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# INCAS

## *DP Series*

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### **Premature financialization: a conceptual exploration**

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INCAS

Understanding institutional change in Asia: a comparative perspective with Europe

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## ABOUT THE INCAS PROJECT

INCAS is a Marie Skłodowska-Curie Actions R.I.S.E funded project under the European Commission's H2020 Programme.

The project INCAS aims at creating a top-level research and advanced training network on institutional change in Asia, in comparative perspective with Europe.

The coordinator, Ecole des Hautes Etudes en Sciences Sociales (France), promotes this network together with Oxford University (UK), Freie Universität Berlin (Germany), and in collaboration with Waseda University (Japan). The aim of the proposed mobility scheme is to give birth to a European consortium and network of faculties and advanced graduate students specialized in the comparative analysis of institutional change in Asia and Europe. The partners have chosen Japan as a reference point because of its comparability with Europe as shown by previous studies, its historical influence on development and further institutional changes in Asia, and the expertise accumulated within our research team.

Analyzing current economic dynamics in Japan and later expanding this analysis to other Asian countries promises to generate insights that might be help to better understand challenges for Europe and to prepare relevant policy proposals. Our purpose is to compare the results obtained in the case of Japan and few other Asian countries (South Korea, Taiwan, China, and possibly Thailand, after having checked the data availability), not only to previous results on Europe but also to original results we will get on European countries (primarily France – which will be our reference country in Europe – and then the UK, Germany, and Italy) in mobilizing new historical data and applying our theoretical framework.

# Premature financialization: a conceptual exploration

## Abstract

This paper reviews some of the recent writing on financialization and its effects in developing countries. Acknowledging the positive role of finance in development, it argues that beyond a certain point of ‘financial deepening’ there are negative consequences. Financialization affects the economy, and also the state. In developing countries financialization does not necessarily follow a long period of industrialization, but may happen simultaneously with it, and indeed may be linked to ‘premature de-industrialization.’ From this perspective, namely of timing, it may also be meaningful to talk of ‘premature financialization.’

**Keywords:** *financialization, development, premature deindustrialization*

**JEL Codes:** *B52, F63, G10, N20, O19*

## Introduction

Finance is undoubtedly necessary and beneficial for economic development – up to a point, and in certain forms. The relationship is far from simple, however, and beyond that point, it can have negative consequences. These are (at least) threefold. First, although advocates claim that financial ‘deepening’ and ‘openness’ enhances stability, finance also contains the seeds of instability, the fruits of which have proven to be crisis.

Second, in addition to cyclical tensions, there are structural tensions between finance and industry. Finance as a *facilitator* of development through industrialization, without restraint, eventually comes to dominate it, and indeed can become *predatory* to it. This happens through financialization, which changes the orientation not just of financial institutions, but also those of non-financial businesses, and of households. In doing so it concentrates wealth and amplifies inequality. It contributes to ‘de-regularization’ of employment and to de-industrialization.<sup>1</sup>

Third, there is a political dimension. In state-market dichotomies this is seen as encroachment of markets into the public sphere of activity, and a contraction of policy space. But ‘financialization of the state’ is more than this; state institutions and objectives are reshaped as well, often willingly, for political as well as economic objectives. This has implications for democracy as well as governance.

This discussion paper will explore these propositions in a historical context, with a particular interest in today’s developing countries. While present day financialization is associate with post-industrial transition, of not de-industrialization, in developed countries, it has been occurring at the same time as industrialization in newly emerging economies. It may be linked to ‘premature de-industrialization,’ and certain features of the so-called ‘middle income trap.’ Thus it is crucial to consider ‘appropriate finance’ for developing countries, and possibly measures for ‘de-financialization.’

The title of the paper is perhaps inappropriate in implying that financialization may be appropriate for ‘mature’ economies. The intent, however, is to draw attention to issues of time and timing in the evolution of economies, as part of a bigger project on ‘compressed development.’<sup>2</sup> There are many possible perspectives for considering financialization, and many currents have emerged in recent years. While liberally trespassing on some of these, the goal is to consider current dilemmas of development. ‘Conceptual exploration’ signifies that the paper is exploratory, rather than tightly focused and defended with empirical evidence.

The paper is structured as follows. The first section starts with a Schumpeterian view of the role of finance in economic development. It then considers Minsky’s Keynesian twist and its application to international development finance, and developing country financial crises since the 1980s. Minsky also proposed four historical periods in the relation

1. Although important, the relationship between financialization on the one hand and employment and inequality on the other is not considered here. Cf., for example, Lim and Tomaskovic-Devy, 2013; Arnum and Naples, 2013; and Jacoby, 2008, concerning the US.

2. Whittaker et.al., *Compressed Development* (provisional title, forthcoming, Oxford University Press).

between finance and business (and households). We consider this in section 2 under the concept of financialization, and compare the late 19<sup>th</sup>-early 20<sup>th</sup> century version with that of a century later. Financialization of now-developed countries has a strong influence on developing countries.

The third section considers financialization in developing countries themselves, which takes similar forms to that of developed countries, but in a different context, and hence with potentially different results. The fourth section considers financialization *and* the state – including state policies towards the financial sector – as well as financialization of the state, involving (re)structuring of the state and state policies, as well as the use of financial instruments by the state itself. Section 5 considers the concept of ‘premature financialization,’ and ‘appropriate finance’ for developing countries.

## 1. Finance and economic development

*‘(C)redit is essentially the creation of purchasing power for the purpose of transferring it to the entrepreneur, but not simply the transfer of existing purchasing power. The creation of purchasing power characterises, in principle, the method by which development is carried out in a system with private property and division of labour. By credit, entrepreneurs are given access to the social stream of goods before they have acquired the normal claim to it. It temporarily substitutes, as it were, a fiction of this claim for the claim itself. Granting credit in this sense operates as an order on the economic system to accommodate itself to the purposes of the entrepreneur, as an order on the goods which he needs: it means entrusting him with productive forces. It is only thus that economic development could arise from the mere circular flow in perfect equilibrium. And this function constitutes the keystone of the modern credit structure’ (Schumpeter 1934/1983: 107).*

For Schumpeter, economic development is driven by innovation, which is funded by credit-money. A large number of studies have tested the link between credit-money and economic development. In their study of 80 countries between 1960 and 1989, for example, King and Levine (1993: 719) found ‘an important link between financial development and long-run growth as suggested by Schumpeter 80 years ago.’ Historically, Rousseau (2002) found that ‘financial revolutions’ (new financial instruments, institutions and markets) played a central role in the subsequent growth of trade, commerce and industrialization in the Dutch Republic (1600-1794), England (1700-1850), the US (1790-1850), and Japan (1880-1913). They did so by generating information, pooling funds, facilitating payments and providing working capital, particularly for the large companies which traded on early stock exchanges.

Rousseau’s ‘financial revolutions’ refer to the establishment of a sound financial and banking systems; revolutionary for those countries, but not necessarily relative to earlier developers. However, the nature of ‘financial revolutions’ changes over time. Gerschenkron (1962: 13-14) pointed out that long-term financing institutions played little part in the industrialization of England due to its gradual unfolding, and the greater prior accumulation of capital. By contrast, capital-scarce (and capital-diffused) continental late developers in the 19<sup>th</sup> century, particularly Germany, forged a close link between finance and industry through institutions providing long term finance. This helped them to catch up with England industrially.

*‘Between the English bank essentially designed to serve as a source of short term capital and a bank designed to finance the long-run investment needs of the economy there was a complete gulf. The German banks, which may be taken as a paragon of the type of universal bank, successfully combined the basic idea of the *crédit mobilier* with the short term activities of commercial banks’ (Gerschenkron, 1962: 13).<sup>3</sup>*

*Significantly, the increasing scale of industry and pressure for bigness foreclosed the English path. Thus Gerschenkron pointed to a co-evolutionary link between finance and industry; if production systems change, so do financial institutions. The reverse might also apply. As Minsky points out, the Schumpeterian entrepreneur is also active in the realm of finance: ‘Those who finance a Schumpeterian innovator always have novel problems in structuring the financing. Two new sets of combinations, in production and in finance, drive the evolution of the economy’ (Minsky, 1988: 3).*

### **Cycles and financial instability**

The ‘two sets of combinations’ are not only co-evolutionary, but also cyclical. In Schumpeter’s schema, a primary wave of credit-financed innovation creates a secondary wave which spreads throughout the economy; investment rises as others rush to imitate the new combination, and others invest to supply them; rising incomes promote consumption, and people come to expect the expansion to continue. This expectation creates the conditions for speculation: ‘Many

3. Russia had its great spurt three decades after Germany, in the 1880s-90s, on the basis of an even more ‘backward’ economy, with less capital available, and low levels of trust for long-term banking. Here the state had to play a more direct role, and it did so with considerable repression (ibid, pp.17-20).

things float on this “secondary wave,” without any new or direct impulse from the real driving force, and speculative anticipation in the end acquires a causal significance.<sup>4</sup> The collapse of the speculative phase of the secondary wave is accompanied by downturn from the first. Entrepreneurial investments have already been made, the innovations produce downward pressures on prices, and firms and industries decline. Downturns have a cleansing function, but the collapse of speculation produces other casualties, as normally viable businesses are forced into liquidation when bankers swing from reckless lending to excessive caution (Leather and Raines, 2004).

Perez (2002) amplifies this schema and its links with Kondratiev cycles. An ‘installation’ period begins with an irruption of the new technology – a kind of big bang in the midst of a period of stagnation. Investors are attracted, and a split occurs with the old paradigm. This is followed by a frenzy, as investors pile in, speculation mounts, and financial capital comes to dominate, both in the decline of the old paradigm, and the emergence of the new. This is unsustainable, however, and a turning point is reached – often in the form of a crash – which forces the government to step in with regulation, laying the grounds for a ‘development’ period, starting with a golden age of synergy, and then maturation and eventually stagnation. Perez describes five such cycles since the late 18<sup>th</sup> century, the last of these (IT) beginning in the 1970s.

While drawing on Schumpeter, Minsky also drew on Keynes, and argued that instability is *endogenous to finance*. Like Keynes, Minsky linked the monetary mechanism to the cost of capital as well as the financing of investment. Investment occurs when profits are foreseen in both spheres. Considering firm balance sheets, repayment schedules, and future income uncertainties, Minsky identified three profiles – hedge, speculative and Ponzi.<sup>5</sup> Periods of stability and expansion breed euphoria and speculative bubbles which, when they are eventually popped as credit is tightened, create crises which engulf firms with even sound profiles: ‘Borrowers attempt to sell assets to repay liabilities, which causes the value of the assets to plunge further, as investors sell position to make position, creating a downward spiral in which everyone is a seller and prices continue to fall, causing even hedge units to be driven into speculative and then Ponzi financing’ (Kregel, 2004: 5). Bernanke’s (2015) account of how the US subprime mortgage crisis morphed into a full-blown financial crisis, and then an economic crisis.

Kregel (2004) applies Minsky’s repayment profiles to financing for development. In the case of domestic business firms, repayment obligations are generally known, or under control of the firm, while uncertainty lies on the side of income. Developing countries, on the other hand, face uncertainties both in respect to their repayment schedules, and in the case of exports, due to exchange rate movements. In the early postwar period most international lending was to industrialized countries, under conditions similar to ‘hedge’ or ‘speculative’ financing. From the 1970s, however, as international capital flows increased, and following the sharp rise of interests rates in the US in 1980, Latin American countries in particular saw their speculative profiles become Ponzi ones. The result was a series of crises, and a ‘lost decade’ of growth and political instability, which the opening of capital accounts prolonged. Kregel (1998) also applied this perspective to the countries engulfed by the Asian Financial Crisis.

## 2. Financialization

Observing the US, Minsky (1992) described four models of structured relations between finance and business (and households), dominant in successive eras, or stages, with some overlap. *Commercial capitalism* involved the financing of goods that were traded or processed. The main instrument was the bill of exchange, and it corresponded to the structure of finance when production was small in scale. The second was *finance capitalism*, in which non-labour costs – machinery – became more important and the corporation emerged as the dominant form of ownership. Here markets for stock and bond flotations were created under the organization of investment bankers (in Germany universal banks played this role, as noted), some of whom, like J.P.Morgan, became extremely influential, both politically, and in the process of industrial concentration.

Third, *managerial capitalism* emerged after the Wall Street crash of 1929, the Depression, New Deal and Second World War. Here the government played a much larger role, supporting mortgages and the institutions which finance them, and maintaining aggregate demand. This ensured a level of profits which enabled companies to finance their needs

4. Schumpeter 1934: 226.

5. In a *hedge* profile firms have a sufficient cushion to cover future repayments, even with unexpected income disturbances. In a *speculative* profile firms are still viable (they have positive net present value) but there may be short periods in which repayments can’t be covered from cash flow and reserves. In a *Ponzi* profile the business itself is not or no longer viable, and the firm needs new finance simply to cover debt obligations.

from internal cash flows, enhancing managerial autonomy. Finally, under *money manager capitalism* from the 1970s the financial sector became unshackled and capital-gains-oriented blocks of managed money became a major influence. Minsky viewed this stage with deep concern:

*Today's narrowly-focused financiers do not conform to Schumpeter's vision of bankers as the ephors of capitalism who assure that finance serves progress. Today's financial structure is more akin to Keynes' characterization of the financial arrangements of advanced capitalism as a casino' (Minsky, 1992: 113).*

Unsurprisingly, there has been an upsurge of interest in these views, and the downside of financial innovations, as financial crises have proliferated since the 1980s. Leathers and Raines (2004) criticize Alan Greenspan's appropriation of Schumpeter to defend financial innovations and de-regulation in the US, which they characterize as 'reckless finance' and speculative excess, which Schumpeter disapproved of. Analyzing the build up to the Global Financial Crisis of 2007-08 in terms of Minsky's money manager capitalism, Wray (2009; 2011) also argues that the crisis was the culmination of countless financial innovations, and more systemic changes which reversed the relationship between finance and the real economy. It was overseen, he suggests, by financial and political elites which he dubs the 'predator state.'<sup>6 7</sup>

The term 'financialization' has been applied to these developments, although it is a slippery one. Increasing financial sector activity in itself is not evidence of a structural shift. Increased international activity by MNCs, for example, may require a number of balance sheet operations to develop a project, as well as increased hedging activity. Dividend payments from foreign direct investment become financial income (Mitchell and Toporowski, 2014). Yet quantitative growth in financial transactions has also been accompanied by qualitative changes in the relationship between the financial sector and other sectors of the economy.

Agreeing that industrial employment and GDP shares are not appropriate measures of financialization, Krippner (2005) argues for an 'accumulation centred' approach. She defines financialization as 'a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production' (p.12). Profits thus accrue increasingly to the financial sector, and to financial activities (interest payments, dividends and capital gains on investments) of non-financial firms, which she empirically demonstrates for the US. Epstein's broader definition is also widely cited. He sees financialization as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of domestic and international economies' (Epstein, 2005: 3).

Lapavistas (2011) emphasizes three concrete, inter-related features: Large corporations rely less on banks, and acquire their own financial capacities; banks shift from traditional business lending to mediation in open financial markets as well as transacting with households; and households themselves become increasingly oriented towards financial activities. Looking briefly at each of these in turn, and again focusing on the US, from the 1970s, corporate managers came under pressure to manage for shareholders, partly as a result of failed diversification efforts and declining profits (Useem, 1996). They were disciplined by 'markets for corporate control' and incentivized by stock options, orienting them towards financial markets, to which they increasingly went when they needed finance. Under pressure to focus on core value adding activities, they restructured their organizations, slashed their workforces and sought flexibility from those left. Lazonick (2015) characterizes this as a shift from 'retain and reinvest' to 'downsize and distribute,' and argues that the shift has fundamentally undermined the ability of US corporations to innovate.<sup>8</sup>

For their part, financial firms shifted from using deposits for loans which they kept on their books until maturity ('originate-to-hold'), to trading a range of products, including corporate loans, funded by a range of sources ('originate-to-distribute': Bord and Santos, 2012; Lazonick and O'Sullivan, 2000). The 'originate-to-distribute' model stimulated growth in the syndicated loan market, the secondary loan market, and in collateralized loan obligations.<sup>9</sup> This shift also provided a stimulus for the huge growth in nonbank financial intermediation chains – the so-called shadow banking system.<sup>10</sup> These activities became increasingly distant from production and exchange of conventional goods

6. 'That is, the predator state is a Big Government operating in the interests of money managers under cover of laissez faire marketing – and this played a key role in the transition from paternalistic to money manager capitalism' (Wray, 2009: 815). Wray is probably drawing on Veblen's (1904) concept of predation and predator capitalism, as well as Galbraith's (2008) *The Predator State*.

7. Paul Volcker, an earlier Fed Chairman, famously commented in 2009 that the most useful 'financial' innovation over the past two decades had been the automated teller machine.

8. Cf. also Lazonick, 2009. Stockhammer (2004) attempts to quantify the impact of such financialization on investment, cautiously finding support in the case of the US, UK and France.

9. The scale of these markets rose from \$339 billion in 1988 to \$2.7 trillion in 2007, \$8 billion in 1991 to \$176 billion in 2005, and under \$20 billion before 2003 to \$180 billion in 2007 respectively (Bord and Santos, 2012: 21-22).

10. Pozsar et.al (2010: 9) estimate gross liabilities of the shadow banking system in June 2007 at \$22 trillion, as against \$14 trillion for banks.

and services (Fine, 2014), and they created commodities which could be compared and traded across space and time.

Banks also turned to households and individuals with mortgages and other financial products. Household borrowing increased substantially, and as did ownership of financial assets – most significantly of housing, but also money market accounts, pensions, insurance, etc. And with the retreat of the state from the provision of a range of services ‘workers’ consumption has become increasingly privatized and mediated by the financial system’ (Lapavistas, 2011: 620).

These developments have gone further in the US and UK, which were historically more market-based, than late developers such as Germany and Japan, in which banks played a larger role in intermediation, for developmental purposes. Nonetheless, as Zalewski and Whalen (2010) show using IMF Financial Index data from 1995 and 2004, financialization advanced broadly in developed countries, albeit more in Anglo-American countries, and less in continental European and Nordic countries.<sup>11</sup> (They also show a corresponding rise in inequality, most strongly in the Nordic countries, albeit from a low base – and argue that the variable impact may be due to welfare and egalitarian public policies.)

### **‘First’ versus ‘second’ financialization**

There are both similarities and differences between the financialization of the late 19<sup>th</sup>-early 20<sup>th</sup> century and that of a century later (Minsky’s finance capitalism and money manager capitalism). The first occurred in the context of industrialization of the Global North (and de-industrialization of the Global South), and the emergence of ‘late developers’ such as Germany, which were attempting to shift from ‘Ricardian’ strategies of exporting agricultural and labour-intensive products, to ‘Kaldorian’ industrialization strategies (Schwartz, 2010). With multiple states pursuing similar strategies at the same time, and needing to maximize their production to recoup their Kaldorian investments, the result was overproduction and depressed prices. It did not help that they were being inserted into the global economy on the gold standard when supplies of gold were not expanding (ibid). The Great Depression, starting in 1873, pushed millions into poverty or migration.

The first financialization took place in this context. It fused commercial, industrial and banking interests into banker-dominated finance capital, a ‘capitalist oligarchy’ which in Germany’s case sought to create a ‘centralized and privilege-dispensing state’ (Hilferding, 1981 [1910], pp.370; 301). Writing at roughly the same time in the US, Veblen (1904) pointed to the transition to large corporations and the growth of intangible assets, which had become central to capitalization. Leaders of large corporations found they could affect their share prices through production, or conversely the disruption of production, as well as manipulation of information.

*It follows... that under these circumstances the men who have the management of such an industrial enterprise, capitalized and quotable on the market, will be able to induce the putative and actual earning-capacity, by expedients well known and approved for the purpose, partial information, as well as misinformation, sagaciously given out at a critical juncture, will go far toward producing a favourable temporary discrepancy of this kind, and so enabling the managers to buy and sell securities of the concern with advantage to themselves (Veblen, 1904: 156-7).*

Veblen believed this had a negative impact on (industrial) innovation, and lamented how many engineers had become willing to serve as ‘lieutenants’ to business men and the captains of industry.<sup>12</sup>

The second financialization, on the other hand, followed a sustained period of postwar prosperity in many countries, albeit with slowing growth, inflationary pressures, and the end of the US gold standard and Bretton Woods system. It accompanied de-industrialization of the Global North (and partial industrialization of the Global South). Vercelli (2014) proposes a number of further differences. First, the power of finance over the productive economy was ‘extrinsic’ in the first financialization, and ‘intrinsic’ in the second (although Veblen might disagree). Second, the former was bank-based, and the second market-based. Third, the former saw a geographical expansion through imperialism and colonialism; the second an ‘invasion’ of the ‘territory’ of the welfare state – into health, education and pensions. And fourth, in the second financialization central banks directed their efforts to supporting finance, implicitly insuring financial investment and speculation (others might disagree that this is different as well; cf. Ahamed, 2010). Whether interpenetration of the financial sector with other sectors of the economy, including households, has raised systemic risk to much higher levels relative to the first financialization is hard to know.

11. The Index weights market-based and new banking activities related to securitization relative to traditional banking.

12. ‘Addiction to a strict and unremitting valuation of all things in terms of price and profit leaves them by settled habit, unfit to appreciate those technological facts and habits that can be formulated only in terms of tangible mechanical performance; increasingly so with every further move into a stricter addiction to businesslike management...’ (Veblen, 1921: 39). Lazonic’s views, cited above, strongly echo this censure.



### 3. Financialization of developing countries

Lapavistas' three inter-related features of financialization in developed countries can also be found in developing countries. Bonizzi (2014) finds increasing investments of non-financial firms in financial activities, the espousal of shareholder value corporate governance, and 'over-capitalization' (holding substantially more financial assets than those needed for productive activities). Within the financial sector there has been a move towards market-based systems, expansion of stock markets, changing role of banks, and rise of institutional investors.

Bonizzi cites as paradigmatic the case of Cagmas in Malaysia, 'a state-led financial institution set up to facilitate the availability of affordable housing, which slowly turned into the biggest securitization provider in the country.'<sup>13</sup> In neighbouring Singapore, too, banks have merged, and transformed from traditional banking service providers to 'more complex financial institutions offering an extensive and sophisticated array of financial products and services to an expanded customer base in regional and global markets' (Lai and Daniels, 2015: 2). Singapore is no longer an emerging economy, but the rapidity with which the Development Bank of Singapore, which provided long term financing in the 1960s and 1970s, was transformed into DBS, a regional financial services powerhouse, is emblematic (ibid.).

Not surprisingly, processes of financialization in developing countries are influenced by the context of their emergence, and their integration with global capital flows and markets. Postwar international development policy stressed the importance of high and stable capital flows from developed to developing countries, but in reality, capital flows were often neither high, nor stable.<sup>14</sup> ; The surge in the 1970s, moreover, was followed by a sharp reversal, creating financial crises which became sovereign debt crises. 'The conventional wisdom that emerged emphasized getting a country's fiscal house in order, and letting markets do the rest' (UNCTAD, 2015: 41). Structural adjustment programmes targeted (among other things) public sector expenditures, de-regulation and capital account opening. Private capital inflows surged in the 1990s, the crises continued.

To avoid them, developing countries had to build large external reserves, through the purchase of US Treasury bonds, but also securitized mortgage-backed assets, which were considered relatively safe (and ironically fed the US housing bubble). The creation of large financial reserves, including sovereign wealth funds, and accompanying sterilization policies also expanded the balance sheets of developing country banks, contributing to financialization. Foreign banks, which had become a major presence in many developing countries (sometimes through post-crisis 'fire sales') 'are often key agencies in transmitting "financialized" practices, that is, they obtain high profits through activities unrelated to lending, such as trading, as well as through fees and commissions and aggressive household lending' (Bonizzi, 2014: 91).

In its pessimistic review of the effects of integration of developing and transition economies (DTEs) into the global financial system, UNCTAD (2015: 27) argues that 'there has only been a weak link between the integration of most DTEs and their long-term development.' Indeed, DTEs have become more vulnerable to short-term speculative capital flows, and the risks of financial boom-and-bust cycles. Such flows 'alter prices and influence policy in ways that compromise the potential for sustainable growth and development' (p.28).<sup>15</sup>

#### *Foreign direct investment*

Foreign direct investment (FDI) to – and from – developing countries has surged since the 2000s.<sup>16</sup> FDI is often seen as more stable than portfolio investment, and both are seen as more stable than debt. Because of this, in addition to the build-up – and use – of foreign currency reserves by developing countries, volatility of flows has been more muted in the 2000s than in the previous three decades. FDI is often seen as a long-term commitment, which can bring with it much-needed technology, expertise and network connections. It can stimulate local businesses to raise their game through independent efforts at innovation as well. For these reasons, it is often viewed more favourably by developing countries than other types of finance, especially debt.

13. Bonizzi, 2014: 90-91. He might also have added 1MDB, set up in 2009 to make Kuala Lumpur a financial centre, which became embroiled in scandal in 2016.

14. Brazilian President Vargas complained in 1951 that Brazil had been experiencing negative net capital flows from 1939: Kregel, 2004: 2.

15. UNCTAD's review is titled 'Financialization and its Discontents.'

16. In 2014, 55% of global FDI was directed to developing countries (and roughly two thirds of this went to developing Asia, particularly China and Hong Kong: UNCTAD, 2015). By sector, roughly two thirds of the global stock of FDI was in services, a quarter in manufacturing, and the balance in the primary sector. From 1990-2012 the share of services rose from 49% to 63%, while the share of manufacturing dropped from 41% to 26%, a shift which can be seen in both developed and developing countries. M&A has become more prominent over time (ibid).

But the extent of spillover effects is strongly contested, with high value added activities and key decisions typically concentrated in the home country/headquarters, and lower value adding activities in subsidiary host countries. Moreover, as Kregel (2014) argues, multinational enterprises (MNEs) have various mechanisms to make their investments more liquid, so the distinction with debt can be more apparent than real. And third, MNCs have become increasingly financialized, one aspect of which is the use of ‘offshore hubs.’ Some 30% of cross-border corporate investments are routed through such hubs, largely – but not exclusively – for ‘tax planning’ purposes. Tax planning – or avoidance – structures and strategies affect both developed and developing countries, but are particularly consequential for developing countries, and may negate the incentives they offer to attract FDI in the first place. UNCTAD (2015: xiii) estimates that while MNE foreign affiliates contribute \$730 billion in taxes to developing countries annually, an additional \$100 billion may be lost through these mechanisms. That is most likely a very conservative estimate.

UNCTAD (2016) estimates that 40% of foreign affiliates worldwide have ‘multiple passports’

*“Multiple passport affiliates” are the result of indirect foreign ownership, transit investment through third countries, and round-tripping. About 30 per cent of foreign affiliates are indirectly foreign owned through a domestic entity; more than 10 per cent are owned through an intermediate entity in a third country; about 1 per cent are ultimately owned by a domestic entity. These types of affiliates are much more common in the largest MNEs: 60 per cent of their foreign affiliates have multiple cross-border ownership links to the parent company’ (UNCTAD, 2016: xii).*

The top 100 MNEs on UNCTAD’s Transnationality Index have ‘on average more than 500 affiliates each, across 50 countries. They have 7 hierarchical levels in their ownership structure (i.e. ownership links to affiliates could potentially cross 6 borders), they have about 20 holding companies owning affiliates across multiple jurisdictions, and they have almost 70 entities in offshore investment hubs’ (UNCTAD, 2016: xiii)!

Proponents of such structures claim they are necessary to handle complex investment and taxation issues – to avoid double taxation, for instance – and to provide stability in a complex and uncertain world. They are ‘the grease on the wheels of international trade.’<sup>17</sup> However UNCTAD (2016: 21) notes that a sample of MNEs from 25 developed countries booked more profits in Bermuda than China in 2014 (\$44 billion versus \$24 billion), and those profits were almost eight times the GDP of Bermuda! Holding company structures have become very complex, and are very difficult for tax authorities and experts to understand. Their complexity is somewhat reminiscent of the structures of combinations and trusts of the first financialization, only now they are orders of magnitude larger, transnational in scope, and effectively operate in a regulatory no man’s land.

#### 4. Financialization and the state

While most studies of financialization consider changes in the economy, there is a growing interest in the role of the state in financialization, and indeed in the financialization of the state itself. The state is largely implicit or passive in some perspectives, but active and contested in others. In the Singaporean case cited above (Lai and Daniels, 2015), the state’s policies are seen to still be developmental; finance is a new industry to be promoted. The nature of the state itself is constant. From a states-versus-markets perspective, the state is encroached financialization, which eats into the ‘territory’ of the state in areas such as pensions, health and education (cf. Vercelli, 2014, above). *Policy space* is also encroached. Without using the concept of financialization, Wade (2003) depicts growing policy constraints on developing countries as follows:

*‘Developing countries today, as a group, are being ever more tightly constrained in their national development strategies by proliferating regulations formulated and enforced by international organizations. These regulations are not about limiting companies’ options, as ‘regulation’ normally connotes; rather, they are about limiting the options of developing country governments to constrain the options of companies operating or hoping to operate within their borders. In effect, the new regulations are designed to expand the options of developed country firms to enter and exit markets more easily, with fewer restrictions and obligations, and to lock-in their appropriation of technological rents’ (Wade, 2003: 621-22).<sup>18</sup>*

17. ‘Wealth structuring expert’ cited in Financial Times, 7 April, 2016 (‘Tax Havens are a Cog in Global Economy, Say Defenders’).

18. Akyüz (2009), too, argues that globalization and liberalization have impacted on the policy space of developing countries in two mutually reinforcing ways. First, their own dismantling of trade and capital restrictions makes them more susceptible to external conditions – such as financial shocks – and weakens the impact of national policy. Second, as Wade argues, international rules and obligations reduce developing countries’ control over policy instruments. Governments of countries with structural weaknesses and high dependence of foreign capital in particular have constrained policy space, and are less willing to use what space they have.

These firms, needless to say, include FIRE (finance, insurance and real estate) and financialized firms. Under such pressures, moreover, some state actors will be constrained and others will be empowered, notably those who will gain from allying themselves with external (and internal) financial interests, or who have a cultural or ideological affinity with them.

The balance of power within states is thus influenced by, and influences, financialization. As the first modern industrializer, and de-industrializer, Britain was an early convert. Finance and industry were always divided to some extent (Ingham, 1984) under 'gentlemanly capitalism' (Cain and Hopkins, 1980; 1993).<sup>19</sup> The postwar balance was overturned following the IMF bailout in 1976, an early example of conditionalities, and Mrs Thatcher's subsequent accession in 1979. These led to greater Treasury oversight and control of government department budgets, and strengthened the Treasury while weakening the Department of Trade and Industry (DTI). Mrs Thatcher accentuated this for political reasons (Davis and Walsh, 2015). The Treasury 'attempted to remake the DTI in its own image, subjugating its alternative economic outlook to that of its own. In the process, the UK financial sector was continually boosted while its core industrial base was undermined and further placed in the hands of its London-centred financial sector. This was not simply a lurch towards free markets, but a particular economic policy paradigm that advantaged finance and aided the financialization of UK industry' (ibid, p. 1). Investment in financial services grew by 320 percent between 1979 and 1989, while that in manufacturing grew by a mere 13 percent (ibid.).

Britain is by no means alone in intra-state struggles and rebalancing. Werner (2003) describes how, even in Asia's original Asian developmental state, the Bank of Japan waged a long-running campaign not just to gain independence, but to fundamentally reshape Japan's economic policy, believing that the postwar system which had delivered unprecedented growth was now becoming a liability. Werner suggests that the BOJ went so far as to accentuate Japan's bubble and undermine its recovery to achieve these ends. The politics may be debated, but it is clear that the government's support for Japan's industry-led postwar model switched to actively trying to dismantle it from the 1990s, and that a neoliberal, financial view of wealth generation steadily gained influence.

In these analyses, financialization of the economy is accompanied by, or preceded by, a changing balance of power within the state. Indeed, the rise of monetary policy administered by independent central banks using inflation targeting simultaneously changes the economy and the state. In developing and transition countries in particular, dependence on foreign capital and integration into global financial markets has effectively meant adopting these policies, thereby ensuring that the interests of international investors are prioritized, as Wade suggests.<sup>20</sup> Gabor (2015), for example, details a two-stage process of financialization of the Romanian economy, designed by the state under IMF guidance. The first stage, 'central-bank led financialization,' changed relational banking into arms-length relations between finance and industry through tight monetary policies and exchange rate flexibility. The second stage of 'dependent financialization' privileged transnational financial actors in the incorporation of Romania into European financial structures.

Why, Epstein (2005) asks, has inflation targeting by independent central banks become so widespread despite a lack of convincing evidence supporting the claims of its proponents (apart from inflation reduction)? The answer, he suggests, is that it increases the power of 'rentier interests' and insulates them from the influence of democratic forces over central bank policy. In other words, it is not simply a matter of policy, or a changing balance of power within ministries, but a highly political process as well. Nowhere is this more apparent than in the US itself.<sup>21</sup>

Finally, financialization not only concerned with changing policies and politics, but it has become a part of state governance and management processes as well. In Italy, for example, an alliance of pro-market technocrats and centre-left politicians came to power in Italy, and from 1993 to 1999 used a series of financial innovations to both bolster their power, and to entrench it by participating in the EMU. One unfortunate result of their (mis)use of derivatives was huge mark-to-market losses, which have recently come to light (Lagna, 2015).

19. '(T)he gentlemen of the City were well placed, by virtue of social and physical proximity, to carry their interests into the corridors of power in London, unlike British industry, which suffered from being heterogeneous, small scale and provincial' (Cain and Hopkins, 1993: 87).

20. Inflation targeting and related policies 'are designed to create a neo-liberal central banking structure, that is, a central bank that is consistent with an economy with a small government role, privatized industries, liberalized financial markets, and flexible labor markets. These central bank proposals include adopting central bank "independence", and in developing countries, adopting currency boards, and/or substituting a foreign currency -- most commonly the dollar -- as domestic legal tender' (Epstein, 2005: 3). If a key institutional feature of the developmental state was a 'pilot agency' (MITI in Japan's case, the Economic Planning Board in Korea's case), its counterpart in the financialized state is an independent central bank.

21. Cf. Wray (2009), cited above. Galbraith contrasts the 'New Industrial State' analyzed by his father with the emergence of the 'Predator State' – 'a coalition of relentless opponents of the regulatory framework on which public purpose depends, with enterprises whose major lines of business compete with or encroach on the principal public functions of the enduring New Deal' who 'have no intrinsic loyalty to any country' and 'operate as a rule on a transnational basis' (2008: 131).

In a completely different state context the Chinese government revamped its relations with state owned enterprises. Born out of budget constraints, and central government alarm at wildcat privatizations in the initial stage of SOE reform, the measures created a whole new asset management structure which simultaneously enabled the state to maintain control over SOEs as the key shareholder, to pursue restructuring and efficiency improvements, and to tap external sources of finance. The measures provided a huge boost to China's stock markets. Wang (2015) calls it the 'shareholder state' and argues that the shift from 'managerialism' to 'shareholder value' parallels what happened in Western corporations from the 1960s to 1990s, but in China's case the combination of 'state developmentalism and entrepreneurship coupled with financialization' created 'a new stage of late development' (pp.608; 604). It appears that at least some of the governance processes or techniques associated with financialization can be applied outside neoliberal contexts, for different purposes, and under different political coalitions or configurations

To see the state as deeply involved in financialization in both developed and developing countries is only natural from a Polanyian perspective. The British state, Polanyi argued, was not a passive bystander or victim of nineteenth century liberalism, but its architect and enforcer: The 1830s and 1840s 'saw not only an outburst of legislation repealing restrictive regulations, but also an enormous increase in the administrative functions of the state, which was now being endowed with a central bureaucracy able to fulfill the tasks set by the adherents of liberalism' (Polanyi, 1944:145). The utopian – or dystopian – self-regulating market required constant intervention, and where necessary, state-sanctioned violence, at home and abroad.

From a Polanyian perspective, the underlying dynamics between the first and second financialization are similar. They reflect the quest by the 'rentier class,' in conjunction with the state, to create self-regulating markets through a process of 'dis-embedding' from social constraints. Polanyi's work stands as a warning to the consequences of this utopian project, which destroys the social foundations required to maintain it, and the tensions between economic liberalism and democracy. We will return to this view in section 4, when we consider the state and financialization.<sup>22</sup>

## 5. Premature financialization?

Financialization is a feature of developed, developing and transition economies. Indeed, it is a global phenomenon. But the implications are different for different types of countries. Here we consider implications for developing countries. As noted in the first section, finance is crucial for economic development, but developing countries initially face severe limitations in its availability. To accelerate economic development, international development finance was promoted in the postwar period. Reforms aimed at 'financial deepening,' sometimes imposed through loan conditions, were also justified on this basis. However, a growing number of studies have pointed to a 'vanishing effect' of financial deepening (Rousseau and Watchel, 2011). Arcand, Berkes and Panizza (2012: 1) found that 'at high levels of financial depth, more finance is associated with less growth.' They found an inverted U – bell shaped – relationship between depth and growth, similar to that of Easterly, Islam and Stiglitz (2000), who examined the relationship between financial depth and volatility of output growth. In both cases, the curve peaked when credit to the private sector reached approximately 100% of GDP. Similarly, in their study of financial deepening, access and efficiency, Sahay et.al. (2015) found a bell curve associated with deepening, and a negative impact on total factor productivity growth beyond a certain point.

Other researchers have posited a link between financialization and de-industrialization (and sometimes reprimarization) in developing countries, especially in Latin America.<sup>23</sup> Given that such a link has been posited in developed countries, it is worth considering. In particular, is there a link between financialization on the one hand, and 'premature de-industrialization' (Dasgupta and Singh, 2006; Rodrik, 2014) or 'simultaneous industrialization and de-industrialization' (Whittaker *et.al.*, 2010) on the other?

'Premature de-industrialization' highlights the diminishing share of manufacturing employment in recent developers relative to earlier developers. Another inverted U or bell-shaped curve has been found, between the employment share of manufacturing and per capita GDP; it rises, peaks, and then declines as de-industrialization. This is a general pattern, but the bell curve has changed over time. The height has fallen, meaning that manufacturing has come to absorb a smaller share of the working population than previously, and the peak has moved to the left, meaning that de-industrialization has been starting at increasingly lower levels of per capital GDP. Rodrik (2015) and Felipe *et.al* (2014) find a 'premature' fall in both the employment share of manufacturing and manufacturing output in developing countries, but particularly in employment. It is 'premature' not only because it is happening earlier, but also because of

22. Cf. Block and Somers (2014); Levitt (2013).

23. E.g. Cibils and Allami (2013), Demir (2007), and Levy-Orlik (2014).

its negative effects on economic growth (and democracy).

By Palma's (2005: 9) calculation, the peak moved from \$20,645 in 1980 to \$9,805 in 1990 and \$8691 in 1998 (in 1985 international US\$). Palma considers a number of reasons behind this double trend, including neoliberal policies and monetarist economics policies ('massive institutional and financial transformations') from the 1980s as well as productivity catch-up. He proposes a 'Dutch disease' effect from new primary commodities on the one hand, and services, including financial services, on the other. Thus there are two links between financialization and premature de-industrialization in his analysis, although he does not use the former term.

Although the analogy is imperfect, it might also be possible to talk about 'premature financialization' in developing countries, in two senses.<sup>24</sup> First, rather than financialization happening *after* the establishment of a financial system primarily to support industrialization, in a supporting role, the financial sector has come to assume a leading role *simultaneously* with the development of financial infrastructure. It is 'premature' relative to the development of finance. Second in its relationship with industrialization, financialization coincides not with a post-industrial transition, but with industrialization itself. Not simply coinciding, it contributes to 'premature de-industrialization.' Non-financial firms are financialized from a very early stage of their development; sectors such as real estate receive large injections of finance, creating early bubbles; and household finances become financialized.

This is admittedly speculative, and it might be countered that industrializers of the late nineteenth century also experienced financialization as they were setting up their central banks and financial systems. But this was a different kind of financialization. The newly created central banks of late developers in the 1870s were used to cushion shocks and allocate stresses transmitted by the gold standard, while bank-led cartels and mergers restricted competition rather than intensifying it (Polanyi, 1944). Moreover, the period was followed by substantial reforms and financial regulation as countries left the gold standard in the early 1930s, and finance was heavily regulated. By contrast, the recent financialization removes buffers to international competition, and imposes a monetary straightjacket tighter than that of the gold standard in practice.

More work is clearly needed to establish a link between financialization and 'premature de-industrialization' in developing countries. At the very least, however, it suggests a need to consider appropriate forms of finance for development in place of a simplistic belief in the virtues of financial deepening, or ideological belief in the virtues of self-regulating markets, including financial markets.

Returning to the Schumpeterian perspective, Mazzucato (2013) considers 'appropriate' finance for innovation. Dismissing the 'romanticization' of venture capital, she argues that this is actually a poor fit for the needs of many startups, especially in science-based sectors, or sectors in which the knowledge base is complex and uncertain. In the case of large firms, she agrees with Lazonick (2007) that the financialization of US corporations, and pressure from shareholders, results in a focus on share price maximization rather than innovation for the long term. The financialization of banks, moreover, has left them unable or unwilling to distinguish between different risk profiles – of the 'good' risk arising from R&D uncertainty versus the 'bad' risk of weak performance, high debt and speculative activities.

Mazzucato concludes that financial markets should be reformed to support rather than hinder innovation. Regulation of financial markets and the de-financialization of real economy companies should be coordinated with innovation and industrial policy to incentivize and reward value creation activities over value extraction. A similar logic applies to financing for economic development. Given that instability is endogenous to finance, and that facilitation can turn into predation (or value creation to value extraction), it is vital to ensure that developing countries have appropriate financial structures, markets and regulations. If not, what promises to offer the shortest path – through untrammelled financial deepening – may turn out to be the most perilous.

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24. 'Premature financialization' is not intended to imply that 'mature' financialization is a natural process. For Arrighi (1994), financialization is a 'sign of autumn' for a hegemonic power, as it exhausts sources of profits from commerce and industry. 'Premature' here would suggest autumn coinciding with spring.

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