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Financialization in a Long-Run Perspective

An Evolutionary Approach

Abstract: *This paper argues that there is a secular tendency toward financialization that is intrinsic in the development of market relations. The driving force of this evolutionary process is rooted in a fairly continuous flow of financial innovations meant to remove the existing constraints to the flexibility of economic transactions. For example, according to received wisdom, the adoption of money as a medium of exchange has removed the strictures of* **<the?>***double coincidence of wants, while the modern forms of credit have been developed to relax the cash-in-advance constraint on economic transactions. As these examples suggest, financial innovations aim to extend the set of exchange options in time, space, and contents for the decision makers who introduce them. Financial innovations are adopted because,* ceteris paribus, *a larger option set is positively correlated with higher expected returns and pay-off opportunities. Their systemic effects, however, may have negative implications such as*

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financial instability, underinvestment in the real sector, unemployment, and stagnation. When the negative consequences accumulate beyond a tolerable threshold, the remedy has to be sought in stricter rules of self-regulation, or rather of regulation by law, or even in severe measures of financial repression. The fact that this has not happened since the recent deep crisis has further enhanced the unsustainability of the current process of financialization.

Keywords: *financialization, globalization, sustainability*

Financialization is a neologism that was first used systematically in the early 1990s. The current usage of the term owes much to the work of Kevin Phillips, "who devoted a key chapter of his *Arrogant Capital* to the 'Financialization of America,' defining financialization as 'a prolonged split between the divergent real and financial economies' . . . in the same year Giovanni Arrighi used the concept in an analysis of international hegemonic transition" (Bellamy Foster 2008: <pg>, n. 3). The word and the underlying concept started to be adopted widely in the following years but almost exclusively by heterodox economists who, differently from orthodox ones, see financialization as a serious problem to be understood and removed, or at least mitigated. Notwithstanding its fortune, which subsequently gathered momentum with the growing strength of the process, the concept of financialization is still particularly controversial, as it has been defined in many ways that often look mutually inconsistent.

As in the case of globalization, industrialization, and many other words terminating with the suffix "–ization," the word designates a process characterized by an increasing weight and importance of the thing or quality preceding the suffix, in this case finance or, more generally, the financial side of economic decisions.[1] A portmanteau definition of this kind has the advantage of being broad enough to compare various episodes of financialization occurring in different times and places, but has the disadvantage of being too generic for a thorough causal analysis of specific episodes of financialization. The first part of this article presents a broad descriptive definition to clarify the outlines of a suggested evolutionary approach that is based on long-run analogies. The second part hints at some of the specificities that characterize the most recent episodes of financialization and some of their broad policy implications from the point of view of sustainability.

The first and main concern of the recent debate over financialization

is the process that started in the 1970s that may be called “neoliberal financialization” (or the “second financialization” since the industrial revolution). The position taken in this paper is that we cannot understand the meaning and implications of financialization without putting it in a long-run perspective. To this end, there are three main paradigmatic options: financialization is seen as a “unique” historical episode, or as a recurring phenomenon, or as a stage of a long-run process (or tendency). In this author’s opinion, the three options do not exclude each other: the three approaches can be combined within a comprehensive evolutionary paradigm.

The Secular Tendency Toward Financialization

All the episodes of financialization have specific characteristics that have to be thoroughly analyzed to understand their specific causes and implications, but it should first be made clear whether or not these episodes have something in common as is *prima facie* suggested by the use of the same descriptive word (financialization).

The investigation presented here starts from a very broad descriptive definition of financialization that may accommodate different stages of the evolution of “money” in a broad sense (including any variety of money, credit, and finance). Financialization designates the process of evolution, which has progressively increased the crucial role of money in the economy and society shaping the forms of exchange, circulation, distribution, and accumulation of exchange value. The increasing importance of money refers thus to the growing influence of the quantity of “money” in its different dimensions on one side, and of its institutional and technological structure on the other side. The second side is particularly important from the evolutionary point of view since monetary and financial instruments are fit for a particular technology of exchange and are introduced, managed, and monitored by specific institutions.

The driving force of financialization as evolutionary process is rooted in a fairly continuous flow of financial innovations, some of which are epoch making, meant to remove existing obstacles to the flexibility of exchanges. For example, according to received wisdom, the adoption of money as a medium of exchange has removed the strictures of **<the?>** double coincidence of wants **<what is this?>**, while credit has developed to relax the cash-in-advance constraint on economic transactions. As these examples suggest, financial innovations aim to extend the set of exchange

options in time, space, and contents for the decision makers who introduce them, so improve *ceteris paribus* their expected pay-off. Their systemic effects, however, often turn out to have negative implications, such as financial instability, unemployment, underinvestment in the real sector, and stagnation, as well as growing inequality and poverty. When these consequences accumulate beyond a certain threshold and their unsustainability becomes clear to a broad and influential constituency, the remedy may be sought in stricter rules of regulation by law and self-regulation, or in more severe measures of financial repression.

The secular tendency toward a progressive financialization of the economy has developed very slowly because it has been often constrained—if not repressed—for religious, ethical, and political reasons. A case in point is the fight against interest rates in the ancient world and in the middle ages. Charging a fee or interest for the use of money was considered "usury" no matter the rate of interest charged: "usury was forbidden in the Christian Bible, and anti-usury laws were strictly enforced by the Catholic Church until the end of the Middle ages. But in the Jewish scriptures, which were later joined to the Christian books as the "Old Testament," usury was forbidden only between 'brothers.' Charging interest to foreigners was thus allowed and even encouraged" (Hodgson Brown 2010: 57).[2] Therefore, we observe periods of acceleration of the process when financial repression is relaxed and periods of deceleration, even regression of the process (phases of de-financialization), when financial repression has been systematically strengthened. The latter, however, has never succeeded in interrupting the process for a long period of time.

The claim that we may detect a general tendency toward financialization is unusual and requires some clarification. It must be emphasized that it refers to the relative weight of "money" and the real economy in societies in which the economic motives are sufficiently autonomous and important to stimulate the concern and creativity of decision makers. This tendency has nothing to do with the alleged historical sequence from a barter economy to one dominated by metallic money, and finally one dominated by credit money, as in most standard accounts of the history of money in mainstream economics (see Graeber 2012: 21-41 for a short critical review). First, according to anthropological, ethnographic, and archeological knowledge, a barter economy has never existed (see in particular Graeber 2012 for an extensive analysis). As Caroline Humphrey maintained, summarizing the extensive anthropological research on barter, "no example of a barter economy, pure and simple, has ever

been described, let alone the emergence from it of money; all available ethnography suggests that there never has been such a thing" (quoted in Graeber 2012: 29). Second, Egyptian hieroglyphics and Mesopotamian cuneiform texts "revealed that credit systems . . . actually preceded the invention of coinage by thousands of years" (Graeber 2012: 38). Third, according to the same extensive corpus of knowledge, in the past 5,000 years there has been an alternation between (i) long periods in which virtual credit money dominated, as in the first agrarian empires (from about 3600 B.C. to 800 B.C.), then in the Middle Ages from about 600 A.D. to 1450 A.D., and finally, after 1971 when the link between currencies and gold was severed by President Richard Nixon; and (ii) long periods in which commodity money dominated, as in the Axial Ages (from about 800 B.C. to about 600 A.D.), and in the Contemporary Age (from about 1450 A.D. to 1971).

The process of financialization, as here conceived, is driven by financial innovations introduced with some continuity, in periods dominated by metallic money as well as in periods dominated by virtual credit money, whenever such innovations are not repressed and look profitable at the micro level. We <[illegible]?>detect a general tendency toward financialization because financial innovations in different temporal and specific contexts have something in common: they increase the flexibility of decision makers to make choices and are adopted in the belief that more flexibility brings about higher returns for the innovators.

The increasing flexibility of choice is realized through the liquidification and mobilization of assets and capital. Financial innovations increase the current and intertemporal flexibility of choices. This is the case in particular of liquidity-enhancing innovations (see in particular Hicks 1962 1974, 1989; see also Vercelli 1991 and 2013 and the literature surveyed there). In a situation characterized by uncertainty, a more liquid set of options, *ceteris paribus*, is in general valuable for the decision maker, as is confirmed by decision theory under uncertainty and, more specifically, by portfolio theory (an early formalization may be found in Jones and Ostroy 1984).

Liquidity preference has a cyclical component that may increase or decrease in different phases of the business cycle, but the trend toward more liquid assets and positions proceeds uninterrupted, at least in principle, because it promises to provide more freedom of choice for the decision makers exploiting the enhanced choice flexibility. A well-known epoch-making example of liquidity-enhancing innovations is the introduction

of joint-stock companies as magisterially analyzed by Keynes in Chapter 12 of the *General Theory*:

> Decisions to invest in private business of the old-fashioned type were . . . largely irrevocable. . . . With the separation between ownership and management which prevails to-day and with the development of organized investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. . . . [T]he Stock Exchange revaluates many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise its commitments. It is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week." (Keynes 1936<73>: 150–51).

The recent process of financialization confirms the interpretive key suggested above. A very significant example is the process of securitization that makes immediately liquid the expected flows of earnings that, as in the case of a mortgage, could otherwise extend for a long period of time (Minsky 1987).[3] Analogously, the emergence and development of shadow banking may be interpreted as a cluster of flexibility-enhancing innovations (Gorton 2009 and 2010). The systematic use of off-balance-sheet operations releases reserve capital, making it liquid, and extends the range of viable decisions by sheltering them from regulation and supervision. In addition, the systematic use of securitized assets as collateral in the repurchase-agreement (repo) market greatly increases available liquidity. It is not surprising that any attempt to regulate shadow banking has been stopped immediately by powerful lobbies claiming that the liquidity of the system would have dried up.

The trouble is that flexibility-enhancing innovations very often produce negative externalities at the macro level. In particular, a micro increase of efficiency produced by enhanced flexibility is often accompanied by more systemic instability that may jeopardize systemic efficiency. The trade-off between efficiency and stability was extensively discussed in the 1960s and 1970s, most economists claiming that the deregulation of finance would have greatly increased its efficiency without necessarily jeopardizing the stability of the system (see, e.g., Friedman 1960). This gave crucial support to the liberalization of finance, which has been systematically implemented since the late 1970s. We may now say with hindsight that in the above and subsequent debates, the advantages of

efficiency were greatly overstated while the disadvantages of instability were greatly underestimated.

Focusing on the period after the industrial revolution, we observe two periods of acceleration of the long-term process of financialization that have been defined as periods of financialization in the strict sense of the word, that is, of acceleration of the process leading to rapid structural change altering the operating rules of capitalism. The first financialization occurred in the second half of the nineteenth century and lasted until the beginning of the Great Depression, while the second financialization started after the end of the Bretton Woods period (1971) and is going on unchallenged notwithstanding the crisis. Though the immediate causes, modalities, and consequences of the first and second financializations are different due to being intertwined with contemporaneous processes and events, it is possible to find a few interesting analogies.

Let us first observe that the timing of the first and second financialization broadly overlap with the timing of the first and second globalizations (see Baldwin and Martin 1999; Borghesi and Vercelli 2008). This is not surprising, since the process of financialization may thrive only to the extent that the spatial constraints of exchange are removed, while the process of globalization may be implemented to the extent that it is supported by internationalized finance (see Figures 1 and 2).

Second, the processes of both financialization and globalization need a common permissive condition, namely, the liberalization of cross-country flows of goods, services, and capital: "both globalization waves were driven by radical reductions in technical and policy barriers to international transactions" (Baldwin and Martin 1999: 1). Both processes have been interrupted and to some extent repressed during the Bretton Woods period by the adoption of a policy strategy, influenced by Keynes, of strengthening public control over the economy, in particular over banks and finance. President Nixon's unilateral repeal of dollar convertibility in 1971 started a new era of deregulation, soon characterized by the adoption of neoliberal policy strategies that greatly accelerated both globalization and financialization.

Third, both processes have been boosted by the need to react to the slowdown of growth and consequently reduced profits in the real economy. In particular, it has been observed from the point of view of long waves that financialization of the economy is typical of a development cycle's periods of decline. This is confirmed by the two most recent episodes of financialization. The first financialization reacted to the long

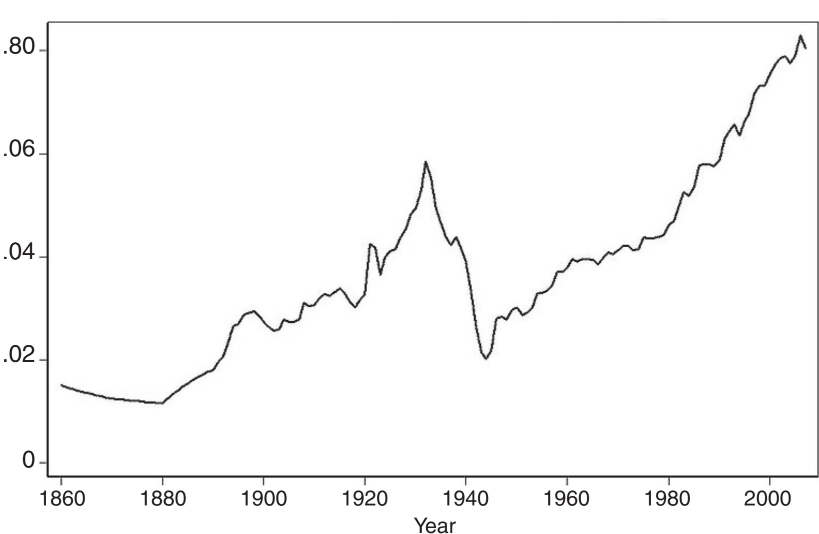

Figure 1. An Index of Financialization: GDP Share of U.S. Financial Industry

Sources: Philippon, 2008.

depression (1874–1896) that haunted the industrialized economies at the end of the nineteenth century and signaled the decline of competitive capitalism, while the second financialization reacted to the stagflation of the 1970s followed by the recession of the early 1980s that signaled the decline of the Keynesian Era. This link between financialization and great crises, however, does not exclude the role of different explanatory factors as those mentioned above.

Financialization as a Recurring Phenomenon

Financialization is sometimes conceived as a recurring phenomenon, in the sense that episodes of financialization lasting typically a few decades alternate with periods of de-financialization lasting a similar time span (see, e.g., Perez 2002). While significant analogies may be detected between these phases in different historical periods, different episodes of financialization are also characterized by significant differences that have to be thoroughly investigated to understand their specific causes and consequences.

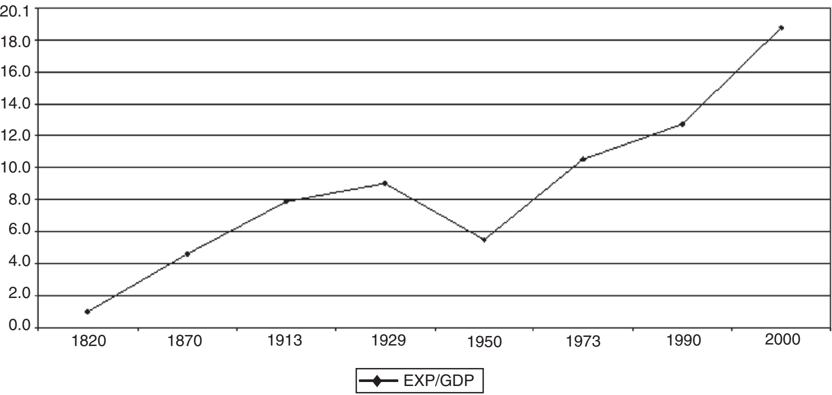

Figure 2. An Index of Globalization: Ratio Between World Exports of Goods and World GDP

Source: Maddison (2001), updated using WTO (2001) **<add both to ref list>**

The crucial challenge is to clarify under what conditions financialization may recur. The answer is often framed in terms of a long-wave approach (e.g., Arrighi 1994; Perez 2002; Phillips 2006). According to Arrighi, the phases of financialization characterize the decline of the existing “systemic cycle of accumulation” (1994: **<pg>**)when its role in driving the expansion of the capitalist world-system reaches its limits. This depends not only on the deterioration of economic conditions as expressed, in particular, by a declining rate of profit, but also on crucial political conditions. The hegemonic power underlying a certain systemic cycle of accumulation tries to defend its supremacy by turning to financial capital and undertaking aggressive (often militarized) initiatives at the world level. Financial capital provides in this view the necessary support for an increasingly imperialistic and colonialist policy. A succession of authors has emphasized the nexus between financialization and imperialism in reference to the first financialization (in particular Bukharin 1915/1929; Hilferding 1910/1981; Hobson 1902; and Lenin 1917/1999)**<preferably cite only the publication you actually used>**. In Arrighi’s (1994) opinion, the first financialization at the turn of 20th century is related to the decline of the hegemony of the British Empire, while the second financialization, which has been spreading since the late 1970s, is related to the decline of American hegemony. Phillips (2006) stresses that the parabola of the U.S. hegemony follows the same pattern that characterized the decline of Habsburg Spain in the sixteenth century, the Dutch trading empire in

the eighteenth century, and the British Empire in the nineteenth century. Braudel (1982), who starts **<his/her?>** analysis from the end of the Renaissance, detects a first wave of financialization starting around 1560, when the Genoese businessmen withdrew from commerce and specialized in finance, thereby establishing a symbiotic relation with the Kingdom of Spain (military protection in exchange for abundant credit for its ambitious programs of expansion and exploration of new commercial routes). A second wave began around 1740 when the Dutch started to withdraw from commerce to become "the bankers of Europe." In a similar vein, in his discussion of primitive accumulation, Marx (1867/1976: 920) reconstructs an historical sequence that started with Venice, which, in the period of its declining commercial power, lent huge sums of money to Holland, the emerging commercial power. A century later, during the declining part of its commercial parabola, Holland analogously lent enormous amounts of capital to its emerging rival, England. Another century later, in Marx's time, England's power was declining and it was doing the same thing with the emerging power, the United States.

Another interesting approach to financialization as recurrent phenomenon has been recently suggested by Carlota Perez. With a wealth of historical, technological, and institutional details, she has updated and further developed the Schumpeterian view (mentioned above) of the crucial role of finance in promoting innovation and development. In her view, each industrial revolution triggers "a basic stable sequence: irruption of the revolution, two or three decades of a turbulent *installation period* ending in a major bubble collapse, then a recomposition of the socio-institutional framework that regulates finance and sets the conditions for the final *deployment period,* a time of more organic growth that lasts until maturity and exhaustion are reached, setting the stage for the irruption of the next technological revolution" (Perez 2009: 781). The period of installation of the new techno-economic paradigm is a phase of Schumpeterian "creative destruction" dominated by finance, since "it is the high mobility of finance that will then enable the reallocation of available funds from the established and mature technologies and industries to the emerging ones" (Perez 2009: 781). The period of deployment of the new paradigm after the crisis is a phase of "creative construction" characterized by a recomposition of the contradictions between the development of productive forces and the social relations of production. This is made possible by a re-regulation of finance and the ensuing shift of investment from finance to the real economy. In

this view, the periods of financialization are recurrent phases that are associated with pathological consequences, such as economic turmoil, financial speculation, and a shift of investment from the real economy to finance. However, the process of financialization in these periods plays the physiological role of facilitating the structural changes made necessary by the introduction and spread of new technologies. In this view, the first financialization was instrumental to the introduction and spread of the age of the automobile, oil, and petrochemicals, while the second financialization facilitated the introduction and spread of the new techno-economic paradigm based on information and digital communications. The first phase of creative destruction culminating in the "roaring twenties" led to the Great Depression, while the phase of creative construction in the period of Bretton Woods was triggered by strict control and supervision of finance and implemented through full-employment Keynesian policies and the progressive construction of a robust welfare state. The recent phase of creative destruction that started in the late 1970s led to a double bubble: the dotcom mania that collapsed in the 2000-2001 and the housing mania that triggered the subprime mortgage crisis in 2007. What is now required is a new phase of more harmonious growth that "will depend on the capacity of the State to restrain the financial casino . . . and to hand over power to production capital, allowing its longer term horizons to guide investment once more "(Perez 2009: 790).

In short, the recurrence of alternating periods of financialization and de-financialization is well documented. It must now be clarified whether the long waves of financialization occur along a trend of increasing financialization or not. This article is inclined to interpret the episodes of financialization as an acceleration of the secular trend discussed in the preceding section, and the phases of de-financialization as a deceleration, sometimes even temporary reversal, of this trend. Focusing on the period after the Industrial Revolution shows this view to be particularly plausible. A first phase of rapid financialization may be distinguished at the turn of nineteenth century, and a second phase since the late 1970s. These phases may be interpreted as phases during which the process promoted by the systematic adoption of laissez-faire policies accelerated. The first financialization was fostered in the second half of nineteenth century by the widespread adoption of liberal policy strategies in industrializing countries, while the second financialization has been promoted since the late 1970s by the abandonment of Keynesian policies in favor of neoliberal policies.

What are called in this paper the first and second financializations are just the most recent waves of financialization occurring since the industrial revolution, but some of their features may be found in earlier episodes of accelerating financialization, including those briefly mentioned above. The analogies between these episodes should not, however, cloud the significant differences between them.

Financialization in (Neo)Classical Economics

In classical and neoclassical theory, financialization's importance to the way in which the economic system functions is somehow recognized, though only in a very rudimentary form. Standard economic theory does not go beyond the basic distinction between a barter economy and a monetary economy. Though these are considered two successive stages of the evolution of exchange relations, the historical scope of the two hypotheses and the evolution leading from the first to the second is rarely investigated.

A monetary economy is believed to be much more efficient than a barter economy, as it relaxes the strictures of the "double coincidence of wants," which confers on the economic system a much higher degree of flexibility and thus allows for an enhanced degree of efficiency. However, a higher degree of flexibility may also lead to more instability. The trade-off between efficiency and instability is managed by forcing a monetary economy to behave as a barter economy ("neutral economy") by anchoring it to rigid pegs and constraints, such as the gold standard or an orthodox budget policy, or by imposing strict monetary policy rules. This standard approach raises serious problems that have never been solved in a satisfactory way.

First, as shown above, a barter economy has never existed. Second, the deep impact of the evolution of money on the operating of the economic system has been ignored **<by whom?>** operating under the illusion that simple policy rules may force the economy to function as if it were a barter (or neutral money) economy.

For example, the process of financialization that spread and intensified in the second half of the nineteenth century until World War I progressively changed the operating rules of capitalism by giving a growing economic importance to credit, but the implications for theory and policy of this epoch-making process is almost completely disregarded. In particular, the increasingly endogenous process of money creation on the part of

the banking system was inconsistent with the quantity theory of money (QTM), but this passed unnoticed by most classical economists.

A few perceptive neoclassical economists provide significant exceptions in the most heterodox part of their contributions: Fisher (debt-deflation), Schumpeter (theory of economic development), and Wicksell (cumulative process). They understood that the growing economic importance of new forms of credit emerging in the most industrialized market economies was altering their operating rules in a crucial way. These authors sought a compromise with classical theory by suggesting an institutional/technological dichotomy that was much more interesting and full of possibilities than the standard dichotomy between a barter and a monetary economy.

Wicksell (1898) introduced the distinction between a monetary economy and a pure credit economy: in a pure credit economy, circulating money crucially depends on the interest rate rather than on the general price index. A gap between the monetary rate of interest and the real rate of interest, as fixed in a general equilibrium model, triggers a cumulative process that increases the instability of the economy and the impact of its fluctuations. Schumpeter (1917/1934) introduced the distinction between "circular flow" and "development." This distinction emphasizes the crucial role of credit in supporting innovative entrepreneurs, promoting capitalist development, and escaping the stationary routine of circular flow typical of pre-capitalistic economies. Fisher (1933) distinguished between ordinary crises and great depressions: the development of a credit economy may lead to the overindebtedness of economic units, which may lead to price deflation and trigger a vicious cycle that may degenerate into a great crisis.

These distinctions are meta-theoretical principles that associate specific approaches with different situations characterized by different institutional assumptions. In each of these three instances, the first side of the dichotomy **<what do you mean by the "first side/2nd polarity" of the dichotomy? You have mentioned 3 distinctions made between 2 things/ideas>** defines the limits of the validity of standard (general equilibrium) theory. Beyond these boundaries, the theory has to be modified in a substantial way to avoid factual misinterpretations and misguided policy strategies. The second polarity of the dichotomy focuses on the enhanced role of credit, gained as a consequence of the first financialization, and its policy implications seen from three, different yet mutually consistent points of view. **<first you say these 3 authors**

introduced these distinctions. Now you're saying that the 2nd half of each distinction focuses on the role of credit as seen by these same 3 authors. That would be 9 2nd polarities. I think you mean simply that "in each of these 3 instances," the distinction shows the limits of standard theory and focuses on (some aspect of) the enhanced role of credit.> Schumpeter emphasizes the positive role of credit in promoting investment, innovation, and development. Wicksell (1898) emphasizes the increasing instability introduced by credit and its implications for policy. Fisher (1933) points out that under specific conditions, the enhanced role of credit may lead to the generalized overindebtedness of economic units, which would jeopardize the market's ability to self-regulate and require massive state intervention.

Though Wicksell, Schumpeter, and Fisher acknowledge some of the implications of one important consequence of the first financialization—the growing economic importance of new forms of credit—their analyses stop short of recognizing the impact of financialization from the social and political point of view.[4] These consequences of the first financialization started to be analyzed by Marx and his immediate followers.

Financialization in Marx and his Immediate Followers

Marx was the first to develop a radical critique of the quantitative theory of money (QTM), mainly because this theory ignores the essence of the circulation of goods in a monetary economy:

"The illusion that it is . . . prices which are determined by the quantity of **<a/the?>** circulating medium . . . has its roots in the absurd hypothesis . . . that commodities enter into the process of circulation without a price, and that money enter**<s?>** without a value . . ." (Marx 1976: 217–8).

This sharp criticism of the QTM may also explain why many interpreters and followers of Marx reached the conclusion that money is not so important in the understanding of the basic laws of motion of capitalism. In reaching this conclusion however, Marx does not take into account the role of "money" as a technological and institutional structure, and therefore overlooks the crucial role, in his own paradigm, of the process of financialization as here defined. A case in point is the claim that finance is a symptom, rather than the cause, of stagnation and the crisis of the capitalist system (e.g., Orhangazi 2007; Palley 2007). To support such an assertion, Bellamy Foster quotes Marx: "The superficiality of political economy shows itself in the fact that it views the expansion and

contraction of credit as the cause of the periodic alterations of the industrial cycle, while it is a mere symptom of them” (2008: 9). Here Marx correctly emphasizes that credit is endogenous to the capitalist dynamics, but he is referring to credit as quantity, not to the evolution of credit as an institution and technological structure of the circulation and accumulation that is part and parcel of the long-term laws of the motion of capitalism. In Marx’s work, money as technological and institutional structure in capital circulation plays a crucial role **< “money as…” (and even less so “the role of money as…”) cannot “play a role in identifying…”.>** in identifying different forms and phases in the exchange and circulation of commodities, money, and capital. What follows is a much simplified reconstruction of the “genetic process” through which non-capitalistic circulation forms lead to capitalistic circulation forms (a more detailed reconstruction may be found in Vercelli 1973: Appendix 1):

U–U Immediate exchange of use values (occasional barter)

C–C Immediate exchange of commodities

C–M – C Simple circulation of commodities

C–M–C’ Petty (or simple) commodity production

M–C –M’ Circulation of commercial capital

C . . . .P . . . . C’ Circulation of commodities in industrial capitalism

M–C . . . . P . . . . C’–M’ Circulation of money capital

where U stands for use value, C stands for commodities, M for money, and …P… for the process of production, while M’ = M+ΔM and C’= C+ΔC designate a positive surplus over the initial quantity.

This simplified sequence of circulation forms is sufficient to clarify how different Marx’s approach to the evolution of money is from the classical and neoclassical approaches. First, Marx does not start from the dubious category of “barter economy,” as barter is not seen as a direct exchange between commodities, but as an exchange between objects having utility but not yet a value of exchange (U – U). Barter exchange is thus seen as occasional and local, while the (neo)classical concept of barter economy implies its systematic nature. The simple circulation of commodities that characterizes early mercantile societies presupposes a long and complex evolution from the immediate exchange of commodi-

ties, in which the exchange value of commodities starts to be appreciated **<understood/evaluated?>**, to a system characterized by simple (or petty) but systematic production of commodities within an emerging division of labor. Marx's rejection of the concept of "barter economy" is fully consistent with the most up-to-date archeological and anthropological knowledge mentioned above (see Graeber 2012).

In the analysis of the evolution of circulation forms, Marx applies a sort of Darwinian method to the morphogenesis of exchange structures, that is, to the evolution of the circulation and accumulation of commodities, money, and eventually capital. In this approach, the evolutionary process is in principle both logical and historical. The structure of the most recent stage encompasses the structure of the preceding stages but alters their meanings, roles, and operating rules. As a consequence of this evolutionary process, money as structure plays an increasingly crucial role because it increases the flexibility to choose, such that choices become increasingly independent of time, space, and utility content. The increasing separation and contradiction between use and exchange value, however, increases the potential instability of the process. Exchange value progressively increases its domination over use value (fetishism of money and capital) while the needs of concrete persons are increasingly displaced by the needs of capital valorization (alienation).

In this approach, financialization is represented by the increasingly crucial role of money capital in the circulation of commodities. The typical circulation circuit starts from money and aims at the end to realize the maximum possible surplus value in money form. The circulation of commodities characterizing commercial capital and industrial capital is thus "subsumed" under the process of circulating money capital. This clarifies in what sense, according to Marx, there is a long-run tendency toward financialization. What we call financialization is nothing but the process through which exchange value becomes independent from and gains predominance over use value. In this sense, financialization is not just a symptom of the basic contradictions of capitalism but is an essential feature of the law of motion of capitalism.

Marx started to investigate the specific features and consequences of the process of first financialization, which was emerging during the late part of his life. He focused his analysis mainly on the process of concentrating and centralizing capital that determines the decline of competitive capitalism. This process is the result of attempts by single capitalists to increase their absolute profits: ". . . a capitalist controlling large capital

will make more profit in absolute terms than a smaller capitalist making apparently high profits" (Marx 1867/1976: 331). Marx predicted that, in theory, this process would reduce the profit rate: "the same reasons that produce a tendential fall in the general rate of profit also bring about an accelerated accumulation of capital and hence a growth in the absolute magnitude or total mass of the surplus labour (surplus value, profit) appropriated by it" (Marx 1867/1976: 331).

As a consequence of this process, competitive capitalism was superseded in the second half of the 19th century by monopoly capital, which was dominated **<predominantly controlled by?>** by increasingly big and powerful monopolies and oligopolies. This **<this what?>** triggered a series of strategies to counter the tendency to stagnation induced by monopoly capital. These strategies led to the process referred to in this paper as the first financialization. Hilferding (1910/1981) maintains this process led to the emergence of a new stage of capitalism, which he calls "finance capitalism," a stage that Lenin (1917/1999) considered to be the "ultimate stage of capitalism." Building on Hobson (1902), Hilferding (1910/1981) analyzes the link between the economic strategies of the emerging oligopolies and the imperialist policies pursued by the governments of the most-industrialized powers. A substantial unification of industrial, mercantile, and banking interests had weakened the earlier, liberal request **<demand?>**for decreased state intervention in the economy; instead, finance capital sought state support for the interests of the ruling class. Hilferding (1910/1981) claims that this convergence of interests was supported and coordinated by big investment banks, which played the role of strategic decision makers in the new stage of capitalism. In the words of Lenin, as a consequence of this transformation "the typical ruler of the world became finance capital, a power that is peculiarly mobile and flexible, peculiarly intertwined at home and internationally, peculiarly devoid of individuality and divorced from the immediate processes of production. . . . so that literally several hundred billionaires and millionaires hold in their hands the fate of the whole world" (Lenin 1917/1999: 14).

The Marxist tradition of thought on financialization has been kept alive since World War II mainly by**<first names for these 3 authors>** Sweezy and his collaborators (in particular Baran and Magdoff) in a few books (see in particular Baran and Sweezy 1966; Magdoff and Sweezy 1987) and many articles published in the *Monthly Review*. Baran and Sweezy (1966) summarized, extended, and updated Hilferding's analysis

of "monopoly capital," taking into account but underplaying the role of financialization because its role had been reduced in the three decades between the publication of Hilferding's analysis and their book. In subsequent work, however, financialization progressively regained significance due to the second financialization. Sweezy observed in 1995 that by the end of the 1980s, "the old structure of the economy had given way to a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on top of the underlying production system" (1995: 8–9). John Bellamy Foster, who succeeded Sweezy as director of the *Monthly Review,* suggested calling the phase since the 1970s "monopoly-finance capital" as a period in which financialization became a permanent structural necessity of the stagnation-prone economy (Bellamy Foster 2006). **<did the phase begin in the 1970s or is it a phase that set in after the 1970s? Is the phase of "m-f capital(ism)" to be considered a period in which…, or is the period since the 70s during which … to be called "m-f capital(ism)"?>** This recent **<40 years is recent?>** phase is not seen **<by whom? Was not seen? When?>** as a new stage of capitalism but as an unstable metamorphosis of the monopoly stage. This **<Bellamy Foster's?>** approach helps clarify monopoly capital's tendency toward stagnation, which underlies both the first and second financializations, but underplays the radical differences between **<what and what?>**(see below).

Financialization in Keynes and Minsky

In the *General Theory* (GT), Keynes resumes < summarizes? Reviews?> the traditional distinction between a barter economy and a monetary economy but shows that the second cannot be forced to work as a barter economy through monetary means only. The illusion of rendering a monetary economy "neutral" must therefore be abandoned, since its operating rules are necessarily different from those of a barter economy and evolve in an irreversible way. A new theoretical approach and new policy rules are therefore required. Keynes eventually chose to adopt the language of classical economics on this issue (dichotomy between a barter and a monetary economy) to emphasize the radical differences of meaning to be attributed to this dichotomy. However, his argument thereby lost in clarity and **< Meaning? Implications?>**.

Stronger foundations for Keynes's monetary theory of production may be found in his preparatory works (in particular Keynes 1933), in which

he distinguishes between a cooperative economy (or “real-exchange economy”) that “uses money but uses it merely as a neutral link between transactions in real things and real assets and does not allow it to enter into the ‘motives and or decisions’” (Keynes 1933: 408), and an entrepreneurial economy (or “monetary economy”), in which “money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a **< “a” in original?>** knowledge of the behavior of money between the first state and the last” (ibid.). Keynes further clarifies the suggested meaning to be attributed to the dichotomy by quoting Marx’s distinction between “simple circulation of commodities” (C-M-C), which broadly corresponds to his cooperative economy, and “circulation of money as capital” (M-C-M’), which broadly corresponds to his entrepreneurial economy. This analysis clarifies the new-Keynesian meaning of the dichotomy adopted in the GT: “barter economy” should not be interpreted as in the classical version but in the sense of Marx’s C-M-C: money is not the end but the means, while in a “monetary economy,” surplus money (*i.e.*, profit) is the goal of the process and crucially influences decisions. This is why, according to Keynes, the trouble with classical economics is that it assumes axioms fit for a barter economy (C-M-C) rather than for a monetary economy (M-C-M’).

In chapter 17 of the GT, Keynes clarifies that in a monetary economy, investment decisions are made according to a short-term portfolio approach. Investible funds are allocated to maximize short-run expected returns. Whenever the expected returns are higher in finance than in the real economy, finance thrives and industrial investment declines. This is what happened during the second financialization as a consequence of the systematic adoption of neoliberal policies from the early 1980s to <when, since this period is over?> and the asymmetric monetarism rules **<set by? Followed by? Enforced by?>** central banks: the higher expected returns in finance crowded out productive investment, thus slowing the average rate of growth of gross domestic product (GDP) (see Orhangazi 2007).

While classical economics recognizes a long-term tendency toward financialization in a rudimentary way, only to deny that this tendency matters, Keynes argues that simple policy rules cannot force a monetary economy’s operating rules to simulate those the operating rules of a barter economy. Minsky builds upon Keynes’ insights to show that a distinction

must be made among the various stages of a monetary economy that alter that economy's operating rules in a significant way. His Financial Instability Hypothesis (Minsky 1986) does not refer to a generic monetary economy but to a "sophisticated monetary economy," **<pg cite if quoting an author>** a mature stage of the evolution of capitalism in which credit and finance play a crucial role, a stage that takes account of the evolution that has occurred since the publication of the GT. Moreover, according to Minsky even a sophisticated monetary economy undergoes evolution.

The last stage examined by Minsky is "money manager capitalism": an economic system characterized by highly leveraged funds seeking maximum returns in an environment that systematically underestimates risk (Minsky 1987: **<pg>**; see also Wray 2009). In an environment characterized since the 1970s by progressive deregulation and increasingly permissive supervision of financial institutions, money managers relied on securitization to reduce risk and increased profits through fee income for loan origination**<by charging fees to grant loans? Increased their profits with fee income generated by…?>**. In Minsky's view, this **<this what?>**was consistent with the contemporaneous globalization of finance, since securitization creates assets without national boundaries. The disintermediation of banks and their reaction to securitization and shadow banking produced a decline in their importance and an increase in that of financial markets. In the United States for example, "the bank share of all financial assets fell from around 50 percent in the 1950s to around 25 percent in the 1990s" (Wray 2009: 57). Minsky (1987) observed that:

> banks appear to require a spread of about 450 basis points between interest rates earned on assets less that paid on liabilities. This covers the normal rate of return on capital, plus the required reserve 'tax' imposed on banks (reserves are non-earning assets), and the cost of servicing costumers. By contrast, financial markets can operate with much lower spreads precisely because they are exempt from required reserve ratios, regulated capital requirements, and much of the costs of relationship banking." (Wray 2009: 58) **<Minsky 1987?>**

Minsky showed extreme foresight when he predicted that money manager capitalism was bound to exhibit increasing financial instability: the transfer of risk to the market encouraged risk-taking without insuring it, big governments abandoned full employment policies, and central banks inundated markets with liquidity, thereby encouraging speculation, and tolerated higher leverage ratios. Under these circumstances and policy rules, the collapse of the system could have been postponed only by con-

tinuously inflating asset values. As soon as the price of housing started to decline, the instability of the system became evident and could not be controlled by standard policy instruments (a detailed application of Minsky's analysis of money management capitalism to the recent crisis may be found in Wray 2009).

The Differences Between the First and Second Financializations

This paper has so far focused on drawing analogies between different episodes of financialization, in particular different episodes of accelerated financialization, and has identified a secular trend toward increasing financialization. But an analysis of a particular episode of financialization would be misleading if its particular features were not thoroughly investigated. In this section, some significant differences between the first and second financializations are hinted at, but it must be kept in mind that the long-term process of financialization, as well as its accelerations and decelerations, has never been homogeneous through time and space because it is affected by cultural, material, and political conditions that vary with time and place. Like the related process of globalization or the existing forms of capitalism, financialization has always been "variegated" (see, e.g., Brown and Spencer 2013). However, an ideal-type of the first and second financializations may be constructed to capture, in abstract terms, some features shared by many countries in about the same period. Comparing the two ideal-types may be thus considered a mere preliminary step taken to prepare a thorough analysis of financialization in a specified area and period.

First of all, two channels of influence of finance over the real economy must be distinguished: one extrinsic and one intrinsic. The extrinsic channel is as old as credit itself and is based on the cash-in-advance constraint of any monetary economy. In this sense, finance has always had crucial power as a permissive condition of political and economic decisions. Charles the Fifth was elected ruler of the Holy Roman Empire with the aid of 543,000 florins (broadly equivalent to 60,000 oz(t) of gold) received from the Fuggers, and could not have fought the wars that consolidated an empire "on which the sun never set" without the Fuggers's continuous credit. Analogously, the kingdom of Castilla could not have started its ambitious policy of exploration of new ways of international trade without the support of Genoese bankers. In the mercantilist period, banks systematically played a role in supporting and conditioning the

colonialist and imperialist policies of the most powerful states. This kind of extrinsic power exerted by finance thus pre-exists capitalism. However, this power became more systematic and more influential after the Industrial Revolution, when credit became a crucial condition of a great part of industrial investment, in particular the most innovative one **<which was?>**, as was well understood by Schumpeter (1911/1934). During the first financialization, this power started to be exerted in a more systematic way, leading finance to play the role of coordinator and director of capitalistic decisions, as emphasized by Hilferding (1910/1981). At the turn of twentieth century, a few major investment banks became so powerful one could almost consider them private planning authorities. The influence of finance on the real economy, however, affected mainly which of the possible decisions could be implemented rather than their contents. On the contrary, the influence of finance became increasingly intrinsic during the second financialization, systematically affecting not just the viability but the very contents of the choices made by non-financial firms and households. As Keynes foresaw in chapter 17 of the GT, the logic of choice of any subject in any field is becoming more and more influenced by the financial paradigm of portfolio selection within a time horizon that is compelled to become as short as that of financial choices. The choices consistent with sustainability are thus becoming increasingly non-competitive as compared with alternative choices, since they imply immediate costs and significant benefits only in a relatively distant future **< "immediate costs" in the future?>** (see below).

A second crucial difference has to do with the different role of banks. From the point of view of banking, the first financialization may be called "bank-based financialization," while the second financialization is "market-based financialization" (see Orléan 2009). This is not to say that big banks have played a subordinate role in the second financialization: they played a crucial role in shaping and manipulating financial markets, both directly (Euribor, ratings of crony agencies, "creative accounting," etc.) and indirectly (through governments and regulators). The crucial difference has been, however, that in the second financialization they exerted their power more indirectly than in the first financialization, while financial motivations became decisive even within the real economy.

A third crucial difference may be seen in the strategy to expand capital investment. During the first financialization, the prevailing capitalist strategy pointed to an expansion, with the help of the state, into new

geographical areas (imperialism and colonialism). During the second financialization, territorial expansion was not sought the main focus. Although new forms of imperialism and colonialism continued to play a crucial role, they aimed mainly to systematically invade the "territory" formerly occupied by the welfare state (health, education, pensions, and so on). In particular, the rules underlying the introduction of the euro and the austerity policies implemented after the 2008 crisis went a long way toward dismantling the welfare state and privatizing health, education, and social security services (including pensions) in the European Union. In the second financialization, the invasion of these broad areas traditionally occupied by public expenditure play a role similar to that played by colonialism and imperialism during the first financialization, extending the shock therapies pursued in developing economies to the core countries of Europe and North America.

Finally, a fourth crucial difference has to do with the active role of powerful central banks in the second financialization. Their policy of "asymmetric monetarism" inaugurated by Alan Greenspan in 1987 and pursued afterwards by Ben Bernanke and most other central bankers has significantly distorted the appeal of industrial investment as compared to that of financial investment. Central banks reacted immediately to any inflationary symptom originating in the real economy by restrictive monetary measures (in particular by promptly increasing the rate of discount), while on the contrary asset inflation was not repressed but rather encouraged by the massive creation of liquidity whenever its upward trend looked undermined. This policy resulted in implicit insurance for financial investment and speculation, which crowded out industrial investment (Cecchetti and Kharroubi 2013; Orhangazi 2007). The increased wealth of financiers and rentiers sustained aggregate demand to some extent, but not enough to compensate for the declining profits and wages in the industrial sector. The stagnation tendency that prompted the process of financialization was eventually strengthened by financialization. The latter cannot be considered simply a symptom of the tendency toward stagnation of monopoly capital, as maintained by a few Marxists (see, *e.g.*, Bellamy Foster 2008); it is a crucial determinant of capitalist evolution and its laws of motion.

Financialization, Policy Implications, and Sustainability

The (neo- or new) classical mainstream sees financialization as an organic process by which capitalism evolves that was spontaneously developed

by markets to increase their own efficiency and returns. In this view, the best results may be obtained through laissez faire policies, which do not attempt to condition or limit the process.

The Keynesian mainstream sees financialization as a process by which capitalism evolves that has both organic and pathological aspects. In this view, the right policy strategy should aim to filter the positive effects from the negative effects. This may be done by limiting banks' freedom of action and curbing excessive speculation (for example by imposing a Tobin tax**<add note to define Tobin tax>**). According to most streams of heterodox economics, the process of financialization is mainly a pathological process of evolution within capitalism that requires that capitalism be radically reformed or superseded. The suggested policy recipes vary with the theoretical framework and the normative objectives leading to different normative views, but their analysis is beyond the scope of this article.

According to the view outlined in this article, financialization is a contradictory process. On the one hand, it aims to increase the freedom of decision makers, who could thus use the extra freedom to improve human well-being. On the other hand, in the absence of suitable institutional and policy constraints, the advantages of enhanced freedom are reaped by a small minority of financiers, rentiers, and complacent politicians, as was the case in the recent crisis. The process of financialization is thus driven by the search for expanded decision-making freedom on the part of the agents who adopt financial innovations. This explains the long-run tendency toward financialization and seems, at first sight, to justify it without reservations. The trouble is that the freedom, power, and wealth so created are unevenly distributed across society and are appropriated by the innovators (e.g., the managers of corporations) or their principals (the shareholders). Whether there is an effective trickle-down mechanism to share the advantages of financial innovations with all citizens depends on the nature of the specific innovation and the institutional and political conditions. Generally speaking, such spontaneous redistributive mechanisms do not exist or are not effective enough to avoid increasing inequality (Stiglitz 2012). In the absence of apt redistributive policies, inequality thus tends to increase further, seriously jeopardizing social sustainability. As for environmental sustainability, the growing dominance of exchange value over use value tends to undermine the quality of the environment, since maximizing exchange value is constrained within an increasingly shorter time horizon while sustainability is a very long-term objective focused on use values and ethical principles.

The fact that, in principle, there is a deep conflict between unfettered financialization and sustainability does not imply that the process of financialization has always undermined sustainability in all its dimensions. This is so because the actual process has often been affected and constrained by cultural, religious, and political constraints meant to preserve, as much as possible, the human, social, and environmental values of sustainability. A thorough assessment of the long-term impact of financialization on sustainability has thus to be assessed period by period and location by location, taking account of the institutional and policy constraints, but this goes beyond the scope of this article.

A closer analysis of the effects of unfettered financialization is possible for the periods of accelerating financialization, during which constraints are temporarily removed or relaxed. This happened, as noted above, in periods of economic and political decline when the arguments of financiers and rentiers became persuasive for a broad audience looking for remedies to stagnation while the counterarguments became weaker, being identified with the declining status quo. In the short period, the acceleration of financialization typically succeeded in slowing the decline of profits and growth. This convinced many observers of the therapeutic virtues of financialization; but this happened to be true only in the short period. The liberalization of finance increases financial profits and the increasing wealth and income of financiers and rentiers may support aggregate demand for a while. Relief from stagnation, however, is likely to be unsustainable in the longer period precisely because it is obtained by relaxing the constraints on the process, and thus increasing the conflict with sustainability.

The view expressed in this paper is that during the second financialization, the pathological aspects of financialization far exceeded the alleged advantages. In particular, the systemic negative externalities happened to be much bigger than the few micro advantages that accrued to some financial institutions. In particular, it **<it=what?>**led to an unprecedented concentration of wealth and income that produced a vicious cycle in which a parallel concentration of power undermined sustainability from the economic (unemployment), social (poverty and inequality), and environmental points of view. Worse, this vicious cycle is now undermining democracy itself: without democracy we cannot hope that all the other problems may be solved.

In light of the analysis here developed, the only possible conclusion is that sustainable unfettered financialization is an oxymoron because

financialization is about relaxing all possible constraints on economic decisions, while sustainability is about putting constraints on economic decisions to safeguard sustainability. Sustainable finance, however, is not necessarily a utopian perspective, provided that finance is not seen as an end in itself but as an instrument to support sustainable development.

Notes

1. An often cited definition that gives basic substance and articulation to this descriptive approach is that of Epstein: "Financialization refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level" (2001: 1).

2. A thorough analysis of the nexus between finance, ethics, and religion may be found in Sen (1991).

3.The introduction of joint-stock companies may be interpreted as an early epoch-making example of securitization in which the capital of a firm (including fixed capital) is represented by a given number of tradable securities (shares).

4.This is not completely true of Schumpeter, whose analysis goes much beyond the strictly economic aspects of financialization. However, his analysis did not focus on investigating the consequences of financialization, but rather on grasping the implications of oligopolistic capitalism and state intervention in the economy.

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