial assets has the potential to have a negative impact on real investment. Two cases can be considered in this regard. First, if external funds are relatively limited, either because additional external funds come with a higher cost or because the firm considers internal funds to be safer than external funds, then acquisition of more financial assets would leave less resources for real investment. Second, nonfinancial corporations are under increased pressure from financial markets to maximize short-term returns. This pressure could lead them to choose financial investments over real investments, which bring returns only in a longer-term period.

Financial markets' pressure on management to increase dividend payments and stock buybacks is the second channel through which financialization potentially had a

[13] Note that these financial incomes do not include capital gains and underestimate total financial incomes.

negative impact on investment. First, increasing payments to financial markets leave firms with less funds available to finance real investment. Second, the short-termism imposed upon firm management by financial markets shortens the time-horizon of management and may hamper long-run investment projects. Third, when management uses external financing for real investment, because of the volatility of financial markets, the cost of funding in the coming years for long-term investment projects becomes more uncertain. Various empirical studies have found a negative relationship between financialization variables and the rate of capital accumulation. Orhangazi, for example, found this negative relationship to be particularly significant for large firms.[14] Stockhammer documented similar trends between 1978 and 2005 for the US, the UK, France and Germany,[15] and Clevenot and others for France.[16]

Froud and others analysed these processes through the concept of 'coupon pool capitalism', which is created when capital markets leave their traditional role of intermediation and begin regulating the behaviour of firms and households.[17] Financial markets determine the requirement for returns on capital and they demand an increase in the proportion of corporate earnings distributed to financial markets. While this development may sometimes support booms, it also leads to fragility. For example, between 1995 and 2000, technology companies were able to use capital markets to finance their activities even in the absence of sufficient profitability. This led to excess investment during the high-tech boom of the 1990s. By 2000, the total market capitalization of telecom firms was standing at 2.7 trillion dollars, equal to almost 15 per cent of the value of all nonfinancial corporations. This was an indicator of the newly created excess capacity in the telecom industry where the capacity utilization rate of telecom networks was only around 3 per cent and the same rate for undersea cable was at 13 per cent.[18] However, with the crash of 2000, these companies were now required to produce profits in product markets.

Furthermore, financialization might have contributed to the excess capacity problems in some industries by preventing the exit of unprofitable firms as it allowed them to enhance their profitability through financial investments even though their productive operations were not profitable. This was done first through the extension of consumer credit by companies to their own customers and getting involved in increasingly more complicated financial dealings. The financial crisis of 2007–2008, however, revealed the fragility of these practices. For example, General Electric received a significant loss on subprime UK mortgages, close to 2 billion dollars between 2008 and 2010.[19]

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14 Özgür Orhangazi, 'Financialization and Capital Accumulation in the Nonfinancial Corporate Sector: A Theoretical and Empirical Investigation on the US Economy, 1973–2004' (2008) 32(6) Cambridge J Econ 863–886.

15 Engelbert Stockhammer, 'Financialization and the Slowdown of Accumulation' (2004) 28(5) Cambridge J Econ 719–741.

16 Mickaël Clevenot, 'Investment and the Rate of Profit in a Financial Context: The French Case' (2010) 24(6) Intl Rev of Applied Econ 693–714.

17 Froud and others (n 11).

18 Robert Brenner, 'Towards the Precipice' (2003) 25(3) London Rev of Books 21.

19 Paul Glader, 'Soured Mortgages Weigh on GE Profit' *Wall Street Journal* (New York, 15 October 2009) B1.

Financialization of nonfinancial corporations has been accompanied by increased globalization of production, which involved the breaking up of production processes and relocation of them in different parts of the world depending on cost and market considerations. The result of this process was the shift of sources of profits from domestic output markets to foreign input markets. Milberg[20] and Milberg and Winkler[21] found that this shift had contributed to the maintenance of profit rates and the share of profits in national income in industrialized countries. As manufacturing operations declined in these countries, this process allowed nonfinancial corporations to distribute a larger share of their revenues to financial markets since they no longer needed to invest in productive capacity. Nonfinancial corporations' management preferred to focus on 'core competence' and sought to subcontract remaining operations. In this way, they have reduced domestic investment needs and managed to meet shareholder demands. Moreover, as domestic investment needs were reduced, nonfinancial corporations directly delved into financial investments as well. As financialization created greater incentives for cost-reducing and flexibility-enhancing offshore production by US lead firms, the sustainability of this setup was enhanced by the successful utilization of global value chains. Financialization further encouraged restructuring of production and this was critical in sustaining the financialization trends of the post-1980s era.

It is also important to note that all these dynamics had a significant impact on the banking sector as well. Financial markets usually prefer that nonfinancial corporations use debt financing to finance their activities as this permits some tax advantages and higher returns on equity thanks to leverage. Debt financing also allows firms to distribute their earnings to shareholders, and debt issuance creates interest payment commitments that reduce the free cash flow of companies otherwise available for other claimants. With financial deregulation and the development of capital markets, nonfinancial corporations began raising funds in bond markets instead of using bank loans. The advantages for nonfinancial corporations were flexibility and lower costs. The working capital of nonfinancial corporations increasingly began coming from the commercial paper market. This contributed to the process known as disintermediation, which caused banks to seek new sources of profits. Banks began utilizing increased fees, commissions and profits from trading of financial assets and increased lending to real estate and consumers. Thus, financialization changed the financing behaviour of nonfinancial corporations and led to changes in the banking sector, directing banks towards potentially riskier activities. Of course, as the financial activities and profits have increased in the post-1980 era, financial institutions have also set aside their role as promoters of nonfinancial capital accumulation and started to focus more on their own profits through financial activities. This has resulted in an increase in financial market-based activities replacing loans to nonfinancial corporations. These developments in the banking sector were quite important in paving the way to the financial crash.

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[20] William Milberg, 'Shifting Sources and Uses of Profits: Sustaining U.S. Financialization with Global Value Chains' (2008) 37(3) Economy and Society 420.

[21] William Milberg and David Winkler, 'Financialisation and the Dynamics of Offshoring in the USA' (2010) 34(2) Cambridge Journal of Economics 275.

In terms of labour, we can see that an important feature of the financialization era has been relatively lower real wages. Average real earnings declined from the mid-1970s up until the mid-1990s, and have never reached the highs of the early 1970s, remaining well below the era's rise in labour productivity. There are various factors behind this. The relocation of production to lower-cost sites put US labour in direct competition with the growing reserve army of labour in the rest of the world. The domestic balance of power moved against labour due to the declining power of labour organizations and de-unionization as well as the decline in social wages through cuts in social programmes. Flexible labour markets further undercut job security, bargaining power and wages. The destruction of the power of labour facilitated the alignment of interests of nonfinancial corporate management with financial markets by removing the potential opposition from labour. Furthermore, shareholder value maximization often meant downsizing of the labour force to increase share values. Takeovers facilitated by financial markets have also been quite effective in breaking labour contracts and pushing wages down. When private equity funds took over firms, they restructured them to sell back in the market for a profit. In the process, jobs, health and retirement benefits, and other commitments to employees were usually the first to be eliminated. In fact, the redirecting of income from labour to finance has been a hallmark of the financialization process.[22] While financialization significantly contributed to the undermining of the incomes of workers, it has opened up other venues to contribute to their consumption, such as increased household indebtedness and wealth effects (due to rising asset prices, especially housing prices).[23] Again, this development was one of the critical factors in the build-up to the financial crisis.

IV. FINANCIALIZATION AFTER THE CRISIS

Since the 1980s, the size and significance of all sorts of financial activities have steadily increased. Finance began acquiring a larger share of national incomes and financial decisions began dominating real sector activity. In the case of the US, financialization of nonfinancial corporations meant increased payments to financial markets, as well as increased involvement of nonfinancial corporations in financial activities. This financialization process was accompanied by the internationalization of production and led to lower levels of domestic investment. Increased income and wealth inequality, in addition to increased financial fragility and instability, have marked the era of financialization.

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22 See Özgür Orhangazi, 'Wall Street vs. the Labor Movement' (2008) 17(1) New Labor Forum 101–107; Thomas Palley, 'The Limits of Minsky's Financial Instability Hypothesis as an Explanation of the Crisis' *The Monthly Review* (New York, April 2010) <http://monthlyreview.org/2010/04/01/the-limits-of-minskys-financial-instability-hypothesis-as-an-explanation-of-the-crisis/> accessed 15 November 2014; Gérard Duménil and Dominique Lévy, *Capital Resurgent: Roots of the Neoliberal Revolution* (Harvard UP 2004).

23 Özgür Orhangazi, 'Financial vs "Real": An Overview of the Contradictory Role and Place of Finance in the Modern Economy' (2012) 27 Research in Political Econ 121–148.

The 2007–2008 financial crisis and the ensuing economic stagnation raise questions about the sustainability of a financialized economy. The nonfinancial corporate sector has kept its investment at low levels despite a strong recovery in profitability. While a significant reason behind this is the depressed state of product markets due to low aggregate demand, the recovery in rates of profit are likely to be attributed to the leading positions of large nonfinancial corporations in global value chains. As the profitability of nonfinancial corporations increases, the amount of cash and short-term financial assets they hold has also increased, following the brief decline right after the financial crisis. The financialization process led to the dismantling of the 'retain and reinvest' strategy and prioritization of shareholder value, thereby raising transfers to financial markets and executive compensation and encouraging nonfinancial corporations to behave more like financial institutions. Therefore, the unwillingness of nonfinancial corporations to increase investments together with declining household incomes makes a full recovery of growth and employment in the US economy more difficult. Whether and how the ongoing troubles will change financialized structures is yet to be seen.