Financialisation and stagnation

Introduction

- In this paper I will try to show how financialization contributes to stagnation.

- This contribution will appear most clearly if we manage to overcome one of the limits of the current debate on stagnation: mainly focus on proximate causes rather than deep causes of stagnation

- Deep causes level involves making reference to institutions

- I hold that stagnation from a Keynesian standpoint is mainly due to changes in AD that have to do with trends of the New Economy (NE), including financialisation, which are heavily influenced by institutions.

- Thus financialisation is one of the deep causes of stagnation

1-The proximate and the deep causes of stagnation according to standard theory

- Standard theory relies on a distinction between s.r., m.r. and l.r. to which different types of analysis correspond (Cycle, Production Function, Institutions): while changes in variables in the PF, such as L, K, technology appear as the proximate cause of stagnation in the medium run, institutions appear as the deep causes in the long-run (e.g. Acemoglu and Robinson, Glaeser, Taylor)

- Given the internal stability assumption, stagnation is due to institutional failures, such as activist fiscal policy supporting welfare which creates wrong incentives and uncertainty undermining entrepreneurs' confidence and thus capital accumulation

2-The proximate causes of stagnation according to Keynesian theory

- I suggest that Keynesian theory should also regard institutions as the deep cause of stagnation, though it is much more difficult because there is no distinct analytical apparatus to deal with different time

periods, there is only reference to AD (I believe that AD is not just s.r. but also l.t driver)

- In the literature many claim that a low level of aggregate demand is the cause of stagnation for various reasons:

  Low AD = f (credit rationing, inequalities, debt, too high real interest rates, financialization)

  - this approach can be termed 'proximate level' thinking

  - it is not sufficient because it involves reliance on a kind of <u>ceteris paribus</u> thinking: it amounts to stressing that what causes stagnation is some key causal factor and once this is removed it will be possible to go back to 'normal'

  - this is implausible because:

    1. AD is a multidimensional concept
    2. each of these factors does not act in isolation but in a cumulative fashion, taken together they are part of an interconnected system

3. they are not the ultimate determinant, they are influenced by institutions
4. they influence the economy in a complex manner

- to overcome these limitations it is necessary to go beyond proximate causes accounts and deal with deep causes

3-The deep causes of stagnation in a Keynesian perspective

- The analysis of such causes involves discussion of three points:

  1) what do we mean by interconnected system?
  2) what is the role of institutions?
  3) what is the driver behind AD?

- **Interconnectedness** is the key feature of the NE; its key trends such as financialization, technological change, globalization, role of 'precision' (the increasing role of formal models in decision making) are strictly linked between themselves; in particular, there is an

unprecedented interrelation between institutions and the economy

- All such trends are heavily influenced by **institutions**:
  financialisation and globalisation have been stimulated by deregulation, technological change by the National System of Innovation, 'precision' is influenced by government need to monitor the economy

- This institutional influence rules out the possibility to focus on the 'objective' evolution of capitalism (i.e. as if it were governed by natural or general laws of motion applying to times)

- For this reason it makes sense to refer to some kind of periodization, I prefer ME/NE on the grounds that they involve **different market adjustment processes,** as I explain below

- **The key NE trends exercize their influence on the economy by influencing the propensities** underlying AD components, which are usually taken as given in dynamic models but represent the true **drivers** of Keynes's model

- This means two things:

  A) that in our perspective the impact of these objective changes is not deterministic, stagnation is not inevitable

  B) we open the 'black box' of Propensities, in a quite different manner than behaviouralists like Shiller who focus on animal spirits, emotion, irrational moves

- The point is that these propensities are not just naturalistic givens, simply reflecting psychological features; they are based on conventions that also have a collective socio-institutional dimension, which finds an expression in **agents' 'perception' of relevant aspects of the environment**, such as the market, value, time, that change trough time

- Such perceptions should not be confused with psychological waves of optimism or pessimism that cyclical and thus reversible, they are more structural, persistent and irreversible features

- It can be argued for example that the NE trends influence **permanently** agents' perceptions of

'space' and 'time', inducing a shortening of agents' horizons (with negative implication for true entrepreneurship linked to longer term) as well as the perception of the 'market'. For example, unlike the 1930s, today a part of the wage is 'social', i.e. it takes the form of a bundle of public services.

- the variability of such conventional perceptions can help make sense of **AD as the long-term driver of the economy**, as it crucially allows for two key features of Keynes's approach: namely both the possibility of internal instability, and the compensatory role of policy and institutions

- My hypothesis is that such perceptions tend to change in such a way as to increase instability and undermine agents' confidence and policy's task is to restore it.

- Many policy features ever since the 1940s can actually be interpreted as trust-restoring moves (e.g. the introduction of the welfare state and deposits' insurance)

- On these grounds, I can state my thesis about stagnation: I hold that it is mainly due to changes in AD propensities that make key functions such as investment, much more unresponsive to price changes;

4-The key role of financialisation in bringing about stagnation

- Financialisation is one major factor that justifies the view that **in the NE there is a different kind of market adjustment** with respect to the past,
- I hold that the shift to this new form of market adjustment is of the same significance as that which occurred in the past from the craft-based factory production to Mass Production (underlined for example by Nell 1998 who correctly regards market adjustments not a matter of universal theory but of historical patterns)
- Here are its basic **normal** features:

1-**no significant inflation** (or even deflation) due to globalization and technological change; wages and prices are more flexible, even moderately downward

2-**adjustment in real wages** does not occur mainly through prices, i.e. Keynes's adjustment mechanism (fall in real wages through rising prices and given money wages); adjustment occurs more **through cuts in social wage**;

indeed, the reason why wages do not respond to market dynamics as before is because of **huge G, T and public debt** that have become the most variable part of the adjustment, so that one cannot discuss wage price dynamics as if the economy was really autonomous with respect to institutional side,

3- **relative low AD** due to diminished ability of governments to play a compensatory role;

while during mass production there was one-way street, monotonic increase in G and welfare, the NE is characterized by a retrenchment of G

- **financialisation plays a key role in this adjustment process which makes the NE much more unstable than previous stages of growth**

- financialisation reflects growing instability in both the real and financial sector itself

    - **1.** globalization and technological change break the link between money supply and price level; while massive injections of liquidity no longer cause inflation, **financialisation acts as an escape valve: liquidity raises asset prices,** for this reason **QE** represents a source of instability

    - **2. it impairs accumulation** by influencing agents' perceptions of the market and value that affect negatively the propensity to invest, for at least three reasons that tend to **exacerbate speculative behaviour vis-à-vis true entrepreneurship:**

        a) it generates **higher and safer returns** than profits that could be derived from investment;

            - these returns are '**higher'** because financialisation today implies **the**

creation of ever more complex financial assets (further removed from underlying real assets and thus even more difficult to value than previous ones) which greatly favour the determination of price on the grounds of a pure 'internal' market assessment (guided by formal models) involving a greater possibility to divorce financial trends from real trends

- these returns are **'safer'** than those that can be obtained in the real sector due to the insurance granted by the bail out strategy (lower risk of bankruptcy)

b) **artificially highly paid jobs** in the financial sector tend to attract the best talents and undermine marginal productivity theory of income distribution even further

c) It favours the adoption by the business community in general of typical features of financial markets such as **short-**

termism and bad practices (including fraud and false accounting).

- **3. while apparently loosening liquidity constraints** in the face of destabilizing effects, such as inequality and joblessness, financialisation favours **unsustainable levels of consumption** through **higher debt**, debt society is more fragile, it is not a remedy to unequal income distribution

- **4.** it generates instability by **reducing welfare** and thus consumption, the higher costs of saving the banks have been paid by welfare cuts

  1. while in the 50s or 60s smooth transition towards socialization of investment and growth of the the social wage through the welfare system accounted for golden age

  2. in the NE all this becomes uncertain mainly due to financialisation that changes perception of the market:

banks must be saved and thus financialisation places a higher burden on the state finances

through its higher weight in national economies, the financial sector **undermines governments' possibility to support sluggish private demand** by compelling them to stick to conceptions of orthodox finance (they fear 'market punishment') and cut G both on welfare --this means less social wage, welfare system no longer a 'right'—and R&D and NSI

- **5.** Financialization reflects **strong trade imbalances** and may also contribute **to lower exports** for western countries, due to the growing volatility of financial markets and exchange rates as well as the faster transmission of financial and real disturbances across countries produced by the combination of all the NE trends.