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The Encyclopedia of Central Banking

Edited by Louis-Philippe Rochon and Sergio Rossi

The Encyclopedia of Central Banking

Edited by

Louis-Philippe Rochon

Associate Professor and Director
International Economic Policy Institute, Laurentian University, Sudbury, Canada and Co-editor, Review of Keynesian Economics

Sergio Rossi

Full Professor of Economics, University of Fribourg, Switzerland

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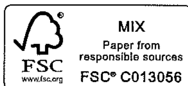

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Contributors

Pietro Alessandrini, Marche Polytechnic University, Ancona, Italy

Natalia Andries, University of Turku, Finland

Philip Arestis, University of Cambridge, United Kingdom

Angel Asensio, Université Paris 13, Sorbonne Paris Cité, France

Mohamed Aslam, University of Malaya, Kuala Lumpur, Malaysia

Oliver Simon Baer, University of Fribourg, Switzerland

Aldo Barba, University of Naples "Federico II", Italy

Juan Barredo Zuriarrain, University of Grenoble, France

Mehdi Ben Guirat, Laurentian University, Sudbury, Canada

Elias Bengtsson, European Central Bank, Frankfurt am Main, Germany

Edoardo Beretta, University of Lugano, Switzerland

Giancarlo Bertocco, University of Insubria, Varese, Italy

Dirk Bezemer, University of Groningen, the Netherlands

Jörg Bibow, Skidmore College, Saratoga Springs, United States

Mathias Binswanger, University of Applied Sciences and Arts Northwestern Switzerland, Olten, Switzerland

Xavier Bradley, University of Burgundy, Dijon, France

Alessandro Caiani, Marche Polytechnic University, Ancona, Italy

Maria Alejandra Caporale Madi, State University of Campinas, Brazil

Anna Carabelli, University of Eastern Piedmont, Vercelli, Italy

Emmanuel Carré, Université Paris 13, Sorbonne Paris Cité, France

Fernando J. Cardim de Carvalho, Federal University of Rio de Janeiro, Brazil

Duccio Cavalieri, University of Florence, Italy

Eugenio Caverzasi, Marche Polytechnic University, Ancona, Italy

Mario Cedrini, University of Turin, Italy

Alvaro Cencini, University of Lugano, Switzerland

Nathaniel Cline, University of Redlands, United States

David Colander, Middlebury College, United States

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Eugenia Correa, National Autonomous University of Mexico, Mexico

Muriel Dal-Pont Legrand, University of Lille 1 and Clersé CNRS, France

Juan Matías De Lucchi, Centro de Economía y Finanzas para el Desarrollo de la Argentina, Buenos Aires, Argentina

Vera Dianova, University of Fribourg, Switzerland

Robert W. Dimand, Brock University, St Catharines, Canada

Sheila C. Dow, University of Stirling, United Kingdom and University of Victoria, Canada

Gerald Epstein, University of Massachusetts, Amherst, United States

Luca Fantacci, Bocconi University, Milan, Italy

Eladio Febrero, University of Castilla–La Mancha, Cuenca, Spain

Germán D. Feldman, Universidad Nacional de San Martín, Buenos Aires, Argentina

James Andrew Felkerson, Bard College, Annandale-on-Hudson, United States

David M. Fields, University of Utah and Salt Lake Community College, Salt Lake City, United States

Stefano Figuera, University of Catania, Italy

Alejandro Fiorito, Universidad Nacional de Luján, Argentina

James Forder, Balliol College, Oxford, United Kingdom

Daniela Gabor, University of the West of England, Bristol, United Kingdom

Kevin P. Gallagher, Boston University, United States

Aleksandr V. Gevorkyan, St John's University, New York, United States

Olivier Giovannoni, Bard College, Annandale-on-Hudson, United States

Alicia Girón, National Autonomous University of Mexico, Mexico

Claude Gnos, University of Burgundy, Dijon, France

Antoine Godin, University of Limerick, Ireland

Rebeca Gomez Betancourt, University of Lyon, France

Charles Albert Eric Goodhart, London School of Economics, United Kingdom

Vincent Grossmann-Wirth, French Treasury, Paris, France

Robert Guttmann, Hofstra University, Hempstead, United States and Université Paris 13, Sorbonne Paris Cité, France

Omar F. Hamouda, York University, Toronto, Canada

Greg Hanngsen, Levy Economics Institute of Bard College, New York, United States

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Eckhard Hein, Berlin School of Economics and Law, Germany

Arne Heise, University of Hamburg, Germany

Eric Helleiner, University of Waterloo, Ontario, Canada

Annina Kaltenbrunner, University of Leeds, United Kingdom

Steve Keen, Kingston University, Kingston upon Thames, United Kingdom

John E. King, La Trobe University, Melbourne and Federation University Australia, Ballarat, Australia

Jane Knodell, University of Vermont, Burlington, United States

Robert H. Koehn, Brock University, St Catharines, Canada

Theodore Koutsobinas, University of Patras, Patras, Greece

Peter Kriesler, University of New South Wales, Sydney, Australia

Neil M. Lancastle, De Montfort University, Leicester, United Kingdom

Dany Lang, CEPN, Université Paris 13, Sorbonne Paris Cité, France

Noemi Levy-Orlik, National Autonomous University of Mexico, Mexico

Gilberto Libanio, Universidade Federal de Minas Gerais, Belo Horizonte, Brazil

Emiliano Libman, Center for the Study of State and Society, Buenos Aires, Argentina

Stefano Lucarelli, University of Bergamo, Italy and University Paris 1 Panthéon Sorbonne, France

Brian K. MacLean, Laurentian University, Sudbury, Canada

Ivo Maes, National Bank of Belgium and University of Louvain, Belgium

Maria Cristina Marcuzzo, La Sapienza University, Rome, Italy

Wesley C. Marshall, Universidad Autónoma Metropolitana, Mexico City, Mexico

Fabio Masini, University of Roma Tre, Rome, Italy

Jonathan Massonnet, University of Fribourg, Switzerland

Giuseppe Mastromatteo, Università Cattolica del Sacro Cuore, Milan, Italy

Claudia Maya, National Autonomous University of Mexico, Mexico

William E. McColloch, Keene State College, United States

Jo Michell, School of Oriental and African Studies, University of London, and University of the West of England, Bristol, United Kingdom

Alexander Mihailov, University of Reading, United Kingdom

Marcelo Milan, Federal University of Rio Grande do Sul, Porto Alegre, Brazil

William Miles, Wichita State University, United States

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Thorvald Grung Moe, Levy Economics Institute of Bard College, New York, United States

Pierre Monnin, Council on Economic Policies, Zurich, Switzerland

Virginie Monvoisin, Grenoble Business School, France

Jamie Morgan, Leeds Metropolitan University, United Kingdom

Tracy Mott, University of Denver, United States

Suranjana Nabar-Bhaduri, Bucknell University, Lewisburg, United States

Daniel H. Neilson, Bard College at Simon's Rock, United States

Edward J. Nell, New School for Social Research, New York, United States

Nikolay Nenovsky, University of Picardie Jules Verne, Amiens, France

Benoît Nguyen, Banque de France, Paris, and University Paris 1 Panthéon-Sorbonne, France

Salewa 'Yinka Olawoye, University of Missouri–Kansas City, United States

Özgür Orhangazi, Kadir Has University, Istanbul, Turkey

Etelberto Ortiz, Universidad Autónoma Metropolitana, Mexico City, Mexico

Andrea Pacella, University of Catania, Italy

Yannis Panagopoulos, Centre for Planning and Economic Research, Athens, Greece

Fabio S. Panzera, University of Fribourg, Switzerland

Aris Papageorgiou, University of Macedonia, Thessaloniki, Greece

Robert W. Parenteau, MacroStrategy Edge, Berkeley, United States

Marco Veronese Passarella, University of Leeds, United Kingdom

Ruxandra Pavelchievici, University of Nice Sophia Antipolis, France

Esteban Pérez Caldentey, Economic Commission for Latin America and the Caribbean, Santiago, Chile

Nathan Perry, Colorado Mesa University, Grand Junction, United States

Philip Pilkington, Kingston University, Kingston upon Thames, United Kingdom

Giovanni Battista Pittaluga, University of Genova, Italy

Massimo Pivetti, La Sapienza University, Rome, Italy

Jean-François Ponsot, University of Grenoble, France

David Pringle, Carleton University, Ottawa, Canada

Devin T. Rafferty, Saint Peter's University, Jersey City, United States

Vijayaraghavan Ramanan, independent researcher, India

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Riccardo Realfonzo, University of Sannio, Benevento, Italy

Marco Flávio Resende, Universidade Federal de Minas Gerais, Belo Horizonte, Brazil

Louis-Philippe Rochon, Laurentian University, Sudbury, Canada

Sergio Rossi, University of Fribourg, Switzerland

Roy J. Rotheim, Skidmore College, Saratoga Springs, United States

Harald Sander, Cologne University of Applied Sciences, Germany and Maastricht School of Management, the Netherlands

Malcolm Sawyer, University of Leeds, United Kingdom

Benjamin Schmidt, University of Hohenheim, Stuttgart, Germany

Carlos Schönerwald, Federal University of Rio de Janeiro, Brazil

Helene Schuberth, Oesterreichische Nationalbank, Vienna, Austria

Robert H. Scott, Monmouth University, West Long Branch, United States

Mario Seccareccia, University of Ottawa, Canada

Mark Setterfield, New School for Social Research, New York, United States

Brendan Sheehan, Leeds Metropolitan University, United Kingdom

John Smithin, York University, Toronto, Canada

Peter Spahn, University of Hohenheim, Stuttgart, Germany

Aristotelis Spiliotis, Bank of Greece, Athens, Greece

Brenda Spotton Visano, York University, Toronto, Canada

Jim Stanford, Unifor, Toronto, Canada

Alexis Stenfors, University of Portsmouth, United Kingdom

Engelbert Stockhammer, Kingston University, Kingston upon Thames, United Kingdom

Ricardo Summa, Federal University of Rio de Janeiro, Brazil

Nathan Tankus, University of Ottawa, Canada

Daniela Tavasci, Queen Mary University of London, United Kingdom

Adelmo Tedeschi, Università Cattolica del Sacro Cuore, Milan, Italy

Vidhura S. Tennekoon, Indiana University–Purdue University Indianapolis, United States

Andrea Terzi, Franklin University Switzerland, Sorengo, Switzerland

Slim Thabet, University of Picardie Jules Verne, Amiens, France

Jan Toporowski, School of Oriental and African Studies, University of London, United Kingdom and University of Bergamo, Italy

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Dominique Torre, University Nice Sophia Antipolis, GREDEG, CNRS, France

Marie-Aimee Tourres, University of Strathclyde, Glasgow, United Kingdom

Domenica Tropeano, University of Macerata, Italy

Lefteris Tsoulfidis, University of Macedonia, Thessaloniki, Greece

Eric Tymoigne, Lewis & Clark College, Portland, United States

Jorge Uxó, University of Castilla–La Mancha, Talavera de la Reina, Spain

Bernard Vallageas, University Paris-Sud, Paris, France

Ramaa Vasudevan, Colorado State University, Fort Collins, United States

Luigi Ventimiglia, Queen Mary University of London, United Kingdom

Richard A. Werner, University of Southampton, United Kingdom

Sebastian Weyih, University of Fribourg, Switzerland

Takashi Yagi, Meiji University, Surugadai, Japan

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References
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Financialization

Financialization is a term that has gained widespread usage in the critical economics literature since the early 2000s, and especially in the aftermath of the 2008–09 global financial crisis. However, the term lacks a clear, agreed-upon definition, and its precise use and form have been ambiguous. At a general level, it refers to the increase in the size, importance and power of financial markets, transactions, institutions, motives and financial elites in the functioning of the economy in the post-1980 era. Some describe the financialization process as a shift from productive activities to financial activities, while others emphasize the dominance of finance in general over economic activities (see Epstein, 2005). In this framework, financial activities include borrowing and lending activities as well as dealings in financial assets such as stocks, bonds, derivatives, futures, and other types of securities. These activities are distinguished from non-financial activities, which include the production and distribution of goods and the production and distribution of services that are not directly related to financial activities.

At the firm level, financialization is used to designate changes in the relationship between the non-financial corporate sector and financial markets. These changes are twofold: on the one hand, non-financial corporations began increasing their acquisition of financial assets and deriving an increasing share of their income from financial sources. On the other hand, the management of non-financial corporations came under increased pressure from financial markets to maximize short-run returns, which led to increased payments to financial markets in the forms of interest payments, dividend payments and stock buybacks (see Orhangazi, 2008).

There are also some more specific uses of the term, such as "financialization of commodities" or "financialization of food", in which financialization refers to increased financial activity in markets where commodity or food items futures are traded and future streams of revenue from these have been transformed into tradeable financial assets.

Indicators of financialization are abundant. For example, total global financial assets as a percentage of world GDP have increased from 109 per cent in 1980 to 263 per cent in 1990, 310 per cent in 2000, and 355 per cent in 2007. The size of the financial sector with respect to GDP, financial incomes as a percentage of national incomes, financial corporations' profits with respect to non-financial corporations' profits, debt-to-GDP ratios,

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non-financial corporations' financial incomes and financial payments have all shown sharp increases since the 1980s (see Orhangazi, 2008, 2012).

While there are different theoretical and historical explanations for the rise of financialization, it is commonly associated with the demise of the Keynesian accumulation regime in the 1970s and the rise of global free-market neoliberalism afterwards. The crisis of the 1970s was characterized by a stagnating economy, declining rates of profit, increased inflation, and bankruptcies. All these, together with the collapse of the Bretton Woods international financial system, created two central dynamics: various attempts to recover profitability and an expansion of finance in an increasingly deregulated/unregulated environment. The collapse of the Bretton Woods system and high rates of inflation led to a number of financial innovations that aimed to address the increased levels of uncertainty and paved the way for decades of complex financial innovations. The rise of institutional investors, such as pension funds and investment funds, contributed to the shift in the balance of power in corporations from managers to financial market participants; and with the contribution of the hostile takeover movement of the 1980s caused significant changes in corporate governance. As the financial sector gained in power, it became very active in pushing for more deregulation. Financial market liberalization and deregulation increased financial investment opportunities, while also allowing for the growth of institutional investors and a surge in non-banking financial institutions.

Financialization received support from mainstream economic and financial theory, which argues that expansion of financial markets enhances efficiency and allows for better management of risk. In addition, the corporate governance literature, which focuses on the relationship between financial markets and firms, argues that the task of firm managers should be to maximize value for shareholders. In order to do this, the interests of shareholders and managers should be aligned. This provides the theoretical background for the expansion of management compensation and stock options as well as increased takeover activity and private equity investment.

Financialization has had a number of consequences. First of all, various types of financial sector activities acquired greater significance with respect to real sector activities, and the transfer of income from the real sector to the financial sector increased. Financial decisions began to dominate real sector activity, and slower economic growth has been associated with financialization. Increased financial fragility and instability, both in the US economy and in the world economy, have also been seen as direct consequences of financialization. For households, it has led to an increased ability to borrow and for non-financial corporations it has precipitated a whole series of changes in firm behaviour. Financialization has also contributed to increasing income and wealth inequality, as it was effective in shifting the balance of power in favour of capital. While the rise of profits and financial incomes – interest and dividend incomes and capital gains – relative to wages was a major factor leading to a concentration of income and wealth at the top, profits made from managing this increasingly concentrated wealth further contributed to the inequalities. Inequality has also further deepened the process of financialization. Increased income and wealth inequality have directed more and more funds into speculation through institutions such as investment and hedge funds.

Özgür Orhangazi

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See also:
Bretton Woods regime; Finance and economic growth; Financial crisis; Financial innovation; Financial instability.

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Financial literacy

While no universally-accepted definition of financial literacy exists, one that is broad and often cited comes from the United States President's Advisory Council on Financial Literacy (2008, p. 4): "the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial wellbeing." Economists (and other researchers), however, are particularly concerned about two issues regarding financial literacy: (i) how best to improve financial literacy; and (ii) how much of an impact (if any) higher financial literacy rates will have on actual financial behaviour.

One of the most comprehensive studies of Americans' financial knowledge, skills and behaviour comes from the FINRA Investor Education Foundation (2009). They surveyed over 28,000 people across the United States in October 2009. The survey included a basic financial literacy test that resulted in a failing average grade (less than 60 per cent). Also, they found that only 35 per cent of households had enough savings to cover three months of expenses (rainy-day funds). 73 per cent of households had at least one credit card, but only 41 per cent of them reported that in the last 12 months they always paid their debts in full. Despite these findings, over two-thirds of people surveyed ranked themselves as highly knowledgeable about personal finance overall.

Financial illiteracy is a worldwide problem. Recent cross-national studies (see Atkinson and Messy, 2012; Xu and Zia, 2012) show that people in many countries (including the United States) have difficulty answering basic personal finance questions. These studies also found significant similarities between countries as to the most financially illiterate groups. For example, women had comparatively lower financial literacy scores in almost all countries. Further, financial literacy follows an inverted-U shape where younger people and older people have the lowest levels of financial literacy (Xu and Zia, 2012).

The need for improved financial literacy has grown over the past 30 years as the complexity and availability of consumer financial products has expanded (student loans, credit cards, complex mortgages). Also, people are increasingly responsible for their financial planning. For example, in the United States (and other countries) a shift from defined benefit plans (for instance, pensions) to defined contribution plans (for instance, 401(k) plans) has placed a greater burden of retirement planning onto individuals – many of whom, as shown in the FINRA survey quoted above, have trouble managing their basic personal finances. Thus, many 401(k) plans have lower returns and lack long-run risk pooling (Ollerman and Boivie, 2011; Olen, 2012).

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