The Political Economy of Financialization in the US, Europe and India

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We discuss the political economy of financialization in three settings: The US, the euro area, and India. The quantitative growth and increased social prominence of financial institutions and markets, we suggest, can be usefully seen in terms of the constraints or "discipline" they impose on other private and public decision makers. The role of finance in allocating real resources may be less important than its role in supporting the claims and authority of wealth-owners vis-a-vis other social actors. In the US, this is most visible in the pressure nonfinancial corporations face to increase payouts to shareholders. In Europe, the financial constraints on national governments are more salient. Tightening these constraints is openly acknowledged as the major benefit of financial integration. On the other hand, the constraints financialization imposes on policy may also limit the extent to which finance can in fact be liberalized. This countervailing pressure is visible in the great expansion of central bank's balance sheets and management of financial markets over the past decade. It is even more clearly visible in India, where the conflict between financialization and concrete policy goals has sharply limited the extent of liberalization, despite consistent rhetorical support.

1. Introduction

As a quantitative phenomenon, financialization is familiar – an increase in the share of output and income generated in the financial sector, higher prices for financial assets, a greater volume

of activity in financial markets. What is less clear is what kind of social actor finance is, and the nature of its linkages to the "real" economy of business, governments and households.

Orthodoxy sees the rise of finance mainly in terms of the benefits it provides. First, of course, is the more efficient allocation of social resources. Second is greater discipline for private and especially public decision makers, who must now submit their decisions to the veto of financial markets.

There is a certain tension between the claims that finance improves allocation and that it tightens discipline. After all, the economic benefits of finance come precisely from the way in which it suspends the discipline of the market. Finance allows companies to grow despite having no profits of their own to reinvest, as vividly illustrated along Sandhill Road and its equivalents around the world. More generally, it breaks the link between current income and current expenditure. The most disciplined government would be one that paid for all expenditure strictly out of current receipts; such a government would have no need of finance. This contradiction is visible in acute form in Europe. The crisis there is said to show that financial markets must be freer and governments must submit more strictly to their discipline. Yet it is those same markets' financing of large deficits and "mispricing" of government debt that is understood to have created the crisis in the first place.

In the US, the federal government is not vulnerable to the discipline of financial markets, despite occasional wistful musings about "bond vigilantes." The corporate sector is a different story. Here, the main demand from financial markets is to "disgorge the cash" (Henwood, 1998, p. 269), with payouts to shareholders increasing from about 40 percent of cashflow in the postwar decades to more than 100 percent in some recent years. These outsized payouts may be an important reason for the weak growth of business investment in the US in recent years, despite historically strong profits. More broadly, shareholder pressure ensures that other stakeholders – most urgently workers, but also customers, communities or regulators – cannot challenge wealth owners for authority over the firm. And yet, ironically, as financialization concentrates of ownership claims in a few big funds, it may weaken the ideological basis for private ownership.

Do these stories apply in the developing world? Not necessarily. Here we focus on India, where – despite the liberalization of the early 1990s – the degree of "financial repression" remains extraordinarily high by the standards of the US or Europe, and where financial markets are more weakly articulated with nonfinancial businesses.

In any case, it is clear that finance cannot be thought of only (or even mainly) as a system for the allocation of resources. Rather they should be thought of as a form of authority – a weapon by which the claims of wealth holders are asserted against the rest of society.

2. The US

Since 1980, the financial sector has doubled its weight in the US economy, with value added and profits for financial businesses rising from 15 and 7.5 percent of total corporate profits and value added in 1980, to 30 percent and 14 percent as of the end of 2016. (In the early 2000s, financial-sector profits briefly reached a full half of corporate profits.) This growth of finance as an industry as gone hand in hand with an expansion of balance sheets across the economy, with households and nonfinancial business increasing their debt from 30 and 50 percent of GDP, respectively, in 1980, to over 70 percent in the mid-2000s. Household financial assets meanwhile have risen from 250 percent of GDP in 1980 to 400 percent today. (The value of nonfinancial household assets – overwhelmingly houses – increased sharply as a share of GDP in the mid 2000s, but has since returned to close to its 1980 level.)

Alongside these quantitative increases in the size of finance is a harder to measure but undeniable expansion in finance's social role. Over the past generation, the US has seen an extension in the range of social claims and obligations that take financial form – that are expressed as a flow of future payments that can be capitalized into an asset and traded on a market (Davis, 2009). Higher education, for instance, has shifted from a model of direct public provision financed by taxes, to a model of financing through debt claims, which enjoy varying degrees of subsidies and guarantees and can in turn be traded as assets. Student debt is perhaps the most visible manifestation of the recasting of social ties as financial assets, but it is far from the only one – even the adoption of a family pet can now involve the creation of a tradable financial asset.[1] One important consequence of this recasting of social ties as financial claims is an increasing pressure for households to prioritize market income over nonmarket activities.

Who is finance? Does it make sense to think of financial and nonfinancial capital as distinct entities with distinct, perhaps conflicting, interests? For orthodoxy, of course, this question doesn't arise – financial and nonfinancial business are just two pockets in which households may happen to hold their wealth. For heterodox traditions the question is central. Keynes famously

[1] Patricia Clark, "I'm Renting a Dog?", Bloomberg News, March 1, 2017.

counterposed the entrepreneur and the rentier, while Marx's extensive but scattered writings on finance writings invite – but don't answer – the question: Should "capital" and "finance" should be imagined as two different social actors or as two moments in a single process? Or perhaps they were formerly distinct actors who are now undergoing "a process of hybridization or merger" (Duménil and Lévy, 2011). The Italian Marxist Antonio Negri famously declared that "money has one face, the face of the boss'." (quoted in Henwood, 1998, p. 231). But other writers in the Marxist tradition have been more inclined to draw a sharp line between finance capital and industrial capital.[2]

These questions are easier to operationalize when we turn to corporate governance. Most concretely, we can imagine a conflict over claims on corporate cash flows. One of the most striking features of financialization is the increase in the permeability, so to speak, of the financial membrane of the corporation. For at least 40 years prior to the early 1980s, the bulk of corporate profits remained within the firm, and the bulk of investment was financed by retained profits. But for the past 30 years, this has not been the case: a much larger share, approaching or exceeding 100 percent, of the firm's profits have been paid out to shareholders. With a concomitant increase in the fraction of investment financed externally (Lazonick, 2012; Mason, 2015*a*). One important implication of this is that relationship between profitability and investment - taken for granted in much of the heterodox literature – is much weaker today, at both the firm and aggregate level, than it was formerly (Brown and Petersen, 2009; Mason, 2015*a*).

Why have payouts increased so much? Two broad answers present themselves: Either there are fewer opportunities for nonfinancial investment, or financial claims are more exigent. In the former case, we might look to the increasing importance of intangible capital, or the greater monopolization of product markets (Durand and Gueuder, forthcoming). But perhaps the most natural explanation is that shareholders are more desirous of, and/or more capable of demanding, higher payouts. Of course this only make sense if corporations and shareholders are, in some sense, distinct social actors - otherwise payouts would just be moving money from one pocket to another. But it is clear from the business press that shareholders do, indeed value payouts – that they do not regard funds in corporate treasuries as equivalent to their persona wealth.

The view of payouts as the result of more pressing shareholder demands is part of a larger

[2]There are many examples; for one, see Russell (2008).

story about the shifting locus of authority within the corporation. The relationship between holders of managerial positions within the firm, and financial claimants on it, has evolved over the past 30 years. From the hostile takeovers of the 1980s to the rise of shareholder activism more recently, along with the shifts of executive career paths and compensation that have aligned their interests with shareholders, the capacity of shareholders to direct the day-to-day operations of the firm is much greater than it was in 1980.

A more recent development is the consolidation of financial claims into a few large, centrally managed funds. The probability that two randomly selected firms in the same industry from the S&P 1500 have a common shareholder with at least 5% stakes in both firms increased from less than 20% in 1999 to 90% in 2014 (Azar, 2016). The positive content of profit maximization doesn't depend on "profits for whom?" when each firm has its own shareholders; but when ownership interests are pooled in a few – or, tendentially, one – large funds, maximization of profits for the firm may imply different behavior from maximization of profits for its owners. Competing for market share makes sense in the first case but not in the second. Finance, in effect, suspends competition. This is obviously a concern for those who see market competition as promoting socially desirable outcomes. But it also carries a more subversive implication. If professional managers can reliably administer corporations in the interests of shareholders in general, it is only a small step further to suggest they could administer them in the interest of society as a whole. So the consolidation of share ownership in a few large funds can be seen as a vindication of the views of Rudolf Hilferding and other theorists of "finance capital" around the turn of the last century.

Turning to the household sector, the rise in household debt has attracted more attention than the quantitatively larger rise in household assets. Arguments from a range of perspectives have linked the rise in household debt to the increasingly unequal distribution of household income. One view sees increasing debt as the result of misguided attempts at redistribution via the financial system – efforts to encourage lending to poorer households left the intended beneficiaries with unmanageable debt. (Rajan, 2011, ch. 1) An alternative view – politically opposed but analytically parallel – sees lower-income households as choosing to borrow more to sustain rising living standards in the face of stagnating incomes. (van Treeck, 2014) Any form of this argument, however, has to accommodate certain challenging facts – that household debt is concentrated in the upper part of the income distribution (60 percent of debt is owed by the richest 20 percent); and that household debt overwhelmingly finances assets and quasi-assets

(credentials, etc.) rather than current consumption. (Mason, 2017)

In the event, credit markets have not done much to support household consumption. While there are major challenges in measuring the distribution of consumption, it appears to have broadly tracked the distribution of income (Aguiar and Bils, 2015). And what appears, by standard measures, to be a rise in aggregate consumption, in fact reflects the classification of a number of items in the national accounts as "consumption" that do not involve any cash outlay by households. The national accounts show a 10 point increase in the headline consumption/GDP measure since 1980. But 5 points of this is public health care spending (Medicare and Medicaid), which is counted as household consumption despite the fact that the payments come from the public sector; 3 points are an increase in employer spending on health insurance, which is similarly counted as household consumption; and 1 point is an increase in owner's equivalent rent – the consumption spending that BEA imputes to home-owning households as rental payments to themselves. If we limit "consumption" to actual cash outlays by households – logically, the only form of consumption that can result in changes to household balance sheets – it is essentially flat as a share of GDP since 1980 (Cynamon and Fazzari, 2014). What, then, were households borrowing for? To a first approximation: interest payments. Essentially all of the increase in the household debt-GDP ratio since 1980 is explained, in an accounting sense, by the rise in the nominal interest rates faced by households, relative to nominal income growth. Most attempts to explain why household debt has risen since 1980 implicitly reframe the question as, why have households borrowed more? But the premise is faulty: the net flow of funds to the household sector through credit markets has been no higher in the 35 years since 1980, when debt ratios have rose steeply, than in the 35 years before, when they were stable (Mason and Jayadev, 2015).

The central role of high real interest rates in the evolution of household debt ratios points to a broader dimension of financialization – the autonomy of financial variables. The autonomy of financial positions in relation to real activity has been important, in debates over Thomas Piketty's *Capital in the 21st Century*. In the book and, to a greater extent, in a number of articles coauthored with Gabriel Zucman and others, Piketty has sought to explain the rise in the ratio of the capital-wealth ratio by net investment relative to output growth, in the same terms as standard growth models. But as a number of critics have pointed out, when capital is measured in financial form – as net wealth – its evolution cannot be understood this way. Most of the variation in net wealth – both over time and across countries – is driven by valuation

changes in existing assets, including land, rather than investment spending. It appears the flow of capital income determines the stock of capital, rather than the other way round (Knibbe, 2014; Naidu, 2017). Piketty has frankly acknowledged this problem, and has suggested the explanation lies in the ways that asset values reflect social relations, and in particular the balance of power between labor and capital. The disproportionate rise in the corporate stock component of "K"

> in Anglo-Saxon countries might be related to the fact that shareholders have more control over corporations than in Germany, France, and Japan. ... the "control right" or "stakeholder" view of the firm can in principle explain why the market value of corporations is particularly low in Germany (where worker representatives have voting rights in corporate boards). (Piketty and Zucman, 2014)

If the evolution of balance sheet positions does not directly depend on the real expenditure and production, is the converse also true? For all the evident expansion of finance, it is not obvious that real activity is particularly sensitive to financial developments. In the wake of the global financial crisis of 2008, there was a good deal of empirical work on how the breakdown in the credit system contributed to fall in real activity, especially investment. No clear consensus emerges from these studies – while it is plausible that smaller firms seeking to invest in the immediate crisis period faced significant financing constraints, it is harder to tell this story for the larger corporations that account for the bulk of economic activity, or for weak recovery in subsequent years. For all the attention given to financial instability and crises, their direct importance for the world beyond finance should not be taken for granted.

This weak articulation of financial and nonfinancial activity poses a particular problem for monetary policy, whose writ is to stabilize the latter by modifying the former. Textbooks still blandly assert that "the central bank sets the interest rate" but it has long been recognized that the actual transmission mechanism is more complex and problematic (Bernanke and Gertler, 1995). There is a range of interest rates and they do not all move in unison. Financing conditions depend on more than the prevailing interest rate. And financing is only one of several factors governing investment decisions, whose importance may be greater or less depending on the circumstances. But while "the" interest rate has never fixed the level of current expenditure in the way textbook models suggest, recent developments have made the conduct of monetary policy even more challenging. The scale of demand management required has increased while

traditional tools have become weaker or are unavailable, and while central banks are being asked – or are taking it on themselves – to perform a broader set of roles. It is likely that macroeconomic stabilization by central banks requires at least some turn back toward financial repression, if not the full socialization of investment. Otherwise the Fed may increasingly find itself "an army with only a signal corps." (Friedman, 1999) Conversely, the extraordinary actions taken by the Fed and other central banks since 2008 make it harder to draw a line between monetary policy and lender of last resort/financial stability functions, on the one hand, and fiscal policy, on the other. While there is increasing talk of "normalizing" interest rates, it is unlikely that the Federal Reserve will ever return to the pre-2008 world of the federal funds rate and small balance sheet.

Fed policymakers often argue that they must move toward normalization rates because very low rates tend to "undermine financial stability." (Yellen, 2015) The idea that persistent low rates contribute to asset bubbles and other forms of financial fragility is, on its face, a reasonable argument for tightening. But implicitly, it suggests a profound critique of the financial system. If abundant liquidity leads not to greater productive investment but only to wasteful or irrational asset speculation, what does that say about financial markets' capacity to allocate scarce resources or coordinate production? The notion of a "global savings glut" as the source of macroeconomic instability, as proposed by Bernanke, carries a similar subversive implication. The task of finance, at its most basic level, is to turn saving into productive investment. If high saving we face a savings glut – that is, increased saving would just goes to waste, or worse – then why are we devoting such a large part of national income to finance? In this light, the increased share of national income going to finance could be seen as a sign of diminished productivity rather than increased output (Philippon, 2015). But the problem goes deeper: What is the financial system even for?

The question is more acute given the increase in payouts from the corporate sector describe above. These payouts are normally justified on the grounds that the channeling of resources to new investment is done better through financial markets than internally through the firm. But it is hard to understand see why we should expect the liquidity created by corporate payouts to be used productively if the liquidity created by the Fed, or by foreign inflows, cannot be. This concern is reinforced by the disproportion between the funds flowing out established corporations as payouts and funds flowing into new or growing businesses from financial markets. In 2014, for instance, corporations paid out $1.2 trillion in dividends and share buybacks, but only $80

billion flowed to new firms through IPOs and venture capitals, less than a tenth as much.For one dollar of new venture capital investment to be worth 10 dollars of lost internal funds for an established corporation, financial market participants would have to be vastly better at identifying opportunities for productive investment than professionals in industry. Skepticism on this point is reinforced by the fact that the era of financialization has seen no growth in output or employment at smaller firms, and no uptick in entrepreneurship (Mason, 2015*b*).

More broadly, even orthodox finance theory has long struggled to explain the vast amount of real resources expended on redirecting, exchanging and transforming financial claims – thus the "dividend puzzle," the "capital structure puzzle," and so on. A critical perspective on financialization should face squarely the possibility that these puzzles do not have solutions. Some large part of financial activity may not involve the efficient allocation of scare resources (Epstein, 2017). It may instead be pure waste, or it may have a different purpose: control. Thinkers from Smith to Marx to Ronald Coase and Peter Drucker have seen the corporation, and managerialism more generally, as a kind of incipient socialism. In its internal operations, the corporation replaces the logic of the market with an alternate form of social coordination that may, in principle, be directed to a variety of ends. It requires active oversight to ensure that it remains, in practice, directed toward maximizing the wealth of its notional owners. From this perspective, the function of finance is not the allocation of scarce resources, but the enforcement of rentiers' claims and authority. (Henwood, 1998, ch. 6)

This tension between the technical and political functions of finance appears in more acute form in the international realm. For a generation, the Washington Consensus has endorsed, and enforced, capital mobility - the freedom to contract financial claims across national borders. But what, even in principle, is a country supposed to gain from this? Set aside FDI, which does integrate a country into global production and distribution chains, for better or worse. Portfolio inflows can only have two macroeconomic benefits – they finance current account deficits, and they allow an expansion of credit beyond what the domestic banking system would otherwise provide. Even aside from the problems arising in practice – herd behavior, systematic mispricing of risk – are these even benefits ? Or are unsustainable deficits and credit booms precisely the source of many of the worst economic crises? If the current account should be roughly balanced and credit growth should be steady, it is hard to see even the best case scenario for macroeconomic gains from capital mobility.

Perhaps the gains are not to be looked for in this area, but rather in the "discipline" free

financial flows impose on national governments. Here at least there is a logically coherent claim – but an overtly political one. To support financial mobility on the grounds of discipline is, in effect, to call for replacement of the sovereignty of the people with the sovereignty of the "marktvolk" - the owners of financial assets, wherever they may reside. (Streeck, 2014) Despite periodic chatter about "the bond vigilantes," the US state remains basically immune to discipline of this sort. It will remain so as long as the dollar remains the world currency – any funds withdrawn by skittish foreign investors can be costlessly replaced by the Fed. With dollars accounting for a steady half of foreign borrowing, two-thirds of foreign exchange reserves and nearly 90 percent of foreign-exchange transactions, this situation does not seem likely to change any time soon. So in the US, the conflict between financial liberalization and national sovereignty remains only notional. But elsewhere this conflict is real and immediate - perhaps nowhere more than in Europe.

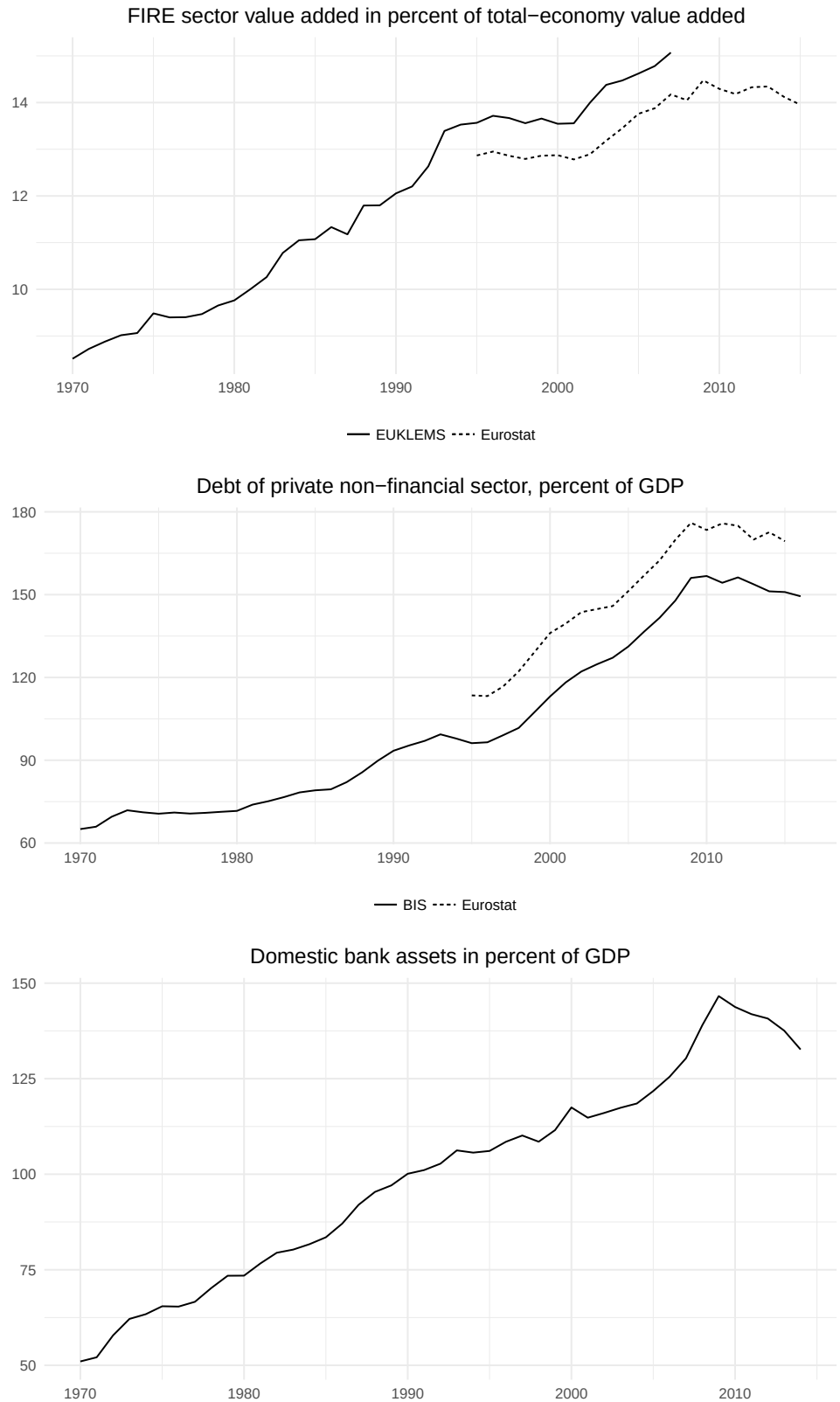
3. Europe

The quantitative financialization trends that can be observed in the United States are also visible in Europe.[3] For almost four decades, incomes in the European financial sector tended to grow faster than in the rest of the economy. The financial sector's share in total-economy value added climbed from 8.5 percent in 1970 to 15.1 percent in 2007 (see figure 1). Domestic bank assets have increased in Europe as well, namely from 51 percent of GDP in 1970 to 130 percent in 2007. European households and non-financial firms hold more debt than in the past: private non-financial sector debt rose from 65 percent of GDP in 1970 to 142 percent in 2007. All three measures indicate an acceleration of financialization trends in the decade preceding the global financial crisis; they tended to decrease slightly or stay roughly constant since.[4]

The triumph of finance has been most decisive in the realm of ideas. Its hallmark is the doctrine – widely shared by European economists – that rational financial markets can be harnessed to impose budgetary discipline on irrational sovereigns. If only new institutional designs were adopted to overcome moral hazard problems and market forces were allowed to work, this doctrine maintains, financial markets would get the price of sovereign borrowing

[3] Europe for the purpose of this article refers to the collection of 32 countries that effectively form a single market, that is, the members of the European Economic Area (as of June 2017) plus Switzerland.

[4] To the extent that research papers report quantitative financialization trends for Europe at all (most studies present data for the United States), the time period covered tends to be rather short. The statistics presented in figure 1 had to be constructed and they should be understood as nominal GDP-weighted averages across 32 European countries, adjusted to account for missing observations. Details in the data appendix.



Notes: The lines represent nominal GDP-weighted averages across 32 European countries, adjusted to account for missing observations. The data appendix reports the sources and describes how the time series were constructed.

Figure 1: Financialization trends in Europe

"right", so that reckless politicians otherwise prone to excessive spending would be led as if by an invisible hand to the adherence of hard budget constraints. In the event that public expenditure plans diverged on paths that financial market participants deem unsustainable, market forces would restore discipline and prudence by driving risk premia and the interest rate charged on government borrowing upwards – of course not too much and not too little – and governments would react by revising their expenditure plans accordingly. It is evident that the proponents of the doctrine welcome an environment in which financial market participants can act as the ultimate arbiters of fiscal policy. While members of the German Council of Economic Experts belong to the most glowing proponents of the doctrine (Feld et al., 2016), the preoccupation with moral hazard problems caused by implicit government guarantees and faith in the market mechanism as a prudent disciplining device are firmly entrenched in the economics establishment (e.g. Corsetti et al., 2016). Bofinger (2016) is a rare example of questioning the rationality of the financial market, which may send "wrong" price signals.

Viewing government as being in need of control by financial markets, orthodoxy has completed a U-turn from the post-war thinking which emanated from the inter-war debt muddle and the stock market crash that preceded the Great Depression. It was accepted then that strict controls on international financial transactions would be necessary to preserve national autonomy in the conduct of economy policy, and direct and extensive government intervention in financial markets would be required to contain the *inherent instability of credit*. This latter term describes the idea that financial markets are *pro-cyclical* in the sense that higher asset prices call forth higher asset demand and a greater willingness to borrow. Thus financial markets can send "wrong" price signals even in the absence of moral hazard problems. It used to be common practice, moreover, to intervene in the financial sector with a view toward influencing the volume and allocation of credit in order to pursue social and developmental goals.

These interventionist ideas have fallen out of fashion. Today they surface only under the rubric of *financial repression*, meaning either policies that aim to lower the interest rate on government debt or more broadly any policy that interferes with the determination of the interest rate and the allocation of capital by free market forces. The financialization of advanced economies since the 1970s occurred on the back of a turn toward market-conforming economic policies, financial market deregulations, and capital account liberalizations worldwide. Europe was special in that the deregulation and liberalization drive received a considerable boost from the process of European integration. The 1957 Treaty of Rome already called for the abolition

of restrictions to the free movement of capital between member states of what then was the European Economic Community. Capital account liberalization did however not progress much in the quarter century after the Treaty was signed; this picture started to change only in the late 1970s and 1980s. The Thatcher government dismantled capital controls rapidly and let the currency float freely in 1979 and the Nordic countries, too, liberalized fairly rapidly in the 1980s. Other European countries adopted a more gradual approach until in 1990 capital controls were abolished in principle as part of the first stage of European Monetary Union.[5]

The capital account liberalizations in the 1980s set the stage for the financial turmoil in the early 1990s. The Nordic countries had joined liberalization with rapid deregulation of the domestic financial sector, and the resulting credit and asset price booms culminated in the Nordic financial crisis in 1990-1992. The EMS crisis in 1992 then demonstrated the increasing difficulty of pursuing national policy objectives in the presence of liberalized cross-border finance – gone was the national policy autonomy which the Bretton Woods institutions had been designed to defend. European states were now subject to the whims of international finance.

Capital controls gave way to the single market, and the creation of the single market helped to set in motion a process of competitive deregulation of the domestic financial sector. The Second Banking Directive, adopted in 1989, played an important role. A major step toward the creation of an integrated market in financial services, the Second Banking Directive incorporated the idea of a single banking license and established the principle of home-country control. Banks licensed in any one member state were then allowed to open branches and to provide cross-border financial services in any other member state, and the supervision of branch activities and of cross-border service provision would rest with the home-country regulatory agency. This much is clear: the task of national regulatory agencies entrusted with the maintenance of financial stability does not become simpler when foreign financial firms under the supervision of foreign regulatory agencies enter the domestic market. But more importantly, to the extent that lax regulatory standards enable domestic financial firms to expand their activities in foreign markets and the risks associated with these activities are concentrated there, the home-country regulatory agency has every incentive to show leniency. That this incentive structure would be capable of setting off a regulatory race to the bottom was well understood at the time – it was regarded as a feature, not a bug – and the race to the bottom materialized indeed: "The

[5]For the post-war history of capital account liberalizations in advanced economies, see for example Bakker and Chapple (2002) and Griffith-Jones, Gottschalk and Cirera (2003).

conjecture of analysts (e.g., Neven, 1993), according to whom the main benefit of the single market was to launch a process of competitive deregulation among national regulatory agencies using their power to help their banking industry, was fully supported by facts" (Dermine, 2003, p.41). The cheerleaders of finance viewed the single market as a welcome means to their end of liberating Europe from financial repression.

Deregulation, liberalization, and European integration thus encouraged a rapid expansion of the financial sector and cross-border banking well before the formal introduction of the euro in 1999. The euro then eliminated exchange rate risk and accelerated the expansion of cross-border banking. Domestic bank lending and cross-border bank lending in Europe virtually exploded until the crisis, as did banking sector leverage. By 2008 the median assets-to-equity ratio of the 20 largest European banks had climbed to 32 (ESRB, 2014). It was the rapid balance sheet lengthening of large, globally active banks headquartered in the financial centers in France, Germany, Switzerland, and the UK which provided a seemingly infinite source of credit to the banks in the periphery, and the easy credit conditions encouraged the development of boom-and-bust cycles in Greece, Ireland, and Spain. Rather than being passive bystanders to the financial boom in the United States, European banks played a pivotal role in the *global banking glut*. European banks used their US branches to obtain dollar-denominated funding in US money markets and invest in securities created by the US shadow banking system (Shin, 2012; Noeth and Sengupta, 2012). European investors accounted for the largest financial flows to the United States prior to the crisis and held the largest chunk of private label mortgage-backed securities (whereas Asian investors preferred to invest in securities issued or guaranteed by the US government (Milesi-Ferretti, 2009)). European banks can be regarded as the spearheads of financialization at least since 1999.

The legacy of the financial boom of unprecedented scale is a huge debt overhang. Many banks have trouble to collect their financial claims, which is a drag on growth because non-performing loans diminish their propensity to lend. Many firms and households struggle to service their debt, which is a drag on growth because overstretched balance sheets and deleveraging efforts reduce their propensity to spend. Some debtors owe their economic survival to the unconventional monetary policy measures of the European Central Bank, which keeps interest rates low and thus eases the debt service burden. The debtors would welcome inflation, debt restructuring, and outright debt forgiveness. The creditors resist and insist on payment. By acknowledging that some claims are uncollectable and some debts are unpayable, government

interventions could unclog the web of credit and debt relations. But even if favorable for growth in the future, interventions involve a redistribution of net wealth from creditors to debtors in the present. To the extent that national borders separate creditors and debtors and narratives, politics, and identities remain largely national, decisive interventions do not appear to be forthcoming. The antagonistic relation between the creditors and the debtors only feeds resentment between countries. The promoters of deregulation and liberalization presumed that a complex web of credit and debt relations between firms, households, and governments in different countries would manage itself. Yet the conflicts brought about by international financial entanglement are pushing Europe to the brink of collapse.

4. India

The evolution of the financial system in independent India can be broadly categorized into three separate periods. The first was a period of relatively unregulated finance between 1947 and 1969 (sometimes called the pre-nationalization era). This was followed by a period of increasing direct intervention between 1969 and 1991 (variously called the era of financial repression, the era of nationalization, or the era of "social control"). The last and ongoing period, consists of a movement back towards a more privatized market oriented financial system from 1991 (called the era of financial reform).

The period of social control began in 1969 when 14 of the largest Indian scheduled commercial banks were nationalized (Sen and Vaidya, 1997). The bank nationalization was part of the attempt to establish the priorities set out in the planning process. Under this policy more than four-fifths of the deposits in the Indian economy came under public control. The consequences wrought by nationalization were deep and abiding. The state had much more direct control over the level and flexibility of interest rates and the distribution of credit to serve its aims.

In 1991, a period of major macroeconomic instability, precipitated by a balance of payments crisis, led to the adoption of wide ranging economic reforms in India. A key element of these economic reforms was the restructuring of the financial sector towards a more market oriented approach, centrally, the refocusing of attention in banking to profit-making and moving the Indian economy away from a dirigiste regime towards a more liberalized and globalized system. The banking system was faced with a large non-performing assets issue in the late 1980s and successive governments have tried to improve its health by reducing some directed lending (i.e.

what was termed priority sector lending) and by allowing for internal and external financial liberalization. (For a more extensive discussion on the policy decisions undertaken and the institutional framing, see (Mohan and Ray, 2017; Shah and Patnaik, 2011)

Perhaps because of India's "strong consensus for weak reforms"(Ahluwalia, 2002), even 25 years following the onset of liberalization, India remains decidedly less liberal in its attitudes towards finance than the west. While interest rates are largely market determined, some interest rates remain administered. Similarly, while there is increased private sector banking competition, public sector banks continue to dominate intermediation, which allows for much more direct and indirect control by the state. With respect to the external market, the exchange rate regime remains one of a dirty float, and there are important restrictions on capital flows that limit the volatility imposed by international financial markets. While policy makers often talk as if there is an end goal of a completely liberal regime, in practice, considerations of equity and maintaining stability has meant that the country continues to engage in extensive policy attempts to balance competing demands. Thus, there is the simultaneous obsession among policy makers with attracting foreign capital and with the performance of the stock market on the one hand and on financial inclusion to address the fact that stable, formal credit is simply not available to a very large mass of the population. In that sense, India's recent financial history provides a concrete example of a pattern that may be true of several developing countries: the stated goal of a fully liberal financial regime colliding head on with the need to provide and direct credit in areas of political or social priority.

Financial liberalization meant a moving away from directed lending as a policy lever, particularly to the agricultural sector and to small scale industry certainly had severe distributional consequences, (see Jayadev (2005) for an extensive discussion of the actual disintermediation of the poor from the formal credit system in the 1990s). In the period following, the country has struggled with attempting to create conditions whereby the poor and disintermediated are able to obtain finance. "Financial inclusion" was explicitly readopted as a stated goal of the Reserve Bank of India in the mid 2000s. These proposals were meant to address distributional concerns at the lower end of the income distribution. Following its Mid Term Monetary Policy review paper in 2005, the RBI began to promote efforts towards financial inclusion in 2005. It recommended that all national banks promote financial inclusion as a prime objective in their plans and detailed some recommendations as to the ways this could be achieved. Again, because of the ideological commitment to a more liberal regime, the discussion has not promoted the

direct provisioning of credit by the banks, but rather suggested that banks offer better and more tailored financial products. As such, the focus has moved away from directed lending to providing some new products such as no-frills accounts, simplifying registration norms, providing credit thorough Kisan Credit Cards (Farmer credit cards) and the like.

While India has maintained some form of state control, there has been an unequivocal move towards greater liberalism, especially with regard to capital markets. Mutual funds and investment vehicles that take part in equity markets have grown considerably in the last decade, and external capital invests heavily in it. The BSE index has more than tripled since 2005 to sit at around 30000 in 2017. This in turn has been driven in part by the massive inflow of capital from abroad. This noted, the stock market, for all its oversize grip on policy makers imagination caters to a very small percentage of the domestic population. Estimates suggest that about 2-3 percent of the population have any holding interest in the stock market.

Throughout the period, despite a clear preference for a measured opening based on a hierarchy of preferences for equity over debt flows and Foreign Direct Investment over Foreign Private Investment, pressures to completely open the capital market with no restrictions continued to gather apace. Throughout the 2000s the RBI was criticized as being antediluvian and ad hoc, since full capital account convertibility was always seen to be the end goal. The implosion of the US financial system in 2008 and the concomitant change in attitudes towards capital account liberalization vindicated, however, the stance of gradualism and pragmatism adopted by Indian policy makers. In 2013, the Governor of the RBI reiterated the stance of gradualism and pointed towards the probability that both quantitative and price controls on capital flows would be maintained indefinitely (Subbarao et al., 2014). To date, despite more dependence on the rest of the world for financial flows (Narayan, Jayadev and Mason, 2017)), some quantitative restrictions remain.

How then is one to understand finance as a locus of power in the Indian economy? At one level it is not an autonomous and powerful actor as in the west. Banking and finance continue to be regulated and credit by and large is still indirectly in the broad locus of state control. While monetary policy is supposedly converging to the 'gold standard' of inflation targeting, it is not clear whether the RBI is in any sense constrained by stated commitments. As such, finance has not achieved a hegemonic status. At the same time, there is constant concern voiced about the need to maintain external inward capital flows. While some of this is due to the fact that India has continued to run trade deficits in the last three decades, at another level, external finance is

seen to be a disciplining mechanism against government overreach. The spokespeople for global capital in their turn constantly reiterate the need for more reforms. On balance, however, while there is certainly a greater turn to a liberal economy and a move towards empowering capital, this is not manifested in a very large space for finance as a separate and powerful player as of yet.

5. Conclusion

The purpose of this brief survey of financialization in three distinct settings was to suggest a particular political-economy perspective on financialization. In addition to, or instead of, a method for allocating claims on productive resources, finance can be seen as a system for constraining the choices of other social actors, both public and private. From this perspective financial liberalization is not – in effect or even in intent – a way of allowing nonfinancial units to redirect their expenditure in more preferred ways. Rather, it serves to *discipline* public and private actors – to constrain their choices in the direction of particular outcomes. In the US, this constraint is primarily directed at the corporate sector, reinforcing the claims on its notional "owners" and other financial claimants as against the claims or workers and their stakeholders, and against the autonomous growth and survival goals of management. In Europe, financialization most importantly constrains the choices of national governments. In today's orthodox view, these constraints – on the fiscal balance in particular, but also on the full range of regulatory and redistributive functions of the state – are in fact the most important benefit of financial integration.

Yet the same conflict between financialization and policy autonomy can also limit the extent to which financialization proceeds. Liberalization of financial markets, and the chronic instability and acute crises that have accompanied it, have led to a vast expansion of central bank balance sheets over the past decade, along with a qualitative extension of their role. In effect, the withdrawal of one form of state management of the macroeconomy, has led to the expansion of another – by "independent" central bankers rather than by democratically accountable governments, but management nonetheless. And both the financial crises and the "mispricing" of public and private debt on which they are blamed, undercut the legitimacy of the claims of financial asset-owners – as does finance's effective suspension of market competition. Finance may be an "instrument in the hand of the capitalist classes as a whole in the domination they

exercise over the entire economy," (Duménil and Lévy, 2011, p. 57) but it is clear that the pressures exerted can run in both directions.

This same dynamic is visible in a different way in India. Here we see how the policy goals and political commitments of a government may deter it from accepting the straitjacket of financialization, even when, rhetorically, this is an accepted goal across the political spectrum. As a result, finance has not (yet) developed as a distinct social actor there in the way it has in the US and Europe. The financial system remains stubbornly bank-based, limiting the ability of shifts in market sentiment to force compliance on nonfinancial decision makers. Restrictions on capital mobility and "financial repression," including regulatory requirement for banks to hold substantial amounts of public debt, mean that the Indian state is not "disciplined" by finance in the way that European states are. (Nor does the Reserve Bank of India have anything like the independence of the ECB, or even the Fed, or their narrow price-stability mandates.) The case of India demonstrates the importance of financialization as constraint in a negative way – if these constraints conflict too sharply with the concrete needs of policy making, they will not be accepted in practice, even if the ideological consensus in support of financialization is strong.

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A. Data Appendix

Two different databases were used to compute the FIRE sector's share in total-economy value added. The EUKLEMS database provides value added in current local-currency prices by industry according to the ISIC Rev.3 industrial classification system. The FIRE sector encompasses financial intermediation actitivies (code J) and real estate activities (code 70). The EUKLEMS database yields an unbalanced panel from 1970 to 2007 composed of Austria, Belgium, Cyprus, Czech Republic, Denmark, Spain, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia, Sweden, United Kingdom. Eurostat provides value added in current euros by industry according to the NACE Rev.2 industrial classification system. The FIRE sector encompasses financial and insurance actitivies (code K) and real estate activities (code L). The Eurostat database yields an unbalanced panel from 1995 to 2015 composed of the aforementioned countries plus Bulgaria, Switzerland, Croatia, Iceland, Macedonia, Montenegro, Norway, Romania, Serbia, and Kosovo.

EUKLEMS Growth and Productivity Accounts: November 2009 Release, updated March 2011: `http://www.euklems.net/`

Eurostat Gross value added and income by A*10 industry breakdowns, ESA 2010: `http://ec.europa.eu/eurostat/data/database`

Two different databases were used to compute the private debt-to-GDP ratio. The BIS database provides a time series that measures total credit to the private non-financial sector (households and non-financial businesses) in percent of GDP. Although observations date back to 1940, 1970 was chosen as the cut-off year because many observations before 1970 are missing. A high share of missing observations would impair the reliability of the estimated European trends. The unbalanced panel from 1970 to 2016 is composed of Austria, Belgium, Switzerland, Czech Republic, Germany, Denmark, Spain, Finland, France, United Kingdom, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Portugal, and Sweden. Eurostat provides time series that measure the total liabilities of the household sector and the non-financial business sector in percent of GDP. The unconsolidated liabilities are summed across the two sectors and equity is subtracted to arrive at a measure of debt. The unbalanced panel is composed of Austria, Belgium, Switzerland, Czech Republic, Germany, Denmark, Spain,

Finland, France, United Kingdom, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Portugal, Sweden, Bulgaria, Cyprus, Estonia, Croatia, Iceland, Lithuania, Latvia, Malta, Slovakia, and Slovenia.

BIS Credit to the non-financial sector: `http://www.bis.org/statistics/totcredit.htm]` `(http://www.bis.org/statistics/totcredit.htm`

Eurostat Annual sector accounts, ESA 2010, financial balance sheets: `http://ec.europa.eu/eurostat/data/database`

Observations on domestic bank assets are sourced from the Global Financial Development Database. The variable measures claims on the domestic real nonfinancial sector held by resident deposit money banks as a share of GDP. The unbalanced panel from 1970 to 2014 is composed of Austria, Belgium, Bulgaria, Switzerland, Cyprus, Czech Republic, Germany, Denmark, Spain, Estonia, Finland, France, United Kingdom, Greece, Croatia, Hungary, Ireland, Iceland, Italy, Lithuania, Luxembourg, Latvia, Malta, Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, and Sweden.

GFDD Global Financial Development Database `http://data.worldbank.org/data-catalog/global-financial-development`

Given a *balanced* panel, indicators for Europe could be computed simply as weighted averages across European countries. Yet only *unbalanced* panels are available, hence regressions are run to correct for missing observations. The European trends presented in section 3 are the result of a weighted dummy variable regression. The estimated country-and-year fixed effects model is $y_{it} = a_i + a_t + u_{it}$, where a_i is the intercept for country i, a_t is the intercept for year t, and u_{it} is the error. Time-invariant weights are used in the least-squares regression; the countries are weighted by their 2007 nominal GDP in euros (sourced from AMECO). The dependent variable y_{it} is the FIRE sector's share in total-economy value added, the debt-to-GDP ratio, and domestic bank assets-to-GDP respectively. Figure 1 shows the estimated year effects $\hat{a}_t$.

AMECO Annual Macro-Economic Database of the European Commission's Directorate General for Economic and Financial Affairs: `http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm`