
Financialization of the global economy

Ronald Dore

The instability of the world financial system, starkly revealed in the recent debacle, is not the only problem it poses. Its secularly increasing dominance over the real economy is in itself a phenomenon that needs examining. The article traces the source of this increasing dominance not just to the increasingly leveraged and increasingly incomprehensible forms of intermediation between savers and those in the real economy who need credit and insurance, but also to the increasingly universal doctrine that maximizing “shareholder value” is the sole *raison d’être* of the firm and the promotion by governments of an “equity culture.” Some of the social consequences of financialization are exacerbating inequalities, greater insecurity, misdirection of talent, and the erosion of trust.

“Era ends as two Banks cut risks and form holding companies,” announces the International Herald Tribune,¹ reporting the humbling application by Morgan Stanley and Goldman Sachs to renounce the money-spinning, and never before so dangerous, advantages of unlimited leverage, off-balance-sheet financing, and secrecy, for the relative security of a regulated deposit-taking bank. Similar “era ends” headlines might well have appeared 70 years ago when the Glass-Steagall Act reached the statute books. But one is entitled to be skeptical. The underlying processes of financialization which have been evident in free-market capitalism since the last world war—processes for the most part originating in the United States and Britain but spreading out from there to the whole world—are not so easily to be reversed.

“Financialization” is a bit like “globalization”—a convenient word for a bundle of more or less discrete structural changes in the economies of the industrialized world. As with globalization, the changes are interlinked and tend to have similar consequences in the distribution of power, income, and wealth, and in the pattern of economic growth. In one of the few books to take up the subject directly, Gerald Epstein’s, *Financialization and the world economy* (Epstein, 2005), he offers a loose definition of “financialization” that will serve as well as any other: “the increasing role of financial motives, financial markets, financial actors and financial institutions

¹23 September 2008, Tokyo edition.

in the operation of the domestic and international economies.” “Increasing” is the key word: the changes involved have notably accelerated over the last 30 years.

Those changes may be summarily described as:

- (1) An increase in the proportion of the income generated by the industrial/post-industrial economies which accrues to those engaged in the finance industry, as a consequence of three things.
- (2) The growth in and increasing complexity of intermediating activities, very largely of a speculative kind, between savers and the users of capital in the real economy.
- (3) The increasingly strident assertion of the property rights of owners as transcending all other forms of social accountability for business corporations.
- (4) Increasing efforts on the part of government to promote an “equity culture” in the belief that it will enhance the ability of its own nationals to compete internationally.

I will describe, and try to explain, each of these in turn, and then comment on their social consequences.

1. Profitable activity

For the increasing share of those engaged in finance, in the income generated in domestic and international economies, there is a good statistical indicator for the United States in Table 6.16 of its national income calculations.² It shows the profits gained, respectively, by financial and non-financial corporations. The series goes back to 1946. In the first 5 years—i.e., up to and including 1950—the proportion of total profits earned by financial corporations fluctuated quite narrowly around an average of 9.5%. Thereafter there was an accelerating increase, until that proportion reached its peak in 2002 at 45%. It has since dropped as a percentage of total profits (to 33% in 2006) but only because of a sharp increase in profits in the non-financial sector. The inexorable growth in the financial sector’s profits continued. They were growing at 16.7% p.a. between 2000 and 2006 (from 200 billion to 505 billion), compared with an annual growth of 9.4% in the first 6 years of the previous decade. The year 2007 will probably, and 2008 will certainly see a reversal of that growth. (It is unlikely that the billions made by short-sellers will match the losses from assets written off.) But this will be the first time since a slight hiccup in 1994 that the financial profits figure has failed to grow over the previous year.

2. The scale of financial markets

Consider the Chicago pork bellies trading pit, the classic text-book example of why speculative trading in futures helps the producers by providing a guide to the optimal

²<http://bea.gov/bea/dn/nipaweb/Tableview.asp#Mid>

timing of their investments and production schedules. When it started operating over a 100 years ago, and even by the 1930s when the information flowing into the market as a basis for speculatively guessing the future had become as comprehensive as it was ever likely to get, the amount invested in futures trading was probably tiny compared with the amount invested in pigs, pig sties, pig feed, pig transporters, pig veterinarians, pig psychologists, and pig butchers.

Today, those relative proportions are vastly different. “Amount currently invested” in derivatives markets—i.e., the size of the (highly leveraged) stakes with which participants are gambling in financial markets—is hard to measure, but the Bank of International Settlements does periodic surveys of outstanding derivative contracts—those “weapons of mass destruction” as Warren Buffet has recently been frequently quoted as calling them. It found at the end of 2004 that over-the-counter (OTC) contracts amounted to \$197 trillion and exchange-traded derivatives to another \$36 trillion, giving a total of \$234 trillion (Dodd, 2005). By June 2007, the figure for OTC contracts alone had grown to \$516 trillion (BIS, 2007a). World GDP in 2006 was calculated to be \$66 trillion at purchasing power parity—only one-eighth of that figure for outstanding derivative contracts.

Parts of those derivatives are currency exchange derivatives, but there are, of course, also spot transactions in foreign exchange markets, and straightforward futures, which have grown steadily since the abandonment of fixed exchange rates in 1970. The BIS reported daily turnover in “traditional foreign exchange markets”—i.e., mostly spot and plain futures, excluding derivatives—to be \$3.2 trillion a day in April 2007 (BIS, 2007b). This is just 100 times the transactions which would be needed if the daily total of world trade (estimated by the WTO to be \$32 billion in 2006) were entirely conducted across and not within currency zones. And meanwhile, all serious discussion of the Tobin tax—a tiny international tax on foreign exchange transactions which would both damp down speculative frenzy and provide funds for the development of poor countries—has been killed by governments dominated by financial interests, and seems to have completely disappeared from the media and academic discussion too.

These ballooning sums in just two of the many types of financial markets are typical of the others. One of the major mechanisms of this expansion is, indeed, the growth of world trade and the uncertainties of exchange and interest rates which make insurance hedging against the risk of movement in those rates a matter of prudence. But the insurer who takes on that risk has found many ingenious ways of sharing it with others, and so have lenders. The basic financial innovation on which the pyramid of ever more arcane financial instruments is built is securitization. The tendency to replace loans from banks with the issuance of tradeable corporate bonds goes back a long way in history; tradeable commercial paper for short-term finance goes back to the 1920s, but the packaging of mortgages, and consumer credit into securities, the complex systems of slicing and tranching that go into those packages, and the sprouting of all kinds of option derivatives from those securities is of more

recent origin. The first Collateralized Debt Obligation (CDO) was issued in 1987. The packaging of mortgage and other debts into relatively long-term and high-yielding securities in turn bred other securities as the banks created off-balance-sheet special investment vehicles (SIVs) which issued their own low-interest short-term securities in order to mobilize the funds for investing in these higher yielding but riskier debt derivatives, thereby profiting from the difference.

These markets have since mushroomed; aggregate issuance in the global CDO market was estimated to be around \$2 trillion in 2006. These were the financial instruments whose arcane nature, sufficiently concealing the riskiness of the underlying mortgages to get them the highest ratings from Standard and Poors and Moodys, was at the root of the 2007 sub-prime mortgage crisis with which the recent melt-down of credit markets began.

Borrowing short and lending long (and on collateral assets as dubious in nature as those of the CDOs), is always a risky business. But that was what the SIVs and the investment banks were doing. Hence, the “management of risk” has become the central skill of the finance industry. Innovative techniques of risk management have been one of the factors permitting the vast expansion of financial markets. It is no longer a matter of a banker sizing up the riskiness of a borrower or inspecting his collateral, it has now become a matter of building mathematical models of such intellectual complexity that they can get their creators Nobel Prizes, as they did for Merton and Scholes who showed how to price options. The big expansion of the CDO market since the beginning of this century, for instance, is attributed to the invention of something called the Gaussian copula model.³ The trouble with all those models and the volatilities that they base themselves on is that the only hard data they can use is historic. They have to make the assumption that the future will be much the same as the past. But often it is not. The micro-behaviour underlying past trends can change. It is said that American consumers have traditionally defaulted on automobile and consumer credit first, house mortgages last; but in the latest credit crunch have been giving up on their houses first (Tett, 2008). Larry Summers, writing in the *Financial Times*, notes: “We have seen institutions hurt again and again by events to which their models implied probabilities of less than one in a million.”⁴

What the current crisis has once again made obvious is that when these “improbable” events occur, the danger of a cascading collapse having a serious effect on the real economy (or the danger that all and not just some of their friends are going to take heavy losses) is such that central banks and governments step in with easy credit and infusions of capital into broken firms. The only astonishing thing this time, in September 2008, was the American government’s following the British example of nationalization (Northern Rock) and on a grand scale. Japan did not get

³http://en.wikipedia.org/wiki/Collateralized_Debt_Obligation

⁴1 June 2008

to its first bank nationalization (Risona) until 11 years after its bubble burst. If it had nationalized the Hokkaido Takushoku Bank and Yamaichi Securities when they failed in 1997 it might have spared itself the 5 years of wrangling agony and the total loss of national self-confidence which followed and the subsequent desperate search for a cure in “reform” via American supply-side economics. (By an odd irony, the Japanese newspaper which announced Paulson’s socialization of AIG reported that the privatization of the state banks which for 60 years had been financing small and medium industry was in its final phase.)

Once again, as governments step in, the media buzz with talk of moral hazard, and the asymmetry of private gains and socialized risks. One day the American Secretary of the Treasury is praised for his exemplary insistence that Lehmann Brothers should pay the consequences of its folly come what may; the next for his recognizing the higher imperative of keeping AIG and the American economy afloat and damn the moral consequences. Once again there is much talk of closer regulation. Much anger is directed at all those bond traders who will lose their jobs and finally have the leisure to enjoy the multi-millions of bonuses they have accumulated, even as the taxpayer bears the cost of rebuilding the financial system they have destroyed. Some form of regulation of a bonus pay system which has encouraged traders to take the most egregious of risks is one favourite proposal—even among those who maintain as an article of faith that the freedom of movement of capital through global markets is a boon to mankind, maximizing the efficiency with which that scarce resource capital is used, and cheapening its cost to the users (Wolf, 2008).

The fact that at this particular juncture (September 2008) one rarely comes across defiant assertions of that article of faith in the business press does not mean that the faith of the true believers has been radically shaken. And that faith, widely held in the policy media and academe, together with the enormous political power of the financial community (Reich, 2008), means that the chances of a really effective re-regulation of the system are not great. Reform would obviously have to start in the hegemonic American economy, but that, while a necessary, is not a sufficient condition. On many things there would also have to be international agreement and that is exceedingly hard to achieve—witness the lengthy negotiations for the Basel Agreements sponsored by the Bank of International Settlements. Meanwhile, national governments are unwilling to regulate independently for the markets in their own territory because they are so anxious to promote the global competitiveness of their own markets and fear losing in that competition by driving business away. As Britain’s economy goes downhill, one may hear less about the wonders of an economy which employs 22% of its labour force in finance, but governments are not going to cease trying to attract a large share of global financial business. And as far as social regulation is concerned the race is still to the bottom.

What needs challenging is that article of faith itself, the thesis that these free, competitive, global financial markets are the best way of providing cheap capital to all who can most efficiently use it. This vast superstructure of gambling transactions

is built on the needs of the producers and consumers of goods and non-financial services for (i) credit, (ii) insurance against uncertainty, and (iii) profitable ways of using their savings. And ultimately it is those producers and consumers who pay the transaction charges, the hedging costs, the asset-management charges which this vast superstructure generates for the people who operate it. With some justice, the *Financial Times*⁵ recently quoted Keynes: “when the capital development of a country becomes the byproduct of the activities of a casino, the job is not likely to be well done.” Even more so when the casino is global and not just national.

It is one of the ironies that, comparing today with the days when, especially in the relational-banking countries like Japan and Germany, savings went mostly into bank deposits, and companies got finance in the form of direct bank loans, the growth of these structures is described as a shift from “intermediated” to “direct” finance.

3. Shares in the value added of the real economy

The multiplication and inflation of transaction and management charges in financial markets is one way in which the finance industry profits at the expense of all other industries. Another is by the exercise of the property rights which legal systems confer on the owners of equity capital through systems of corporate governance.

The United States has again been in the vanguard in “raising the owners’ game.” James Crotty in an article in the Epstein book (Crotty, 2005) quoted earlier has calculated for American corporations other than financial the amount of what he defines as “payments to financial markets”—interest (net), dividends, and share buy-backs—as a proportion of cash flow (profits plus depreciation). Again a steady increase. In the early 1960s, the proportion was around 20%. In the 1970s, the figures were around 30%, with a clear rising trend taking off in 1984, culminating in a 1990 peak of 75%. Thereafter there was a sudden plunge in the mid-1990s but the figure was back up to 70% at the end of the decade.

These figures are symptomatic of a transformation in American capitalism, a shift in power from managers whose expertise lies in their intimate knowledge of the operations of the organization they run, to owners and representatives of owners who closely monitor their activity with an eye to maximizing the returns to capital. Rakesh Khurana (2007) has well described the change in a recent book as a shift from managerial capitalism to investor capitalism. In the 1960s, the decade in which Galbraith (1967) wrote his *Modern Industrial Capitalism*, and several decades after the periods described by Chandler (1977) as the “managerial revolution,” managers were all-powerful. Shareholdings were widely dispersed, expectations about the appropriate returns to shareholders were reasonably stable, and meeting those expectations was seen as only one of managers’ responsibilities, along with providing

⁵7 May 2008.

employment at decent wages, producing safe and reliable products at reasonable prices, contributing to local communities and making economies grow by promoting innovation, increasingly in dialogue with government officials. Talk of “management as a profession” was symptomatic of the notion that corporations were in some sense public institutions, and the people who ran them had responsibilities towards society which called for ethical probity on a par with that expected of doctors and lawyers—and self-restraint when it came to fixing their own salaries.

In today’s investor capitalism, American managers are far less autonomous. They operate under the close surveillance of a board of directors who represent exclusively the interests of shareholders and may frequently include a dominant shareholder. In the mixture of motivations that drive their work, notions of doing a socially useful job or building an organization which will last and will honour their memory are likely to be overshadowed by the carrots and sticks of stock options, bonus systems and the overhanging threat of instant dismissal—all carefully designed, and specified in hard-bargained employment contracts, to induce them to meet those shareholders’ expectations. And those expectations are now much more likely to be a steadily rising, rather than a stable, return on equity. In Khurana’s terms, managers have become hired hands.

The subordination which might be implied by that description requires qualification, however. Even without the financial reinforcement of stock options and the like, the typical modern CEO has no problem identifying with his investor masters. They share the same culture and the same operating standards. Top management is increasingly about the application of financial criteria internally within organizations, cutting out loss-making divisions and expanding the profitable, making strategic acquisitions and divestments. And manager and investor are likely to have similar valuations of their own worth: the salaries of top executives in non-financial firms have spiralled in lock-step with those of the top executives of financial firms. Outraged politicians call on investors to curb executive excesses, but for the top managers of investing firms to put the brakes on would be to question the basis of their own even higher rewards. One recent estimate puts the average American CEO’s take at 475 times the average wage, compared with 25 times 30 years ago.⁶

In the complex processes which explain this evolution, two strands are clear. One is the increasing concentration of capital ownership—or, rather, capital management—and the other, changes in dominant ideologies.

As in the Austria–Hungary of 1910 which prompted Hilferding to write *Finance Capital*, capital ownership in the United States, too, was highly concentrated in major industries like railroads and steel at the beginning of the 12th century. By 1912, “the partners of J.P. Morgan & Co. along with the directors of First National and National City Bank controlled aggregate resources of \$22.245 billion.

⁶www.dailyreckoning.com.au/barclays-executive/2007/03/29

Louis Brandeis, later a US Supreme Court Justice, compared this sum to the value of all the property in the 22 states west of the Mississippi River.”⁷ By the 1930s, in contrast, Berle and Means (1933) were charting, even celebrating, the dispersal of ownership among a myriad of small investors, which gave managers very substantial autonomy. That was a precondition for the long-term organization building of talented managers which Chandler charted, and for the sense of public responsibility which Galbraith discerned in his 1960s contemporaries.

But the reconcentration of capital in the United States gained momentum in the 1980s, with the growth in particular of pension funds, life insurance, and mutual funds. US institutional investors in 1960 owned 12% of equities; by 1990 they owned 45% and their share rose to 61% in 2005. Of the 1000 largest US corporations in 2007, they owned 68% (Jacoby, 2007).

With significant amounts of the stock of leading companies (big enough that they could not sell without driving the price down, so that “voice” became the better option than “exit”), they pressured managers for higher returns. As Jacoby describes the activities of the California Public Employees Retirement Scheme, a giant public-sector pension fund:

To foster shareholder primacy it demanded greater board independence, lower takeover barriers, larger payouts to shareholders, and tighter links between CEO pay and firm performance. It relied on a variety of tactics: proxy resolutions, public targeting of underperformers, and alliances with other owners, including corporate raiders (Jacoby, 2007).

For the most part the institutions tended to be long-term investors, as interested in a firm’s long-term growth as in its immediate yields, which may have meant that they were willing to contemplate cash flow being used for investment, but still were bent on extracting maximum profits at the expense of other stakeholders. The intensification of pressure specifically for short-term yields came from newer forms of concentrations of capital, the private equity funds backed by investment banks, asset management firms, and hedge funds which grew steadily in importance from the 1990s. Some were buy-out funds which would mount a—usually hostile—takeover, delist the company from the stock exchange, put in new managers, reorganize it for greater profitability and then re-list or sell it at a substantial profit. Others simply took a significant stake and harassed the managers into raising yields, thereby raising their share price and enabling them to sell their stake at a profit. This new kind of acquisition activity was distinct from traditional M&A activity, viz. the strategic acquisitions of non-financial firms, directed to acquiring technology, scale economies, complementary competences, or marketing advantage. The growing frequency meant that a firm which made itself a cheap buy by letting its share price

⁷Wikipedia, J.P.Morgan.

fall became vulnerable to hostile takeover, not simply by competitors in the same product markets, but by any one of innumerable funds which might see it as a juicy victim. This toughening of “market discipline” prompting increasing solicitude for shareholders (and an increasing devotion of managerial resources to “investor relations”) raised average earning levels which further raised the standard of *expected* earning levels.

At the same time there was a shift in ideology, both in the general consensual assumptions made by the business press, and the prescriptions of academic economists. There had always been argument between those who held that companies were public institutions with responsibility to a variety of stakeholders, but chief among them their employees, and those who held that they were property of their owners from which they had a right to profit as best they could.⁸ In the 1990s, the latter view, known by then as the doctrine of “shareholder value,” came to dominate. At the same time, in the economic journals, “principle-agent theory” became a favourite topic. Based on those “shareholder value” assumptions, game-theorists explored the infinite variations on the conditions under which the agent’s (i.e., manager’s) interests could be made to coincide with those of the principal, i.e., the owner.

Khurana (2007: 320–321) illustrates this decisive shift by quoting the policy statements of the American Business Roundtable, an authoritative organization of leading American businessmen. In 1990 it was saying:

Some argue that only the interests of the shareholders should be considered by directors. The thrust of history and law supports the broader view of the directors’ responsibility to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders.

By 1997 it was saying:

the paramount duty of management and of boards of directors is to the corporation’s stockholders . . . The notion that the board must somehow balance the interests of other stakeholders fundamentally misconceives the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving the conflict of interests between interests of stockholders and of other stakeholders or among different groups of stakeholders.

The process of reinforcing owner control is still under way. The same Roundtable has conducted surveys of executives in which it asks whether or not in their company the non-management board members ever have formal executive sessions in which they,

⁸Two particularly good accounts of these controversies are Blair (1995) and Charkham (1995).

the shareholder representatives, deliberate together excluding the CEO and other top managers. In 2003, 45% said yes, they did. In 2007, the figure had risen to 71% (Lipton, 2008).

4. The equity culture

Conservative parties, particularly in the Anglo-Saxon world, have long since espoused the notion of the “shareholding democracy” as a means of gaining popular support for the institutions of capitalism. The new thing is that, in recent years, even governments of the centre-left such as that of Britain, have adopted the same slogans. The Chairman of the London Stock Exchange in his inaugural address in 2005, after complaining about recent British tax changes, went on to say, but, nevertheless,

no one should have been surprised when last month Gordon Brown [the British Prime Minister] called for a “Home owning, share owning, asset owning, wealth owning democracy”. That was actually a message aimed at his party’s core supporters. For the truth is that everyone in this country has an interest, direct or otherwise, in the health of the equity market. Whether it’s the traditional shop floor worker, the public sector employee, the middle manager, the boardroom executive, even the senior civil servant - our share owning democracy is a uniting national characteristic (Gibson-Smith, 2005).

And, he said, this was something which Britain with its publicly traded equity amounting to 159% of GDP and the United States with 150% could teach to the backward Germans with a stock exchange worth a mere 50% of GDP.

The active promotion of equity ownership by governments really began in the Anglo-Saxon economies in the 1980s under the Reagan and Thatcher governments, and for a different reason from reconciling electorates to capitalism. [After all, after 1990, capitalism had “won” the match with socialism and that particular need had diminished: the new status-quo-defence need, as Larry Summers recently forcefully argued (Summers, 2008), is to reconcile electorates to free-trade globalization, and its exacerbation of inequalities.] The reason for governments promoting equity ownership in the 1980s and 1990s was increasingly a belief that a plentiful supply of equity capital promoted innovation, and hence the competitiveness of the economy. Specific measures adopted have included selective tax deductions for equity investments in unlisted securities (intended for venture firms, but recently controversial in Britain as a source of great profit for the managers of buy-out funds who hold the shares of the companies they delist), a relaxation of the “safe investment” restrictions on pension funds permitting them to put more into equities, and encouragement of a shift from defined benefit pensions in which employers bore the risks of yield fluctuations, to defined contribution pensions in which the pensioner chooses his investments and bears the risk of their yielding poorly.

The latter was seen to have the double advantage of greater pension portability and hence labour market flexibility, and, through special tax advantages for those who chose equity investment, increasing the flow of capital into it.

The year 2008 was perhaps not the best year for the supply-siders in the Japanese bureaucracy to choose to make the virtues of risk taking the theme of Japan's annual White Paper. They went to the extent of conducting a national survey of financial literacy as part of an inquiry into why Japanese savers were so sadly reluctant to invest in equities and other risk-bearing securities instead of putting their money into the bank. Their figures showed, for instance, that the Germans were even more reluctant, but it was on the comparison with the Americans that the text concentrated (Japan, Cabinet Office, 2008).

4.1 The social consequences

The consequences of these changes for the structure of the economy become much discussed when the financial system periodically seizes up, markets collapse, astronomical sums of paper wealth are destroyed as the market value of financial assets plunges, and loss of confidence, a credit crunch and a fall in demand hit the real economy. People start re-reading Hyman Minsky. There is much discussion of whether financial crises, leading to economic slow-downs, have increased in recent years and whether the skill of monetary and fiscal authorities in dealing with periodic busts has so improved as to render them less lethal than the crash of 1929. The final outcome of the crisis triggered by the 2007 sub-prime debacle will provide further evidence.

Periodic bubbles, their implosion and their implications for the growth and the cyclical stability of the economy are one thing. But, in the long run more serious are the slowly corroding implications of these various trends for social structures and the quality of life. Four in particular need singling out.

(1) The contribution of financialization to growing inequality in the distribution of income and wealth. Gini coefficients are rising everywhere in the developed world, but faster in the most "financialized" Anglo-Saxon economies. Median incomes stagnate while the top percentile, and especially the top permille make spectacular gains. The figures for the United States are familiar. The top 1% own 38% of total wealth; the top 10% own 85% of all publicly traded stocks. These are not traditional rentiers, but beneficiaries of the new pattern of market incomes, with the highest incomes going to those in financial services at the expense of everyone else. A recent British report (Institute of Fiscal Studies, 2008) found that for the top 0.1% of taxpayers (average income £478,000 = €600,000), 80% of their income was labour income—as bankers, fund managers, accountants, lawyers, etc. On top of such annual incomes, they had already accumulated enough to get capital incomes four to five times the average annual salary. The accumulation of wealth at the top is increasingly a function of growing inequality of "labour" incomes, rather than of inheritance.

Much of this growth in inequality can be ascribed to technological change and the consequent change in job requirements; a growth in the number of jobs that require prolonged periods of learning or a high level of native talent, and a lesser growth, and possibly a reduction, in the kind of jobs that almost anybody could learn to do. Much can also be ascribed to trade and the increasing import of manufactures from cheap-wage economies. But the increased costs of finance and insurance for non-financial firms must take their toll, and, especially, the shift to investor dominance is steadily increasing the capital share and reducing the labour share in GDP—at the same time as the distribution of the labour share is increasingly skewed in favour of those who work in finance.

This increase in inequality is the more crucial for the future of industrial societies and their democratic systems of government in that it is accompanied by increasing evidence of a decline in social mobility, as the growth of private education, and the family transmission of both cultural and financial capital entrench class differences and make them more hereditary.

(2) The increased inequality is not only of income and wealth, but also of security. Jacoby notes (Jacoby, 2007), a propos of the shift to investor dominance and doctrines of shareholder value:

As investors press for larger returns, employees are forced to bear the increased risk.

Wage and employment volatility have risen since 1980; pension plans have shifted from defined benefit to defined contribution; and employer-provided health insurance is disappearing. However, what is telling is that the volatility effects occur only in public firms; private firms exhibit a *decline* in employment volatility, suggesting an association with financial markets. There also is an association between shareholder power and reduced levels of employee tenure.

Greater risk, more unregulated competition among financial agents, and more choice for the ordinary citizen—of how much insurance to buy, how much of what equities and bonds to put in your individual defined-contribution pension account, through what medium, with what balance between return and risk, to turn your savings into an investment. More choice, indeed, among alternatives whose small print the ordinary citizen is unable to understand, more time wasted in trying to understand, more angst induced by the thought that you have made the wrong choice. In a more regulated world, life was simpler and there was more time for simpler enjoyments. Your employer offered you a single pension scheme, and a savings account in one bank was very much like that of another, and few people felt that they were missing out, because the world was not full of tempting advertisements for the latest high-yielding financial instrument.

(3) A third consequence is the change in the distribution of talent. It is not only that the elite business schools have been “transformed from training grounds for

general managers to institutions that train professional investors and financial engineers, especially in the areas of investment banking, private equity and hedge funds (Khurana, 2007: 310).” It is not only business schools that have changed. Some of the best and the brightest graduates from engineering and physics departments are also recruited into hedge funds and investment banks for their quickness of mind and their mathematical skills. Chemical engineers can make more money as stock analysts specializing in the chemical industry than they ever could designing new chemical products; clever doctors can earn more with health insurance companies. Finance, once the servant of real-economy firms, now robs them of their best potential recruits in order to control them, much as the Romans who once played second fiddle to the Etruscans absorbed some of their noblest families to help gain control over Etruria.

Some would say, and a good thing, too; the pace of technological change in the production of material goods and services is already bewildering enough; anything that slows it down is welcome. But from any “producerist” perspective, such as that of those ancient Confucian societies which honoured the peasant and the artisan more than the merchant, it does seem a pity that so much native talent should be devoted to what the Japanese call the making of “money” rather than of “things.” It is even more clearly a trend to be deplored when the sector which is losing talent is not private sector R&D, but the public sector. The pool of potential recruits into the administrative ranks of the civil service is being narrowed in at least two countries which once had administrations of the highest prestige and, by general acknowledgement, of the highest quality, namely Britain and Japan.

(4) The general process of what the jargon calls “disintermediation” is also depersonalization. Starting long ago in a small way through the substitution of bank loans with the issuance of marketable bonds, and proceeding recently to the securitization of mortgages, rent contracts, loan contracts, and practically anything else, it is at the heart of so many of the recent developments of financial markets.

It has a general effect on society in that it depersonalizes a large range of intercorporate and interpersonal relationships, between borrowers and lenders, owners and leasers. Once they depended on trust as much as on collateral, and carried some sense of personal or corporate obligation. Now there are only contractual property relationships which can only be enforced in courts. This is one of the important changes contributing to the general erosion of trust among the members of any society.

5. Conclusion

It will be obvious to the reader that I have been seeking not simply to describe and explain that bundle of changes which can be reasonably lumped together as a trend to financialization, but also to air my prejudices against it. There are alternative views, however.

One is as follows. The real world economy is growing. Its need for credit and insurance will obviously grow too. Even if it only grew at the same rate, given that financial markets are increasingly global, it is not surprising that the finance industry should grow lopsidedly in some countries (Britain, for example, where it employed 11% of the working population in 1980 and 22% today) rather than in others. The apparent overblown growth of the finance industry in the Anglo-Saxon economies is simply a function of the division of labour. Maybe, but that is hard to reconcile with the fact that the volume of exchange transactions is a three-figure multiple of the volume needed to settle world trade.

A second argument is as follows. As material technology so improves that a declining fraction of the labour force is needed to produce an ever-expanding volume of material goods, more and more income is devoted to the purchase of, and more and more people are employed in the production of, services. Business services expand as more and more complex specialties are provided through the market rather than in-house, tourism expands, entertainment expands, and naturally financial services expand too; more people have larger volumes of financial assets which they are anxious to have taken care of and the growth of the speculative element in financial transactions simply parallels the growth of casinos in the entertainment industry.

There is a clear answer to that. Most of the speculators are not betting their own money – the principals do not even get a buzz from the gambling – and the speculators do nicely, thank you, whether the principals win or lose. And when ordinary people who do not have millions in hedge funds are forced by the pension or mortgage system to make their own, inevitably speculative decisions – usually on the basis of tenuous information – it is often their own basic security they have to put at risk. So I will stick to my prejudices.

Acknowledgement

This paper draws on a presentation originally prepared for a seminar organized by the journal *Stato e Mercato*, Bologna, January 25, 2008. An Italian version is appearing in *Stato e Mercato* 3, 2008.

Address for correspondence

Ronald Dore, Cavanazza, 14, Veggion, Grizzana Morandi, 40030 BO, Italy.
e-mail: rdore@alinet.it

References

Berle, A. and G. Means (1933), *The Modern Corporation and Private Property*. Macmillan Co: New York.

- Bank of International Settlements (2007a), *Triennial and Semiannual Surveys on Positions in Global Over-the-counter (OTC) Derivatives Markets at End-June 2007*. Press release, 21 November 2007 at www.bis.org/press/p071121.htm.
- Bank of International Settlements (2007b), *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in April 2007 – Preliminary global results – Turnover*. Press release, September 2007 at <http://www.bis.org/publ/rpfx07.htm>.
- Blair, M. M. (1995), *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*. Brookings: Washington.
- Chandler, A. D. Jr (1977), *The Visible Hand: The Managerial Revolution in American Business*. Bellknap Press: Cambridge.
- Charkham, J. (1995), *Keeping Good Company: A Study of Corporate Governance in Five Countries*. OUP: Oxford and New York.
- Crotty, J. (2005), 'The neoliberal paradox: the impact of destructive product market competition and "modern" financial markets on nonfinancial corporation performance in the neoliberal era,' in G. Epstein (ed.), *Financialization and the World Economy*. Edward Elgar: Aldershot.
- Dodd, R. (2005), Global OTC derivatives markets, (Financial Policy Forum, Special Policy Brief 16), <http://www.financialpolicy.org/fpfsfb16.htm>, accessed June 2008.
- Epstein, G. (ed.) (2005) *Financialization and the World Economy*. Edward Elgar: Aldershot.
- Galbraith, J. K. (1967), *The New Industrial State*. Penguin: Harmondsworth.
- Gibson-Smith, C. (2005), 'Why Britain Needs an Equity Culture,' at <http://www.londonstockexchange.com/en-gb/about/Newsroom/Media±Resources/Speeches/equityculture.htm>, accessed 17 October 2005.
- Institute of Fiscal Studies (2008), *Racing Away? Income Inequality And The Evolution Of High Incomes*. IFS Briefing Notes, BN76, January 17, 2008.
- Jacoby, S. (2007), 'Finance and Labor, Perspectives on Risk, Inequality and Democracy,' http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020843, accessed June 2008.
- Japan, Cabinet Office (2008), *Nenji keizai zaisei hokokusho: Risk ni tachimukau Nihon keizai. (Annual Economic and Fiscal White Paper)*, Table 2-5-7, July 2008.
- Khurana, R. (2007), *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession*. Princeton University Press: Princeton.
- Lipton, M. (2008), *Shareholder Activism and the "Eclipse of the Public Corporation": Is the Current Wave of Activism Causing Another Tectonic Shift in the American Corporate World?* Keynote Address, The Directors' Forum, University of Minnesota, June 2008.
- Reich, R. (2008), *Supercapitalism: The Battle for Democracy in an Age of Big Business*. Icon Books: Cambridge.

- Summers, L. (2008), 'America needs to think of a new case for trade,' *Financial Times*, 28 April 2008.
- Tett, G. (2008), 'Insight: A new wave of grime lurks,' *Financial Times*, 22 May 2008.
- Wolf, M. (2008), 'Regulators should intervene in bankers' pay,' *Financial Times*, 15 January 2008.