Introduction

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During the recent decades the financial sectors of developed and developing countries have changed remarkably.[1] There has been a major increase in the degree of financial intermediation, and new financial instruments, triggered by national and international legal liberalisation and by the progress of communication technologies, have been developed. The overall importance of financial factors for real investment and growth of non-financial business has risen, as has the financial activity of non-financial corporations. This has been accompanied by an increasing activity of commercial banks in non-credit financial business. The development of new financial instruments, together with the booms in stock market and real estate prices, has increased the potential for wealth-based and debt-financed consumption of private households. Also power relations between shareholders in joint stock companies, management, and labourers seem to have changed. Finally, financial fragility, to use a term introduced by Hyman Minsky (1977), seems to have increased as a result of these developments. The current financial turbulences, generated by the sub-prime mortgage crisis in the USA and spreading over international financial markets since summer 2007, may be seen as a result of this increased fragility.

The recent developments in the financial sector and their effects on the macro-economy require deeper investigation. The present book attempts to contribute to a better understanding of what has been called

[1] See for example the overview in Eatwell and Taylor (2000) for an early analysis, Krippner (2005) and the contributions in Epstein (2005) for a detailed treatment of the development in the U.S. and other countries, van Treeck, Hein and Dünhaupt (2007) for a comparison of the macroeconomics of 'financialisation' in the U.S. and Germany, and Stockhammer (2007) for the development in Europe.

'financialisation' by some authors (Epstein 2005, Krippner 2005).[2] The book has five sections. In Section I recent trends and implications of 'financialisation' are analysed from different angles. Section II deals with financial systems and economic development, Section III contains contributions on the international monetary order and on global financial imbalances. The chapters in Section IV focus on financial instability and financial crises in general, and Section V is dedicated to the U.S. financial market crisis and its consequences in particular. In what follows an overview over the contributions to these sections is presented.

I. Financialisation – trends and implications

In "Financialization: what it is and why it matters" *Thomas Palley* argues that financialisation is a process whereby financial markets, financial institutions and financial elites gain greater influence over economic policy and economic outcomes. Financialisation transforms the functioning of the economic system at both the macro and the micro level. According to his view, the principal impacts of financialisation are to (1) elevate the significance of the financial sector relative to the real sector; (2) transfer income from the real sector to the financial sector; and (3) increase income inequality and contribute to wage stagnation. Additionally, there are reasons to believe that financialisation may render the economy prone to risks of debt-deflation and prolonged recession. Financialisation operates through three different conduits: (1) changes in the structure and operation of financial markets; (2) changes in the behaviour of non-financial corporations, and (3) changes in economic policy. Finally, Palley argues that countering financialisation calls for a multi-faceted agenda that (1) restores policy control over financial markets, (2) challenges the neo-liberal economic policy paradigm encouraged by financialisation, (3) makes corporations responsive to interests of stakeholders other than just financial markets, and (4) reforms the political process so as to diminish the influence of corporations and wealthy elites.

[2] In the definition of Epstein (2005: 3), "financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies".

Sigurt Vitols then takes a closer look at recent developments in financial markets and asks: “Private equity: financial engineering or solution to market failure?” He finds that on the whole, a critical analysis of Private Equity (PE) activity fails to show a clear gain for either PE investors or for employees. Given the heterogeneity of PE activity, however, which spans from ‘win-win’ cases for both society and PE investors to clearly exploitative activity, it would be desirable, according to Vitols, to consider what type of regulatory regime would discourage negative PE investments while at the same time encouraging (or at least not discouraging) the positive cases. Hence, neither a laissez-faire approach nor an outright ban on PE activity would be desirable. Finally, the author proposes a number of economic policy recommendations for the regulation of PE related to improved transparency, registration of PE funds through a public authority, regulatory standards for debt-equity ratios, eliminating tax subsidies for speculative PE, strengthening of employee rights and pressure on institutional investors (pension funds, mutual funds, insurance companies, and so on) to discourage investment in PE funds which do not fulfil transparency and worker information/participation requirements and respect the code of conduct.

The macroeconomic effects of shareholder value orientation and rising dividend payments are assessed by *Eckhard Hein* in: “Rising shareholder power – effects on distribution, capacity utilisation and capital accumulation in Kaleckian/Post-Kaleckian models”. The focus is on the effects of changes in distribution between shareholders/rentiers, firms and workers, as well as on the effects of increasing ‘shareholder value orientation’ of management’s investment decisions applying two different variants of a Kaleckian model. Hein argues that an isolated increase in the ‘shareholder value orientation’ of management’s investment decisions has a uniquely negative effect on capacity utilisation, the profit rate and capital accumulation in both models. An associated rise in the dividend-capital rate, however, has contradicting effects. In both Kaleckian models the ‘normal’ case of a negative effect on all the endogenous variables, the ‘puzzling’ case of a positive effect throughout, and an ‘intermediate’ case with a positive effect on capacity utilisation and the profit rate and with a negative effect on capital accumulation may arise, depending on the parameter values in the investment and the saving function of the models. ‘Profits without investment’ as observed empirically in the USA since the early 1980s, the ‘intermediate’ case in both models, therefore is a

possible accumulation regime. However, if rising shareholder power is associated with a particularly strong increase in the mark-up and hence with pronounced redistribution at the expense of labour and with a pronounced shareholder value orientation of management's preferences, the viability of such a regime will be undermined.

II. Financial systems and economic development

In his contribution "Financial systems in developing countries and economic development" *Hansjörg Herr* puts forward the argument that in spite of financial globalisation domestic development depends crucially on domestic investment financed by domestic credit in domestic currency. A number of East Asian countries, followed by China seem to be good examples of such an accumulation process. The relatively low quality of currencies of developing countries is one of the most difficult hurdles for development, the author argues. It prevents a domestically financed Schumpeterian-Keynesian credit-investment-income process because a large part of domestic monetary wealth during such a process is exchanged in foreign currency, triggers depreciation and leads to an extremely tight macroeconomic monetary budget constraint which suppresses development. Replacing a domestic accumulation process in domestic money with a foreign financed accumulation process is therefore dangerous and works only under very special conditions. The most important ones are the creation of sufficient domestic demand in spite of demand-reducing current account deficits, long-term stable capital inflows and successful measures against Dutch disease effects. In too many cases the attempt to create sustainable development via net capital inflows and current account deficits have failed and ended in twin crises and a perpetuation of underdevelopment, according to Herr. He therefore concludes that a superior development strategy seems to be to boost domestic investment by domestic credit in domestic currency, allow some selected foreign direct investment inflows, and restrict other types of capital flows, as well as to prevent current account deficits.

The succeeding chapter by *Jan Kregel* is on "Financial flows and international imbalances – the role of catching-up by late industrialising developing countries". He holds that while the traditional approach to the adjustment of international imbalances assumes industrialised countries

at a similar level of development and with similar production structures, such imbalances have historically been the result of a process of catching up by late-industrialising developing countries. This may call for an alternative approach that assesses how the imbalances can be managed in order to support developing countries' efforts to achieve successful industrialisation and integration into the global trade and financial system. In this light, Kregel's chapter presents an alternative explanation of the existence and persistence of the currently high levels of imbalances and suggests reasons why they may persist in the medium term.

Nishtha Khurana then deals with "Crisis prevention and capital controls in India: perspectives of capital account liberalisation in the current scenario". She starts with the observation that India with its long standing capital controls now eyes a full capital account liberalisation by 2009–10, and that further reforms are gradually being put in place including the opening to portfolio investments as capital inflows. Khurana argues that portfolio investments are volatile and any kind of volatile flows make the developing economies vulnerable to financial crisis. The chapter analyses the capital controls in India and the potential risk of a financial crisis and/or a recession hitting the Indian economy under the current scenarios. For this purpose, an analysis of the exchange rate regime, the stock market and the banking sector is undertaken to find out points of risk. It is revealed that the exchange rate in India is quasi-fixed and not market determined as contended by the central bank. It is argued that stock markets are likely to crash in the near future plunging the Indian economy into a recession. The banking sector at present does not constitute a major risk but at the same time is suffering from inherent weaknesses. Finally, the author concludes that time is not yet ripe for full capital account convertibility in India.

III. International monetary order and imbalances

The forces behind the so-called "global capital flows paradox" and the related "dollar glut" observed in the era of advancing financial globalisation are examined by *Jörg Bibow* in "The international monetary (non-) order and the 'global capital flows paradox' ". The supposed paradox is that the developing world has increasingly come to pursue policies that resulted in current account surpluses and thus net capital exports – des-

tined primarily to the capital-rich USA. The hypothesis put forward by Bibow is that systemic deficiencies in the international monetary and financial order have been the root cause behind today's situation. Furthermore, it is argued that the position of the USA as issuer of the world's premier reserve currency and its supremacy in global finance explain the related conundrum of a positive investment income balance despite a negative international investment position. The assessment is carried out in the light of Keynes's views on a sound international monetary and financial order.

Michael Hudson continues with "Trends that can't go on forever, won't: financial bubbles, trade and exchange rates". He deals with several issues: 1. the need to restore the financial dimension to international economics, 2. how interest rates, mortgage credit and real estate bubbles determine cost disparities, 3. the rising importance of finance, insurance, real estate-sector costs, 4. how the post-Soviet property bubbles have financed their trade deficits, 5. how the USA free ride has fuelled a global financial bubble, 6. the U.S. payments deficit as the "engine of world growth" or as economic overhead, and 7. with financialising the global bubble economy.

"Macroeconomic policy with open capital accounts" is the subject and the title of the chapter by *Fernando J. Cardim de Carvalho*. The chapter starts with the observation that for most countries, opening the capital account of the balance of payments reduces domestic autonomy in the choice of goals and even of instruments of monetary policy. Capital account liberalisation increases international financial integration and this means precisely that national financial transactions become part of a bigger market, the global market. However, it is usually proposed that flexible exchange rates should obviate the problem, allowing countries to recover their power to decide on domestic interest rates. It is a central goal of this chapter, however, to argue that the orthodox view that floating exchange rates are efficient alternatives to capital controls, in order to obtain at least partial, but still significant, insulation of domestic policy-making, grossly underestimates the loss of domestic autonomy resulting from opening the capital account. The author encounters several reasons for this: Firstly, financial flows are not similar in behaviour to trade flows. Secondly, the loss of policy-making autonomy is not limited to monetary policy. Thirdly, what flexible exchange rates do is just to shift part of the adjustment burden from the interest rate to the exchange rate.

Finally, market discipline in the case of the financial system is very defective and cannot be trusted to exercise a positive influence on policy-making.

IV. Financial (in)stability and financial crises

The first contribution by *Wolfgang Filc* in this section has the title "Inefficient markets: causes and consequences". The author holds the view that efficient financial markets are an indispensable requirement for economic well-being – economic growth, high employment, and price stability. But as financial turbulences during the last decade have demonstrated impressively according to Filc, the formerly prevailing strong belief that prices and yields in financial markets represent efficient solutions vanished into thin air. The underlying reasons for financial systems' proneness to crisis are risk, uncertainty, ignorance and greed, reinforced by financial globalisation. It is argued that a precondition to prevent financial crises is a credible macroeconomic policy and a much higher degree of coordination of economic policy between countries, which are of great importance for the world economy, as well as the elimination of those exchange rate developments which generate misleading allocation signals. Finally, the need of global governance of financial markets that accords with globalised economic relations is claimed.

The following chapter by *Stephan Schulmeister* "On the manic-depressive fluctuations of speculative prices" deals with the relationship between two phenomena: Asset prices move in a sequence of upward trends ("bull markets") and downward trends ("bear markets") which last for several years. At the same time, trading in financial markets has become progressively "faster", the time horizon of most transactions is shorter than a few hours. This coincidence begs the question: How do very short-term transactions generate long-term asset price trends? The main result of the chapter is the following. Over short periods of time (i.e., days or weeks), asset prices move in a sequence of "underlying" runs, sometimes interrupted by sideways movements ("whipsaws"). Over long periods of time, these runs last longer in one direction than the "counter-runs" do. The accumulation of these price movements results in upward or downward trends, i.e., "bull markets" and "bear markets". The sequences of these trends add up to long-term irregular cycles of asset

prices around the fundamental equilibrium without any tendency to converge towards this level.

V. Financial market crisis in the USA

The section on the recent financial market crisis in the USA starts with a chapter by *David F. Milleker* on "The rise and fall of the U.S. sub-prime mortgage market". The author analyses the impact of the sub-prime mortgage segment on the overall mortgage market within the empirical framework of an endogenous money-supply model. Consistent with the theory of financial crises as put forward by Charles Kindleberger, he finds that the opening of a new credit channel in the form of sub-prime mortgages initially sent the banks a signal of reduced risks by allowing Ponzi schemers into the market which depressed delinquency rates. The Ponzi schemers stayed in the market for as long as the mortgage rate was lower than a) the growth rate of house price appreciation and b) the growth rate of income. Once both conditions were not met any longer, delinquencies started to rise. In addition, Milleker finds that commercial banks tried to hedge potential risks by shifting the emphasis to adjustable rather than fixed rate mortgages. This, however, came at the cost of higher delinquencies down the line.

Christian E. Weller and *Kate Sabatini* in "On shaky ground: the U.S. mortgage boom and its economic consequences" deal with the consequences of the financial market crisis. They argue that following financial market deregulation in the 1990s, the U.S. mortgage market helped to finance an unprecedented housing boom, which boosted the asset values of many families. This meant, on the one hand, that families with homes had more collateral to borrow against, but it also meant that new home buyers needed to take out larger mortgages to afford a home. After 2001, the USA saw a sharp acceleration in the growth rate of household debt. Using micro survey data from the Survey of Consumer Finances conducted by the Federal Reserve and macro economic data from the Flow of Funds Accounts generated by the Federal Reserve, Weller and Sabatini analyse the effect of the housing and mortgage boom on families and the economy. In particular, they consider the growth effects and the impact on the financial and economic stability of home owners and the U.S. economy. The data indicate that entry into homeownership became

harder as the boom progressed, that homeowners became more susceptible to economic and financial shocks, and that the U.S. economy had already laid the foundation for a reduction in economic growth due to less consumption and less access to credit for consumers and investors by 1.0–1.5 percentage points following years of debt-led growth.

In the final chapter by *Dimitri B. Papadimitriou* on "Global imbalances: the U.S. and the rest of the world" starts with the observation that everyone knows the United States is effectively living beyond its means by borrowing heavily from its trade partners (notably, China, Japan and the European Union) to sustain current levels of consumption. But no one really knows how this will end. For America's creditors have become dependent on Americans' profligacy to power their economic growth, and thus have many incentives to keep the co-dependency cycle going on indefinitely. Unless a satisfactory long-term fix that permits full-employment without massive imbalances is achieved with international cooperation, a radical solution may be necessary. This chapter reviews what is believed to be the most important economic issue facing policy-makers in the USA and abroad: the prospect of growth recession in the U.S. linked to imbalances in the country's current account, government, and private sector deficits. The chapter concludes that given the declining housing and equity prices and the concomitant drop in net lending, a renewed stimulus from fiscal policy may be necessary. Alternatively, the solution would be to raise net export demand with 20 to 30 percent dollar devaluation (disorderly or not), even though this might itself be difficult to bring about.

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