Financialisation

a primer

transnationalinstitute

ideas into movement

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Introduction to Financialisation

1. What is financialisation and why is it important?

Financialisation is a relatively new term, which covers such a range of phenomena that it is difficult to define precisely. The most-cited definition, from Gerald Epstein, states: "financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies"[1].

This broad definition reflects the ***multi-faceted*** nature of the financialisation process. The concept unveils the interconnectedness of the global political economy and illuminates the unprecedented influence that financial intermediaries and technologies exert over our daily lives. Financialisation involves changes to our economy and society at three basic levels: within the financial sector itself, within productive industry and its relation to finance, and within the 'average' household.

The USA is at the epicenter of financialisation and the role of the US dollar as an international reserve currency - the currency countries use to trade with each other and to 'store value' in their central banks - has meant that developments in the USA affect the rest of the world. Furthermore, all countries are impacted by financialisation through the power and influence of global financial markets.

One of the immediate reasons why financialisation matters is that the 2007-2008 financial crisis and the subsequent global recession was a consequence of this multifaceted process. Financialisation continues apace and is likely to cause further crises. Generous quantitative easing policies in the US, Japan and Britain, for example, have pushed financial asset prices above pre-crisis levels. Even the Bank of International Settlements is warning that private sector debt and leverage has swelled to a dangerous point again. As the 2013 UN ***Trade and Development Report*** noted: "The dominance of finance over real economic activities persists, and may even have increased further. Yet financial reforms at the national level have been timid at best [... while] reform has all but disappeared from the international agenda"[2].

Financialisation has increased inequality, slowed down investment in 'real' production, mounted pressures on indebted households and individuals, and led to a decline in democratic accountability.

KEY CONCEPTS

QUANTITATIVE EASING is a monetary policy where central banks buy long-term bonds from private investors, like pension funds or insurance companies, using newly created (digital) money. The aim is to inject liquidity into financial markets and keep interest rates low. Governments hope that this will encourage borrowing and jump-start demand in the economy. The Bank of England found, however, that gains from quantitative easing have mainly benefited the wealthy.

LEVERAGE is the ratio of a company's debt to the total value of its equity (assets minus liabilities such as loans or outstanding payments to a supplier). Increasing leverage means companies take on more debt despite the value of their equity remaining unchanged. A company may choose to use borrowed money to increase investment (with the aim of boosting profits) if credit is cheap and/or if the interest paid is tax deductible. Leverage can prove risky (leading to default) if investments go wrong or asset prices fall - like in the last financial crisis.

What an individual or company owns is their ***ASSET.*** A house is an asset, as is crude oil. Financial instruments - such as stocks and bonds - can also be considered assets. People and companies can use assets to borrow money against. It works as the collateral for a loan. Yet if asset prices fall, then the value borrowed may be more than the value of their property and they could face bankruptcy if they can't repay their loan.

Apart from its role in the global economic crisis, research has shown that financialisation has increased inequality, slowed down investment in 'real' production, mounted pressures on indebted households and individuals, and led to a decline in democratic accountability. Clearly the impacts of financialisation have far-reaching implications for human wellbeing, but there is also the possibility for citizens across the world to resist the 'hegemony of finance' and push for change. Such changes will not only depend on mobilisation, but also on greater understanding of the problems and challenges we face.

2. How have global financial markets changed?

While the beginnings of financialisation can be traced back to the 1950s, it was the fall of the Bretton Woods monetary system (defined by the use of gold-backed dollars as the international currency, fixed exchange rates, and limited capital mobility) in the early 1970s that accelerated growth in global liquidity and prompted a surge of financial liberalisation and deregulation. Floating exchange rates and unregulated capital flows presented hazards for many, but also provided opportunities for financial innovation (such as derivatives) to deal with these risks and for speculation to profit from them.

The value of global financial assets soared. Not only did financial markets grow in absolute terms, they also expanded in relative terms: the value of global financial transactions rapidly surpassed that of 'real' production and commerce. For example, in 1973, the ratio of the value of foreign exchange transactions to global trade was 2:1, in 2004 this ratio reached 90:1[4].

New technology has played a critical role in the expansion of finance. For example, computerised trading is said to account for around 70% of financial "market activity" in the USA and just below 40% in Europe. High-frequency trading, as it is known, uses algorithms to sell or buy financial assets in fractions of seconds. Whilst in the 1960s, shares were held for about four years, nowadays "the average share" is "held for around 20 seconds"[6]. Information technology also facilitated 'credit scoring' and computational statistical models that enabled mass lending, previously hampered by banks reliance on time-consuming personalised credit risk assessments.

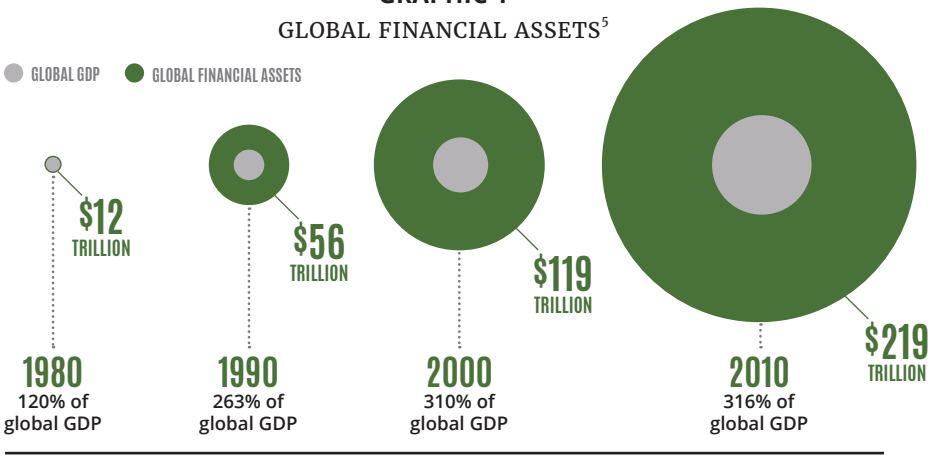
The expansion of financial markets is not only about the volume of financial trading, but also the increasing diversity of transactions and market players. In short, financialisation must be understood as radical transformation within the financial sector that has altered entire economies - from the household and the firm to the functioning of monetary systems and commodity markets.

THE END OF THE BRETTON WOODS SYSTEM

The USA, freed from the commitment to maintain dollar-gold convertibility, could now pay its debts with its own currency without significant constrictions in supply. The US deficit increased rapidly and with it the number of dollars or dollar-denominated financial assets in circulation, most of which ended up in the reserves of other country's central banks. Increased reserves allowed these banks to expand credit in their own economies and "world liquidity surged". This opened up new profit making possibilities in private financial markets, and those seeking to capitalise pushed for the dismantling of barriers to capital mobility and other regulations that limited their activities.[3]

GRAPHIC 1

GLOBAL FINANCIAL ASSETS[5]



3. How has banking changed under the process of financialisation?

Banking has changed dramatically in recent decades from the vision most people have of a local bank providing services of loans and savings for individuals and businesses. It now involves loans being repackaged, sold and traded, and speculation in global markets.

Under financialisation, we have seen the emergence of a 'shadow banking system' (SBS) - new types of financial institutions and practices (e.g. securitisation) that are not subject to the same regulations as traditional commercial banks. The SBS represents "more than a quarter of the entire financial system" and, as of 2011, was "bigger than it was before the financial crisis, despite growing efforts by regulators to rein it in"[7].

At the same time, many commercial banks have turned to households and investment banking (themselves getting involved in the SBS) as new sources of profit. In large part, this was a response to the loss of customary sources of income as corporations became more adept at seeking funds in financial markets and thus reduced their reliance on bank loans. It was this blend of 'financialised personal income' and investment banking practices that created the giant financial bubble and later crisis in 2008[8].

KEY CONCEPTS

INVESTMENT BANKS act as market intermediaries, offering financial services to large firms. For example, if a property developer wants to build a series of luxury housing blocks in London, it needs to find the capital to buy the land, sponsor the development, and advertise the investment. To raise this capital it will go to an investment bank that will help the company develop a financial security and sell this security to investors. Investment banks will often 'underwrite' the offerings of these securities. They also engage in 'trading', i.e. buying financial instruments for the short-term in order to sell on to others. In contrast, ***COMMERCIAL BANKING*** is about taking deposits and lending to consumers and businesses; thus commercial banks should have large reserves in case of defaults on long-term debts. The Glass-Steagall Act had forbidden the mixing of investment and commercial banking in the USA, but was repealed in 1999.

SHADOW BANKING institutions such as hedge funds, mutual funds and structured investment vehicles do not take deposits, but like commercial banks provide credit-type services to other banks and large companies. In that sense, shadow institutions are similar to investment banks, but are differentiated on the basis that they operate without government regulation and monitoring or in the 'shadows'. Many regulated commercial and investment banks engage in unregulated shadow banking activities through (e.g.) subsidiaries. Because shadow banks aren't regulated in the same way as normal investment and commercial banks, they can often raise and lend money more easily, though with substantially more risk.

INSTITUTIONAL INVESTORS are financial firms or organisations - including pension, hedge and mutual funds, investment banks and insurance companies - that trade and/or hold large quantities of financial assets. Institutional investors buy financial securities (bonds and stocks) directly, allowing companies to bypass banks when looking for funding. In the UK and the USA, institutional investors have come to own or manage around 70% of the stock market.[9] Institutional investors not only concentrate market power, but also typically have short-term horizons (e.g. fund managers are often judged on quarterly performance) and are characterised by 'herding' behaviour.[10]

4. What are the main impacts of 'liberalised' capital flows and currency markets?

According to UNCTAD, between 1980 and 2007 international capital flows expanded from $500 billion to $12 trillion. During the same time period, foreign exchange (FX) trading grew to become the biggest market in the world. This reflects the trend of capital account liberalisation - the removal of barriers to the free flow of capital in and out of the country and full exchange rate convertibility- and financial liberalisation more generally, since the 1980s and 1990s.

The IMF and other institutions had encouraged governments to dismantle capital controls, arguing that this would allow for a more efficient allocation of capital and thus encourage economic growth. 'Developing' countries, in particular, were supposed to benefit from capital inflows, given that, theoretically, investors would be attracted to the higher returns available in 'capital-scarce' economies.

Reality has proved quite far removed from the theory. First, there has been no robust evidence to support the claim that capital account liberalisation has positive impacts on growth[11]. Second, evidence does suggest that free capital movements have resulted in unprecedented volatility of exchange rates, stock market values and interest rates, and consequentially greater instability, including a greater probability of financial crises. Third, in the 2000s, capital flowed from 'developing' to 'developed' economies, rather than the other way around. In the wake of the global financial crisis from 2008, the IMF changed its stance to one of acceptance of capital controls - perhaps an implicit acknowledgement of the problems wrought by its earlier policy recommendations.

Short-term speculative interests play a central role in determining the direction of vast movements of global capital and – as such - foreign exchange rates. Instability can follow as investors move their money from place to place looking for better returns. A hasty inrush of capital may whip up a financial bubble, while a sudden outpour can exacerbate or even cause economic crisis. For example, rising interest rates in one country may cause capital to flock there to reap the benefits, leading to capital outflows in other countries. To complicate matters further, investors may engage in a 'carry trade', or borrow in the currency with a low interest rate in order to buy financial assets (e.g. stocks or bonds) or lend in the currency offering higher interest rates. The capital inflow caused by this arbitrage trading may lead the currency of the target country to gain value, which can negatively impact on exports (by making them less competitive in terms of prices) and only reinforces the speculative trend since investors may now gain from currency appreciation as well as interest rate differentials. The capital inflows may also cause inflation (as the inflow of capital may expand the money supply without necessarily increasing production), which is difficult to tackle given that raising interest rates would strengthen incentives for arbitrage further. This is just one example of how free capital flows limit national policy choices.

Essentially, countries are vulnerable to crises with external origins (at least partially) beyond their control.

KEY CONCEPT

In the ***CARRY TRADE*** firms borrow in one currency at a low interest rate in order to lend or invest in another with a higher interest rate (to profit from the interest rate differential). Because interest rates tend to be higher in 'developing' countries, these have become a key target in the carry trade, especially those with appreciating currencies (often this appreciation is caused by the carry trade itself because the inflow of capital attracted by the high interest rates translates into demand for the currency). Short-term loans in foreign currencies can increase pressure to hold large reserves, which imply significant costs, especially for people in the Global South (see box below).

If, or when, the carry trade - and as such the inflow of capital - is reversed (perhaps due to a sudden loss of confidence or a rise in interest rates in the funding country) it can cause enormous upheaval. A depreciation or devaluation of the target country's currency may be a cause or effect (or both!) of the capital outflows. Either way, participants in the carry trade who were not able to 'pull out' of the market before the depreciation or devaluation (which often include firms and banks from the target country itself) may not be able to pay back their debts in the loan currency which is now more expensive, leading to defaults, bankruptcies and possibly a wider credit crunch. It is worth noting that some speculators may have placed bets in the opposite direction and therefore stand to profit directly from the currency depreciation or devaluation. The Asian debacle of the late 1990s is the most cited example of the destructive impact of a carry trade 'unwinding', but this form of interest rate arbitrage/currency speculation also played a role in the 2008 global financial crisis[12].

The risks inherent in capital account liberalisation might make sense if the policy paid off, but according to UNCTAD, "unrestricted capital inflows generally have not been accompanied by a sustained increase of investment in real productive capacity; nor have they led to higher and more stable GDP growth rates". The reality is that most short-term capital flows and currency trades are speculative or have nothing to do with interest in real trade or productive investment abroad.

GRAPHIC 2

COMPARISON OF FOREIGN EXCHANGE TRADING
WITH TRADE IN GOODS AND SERVICES

FOREIGN EXCHANGE MARKETS[13]

Average value of daily trading in April 2013

$5.3 trillion

TRADE IN GOODS AND SERVICES[14]

Average value of WTO member (159 countries) daily exports in 2012

$58.9 billion

The value traded on foreign exchange markets in ***less than a week*** is more than what is sold in goods and services in an ***entire year!***

KEY CONCEPT

CURRENCY DERIVATIVES - the majority of foreign exchange (FX) trading is accounted for by OTC derivatives contracts. Since the collapse of the Bretton Woods system, more and more countries have abandoned fixed or pegged exchange rates and allowed - at least to a certain extent - the value of their currencies to be determined by supply and demand in the market. This implies constant fluctuations in exchange rates, which pose risks for firms across the globe. These companies may use FX derivatives as a sort of insurance (a way to 'hedge') to protect themselves them from potential losses due to exchange rate swings. However, many investors use FX derivatives not as 'insurance' or a protection strategy, but instead to place bets on particular currency movements.

OTC literally means ***OVER THE COUNTER,*** rather than through a formal exchange. Because OTC trading by definition is that which does not take place on a formal exchange, it is much harder to monitor and regulate.

The difference between the global financial markets and an ordinary casino, as pointed out by Susan Strange, is that people choose whether or not to take risks at the card table, whereas "casino capitalism" drags us all into the game involuntarily.[15]

CASE STUDY

Speculation "insurance"- how foreign exchange reserves lead the South to subsidise the North[16,18]

In response to the capital flow and exchange rate volatility experienced in the 1990s, many countries have adopted a strategy of 'protection' by accumulating foreign exchange reserves. These reserves can be used to defend the exchange rate by buying currency on open markets and to counteract other implications of sudden capital outflows; for example, the reserves provide a sort of 'insurance' against default on short-term external debt obligations. A large share of these reserves is held as US public debt, reflecting the dominance of the dollar as international currency and the presumed 'safety' of US government securities.

Though China is by far the largest holder of foreign reserves, the trend is evident across Asia, Eastern Europe, Latin America and Africa. As a result of this international reserve accumulation, net flows to 'developing' countries were negative between 2000 and 2008. In effect, this means that many middle income and poor countries became positive net lenders to wealthy countries - principally the USA.

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Reserve accumulation may sound like a wise policy, but it has major economic and social implications. First, countries renounce the possibility of using considerable portions of export earnings and capital inflows for productive investment or social spending, and instead divert them to amassing giant foreign exchange reserves or what is essentially a pricey insurance plan against speculative currency attacks and sudden capital flow reversals.

Second, the earnings on these reserves tend to be lower than what the government spends in order to upkeep the strategy. As noted by Painceira, "while developing country international reserves have increased enormously, their short-term external debt has also risen substantially". The costs of borrowing abroad are determined by commercial rates, but the payment received for lending abroad (or the interest earned on US government securities held in reserves) is low. Estimates of the cost to 'developing' countries vary: some suggest that it is close to 1% of GDP, while others put the annual loss at circa $100bn[19].

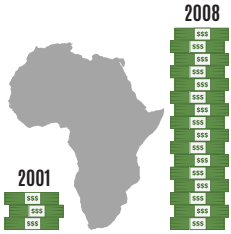
Third, most countries also have to 'sterilise' the potential inflationary effects of reserve accumulation. This means issuing government bonds (increasing domestic public debt), in order to absorb liquidity or remove money from circulation. These domestic bonds are usually issued at higher rates than the US government bonds held in reserves; the difference in interest rates, once more, means a loss for developing countries.

GRAPHIC 3

FLOWS FROM LOW AND MIDDLE INCOME COUNTRIES TO RICH COUNTRIES[17]

In 2008 the net flow of capital from developing to developed economies reached over USD

$800 BILLION



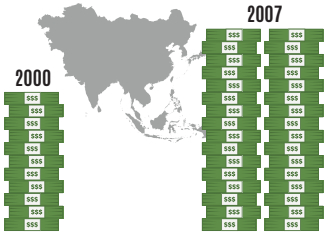
Sub-Saharan Africa increased its international reserves from USD

$35.5BN

in 2001 to

$163.5BN

in 2008.



Reserve accumulation in "developing Asia" (excluding China and India) rose from USD

$113.4BN

in 2000 to

$320.2BN

in 2007.

Knowing your CDOs from your OTCs

Unpacking the jargon

5. What is securitisation and how does it work?

Securitisation is the single most important innovation driving contemporary finance. It was described by British newspaper ***The Guardian*** as the "crack cocaine of the financial services" sector. Securitisation is the transformation of streams of future income into a financial security ready to sell straightaway. To give one example: rather than wait year after year for royalties on his records, David Bowie sold a financial security - a Bowie Bond - that investors could buy. Bowie gets the money straight away, the investor gets the royalties year on year. Securitisation can be applied to anything with a regular flow of income: mortgages, student loans, water services, road tolls, telephone bills, export earnings, wages of a sports star, tax revenues, or even 'sustainable' forest management. It means that rather than wait 25 years for a student loan to be repaid, for example, the loan company can sell off the rights to the repayment (at a discount) and get the money back straight away.

This has two main effects. First, securitisation means finance is forever looking for new sources of future income to transform. The game is to find assets and bundle them up in a way that (allegedly, at least) makes their income predictable and steady. Investors in securities like these, however, are essentially speculating: nobody can be sure Bowie will remain popular, just as nobody could be sure that subprime mortgages would be repaid.

Second, securitisation means there is no time to waste in issuing new loans. If a bank lends a company £1m and expects £100,000 back a year, rather than wait 10 years for its loanable funds to be replenished, it can sell a security for £900,000 straight away, and carry on lending. This means there is ***much*** more liquidity, allowing greater levels of borrowing in the economy.

KEY CONCEPT

SECURITIES are tradable financial instruments that represent either a debt owed (such as bonds or collateralised debt obligations - CDOs) or equity implying a real or potential ownership stake in a firm or asset (such as stocks or stock options, which reserve the right to buy a stock at a certain price on a particular date). The term 'securitisation', however, is not typically applied to the creation of traditional stocks and bonds, but rather new types of financial instruments that convert an income stream - such as mortgage repayments or telephone bills - into a security to be bought and sold.

Securitisation has been applied to an enormously diverse range of assets. For example, migrant's remittance payments and commodity export earnings have both been converted into collateral for financial assets (securities)[20] – with the backing of institutions such as the IMF[21]. Future-flow securitisations allow public and private entities access to low-cost credit in global capital markets, detached from official credit ratings and the economic performance (e.g. foreign exchange reserve levels) of their government. While it is argued they can improve liquidity, the risks are similar to those inherent in the securitisation of mortgages.

6. How did securitisation of mortgages lead to the US financial crisis?

US firms Fannie Mae and Freddie Mac are said to have first used the securitisation technique in the 1970s in order to resell home mortgages to outside investors. Mortgage-backed-securities were at the heart of the 2007/2008 financial crisis. In basic terms, mortgage securitisation involves a commercial bank selling a bundle of mortgages on to an investment bank, which creates a 'special purpose vehicle' or 'entity' (SPV or SPE) that pools and then splices the income from these mortgage payments into securities to be sold to investors. Investors choose from securities with different risk levels and corresponding rates of return. The income generated by the mortgage payments are used to pay interest and principal to the lowest risk 'tranches' first; high(er)-risk tranches only receive payments if and once the other (preceding) tranches have been paid-off .

This is called the 'originate-and-distribute' scheme: banks 'originate' the mortgages and then distribute them onto others. This allows banks to shift credit risk off their balance sheet, plus the proceeds from the sale can be re-loaned onto other customers. Banks may also gain by charging fees for originating the mortgages. The investment bank earns the difference between what it paid for the bundle of mortgages and the amount it sells the securities for. (In some instances, rather than selling on to an external investment bank, the commercial bank itself creates a special purpose vehicle in order to conduct securitisation directly.)

US mortgage lending grew considerably between 2001 and 2006. Once demand from the more 'credit worthy' segment of the population was met, the market turned to the 'subprime sector' or the poorest homebuyers, enabled by securitisation techniques. As interest rates went up and house prices fell, people start defaulting on mortgage payments. A collapse of the subprime market, on its own, could not have caused a general financial crisis.

A large part of the problem was mortgage securitisation: specifically, "particles of subprime debt [...were] embedded in securities held by financial institutions across the world"[22]. Furthermore, a lot of people had taken out extra loans by re-mortgaging their houses on the basis of rising prices (known as 'equity extraction'), which they were now unable to pay. Finally, many financial institutions had taken positions in 'credit default swaps' - a type of derivative seen as a means of hedging potential losses or simply speculating on the performance of mortgage-backed securities and other types of collateralised debt obligations. Thus the financial system built layers of debt and bets on top of securities that ultimately depended on individual homebuyers paying their mortgages.

7. What are derivatives and how do they work?

Derivatives are financial contracts that derive 'value' from the performance of some 'underlying' factor. This underlying factor doesn't even have to be a 'thing': for example, weather derivatives allow one to hedge against or speculate on hurricanes, frost and snowfall, or the amount of sulphur in the air. Unlike securities, which imply a claim on future income streams, derivatives represent an "exchange of performance exposure, where gains and losses are expressed simply in the changing price of the derivative itself"[23]. Most derivatives contracts are officially considered risk management or hedging tools. However, ironically, the use of derivatives to hedge against volatility has itself become a source of volatility, while speculation on derivatives markets depend on volatility for profit making.

There are four ***main types*** of derivatives: ***forwards, futures, swaps*** and ***options.*** Basic agricultural forward contracts are perhaps the origin of derivatives, dating back to at least the 1600s- though centralised futures trading emerged much later, in the 1840s, with the establishment of the Chicago Board of Trade. In a 'conventional' forward contract a producer (e.g. farmer) promises to sell, and an end-user (e.g. chocolate company) promises to buy, a certain amount (e.g. ten tons) of a commodity (e.g. cacao beans) at a fixed price (e.g. $3,000 per ton) on a specified date in the future (e.g. June 1, 2018). This helps the farmer 'hedge' or protect against low prices and the chocolate company to guard against high prices.

Standardised and tradable contracts offered by financial exchanges are known as futures, though the underlying principle is the same as in a forward. Futures offer protection (via the exchange, essentially an intermediary) against the other party defaulting, unlike private forward contracts. In the case of commodity derivatives, they also use standard quantities (e.g. ten metric tons of cacao beans) and usually apply ***'mark-to-market'*** pricing.

KEY CONCEPT

'MARK-TO-MARKET', in the case of commodity futures, means that on a daily basis the contract is essentially 'reset' according to the prevailing 'delivery price' of the commodity in question. The party whom the price is moving against has to pay the price difference into a margin account (in which the investor deposits funds with the brokerage firm), while the counterparty receives that same amount. For example, if the original delivery price is $1,000 and the next day delivery prices are $950, the buyer's margin account is debited the $50 difference, while the seller is credited with $50. The buyer would theoretically be paying $1,000 (as in the contract) or $50 more than the prevailing market price ($950); i.e. the markets moved against his future contract position. The same applies in the other direction: if the delivery price went up to $1,050 then the seller would be debited and the buyer credited.[24]

As suggested by their name, options contracts provide the 'option' to buy or sell at a certain price on a particular date, instead of an obligation. For example, suppose the cacao producer purchases a 'put' (sell) option contract for $100USD fee that gives the option to sell a ton of beans at $3,000 on a specified date or within a specific time frame. If - when the time comes - the ton is priced at $4,000, the cacao producer would choose not to exercise the option because he could get $1,000 more selling at the spot price. The producer lost the $100 USD paid for the option contract, but it could be a price worth paying given that the markets could have moved in the other direction. If the price had fallen to $2,000, the firm would exercise the option provided in the contract to sell for $3,000. Similarly the chocolate company might purchase a 'call' option to buy a ton of cacao for $3,000. A speculative trader would typically purchase a call (buy) option if they want to bet the price of the underlying asset will rise, or a put (sell) option to bet the price of the underlying asset will fall.

It is worth noting that the institution that sells ('option writer') the contract IS obligated to sell or buy if the counterparty ('option holder') chooses to exercise the option, which is why this company charges a fee for the option contract.

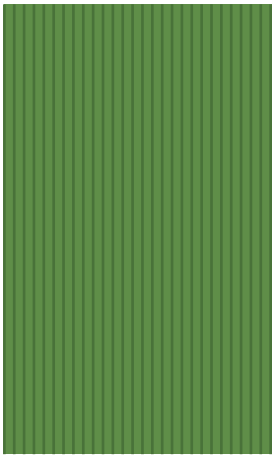
The examples above focus on commodity derivatives; however, it is worth reiterating that these instruments trade in many other assets and areas such as interest rates, currencies, inflation, energy, weather, and so forth.

In a credit default swap (CDS), for example, the seller promises to pay the buyer for the value of a debt if the debtor defaults. For this, the buyer must pay the seller premium instalments. Unlike conventional insurance, it is not necessary that those involved in the derivative exchange have any direct interest or involvement in the underlying debt. In short, using CDS derivatives, speculators ***external*** to a particular credit contract can make bets on the likelihood of default. These became very popular instruments during the financial bubble and played an important role in the crisis. Between June 2005 and June 2007 the ***notional amount outstanding*** in credit default swaps rose from just over USD $10.2 trillion to $42.85 trillion[25]. A few years before the crisis, Alan Greenspan, head of the US Federal Reserve, celebrated the development of the CDS market, while government 'financial experts' prevented these innovations from being regulated.

GRAPHIC 4

NOTIONAL AMOUNT OUTSTANDING
in the OTC derivatives markets, June 2013[26]

$693 tn



Derivatives markets, even when measured by gross market value are enormous relative to gross world product. I.e. these financial instruments are supposedly 'worth' more than a quarter of all the products and services the world economy produces in an entire year.

GROSS MARKET VALUE
of the OTC derivatives markets, June 2013[26]

$20 tn

GROSS WORLD PRODUCT
for 2013[27]

$73.87 tn

KEY CONCEPTS

The ***NOTIONAL AMOUNT OUTSTANDING*** (NAO) is the current value of the underlying assets represented in derivatives contracts not yet settled. So, the notional worth of a futures contract for 20 tons of cacao beans that have a spot price of $3,000 per ton would be $60,000 USD, or 20 x 3,000. In the case of a credit default swap, the NAO would be the amount of debt being secured.

GROSS MARKET VALUE, in contrast, represents "the cost of replacing all outstanding contracts at current market prices". It is a measure of the worth (related to changes in risk) of the derivative contract itself, rather than the underlying asset. In other words, the right to buy cacao beans at a specified price on a particular date (futures derivative contract) could suddenly become more valuable if an event occurs that makes cacao prices shoot up and if investors believe the price will continue to rise until the contract settlement date; in this case, the futures contract essentially guarantees access to low priced cacao in a high-price market. The person who owns this right to buy (holds the derivative) could sell the right onto another for a price - the market value of the contract.

8. So does securitisation and derivatives trading control risk or create it?

Computerised risk modelling (used in the design of derivatives and securitisation) may appear rigorous and scientific, but the inferences used in these models (based on past prices) do not hold in unprecedented times of crisis where prices of different assets move in the same direction. In practice, these risk management techniques made financial players act en masse in similar ways, increasing instability and the likelihood of large price swings.

Furthermore, the system has built in incentives that actually increased levels of risks and instability. For example, commercial banks had incentives to ignore the levels of risk in the original mortgage loan given the originate-to-distribute model. At the same time, credit ratings agencies were not only paid by banks to rate well, but their own risk assessments were also based on these flawed inference computations. Finally, as discussed below, the participation of financial speculators in commodity derivatives markets has undermined their potential for risk management, while contributing to volatility in 'real' markets.

How financialisation impacts commodity markets, food prices and the environment

9. How has financialisation affected commodity markets?

Towards the beginning of the 21st century, and especially in the wake of declining returns on equities following the dot.com crash, financial market actors took increasing interest in commodity derivatives. Commodities are raw materials or primary agricultural products, such as gold, oil, copper, coffee, cacao, wheat, sugar or cotton. (Note that not all primary products are traded on international financial markets.) Historically, commodity prices have tended to change in line with - and thus provide a good hedge against- inflation and to move in the opposite direction of bonds and equities (though this was not true between 2005 and 2008 when commodity and equity prices were positively correlated). This made commodities alluring to those wishing to protect against losses in other investments or to diversify their portfolios. The growing demand for commodity derivatives pushes up their prices, making them even more alluring to financial investors, creating a self-fulfilling cycle.

KEY FACTS

Investment in US commodity futures indices (baskets of exchange-traded derivatives on a variety of commodities) rose from an estimated USD $13 billion in 2003 to USD $260 billion in 2008.[28]

The 'notional value' outstanding on OTC commodity derivatives contracts grew '14-fold' between 2002 and mid-2008, when it reached circa $13 trillion USD.[29]

The rapid growth in commodity derivatives trading was facilitated by deregulation such as the 2000 ***Commodity Futures Modernization Act,*** which reversed legislation implemented by the US government in the 1930s in response to the Wall Street crash. This, together with other decisions taken by the US Commodity Futures Trading Commission, weakened regulations that applied to the listed exchanges (e.g. reductions in and exemptions from 'position limits') and opened the door to over-the-counter (unregulated) speculative trading without supervision or obligatory disclosure. This deregulation resulted from lobbying pressures by large financial enterprises.

Just 2% of commodity futures contracts end with delivery of the physical good.

The increased participation of financial investors and speculators has led to changes in the way these commodity markets now work, to a certain extent 'de-linking' them from physical market conditions and tying them more closely to movements in stocks and bonds. For example, ***index*** speculators take positions in commodities as an ***entire group;*** in other words, they do not usually make investment decisions according to supply and demand conditions in specific physical markets, but rather in relation to the performance of other financial assets. Such speculation is probably behind the simultaneous rise and fall of ***different*** commodity prices – not easily explicable by factors of supply and demand[30]. Also, speculators don't have an interest in the commodities themselves. According to the FAO, just 2% of commodity futures contracts end with delivery of the physical good[31].

Responsibility for the growing eminence of commodity derivatives, however, is not limited to external (financial) actors. Non-financial firms, especially international traders, have also increased their participation. Since the 1980s, policy-makers (with the backing of institutions such as the World Bank) have shifted emphasis from the "stabilisation of prices" through international commodity agreements, centralised marketing boards and cooperative schemes, to "private, market-based, price risk management strategies"[32], especially derivatives trading. In practice, participation in derivatives markets is mostly limited to larger market players, which do not just use derivatives to hedge physical positions, but also derive a growing proportion of their profit from speculative trading.

The main problem with speculation in commodity derivatives is that it contributes to 'real' commodity price volatility. Labban argues, for example, that the price of oil is determined – to a considerable degree – by the sale of "fictitious barrels" on financial markets. He shows how oil prices rose by over 60% the first six months of 2008, reaching a high of $147 per barrel, despite a "decline in demand and increase in spare production capacity"[33]. In other words, changing valuations in derivatives markets – which often do not correspond to the underlying supply and demand conditions of a particular commodity – may be translated into swings in physical market prices.

In addition to the wider implications of price volatility and crisis, the financialisation of commodities contributes to inequality between different actors within these markets. While some benefit from increasing volatility through speculation, others lose out. One of the main losers are the 'traditional' users of commodity derivatives since it has become more "costly and unpredictable for hedgers to use the futures markets for hedging purposes"[34]. In other words, commodity derivatives apparently no longer even serve the purpose for which they were originally designed. Regulations need to be put in place to ensure that these financial instruments serve traditional hedgers who actually have interests in the physical commodities. The problem is that strong lobbying by the financial industry has thus far prevented this.

Many small-scale producers and traders, especially in the Global South, were excluded from the outset. Apart from the problem of cost, participating in derivatives trading requires access to and minimum knowledge of financial markets. In addition, many small firms (traders or producers) do not use futures and options contracts to hedge because of the smaller commodity volumes they handle relative to the 'lot sizes' required on international exchanges.

CASE STUDY

Financialisation and Inequality in Coffee Markets

Examining the case of coffee (specifically in Uganda and Tanzania), Newman argues that financialisation has contributed to increasing inequality in terms of income and power within the commodity chain. Large international trading firms with sufficient funds, access, and knowledge to participate actively in financial markets have been able to gain from price volatility through speculation. Meanwhile, many medium sized traders were unable to compete financially and went bankrupt or were subject to take-overs. Finally, smaller (especially local) traders and producers tend to lose, as they must accept lower prices in return for stability or the risk implied by volatility.

10. What role did speculative trading play in the recent global food crisis?

The impact of speculative trading on food prices has been particularly severe, though the extent to which speculation was to blame for the recent global food crisis is hotly contested.

The price of "internationally traded food" goods rose around 130% between the beginning of 2002 and mid-2008[35]. These rising food costs are especially difficult for people in the Global South, where food purchases represent 60-80% of income. Subsequent to the food crisis, the number of people considered "undernourished and food insecure" rose by approximately 75 million. The crisis led to civil disorder in more than 40 different countries around the world and a significant increase in the costs of food imports for the 50 "least developed countries"[36].

Commodity prices fell sharply after June 2008, in conjunction with the financial crisis, but from late 2009 they were back on the rise. For Kerckhoffs et al. it is clear that the steady injection (2003 to mid-2008) and then rapid withdrawal (later 2008) of speculative money in commodity derivatives markets was behind the inflation and then sudden bursting of the bubble[37].

11. What is the financialisation of nature?

As financial innovations are used to extend and deepen commodification in ever more areas, it is not just primary commodities, but nature more generally that is being financialised. Even immaterial 'goods' such as greenhouse gas emissions have become tradable on financial markets.

The practice of emissions trading emerged in the United States in the 1970s as an attempt to limit sulphur dioxide contamination through 'market' mechanisms[38]. The idea behind 'cap and trade', which is perhaps the clearest example of the financialisation of nature, is to create a market for pollution permits. In basic terms: a maximum pollution threshold is established (the 'cap' part), forming the basis for the creation of a ***limited*** number of permits, which can then be traded.

This trading takes many different forms (e.g. some involve pollution 'offsets', where a company can compensate for its own emissions by reducing them elsewhere, such as by investing in a reforestation or a renewable energy project), but the basic underlying principle is the same: to create market incentives for reductions in pollution. Supposedly, more environmentally 'sustainable' companies can gain by selling unused quotas, while companies with unsustainable practices lose because they have to pay for additional allowances.

Variations on this theme are used to 'control' air and water quality, and similar mechanisms have been designed (supposedly) to halt the exhaustion of marine life by creating tradable fishing quotas or rights. Once the initial markets have been created, this opens up opportunities for the development of derivatives (e.g. carbon options or proposed fishing 'catch shares' futures) that allow companies to hedge against, or speculate on, the prices of these tradable permits, quotas or credits[39].

The financialisation of nature is encouraged by market-oriented environmentalists who view it as a way of increasing sustainability and by financial actors who see it as a new profit opportunity. However, in addition to debates surrounding the ethics of pricing and commodifying ecosystem 'services' and 'goods', growing evidence suggests that these financial 'solutions' fail to resolve environmental degradation and could actually aggravate the problem, as well as creating new social inequalities by putting the financial sector in control of common resources[40] (see TNI 's book: 'What is Carbon trading and why does it fail?'). In the case of fishing, for example, 'financialised' fisheries management is often based on the expropriation -via the creation of privatised fishing 'rights'- and exclusion of subsistence fishing communities (see: TNI Primer on 'The Global Ocean Grab'). Finally, there are fears that new forms of volatility and even crises could be unleashed in the wake of expanding 'natural capital' derivatives markets.

How financialisation impacts on households, firms and the wider economy

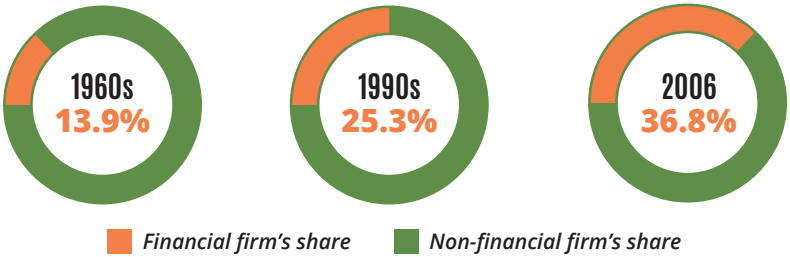
12. How does financialisation change the wider economy?

Financialisation is a shift in the way wealth is accumulated. Whereas in the past profits were mostly derived from the mass production and sale of goods, in our financialised era a large proportion of profits come from the buying and selling of financial securities and the interest payments they accrue[41].

A study conducted by the ILO covering 17 different countries found that the portion of profits represented by the financial sector rose to over 40% in 2005.[43]

GRAPHIC 5

FINANCIAL FIRMS' SHARE OF TOTAL (PRE-TAX) CORPORATE PROFITS, USA[42]



Although the financial sector's share in US domestic profits fell drastically during the first few years of the Great Recession, by 2010 it had recovered to almost 30%.[44]

Financialised accumulation profoundly affects how the economy works. If companies can make more from trading financial assets than manufacturing products, they may choose not to invest in new technology; or they may spend on expanding their finance department to the detriment of other areas. In other words, financialisation has been shown to negatively impact on 'real' investment. The trend is clear: where higher profits can be made through financial speculation, productive investment tends to decline.

Meanwhile, households have become increasingly reliant on credit in the face of declining or stagnating real wages and employment instability.

CASE STUDY

Financialisation reduces 'real investment' in US

A study of a large sample of US firms (1973-2003) by Ozgur Orhangazi discovered that financialisation impacts negatively on 'real ' investment or 'real capital accumulation'. First, growing profitability in the financial sector relative to the non-financial sector "crowds out real investment". Put simply, managers will invest in financial over other assets if it is more profitable to do so. Second, the growing transfer of earnings to the financial sector (through increased interest payments on debt, dividends distribution, and stock buybacks) reduces the portion of funds that can be reinvested in the firm, for example, in physical capital or research and development.

Financialisation may also create a preference for the short-term gains offered by financial assets over the medium to long-term strategies usually required for real investment. This is reinforced by the need to service rising debt levels in many firms, shareholder demands for speedy returns, and stock option pay, which creates incentives to temporarily inflate the share price/earnings.

Orhangazi is careful to point out, however, that these effects are not homogenous; for example, there are differences between large and small corporations and across different industries.[45]

Meanwhile, households have become increasingly reliant on credit in the face of declining or stagnating real wages and employment instability. Debt is now a major source of funding for people's everyday spending, especially in countries like the US and the UK. In the past productivity increases were tied to wage growth, which allowed for rises in spending and thus demand and growth. Over the last few decades, in contrast, demand (and hence growth) has become increasingly reliant on greater indebtedness.

Debt is not only used to sustain consumption, but also to fund financial investment and speculation. Many countries' tax codes encourage companies to increase their indebtedness by allowing interest repayments to be counted as a cost, reducing overall

profits that are taxed. Many companies raise finance from debt, rather than by issuing shares, because this allows them to maintain high profits per share, which helps keep share prices up. Both financial and non-financial firms have become increasingly reliant on credit for financial investments; this trend is especially evident in the USA, but is also matched in the UK, Japan and Ireland.

KEY FACTS

In the USA, between 1976 and 2009, non-financial business debt rose from 52% to 77% of GDP, household debt increased from 45% to 96%, and financial sector debts shot up from 16% to 111% of GDP.[46]

Overall, total outstanding US credit market debt increased from 140% of GDP in 1973 to 328.6% in 2005.[47]

A number of studies have shown that debt-led growth, in addition to being inherently unstable and hence prone to crisis, is also ineffective in the long-run. Debt-led growth, however, is just one side of the story. For while financialisation has led countries such as the US and the UK to offset falling income levels with increased debt, others, such as Germany or China, have attempted to resolve similar demand problems by means of increased exports.

It is sometimes argued that financialisation in the Global North simply reflects the shifting of production and manufacturing activities to other parts of the world (in the Global South), which leaves predominantly financial functions in multinational corporation's 'home country'. However, Krippner found that US multinationals' profits from foreign financial activities have increased relative to profits from overseas production. In other words, US companies appear to be bringing their 'financialised' practices with them to other countries. In sum, corporations are not only reaping profits from relocating production but also increasingly from a boom in financial activities overseas. In both cases, the benefits to countries in the Global South are limited and have contributed to the "persistence of the North-South divide"[48].

13. How are non-financial firms, such as supermarkets, changing in the context of financialisation?

As Demir puts it: many non-financial companies have themselves "metamorphosed" into "financial rentiers". A retail giant like Tesco may choose to buy up large parcels of land, speculating that rising prices mean it can sell the land later for a profit, without ever building a new outlet. Similarly, Sainsbury's - another UK supermarket chain - now offers insurance and banking services to its customers. Such is the involvement of large (ostensibly non-financial) corporations in finance that many have their own departments specialised in financial activities. For example, in the case of Enron (discussed below), financial assets were so central in the business strategy that the company building had its own trading floor.

Krippner shows that since the 1950s, US non-financial firms, particularly manufacturing companies, have increasingly relied on financial income streams. According to another study, US non-financial firms' financial returns (as measured by "interest and dividend income as a percentage of internal funds") grew from 20% for most of the 1960s to a high of over 50% from the late 1980s on into the early 2000s.[49] Around the same period, US non-financial corporations began to invest more in financial assets (like stocks and bonds) than they did in their own non-financial assets (like machinery). Their proportion of financial assets relative to 'real assets' increased from around 30% in the 1970s to over 100% in the early 2000s.[49] Various case studies – examining coffee traders, oil companies, agribusiness and auto-assembly firms – provide concrete evidence of the 'financialisation of non-financial firms' from across the world.[50]

Lapavitsas argues that the financialisation of corporations ties in closely to their reduced reliance on banks for credit and their pursuit of profit from unused funds. In other words, corporations sought ways to both lend and borrow money, and engaging in financial markets directly offered 'lower costs' and more 'flexibility' than going through banks. Gradually, non-financial firms developed financial 'skills' and "acquired functions that previously belonged to financial institutions"[51]. As discussed below, the financialisation of non-financial companies also relates to the imposition of shareholder value principles and the short-term profitability of financial relative to real investments.

CASE STUDY

Enron and financialisation

Enron Corporation provides an emblematic case of the financialised firm. Originally focused on the distribution of natural gas and electricity, this energy company shifted to a more 'innovative' business model based on trading in the financial sector, especially in energy and weather derivatives. The media, academics and market analysts loudly applauded Enron's creativity until its bankruptcy at the end of 2001. The financialised business model was not sustainable, leading Enron to engage in fraudulent activities. They "used legitimate accounting devices for the illegitimate purpose of hiding debt and fabricating earnings" in order to maintain optimism in the firm and sustain a rising share price, despite Enron's poor performance. Though the Enron scandal is usually taken to be an example of criminal fraud and governance failure, it is illustrative of the wider process of financialisation.[52]

14. How does financialisation impact on employment and income inequality?

The effects of financialisation on investment extend to employment. Businesses, of course, invest not just in equipment but also in their staff. Whereas in the past new job opportunities and expansion of productive activity would have been an indication of economic well-being, in the era of financialisation share prices often rise following the announcement of job cuts and physical capital downsizing. For example, in May 2014 Hewlett-Packard's stock prices rose more than 6% the day after it announced that it would cut between 11,000 and 16,000 jobs[53]. Furthermore, many businesses transfer the burden of capital market demands onto their workers, slashing wages and adding, in different ways, to the growing precariousness of employment.

Real wage growth has been stagnating or declining in countries such as the USA and the UK over the last thirty-or-so years[54]. At the same time, managers and CEOs within the productive sector and top-level financial sector employees have seen their pay-packets swell, in large part due to stock option pay and bonuses – contributing to growing income inequality.

KEY FACTS

In the USA "compensation per full-time equivalent employee in the security and commodity brokering industry increased from 146 percent above the national average in 1990 to 290 per cent above average in 2007".[55]

One hedge fund manager received US$3.7 billion in just one year of 'work', circa 74,000 times more that the average US household income.[56]

If the impacts are negative for labour when finance is 'doing well', they are even worse when it isn't. Workers were the group worst affected by the global economic crisis. Not only did unemployment grow across the Global North, but wealth inequality also continued to rise. Thus, in contrast to the Great Depression when inequality fell because of declining asset values held by a minority elite, in the contemporary Great Recession asset prices recovered relatively quickly (in part due to the help of government bailouts) and the wealthy got by relatively unscathed.

The increasing importance of the financial sector overall, combined with the growing reliance of non-financial firms on financial income relative to productive activities, seems to have made capital less dependent on labour for profits and thus further tilted the balance of class power. Still, it is important not to make overly simplistic generalisations. Drawing on evidence from the German automobile industry, Kadtler and Sperling show, for example, the continued importance of collective bargaining and trade unionism in influencing key decisions within some globalised and financialised firms[57].

15. What is shareholder value and what is its role in financialisation?

One of the most important aspects of financialisation is also one of the least well understood: shareholder value governance. Over the last forty years non-financial companies have become obsessed with their share prices, and seem to dedicate more resources to improving their share price than they do improving the products or services they sell. To do so, firms sell off divisions that are less profitable, fire staff, outsource services, and often spend vast sums buying their own shares.

The chase for high share prices and sound creditworthiness has made financial criteria – and financial experts and accountants – central to the strategies companies adopt. Accountants, not engineers, now decide what's best for industrial companies.

Many argue that shareholders – investors on financial markets – have used the stock markets to force companies to prioritise shareholder returns above all other concerns; this is often called 'shareholder value maximization'.[58] If shareholders felt managers were not delivering high enough returns, they would sell the equity and take their money to a company that did. This market pressure is supposedly exacerbated by the fact that ownership of corporate stocks is concentrated in a few hands. If a big institutional investor decided to sell all the shares it owned, share prices could tumble. In this way the stock market – supposedly – left managers with no choice ***but*** to obsess over share prices.

However the reality is that the big institutional funds, bar a few isolated incidents, have actually been unable to force their will on non-financial companies. More often than not, it's easier for them to go along with management's decisions than to challenge them. So rather than shareholders forcing managers to make share price the main priority, it is the managers of non-financial companies ***themselves*** that have led the change.

In a financialised environment where lots of debt can be raised very quickly (thanks to securitisation), it is far easier to acquire companies, restructure them and sell off divisions than it is to try and build long term plans and improve productivity. In today's age, many corporations' main priority is to be able to borrow money quickly and easily, and a high share price is a good route to creditworthiness. The chase for high share prices and sound creditworthiness has made financial criteria - and financial experts and accountants - central to the strategies companies adopt. Accountants, not engineers, now decide what's best for industrial companies.

To compound matters, managers have tied their own salaries to share prices by paying themselves partly through stock options. So when share prices increase, so do their own salaries.

Overall, it is clear that financial markets have an enormous impact on corporate behaviour.

KEY CONCEPT

SHARE BUYBACKS or ***STOCK REPURCHASES*** are when a company uses its own (or borrowed) money to buy its own shares back off the open market. It does this because greater demand for shares pushes up their price, so companies can 'artificially' increase their stock prices by buying substantial portions of the shares themselves. Traditionally, companies issued shares to investors so that they could finance big investments like new factories. Now they spend their own money buying back shares just so that their price remains high. Share buybacks are also supposed to inflate share earnings (or dividends); fewer shares imply company profits are distributed between fewer numbers, or more earnings per share.

KEY FACTS

As a percentage of US corporate profits, share buybacks rose from less than 5% in the late 1970s to a high of over 30% in 1992. In 2006, share buy-backs represented 43.9% of 'non-residential investment spending'.[59]

The increase in share prices has also been boosted by general demand on the stock markets. This new demand is a result of the massive inflow of funds from households drawn into financial investment through pension plans or special saving schemes. Thus, as Froud *et al.* point out "with financialisation, stock prices are driven by the pressure of middle class savings bidding for a limited supply of securities". This has made the underpinnings of recent shareholder gains extremely unstable. The authors even liken the operation of the US and UK financial markets to a giant Ponzi scheme: the income of existing shareholders largely depending on the continual entrance of new players[60].

Overall, it is clear that financial markets have an enormous impact on corporate behaviour. In the race to increase share prices many corporate managers have begun to mimic financial market conduct – changing the disposition of the company towards 'short-termism'. Non-financial firms have chosen to seek new profit channels through financial activities, restructuring (e.g. outsourcing, takeovers and mergers) and financial engineering (e.g. share buy backs or tax dodges), instead of investing in new products or to improve productivity.

16. How does financialisation affect the 'average' household?

A lot of people have become more dependent on financial products for their wants and needs. Though use of credit by households is a not new phenomenon, household financial activities have changed both quantitatively and qualitatively. Individuals may be involved in financial markets through their insurance cover (health, home, car, life, unemployment), their pension plans, their savings schemes, their student loans, mortgages and different consumer borrowing options -overdrafts, short-term loans, credit cards. The reliance on loans, especially, has become habitual in many countries, the normality of credit card usage being an obvious example. Increasing use of and access to credit is sometimes treated as a symptom of affluence; however, it can also be viewed as the result of social pressures for maintaining or increasing consumption whilst facing stagnating or falling real wages.

As Montgomerie has described, retail banking innovations have integrated individuals and households into capital market networks whether they know it or not[61]. For example, by securitising credit card and mortgage debt and selling these securities on international markets, retail banks brought consumers and households into direct contact with investment banking. This made consumer debt a very profitable and apparently secure activity and allowed for an increase in the credit available.

KEY FACTS

The UK and the USA lead in household credit consumption: in 2007 'individual debt as a percentage of disposable income' reached circa 160% and 130% respectively – in great part as a result of mortgage borrowing.[62]

In Turkey debt payments as a percentage of 'household disposable income' rose rapidly from around 8% in 2003 to almost 30% in 2007 – here the marked escalation was in credit card and consumer, rather than housing, debt.[63]

The mounting reliance of households on financial markets is the corollary of a total or partial withdrawal of state provisions such as pensions and other types of social security, subsidised housing, health, and education. It is about "the transfer of risk and responsibility from the collective to the individual".

Households do not only engage in financial markets as debtors, but also as investors. Since the 1980s and 1990s, many governments have been pushing reforms encouraging (for example, with tax incentives) the adoption of private 'individual retirement plans'. There has been a drift away from 'pay-as-you-go' or PAYG (where retirees or pensioners are paid with taxes and contributions from people currently working) towards 'partially-funded' or 'fully-funded' (in which contributions are invested in a fund, later used to pay benefits) systems. As such, retirement savings have been channelled into financial institutions. Even those countries (e.g. France) that maintain relatively large public pension systems have been gradually changing from PAYG to investing state funds in financial markets.

At the same time, within companies, there has also been a shift from 'defined benefit' to 'defined contribution' type plans, which has implied the transfer of risk from employer to employee. Under defined benefit plans, the employer or company provides pensions for its employees. It bears the financial risks and has to pay its workers as promised even when its investments don't perform as expected. With defined contribution plans, in contrast, individuals hold their own accounts that incur gains or losses depending on investment performance. In sum, pension reform has converted many workers into investors with a direct stake in the performance of stocks and bonds.

All in all, through debt, pension and other types of savings, households have become more closely involved in financial markets. This implies a cultural transformation in which households are supposed to adopt a "finance rationality". In making decisions about which pension plan to choose, the type of savings scheme to invest in, between variable and fixed interest rate loans, and so forth, the individual or family is expected to act as a rational financial actor, analysing and calculating the costs and benefits of different options. In short, he or she should behave as any other investor. Above all, the individual worker or household should allegedly assume financial risks and take responsibility for his or her own future.

Indeed, the mounting reliance of households on financial markets is the corollary of a total or partial withdrawal of state provisions such as pensions and other types of social security, subsidised housing, health, and education. It is about "the transfer of risk and responsibility from the collective to the individual"[64]. With this in mind, many governments and institutions have been aggressively advocating 'financial literacy' for everyone. Neoliberal discourse calls this 'financial empowerment'. However, the result has been to "naturalize ideas about self-reliance and to depoliticize more specific questions about the privatization of risk"[65].

Exploring the forces behind financialisation

17. How did financialisation become so dominant?

Financialisation is not something that simply occurred. Political decisions or non-decisions permitted the process of financialisation to take-off and continue apace. Although deregulation responded, in part, to 'regulatory arbitrage' and loopholes that some corporations were already taking advantage of, policies at national and international level also actively encouraged activities and changes that buttressed financialisation. Finally, non-action, such as the refusal to intervene in financial activities that are potentially destabilising, has been at least as important as active policy reform.

Neoliberal policy, in particular, bolstered financialisation[66]. The focus in the last few decades on maintaining low inflation, as opposed to the post-war Keynesian era macroeconomic goal of maintaining full employment, has particularly benefited the financial sector because inflation erodes the value of financial assets. Of course, inflation affects everyone; it eats away at savings and makes salaries lose their purchasing power, but the priority it has been given, the goals that have been set and the methods (austerity or interest rate hikes) by which it has been contained, skew benefits to the financial sector.

A rise in interest rates, for example, worsens debt loads (for governments, companies and homes) and can contribute to a stifling of growth as a result of increasing credit costs. Yet at the same time, high interest rates tend to benefit the financial sector and may encourage investors to flock to financial assets at the expense of long-term productive investment in the 'real' economy.

The relation between financial gain and interest rates, however, is not straightforward. It is important to note that it was extremely low interest rates that initially fuelled the financial bubble in the USA. Financial institutions took advantage of low Federal Funds Rates by leveraging their investments. This is reflected in the high levels of debt taken on by these firms during the boom.

Some governments have become resigned to such economic policies, arguing that they have little choice in the matter. Once financial liberalisation has taken place and capital is unshackled from its chains, national policy autonomy is limited to an extent. On the one hand, the ability to tap into private financial sources depends on 'creditworthiness' as assessed by international institutions and rating agencies. On the other hand, countries that don't comply with investor interests are punished by 'capital flight' where investors take their money out of a country to pursue greater returns elsewhere.

Thus market discipline dictates not the desired amount of government spending, but the desired form: budgets which include funds for health, education, or social security, for example, are seen as objectionable, whilst in the case of a financial crisis the government is expected to empty its purse.

There are, however, significant differences between countries in this regard, depending on global political economic positioning and power. Some governments are more restrained by capital market valuations than others, while how countries respond to these pressures depends upon outcomes of conflicts and negotiations between different actors within specific contexts. Examining the case of Argentina, Jiménez observes that neoliberal restructuring in the 1990s "reflected an alliance of political power between the state and transnational financial power at the expense of industry". Financialisation, she argues, was imposed by a particular coalition of interest groups who ***intended*** to encourage a finance-led growth regime in the Argentine economy. This created a boom in the mid-nineties followed by a bust in 2001[67].

Many economists celebrate the restrictions imposed on public policy through capital mobility; Thomas Friedman for example, calls this the "golden straitjacket". From this point of view, capital mobility serves as a 'disciplinary instrument', forcing governments to adopt the 'appropriate' monetary and fiscal policies such as balanced budgets (which may require harsh austerity measures), low inflation, generous tax codes, and deregulated financial markets. Ironically, rules of fiscal austerity do not apply in an event of a financial crisis in which the government is expected to bail out private investors and institutions. Thus market discipline dictates not the desired ***amount*** of government spending, but the desired ***form:*** budgets which include funds for health, education, or social security, for example, are seen as objectionable, whilst in the case of a financial crisis the government is expected to empty its purse.

The financial institution bailouts imposed by the US and various European country governments following the 2008 crisis are a good example. In autumn 2008 US Congress passed the Troubled Asset Relief Program or TARP, which provided up to $700 billion USD for buying up or insuring 'troubled' financial assets[68]. For Palley, the purpose was not necessarily to save investors from incurring loss, but to prevent a wider crisis, since under financialisation the fortunes of the broader economy depend on the financial system.

Despite the US governments' injection of cash, the financial system remained reticent to lend and the 'credit crunch' dragged on. At the same time, financial institutions quickly recovered profitability and were not so reticent about paying out large 'rewards' to their top employees.

18. How have political and economic interests promoted financialisation?

Notwithstanding those examples where regulators choices were (apparently) constrained, there are countless cases from across the world that clearly point to political and economic interests as the ultimate determinants in financially biased policymaking. Pension reform is a good example. In many countries an ageing population is said to pose an imminent risk of a pension crisis. There are many different possible solutions to this problem, but un-coincidentally most governments have veered in the same direction: a closer integration of the pension system with global financial markets. Put simply, more and more people's retirement savings are now invested in capital markets.

This has three main impacts favourable to financial firms. First, it provides them with new income and profit channels. Second, in contributing to demand for financial assets it encourages asset price inflation that props up finance-led accumulation. Third, the growing number of individuals with a stake in the financial markets facilitates support for policies that end up benefitting large financial firms. Financialised pension regimes help to cultivate a culture of finance among the population that normalises the finance-dominated society in which we live.

One of the countries with the worst fame for its politicians pandering to financial sector interests is the USA. Apart from the extensive congressional lobbying by big banks and the huge sums financiers 'donate' to political campaigns, there is a 'revolving door' between Wall Street and Washington, in which individuals move between positions as politicians and regulators and high-end jobs in the financial sector.

CASE STUDY

The Enron Lobby

Froud *et al.'s* case study of the 'financialised' US Enron Corporation is instructive. Enron's senior managers were from the regional Texan elite, with strategic national connections. Kenneth Lay, the CEO of Enron, was an expert lobbyist. Enron made donations to both political parties. These connections helped Enron push for deregulation of the energy sector, especially in relation to financial trading.

For example, in 1993 the Commodity Futures Trading Commission (CFTC) exempted energy derivatives from government supervision. The Chair of the Commission at the time was Wendy Gramm, who left her position after making this decision and a few weeks later became a member of the Enron Board. Enron was also behind legal reform "which limited the amount that companies would have to pay out as damages in the event of conviction".

When Enron went into bankruptcy at the end of 2001, the same people who had received generous offerings from the firm were expected to investigate the company for fraud. 212 of the 248 Senators and members of the House of Representatives involved in committees investigating Enron's collapse or the conduct of Andersen (Enron's accounting firm) had received donations from one or both companies.

In 2004, the US Securities and Exchange Commission (SEC) heeded to the largest investment banks' lobby for an exemption from the established 'net capital rule'. The regulation required brokers to maintain a certain level of liquid asset reserves relative to their liabilities, ensuring their ability to meet payments even under unforeseen circumstances of severe investment losses. In effect, the regulation limited the amount of debt the brokers could take on and thus restricted their participation in lucrative leveraging strategies; it also tied up money in reserves that could otherwise be used for different profiteering ventures. From the investment bank's perspective, then, this was something worth lobbying about. The exemption was eventually applied to big investor banks with assets of more than $5 billion USD. In exchange for being released from these rules, the banks promised to allow the commission access to their books, but the SEC basically left them to self-regulate. These decisions were later questioned in light of the

2008 crisis and the enormous amount of tax-payer money spent on bailing out large investment banks[69]. It is worth noting that one of the big investment banks pressuring for this change was Goldman Sachs, which at the time was headed by Henry Paulson, who in 2006 became Treasury Secretary of the USA. In 2008, Paulson supported the government move to use public money to cover private financial losses, including those of Goldman Sachs.

In most countries, gestures of reform since the financial crisis have been meagre – at best. Without a significant change in power dynamics, it is unlikely that governments will do much to halt the financialisation process. Indeed, financial institutions' profitability recovered not long after the financial meltdown, and some of these profits were quickly put to work lobbying congress to block reforms considered detrimental to their interests.

Resisting financialisation

19. What is 'financial democracy' and why is it problematic?

The growing involvement of 'ordinary' people in financial markets is sometimes celebrated as the dawn of a 'financial' or 'investor' democracy. Wealth is supposedly constantly redistributed from corporations to the millions of worker shareowners. Policies that favour Wall Street or the City now allegedly represent the public good instead of a narrow minority.

Yet only a small percentage of the population is able to invest enough savings for financial gains to be truly relevant. The impression made by the statistic of more than half of North Americans having a 'stake in' the financial markets quickly deflates when considering that 40% of stockowners hold only 'negligible' amounts in shares: "70 per cent of US households still own few or no stocks"[70]. In sum, most people do not benefit in a significant way from rising share prices or increasing dividend payments. Furthermore, the notion of financial democracy distracts from the fact that the sector is actually highly concentrated. If before the crisis many institutions were considered 'too big to fail', this only worsened with restructurings: as of 2009 just five investment banks controlled 37% of financial assets in the USA[71].

Still, the mere impression of financial democracy, regardless of the fact that it is not backed by the figures, consolidates the hegemony of finance: "As investors, many workers now appear to have a direct material interest in neoliberal policies such as capital mobility, price stability, low capital-gains tax and shareholder value"[72]. In reality the losses suffered by the majority under these policies are more than the measly gains obtained from them.

The financial democracy thesis is also questionable given that workers and large corporations are clearly un-equals in the finance game. Most big firms cannot easily be taken advantage of by financial institutions given they have a similar level of power and information access, but individuals often use finance to meet basic needs and may have few alternatives. For example, a company may take out credit as part of a calculated leveraging strategy (i.e. in order to multiply gains), whilst an individual may have little option but to take on a student loan or even use a credit card to pay for groceries when his or her derisory salary runs out. Furthermore, workers continue to be mere consumers of financial products, while large firms have the capacity not only to buy in the financial markets, but also to sell. Finally, "limited liability" gives corporations exceptional power compared to the household: unlike workers, the homes of shareholders are not expropriated in order to pay the debts of an insolvent company. There is clear evidence of

this inequality when considering the outcome of the Great Recession: a lot of families lost homes and jobs, while the State used public funds to rescue many companies.

For Bryan, Martin and Rafferty, far from constituting a "financial democracy", financialisation can be likened to an "enclosure" of the household: "the realm of reproduction and domesticity" has been converted into "a scene for further accumulation". In many cases, households are forced to work more (additional employment or overtime, e.g.) in order to sustain growing levels of debt. As argued by Lapavitsas, there is an "evident contradiction at the core of this phenomenon": the growing reliance of banks on extracting profit from worker's income corresponds with stagnating real wages – in essence, it is not a sustainable strategy as eventually workers may not be able to meet debt payments, which can lead to wider economic crisis, as in the 2007-08 housing market crash.

Despite hopes that greater financial inclusion and literacy could foster wealth creation (by channelling idle savings directly into capital markets) that filters to all rungs of society, and could even provide a mechanism for people (as equity holders) to hold large companies to account, the practice has turned out quite differently. Instead, 'financial democracy' has meant the money of the many fuelling the profits of the few.

20. How can financialisation be resisted?

Financialisation has imposed new pressures on everyday life and made old pressures worse. But it has also opened up new possibilities for resistance.

One is debt itself [73]. Just as striking coal miners once used their access to the engine of the economy - coal - to flip the balance of power and demand better conditions, so now debtors can use their access to credit by declaring a debt strike. A refusal to accept unfair quantities of debt lumbered on people in financialised economies can force creditors to back down or change their terms of payment. In early 2015, a group of 15 students in USA refused to pay back the student loans they took out to attend the for-profit Corinthian colleges. Outstanding student debt in America is over $1 trillion and organisations like ***Strike Debt*** and the ***Debt Collective*** hope to organise mass refusals to help counter the debt-laden financialised norms they live under. Refusing repayment and demanding a write-off of debt is not unfamiliar and has a long history. Anthropologist David Graeber's thorough history ***Debt: The first 5000 years,*** shows how debt jubilees have been common since the debt slates were wiped clean in ancient Mesopotamia.

Another route of resistance is the attempt by campaigners to foster solidarity, and a sense of collective identity among debtors. ***Rolling Jubilee,*** a collective that grew out of Occupy Wall Street, is using the financial markets to this end. It is organising debt jubilees by collecting donations to buy distressed personal debt (money that banks have given up trying to collect) at discount on the secondary debt market. Instead of allowing it to fall into the hands of debt collectors, the group steps in, buys the debt and writes it off. Those who have had their outstanding loans cleared are then encouraged to donate to keep it moving. Because the debt is worth much less than the value of the initial loan, they are able to buy up large quantities. By March 2015 Rolling Jubilee had raised over $70,000 to abolish almost $32 million of distressed debt. They hope that such actions will make even more radical debt strikes possible.

Another way of exercising pressure on large banks is by simply "moving your money" to smaller institutions with different operating logics. The ***Move Your Money*** campaign created a "Bank Ranking Scorecard", which ranks UK banks and building societies according to criteria including "honesty, customer service, culture, impact on the real economy and ethics" in order to help consumers decide which institution to hold an account with. Crowdfunding and peer-to-peer lending, in which individuals lend or donate directly to the project or enterprise of their choosing, is also a means of bypassing large financial institutions. However, the growing popularity of these schemes puts them at risk of corporate takeover; in this sense, it is worth investigating how different platforms operate before jumping on the bandwagon.

There are also a number of different campaigns aimed at addressing the problems wrought by financialisation. Most of these campaigns focus on lobbying governments to regulate specific aspects of the financial industry. For example, the US "Stop Gambling on Hunger" and the European campaign against "Food Speculation" (which combines the work of a number of civil society organisations and NGOs) have been pressuring for the introduction of new rules to roll back the financialisation of agricultural commodity markets. The latter campaign contributed to the European Union's decision to impose position limits, capping the number of contracts on agricultural commodities that any one financial trader or group of traders can hold. Unfortunately, opposition to the regulations, especially from the UK government, watered down the agreement and left key loopholes open[74]. There are also multiple campaigns for implementing or strengthening more general financial transaction or "Tobin" taxes, aimed at stifling speculation.

We have outlined just a few channels through which financialisation is being challenged. Throughout history people have responded to coercion in creative and unexpected ways. Just as financialisation is a recent historical phenomenon, so resistance to it has just begun.

Recommended reading

NGO PUBLICATIONS

The Corner House has a number of publications on economics and finance: http://www.thecornerhouse.org.uk/resources/results/taxonomy:21

Debt Strike and **Occupy Wall Street**. 2014. *Debt Resisters' Operations Manual*. The PM Press.

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The **Khan Academy** has a number of videos that explain complex finance/economics topics in a simple way: https://www.khanacademy.org/economics-finance-domain/core-finance.

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TNI Primers

TNI has a series of primers on key critical issues, all available for free on TNI's website.

Notes

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Global financial markets have expanded massively in recent decades, dwarfing 'real' production and trade and impacting on multiple aspects of our economy, society and environment.

The global financial crisis of 2008 sounded the alarm bells about the dangers of an unregulated financialised world, but hidden behind the seemingly impenetrable jargon of collateralised debt obligations and over-the-counter derivatives, it is hard to understand the nature of financialisation let alone know how to confront it. In the meantime, financialisation of our global economy has continued unchecked.

This primer is a beginner's guide to financialisation – explaining how it works, how it shapes our lives, the forces that lie behind it, and how we might start resisting processes that prioritise freedom for capital over human rights and democracy.

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