2018, WEA On Line Conference

The 2008 Economic Crisis Ten Years On

in Retrospect, Context and Prospect

Discussion Forum: from October 15th to November 30

Financialization and the 'New Normal'. At the root of the aggregate demand problem undermining New Capitalism

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Abstract

This paper focuses on how financialization contributes to the 'New Normal' in advanced countries -- namely, the current macroeconomic context characterized by slow growth and low inflation -- which has been generated by deep structural change since the 1980s. The paper emphasizes that such structural change, which brings about a new growth regime labelled 'New Capitalism' (NC), consists of both 'objective' changes -- namely key trends, such as financialization, globalization, information technology, deregulation and the performativity of standard theory -- and 'subjective' changes, such as shifts in agents' conventional perceptions of these trends, which crucially affect the drivers of aggregate demand. The key thesis of this paper is that the interconnectedness between these dimensions of structural change undermines the stability of NC. More specifically, it stresses that financialization crucially affects the *modus operandi* of NC by changing agents' perceptions in such a way as to undermine the drivers of aggregate demand.

Key words: Financialization, Instability, Conventions, Effective demand, Growth regimes.

JEL classification: E2, E5, G2

1. Introduction

This paper focuses on how financialization -- broadly defined[1]-- contributes to the so-called 'New Normal' (NN) (see e.g. El-Erian, 2010) in developed countries, that is to the current, post-Great Recession scenario, characterized by relatively slow growth, low inflation, high asset prices, high inequality, low aggregate demand and welfare cuts. The NN is the product of the deep structural change that has occurred since the 1980s within the current stage of growth, or regime, of capitalist development, conveniently labelled as 'New Capitalism' (NC) (see e.g. Sennett, 1997),[2] to mark the fact that it is a complex, broad socio-political and cultural -- rather than just economic -- formation.

What is the relevant structural change occurring in NC? It involves factors of both an objective and a subjective kind, which are strictly interconnected. As for the objective factors that distinguish NC from the past stage (which can be

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labelled as Modern Capitalism, MC), a prominent role is played by the following two. First of all, NC involves the acceleration of key phenomena, such as financialization, globalization, the introduction of information technology, the diffusion of deregulation moves -- neoliberalism-- as well as postmodern cultural factors, such as the performativity of standard theory. Secondly, these phenomena appear to be much more interconnected than ever before.

As for the subjective factors, it can be argued that the above objective features do not act in a deterministic manner. They affect the economy by changing not just the environment but also agents' perceptions of it, with the result that new types of decisions are made or new conventions are adopted. In particular, I suggest that the objective changes in the environment of NC stimulate shifts in agents' collective perceptions concerning a number of key dimensions, such as those of space, market, time and value.

The key thesis of this paper is that, because of this double level of interconnectedness -- namely, that between objective factors and between objective and subjective dimensions of structural change -- NC turns out to be more unstable than the MC, rather than a golden age, or the era of the Great Moderation, celebrated by standard theorists until the outbreak of the crisis. In particular, as pointed out by several heterodox economists,[3] NC involves a growth model that tends to generate low-aggregate demand and stagnation,

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mainly because of the perverse effects of financialization. For this reason, many characterize NC as 'finance-dominated capitalism' (e.g. Hein, 2012; Palley, 2013) or 'money manager capitalism' (Wray 2010).

While subscribing to this broad stance, this paper's contribution is to stress the following two points that are substantially neglected in the literature: first, financialization plays a key role in NC because it dramatically increases its interconnectedness; secondly, this higher interconnectedness accounts for the persistent lack of aggregate demand and the NN in NC. In particular, following an interpretation of Keynesian theory placing the emphasis on the role of agents' conventions as major determinants of the drivers of aggregate demand, it stresses that financialization crucially affects the *modus operandi* of NC by changing agents' perceptions of the environment in such a way as to lead them to adopt riskier, more fragile conventions that ultimately undermine the drivers of aggregate demand. On these grounds, it seeks to provide a more complete account of the persistent aggregate demand problem in NC than those present in current literature.

To discuss these issues, the paper is organized as follows. Section 2 focuses on the interconnectedness of NC. Section 3 analyzes how financialization contributes to this phenomenon. Section 4 deals with the link between financialization and the aggregate demand problem in NC.

2. The interconnectedness of New Capitalism

2.1 Interconnectedness between objective and subjective factors

As already noted, the adoption of the NC label is justified by the fact that, in comparison with modern capitalism (MC), NC presents a number of significant novelties that appear as structural, irreversible changes. Here I place the emphasis on two basic novelties. The first is the acceleration of certain key trends, such as financialization, globalization, the introduction of information technology (as well as other technologies which bring about continuous small innovations, more diversification of goods, as opposed to mass production of MC), the diffusion of deregulation moves – neoliberalism -- as well as postmodern cultural factors, such as the performativity of standard theory, which amounts, for example, to the fact that society as a whole takes standard theory in general as the only scientific approach to economics, 'the only game in town', providing a secure anchor to agents' expectations and policymakers' choices. The second novelty of NC is the fact that such trends appear more strictly interconnected than ever before. These two novel features are linked: for example, the acceleration of globalization implies greater interconnectedness and amplifies the transmission mechanisms of global disturbances. In particular, it explains why in the recent crisis, world trade collapsed at its fastest rate since the Great Depression (see e.g., Palley, 2012, pp.72-3).

There are many signs, not just economic, that high interconnectedness is a key

feature of NC, starting from the social imperative that any person must always be 'connected' to all others across the web to be a person at all. Another important sign is that NC defies rigid classifications or one-sided approaches. As pointed out by postmodernist authors such as Bauman (2000), NC can be labelled as a 'liquid' society in which all rigid separations -- such as those between economic sectors (e.g. financial/real), between different spheres of society (e.g. cultural/institutional/ economic) or between different temporal trends -- break down. At the economic level, among the most significant new phenomena implying a higher degree of interconnectedness in NC with respect to MC, one can mention the increasing specialization or deepening of the division of labour,[4] raising interconnectedness among enterprises; a greater diversity of capitalisms and a greater interconnectedness between the economy and political system.

However, in NC another form of interconnectedness acquires special significance, namely that between the objective trends and subjective features governing agents' behaviour, such as their perceptions of these trends. There are a few reasons why we need to go beyond purely 'objectivistic' accounts of NC to considering agents' responses too. First of all, in NC there is a widening gap between 'objective' material conditions and agents' social aspirations and perceptions of their well-being, as testified, for example, by the concern of economists for the happiness issue (see e.g., Helliwell, Layard and Sachs, 2016)

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and the debate over 'going beyond GDP' (see e.g., Deb, 2015). Secondly, the NC appears as a 'totalitarian' regime, which shapes agents' lives and characters in an unprecedented manner. This means, for example, that the 'biological self' -- the bodily basis of personality, the source of its passions and desires -- undergoes the universal shaping pressure of dominant culture. Enterprises plan consumer lifesytles before production in a more scientific way than ever before. As pointed out by Barber (2007), this phenomenon can be described in terms of the shortening of people's mature lives; that is, whatever the length of their biological life, they will always appear to be 'corrupt children'. Thirdly, a further influence on agents' behaviour is the performative role of standard theory, a significant part of dominant culture. It can be argued that neoliberalism has constructed 'economic man'; that is, it has shaped agents' perceptions along the lines of the rational man model, which has come to be accepted even by different social classes or by people with different material interests (see e.g., Metcalf, 2017).[5]

[5] **'neoliberalism… helped shape the ideal of society as a kind of universal market (and not, for example, a polis, a civil sphere or a kind of family) and of human beings as profit-and-loss calculators (and not bearers of grace, or of inalienable rights and duties). Of course the goal was to weaken the welfare state and any commitment to full employment, and – always – to cut taxes and deregulate. But "neoliberalism" indicates something more than a standard rightwing wish list. It was a way of reordering social reality, and of rethinking our status as individuals. Still peering through the lens, you see how, no less than the welfare state, the free market is a human invention. You see how pervasively we are now urged to think of ourselves as proprietors of our own talents and initiative, how glibly we are told to compete and adapt. *You see the extent to which a language formerly confined to chalkboard simplifications describing commodity markets (competition, perfect information, rational behaviour) has been applied to all of society, until it has invaded the grit of our personal lives, and how the attitude of the salesman has become enmeshed in all modes of self-expressio*n. (Metcalf, 2017, emphasis added).**

2.2. How to account for shifts in agents' perceptions

Providing an account of the modus operandi of NC that considers both objective and subjective factors is no straightforward matter, and current macroeconomic theory is not well equipped to deal with the task. While standard theory relies on exogenous preferences, Keynes' *General Theory* -- focusing mainly on short-period equilibrium -- treats the propensities to consume and invest essentially as given psychological factors and thus as 'natural' features of agents' behaviour. However, given our emphasis on the link between the NN and the lack of effective demand, the problem we face is how to provide a dynamic extension of Keynesian analysis. Of course, this issue has been widely addressed in the literature ever since the late 1930s and many different approaches have been proposed.

Although I cannot discuss the matter at length here,[6] I do suggest that a proper way to carry out this extension for analysis of the *modus operandi* of NC is to provide an account of endogenous changes in propensities to consume and invest underlying aggregate demand. This account has been at least implicitly

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advocated by a few post-Keynesians, such as Minsky,[7] but it has seldom been attempted or carried out successfully.

One reason is that many post-Keynesians still rely on 'animal spirits' as a kind of all-encompassing term capturing several psychological factors. This term ultimately acts as an 'exogenous' shock in models stressing 'objectivistic' drivers of aggregate demand, such as technology and market forms. [8] Two remarks are in order here. First of all, as Akerlof and Shiller (2009) convincingly suggest, in Keynesian theory the ultimate drivers are 'subjective' and progress could be made in Keynesian dynamic analysis, aimed at uncovering the causes of endogenous instability, by opening the black box of animal spirits, i.e. by endogenizing them. Secondly, we should pursue this endogenization by adopting an approach different from Akerlof and Shiller's behavioural one, since the components of animal spirits they single out are ultimately forms of irrational behaviour.[9] In particular, I suggest that the ultimate drivers of dynamic analysis should be conventions as forms of rational behaviour.

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To understand this claim, we should consider another reason why post-Keynesians have failed to provide an endogenous account of Keynesian propensities. The key point is that the shift from the psychological propensities suitable for short-period equilibrium or cyclical analysis to the subjective factors that are sufficiently persistent to fit into a long-period dynamic perspective is not an easy one. For example, in this perspective one cannot rely on purely psychological features, such as optimism or pessimism, because they are cyclical and thus reversible. This is why reference to conventions, which Keynes himself makes in his book, seems more appropriate. Conventions, in fact, turn out to be widely shared, relatively persistent habits or modes of thought with a dual dimension: they have both a psychological dimension, reflecting natural tendencies of human kind such as imitation, and a socio-institutional one, reflecting the fact that they are embedded in a particular context (one example is the current 'originate and distribute' business model followed by banks).

But what accounts for changes in conventions? To capture their dynamics, it is better not to see a sharp contrast between psychological and conventional features. It is possible to regard psychological propensities themselves as becoming permanent features of agents' behaviour, i.e. conventions, due to the occurrence of evolutionary mechanisms that ensure their persistence in the real world. An interesting example of this kind of analysis is provided by Palley (2012). In his account of the Great Recession, he emphasizes changed psychology and perceptions of market participants as one factor driving the increase in the

supply of finance and risk-taking. He also notes that this factor connects the crisis to Minsky' s financial instability hypothesis:

[…] his fundamental insight was that in financial markets success breeds excess, which breeds failure. Success drives market participants to become overconfident and also to believe that the world has changed permanently for the better, so that they can take yet more risk and make even greater profits. Moreover, these changes in psychology and perception affect all market participants, including regulators (and economists). This is critical because it explains why market discipline tends to gradually break down. Periods of boom promote optimism and memory loss regarding past crashes, as well as change business culture. Regulators are also taken in by the same mechanisms. Thus, business cycle expansions often generate chatter about the 'death of the business cycle'. (2012, p.65)

While being based on cyclical features such as pessimism and overconfidence, this account is not irrelevant to a long-run perspective, such as the one advocated here. The point is that there are mechanisms that ensure persistence of certain psychological propensities, such as risk-taking:

Moreover, there are evolutionary mechanisms that lock in proclivity to risk taking via success and promotion. Thus, managers and entrepreneurs who make profits come to dominate. Since risk takers tend to make more profit, cautious investment managers and entrepreneurs will tend to fall behind over time and the population of managers and entrepreneurs will be increasingly dominated by high rollers. (ibid.).

As Palley notes, this process is well described by Zakaria:

As Boykin Curry, managing director of Eagle Capital, says: 'For 20 years, the DNA of nearly every financial institutions had morphed dangerously. Each time someone pressed for more leverage and more risk, the next few years proved them 'right'. These people were emboldened, they were promoted and they gained control over ever more capital. The cautious types were increasingly intimidated, passed over for promotion…' (ibid.)

However, in order to provide an account of conventions' dynamics, this important insight is not sufficient. It is also necessary to specify their socio-institutional dimension in more precise terms. In particular, we need to answer two questions: what institutional factors actually drive the evolutionary mechanism and lead to the 'lock in' of risk taking behaviour? Are there other kinds of agents' persistent perceptions that are relevant to analysis of NC? To answer the first question, it is necessary to focus on the role of financialization in NC, a task which will be addressed in the next section. As for the second question, the answer is affirmative. There are indeed several perceptions that are relevant to discussion of the nature of the present regime of growth. One possible way to identify them is to establish a connection between the environment of NC, summarized by the objective characteristics of structural change listed above, and a number of agents' perceptions of this environment that are relevant to define their behaviour not in abstract terms, as is customary in standard models (that characterize such behaviour in terms of given preferences, for example), but across different periods of historical time. I refer to 'coordinates',

such as those of the 'market', 'value', 'space' and 'time', which are relatively persistent features that change in a discontinuous but irreversible fashion, in relation to major structural changes, such as those occurring in the passage from MC to NC. It can be argued, for example, that the new technologies and globalization stimulate a new perception of 'time' (e.g. short-termism), 'space' (e.g. the 'world is flat' metaphor used by Friedman, 2005) and 'value' (e.g. the acceptance of greater inequalities in income distribution); moreover, the performativity of standard theory has changed people's perception of the 'market', leading to the widespread acceptance of markets as the ultimate mechanism to allocate resources. Again, a more complete analysis of such perceptions will be provided in the next section, in the light of our account of the role of financialization in NC.

3. Financialization and the interconnectedness of NC

3.1. Increasing interconnectedness in the financial sector

As implied by the various labels used in the literature to categorize the recent stage of growth -- such as, 'finance-dominated capitalism' (e.g. Hein, 2012; Palley, 2013), 'credit-led regime', or 'money-manager capitalism' Wray (2010) -- the role of financialization is crucial to understanding of the *modus operandi* of NC. In particular, this paper places the emphasis on a 'qualitative' feature of financialization, namely the fact that it increases the interconnectedness of NC.

Let us start by focusing on the financial sector itself. There is no doubting that this sector is 'naturally' more interconnected than other sectors. Suffice it to note, for example, the 'chain nature of financial systems', according to which, for example, 'a default by a borrower in turn puts lenders at risk' (Palley 2012, p.74) or that such systems generate a 'web of debt' (see, Brown, 2012). However, one major novelty in NC is that financialization generates a drastic acceleration of this natural tendency, as shown by the fast contagion seen in the recent crisis, where a relatively 'local accident', such as the subprime crisis in the U.S., has been very rapidly transmitted to the rest of the world. One reason for this contagion is that, because of the complexity of the new assets and the securitization process, financialization generates longer chains of people involved in the income and profit generation process with respect to MC, as shown, for example, by the fact that in the recent 'originate to distribute' banking business model the cost of default is no longer borne by individual banks as in the traditional 'originate to hold' model, but by the whole financial community and ultimately by the state. (see e.g., Palley, 2012, p.66).

3.2. An endogenous mechanism ensuring the growth of the financial sector

But there is also another reason why the financial sector is growing with respect to other sectors of the economy, thus increasing its interconnectedness: namely, the existence of an endogenous mechanism in NC that protects the financial

system from cyclical fluctuations and deep crisis. This mechanism is fuelled by the interaction between various NC trends and relies upon a number of pillars.

1. **The innovations in financial markets and instruments are strictly linked to the spread of new technologies and the performativity of economic theory (see e.g. Mackenzie, 2006, van der Zwan, 2014, p.112). In particular, to counter the complexity of the new financial assets, agents rely on mathematical models of pricing and risk management.**

2. **Unlike industrial enterprises, financial institutions cannot fail because of the major interconnectedness of the financial system.**

3. **In case of market disruption, last resort 'Keynesian' policies aimed at building powerful safety nets -- such as public expenditure to finance bail out strategies and quantitative easing by central banks -- are implemented, due to the greater interconnectedness between financial markets and state intervention.**

4. **The lack of inflation -- due mainly to the influence of technological change and globalization -- allows such last resort policies to continue.**

5. **Higher leverage ratios and further growth of financial markets -- to a large extent engaged in speculative trading, i.e. unconnected with productive use, and arbitrage activity -- are thus possible.**

6. **The continual success of financial markets further stimulates the performativity of standard theory (in the shape of efficient-market hypothesis), which enhances the pervasiveness of financialization; that is, it extends its influence well beyond the financial community to affect the system as a whole.**

The significance of this mechanism for the working of NC cannot be overemphasized. It is mainly responsible for 'locking in' proclivity to risk and other features of the new business culture linked to financialization. The reason why such changes in agents' perceptions -- and the new conventions or business models they bring about -- are persistent and seem irreversible (unlike cyclical features, such as pessimism and optimism) is that last resort policies concur to isolate the financial system from the business cycle. Indeed, these features have become almost embedded in markets and society as a whole because of the interconnected nature of finance with policy.

Taken all together, these pillars show the striking paradox underlying NC, namely that the continual success of financial markets -- which is strictly linked to the performativity of standard theory based on the presumption of the

efficiency of unregulated markets -- is ultimately due to state intervention and the implementation of Keynesian policies.

3.3. The pervasive nature of financialization

Ultimately, another major cause of the interconnectedness of NC is the pervasiveness of financialization. This means that the latter affects all spheres of the economy and society by influencing the process of formation of agents' perceptions of the environment, mentioned in the last section.[10] As already noted, a number of trends of NC take part in this process. In this section, I place the emphasis on the major role played by financialization. It can be argued that it exercises an influence on the following perceptions of:

a) **'time', by stimulating short termism in all sectors of the economy, including industrial firms;**
b) **'value', by stimulating the dominance of a notion of 'fair' value -- over different dimensions of value, such as use value -- which refers not to 'objective' properties of things, but to the outcome of the valuation process based on the endogenous mechanism described in the previous section, which accounts for an almost autonomous growth of financial asset prices, with respect to the dynamics of real production. In contrast with the traditional logic, according to which financial markets 'mirror' the behaviour of the real economy, almost the opposite appears to be true. In**

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particular, today the basic logic governing the financial system also provides the paradigm for managing industrial enterprises. The latter must comply with the principle of maximizing shareholder value, which does not just imply that financial components have become more important than the productive ones (or that, to survive, even big industrial enterprises are compelled to become ever more linked to finance as a source of greater profits), but that the production process itself must be fashioned in such a way as to generate returns that satisfy financial investors (see e.g., van der Zwan, 2014; Hein, 2012). For example, this means that big institutional investors put industrial firms under strong pressure to obtain a high return on equity, even when the economy grows much less. This principle thus stimulates enterprises' fierce search for a competitive edge, by rationalizing the productive process as much as possible (for example, by decomposing it in a value chain, each ring of which, to 'survive', must generate a certain return by using labour in the most flexible way).

But this is not all. Financialization also influences the perception of value by changing the conception of fairness in income distribution (e.g. larger pay differentials between the financial sector and other sectors are justified as 'normal' market outcomes), as well as the nature of money as a social relationship. This means, for example, that in NC there are new relationships between debtors and banks, managers and property (e.g. investment trusts) or between bond holders and tax payers.

c) **'space', by increasing the mobility of capital (i.e. the possibility of carrying out financial transactions at low cost throughout the world). Financialization certainly contributes to the 'flatness' dimension.**

d) **'market', by changing people's perception of its boundaries. For example, more areas of 'everyday' life, such as housing, consumption, education, health, pensions, become prey to private finance (e.g., Lapavitsas and Powell, 2013; van der Zwan, 2014).**

4.Financialization and the aggregate demand problem in NC

4.1. Alternative approaches to the demand problem in NC

It can be argued that, as a result of its interconnectedness, NC increases instability, interpreted broadly, namely, not as a cyclical phenomenon (seen as a deviation from equilibrium or as equilibrium fluctuation) but as a structural NN. I suggest that the ultimate roots of this greater instability should be found in the *modus operandi* of NC and in the new characteristics of its growth model with respect to past stages of capitalism. This point is widely stressed in the literature (see e.g. Boyer, 2012; Palley 2012). As noted, for example, by Palley since 1980 (as result of neoliberal policy) the NN or stagnation is the result of a shift from a

stable virtuous growth model based on full employment and wages tied to productivity growth to a new growth model based on low aggregate demand-stagnating wages, increasing inequalities, rising indebtedness and asset price inflation as a new source of aggregate demand.

In this section, I largely endorse this view, but I seek to provide a more complete account of the persistent lack of aggregate demand problem in NC than those present in current literature on financialization. In particular, I explain the NN on the grounds of changes in agents' perceptions underlying the Keynesian propensities to consume and investment, brought about especially, though not exclusively, by financialization. In particular, my version of financialization departs from existing accounts for three reasons.

First, financialization is an autonomous cause of the demand problem, rather than an effect of it as held for example by Palley (2012; 2013) according to whom low wages mainly cause insufficient aggregate demand, which indebtedness is insufficient to counteract; that is, financialization does not cause the lack of aggregate demand but prolongs the neo-liberal model:

'[…] financial innovation and deregulation did not cause the crisis. The neoliberal paradigm was already going to fail owing to its internal contradiction, but financial innovation and deregulation kept the model going longer … this extension resulted in the accumulation of large financial imbalances' (Palley, 2012, p.43).

Now, as already noted, it is true that NC generates low wages in western countries. Indeed, it appears as the age of 'devaluation' of labour. On the one hand, the new technologies are labour saving and imply that the cost of labour represents a smaller fraction of total costs; on the other, the goods for which labour is important are subject to more intense international competition. In particular, by stimulating change in agents' perception of space, globalization -- through de-location and FDI -- has shifted production abroad to places where labour costs are lower. Together with the parallel erosion of welfare and other phenomena linked to the 'fragmentation' of the productive process, such as labour market flexibility and intensification of work, this trend has put real wages in industrialized countries under pressure, thus favouring rising inequality. However, it is not sufficient to regard low wages as the main or exclusive cause of low aggregate demand. While certainly lowering consumption and investment (through the accelerator effect), I emphasize that aggregate demand is low also for other reasons that are linked to agents' changed perceptions, especially due to the influence of financialization, which thus plays an autonomous causal role in the story of the Great Recession and the NN.

Second, financialization is not an exclusive cause of the demand problem. In contrast with Minsky's endogenous financial instability hypothesis or Shiller's animal spirits hypothesis, for example, the demand problem is also rooted in real sector dynamics. As Palley notes the recent crisis is not a pure 'Minsky' crisis:

Minsky … saw crises as the result of endogenous financial instability that developed over time. However, the current crisis is a crisis of the neoliberal paradigm. That paradigm fostered financial instability as a way of sustaining itself. Consequently, when the crisis hit, it took on the appearance of a classic Minsky crisis but *its real roots* lie in the neoliberal model. (2012, p.43)

Third, financialization brings about agents' behavioural responses or shifts undermining aggregate demand, this contrasting with authors who, instead, emphasize price rigidities (e.g. negative real interest rate, e.g. Summers, 2014a; 2014b) and/or market imperfections of various kinds, such as asymmetric information and capital market imperfections (e.g. Stiglitz, 2016) or monopoly power (e.g. Hein, 2015). Indeed, the demand problem is due to the interconnectedness between objective and subjective factors that undermine the key propensities to consume and invest in the growth model of NC. This model is more unstable -- or even potentially self-destructive -- than the one underlying MC insofar as it generates permanently low or stagnant aggregate demand. In particular, this outcome is due to two main factors: a) the occurrence of both a consumer and an investor gap which mutually reinforce each other in a cumulative fashion by creating trust crises; b) the lack of a stabilization mechanism due to the 'trust trap' faced by policymakers.

4.2. The consumer gap

One distinctive feature of the NC growth model is that it generates a consumer

gap, the significance of which can be summarized as follows. First, one notes, for example, that in contrast with the MC, in the NC consumption plays a more autonomous role and tends to be more volatile, so that to understand its dynamics it is not sufficient to focus on a given propensity to consume out of current income. It is also necessary to understand the drivers of this propensity.

Second, supported by the values of dominant culture, NC trends stimulate consumers' aspirations by generating powerful pressures to increase their propensity to consume. One may note, for example, that by changing agents' perception of time (i.e. the shortening of their horizons), faster technological change creates a growing number of 'artificial' needs by creating a larger variety of 'luxury' goods -- less durable and more differentiated -- for mass consumption, as well as the expansion of enterprises' advertising budgets to induce consumers to buy[11] Moreover, by changing agents' perception of space, globalization encourages them to buy more foreign goods, which are, for example, more varied and cheaper than domestic goods.

Third, the reality of stagnating wages as well as inequality and joblessness generated by the key trends of the NC (see e.g., Cynamom and Fazzari, 2016) implies that this tendency cannot be accommodated and effective demand is bound to lag behind aspiration levels.

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Fourth, financialization helps to bridge the gap between consumers' aspiration levels and their ability to pay by loosening their liquidity constraints. Indeed, as noted, for example, by Mazzucato and Wray: '[…] consumers have taken over the role of debtor in capitalism which was played by entrepreneurs in the modern economy' (2014, p. 15).

Fifth, in this way financialization favors levels of consumption that prove to be unsustainable.[12] A credit boom clearly cannot go on forever. Indeed, as Cynamon and Fazzari point out, when 'limits on further borrowing for the bottom 95%' were imposed, they 'ultimately forced a historic collapse of consumption leading to the Great Recession' (2016, pp. 374-5).

Sixth, asset price inflation -- representing the revenge of the *rentier* -- acts in principle as a new source of aggregate demand.[13] However, given the strong polarization of income and wealth distribution brought about by the NC trends, together with a relatively low propensity to consume of the highest income groups, this new source of demand is bound to replace only partly relatively stagnant mass consumption.

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4.3. The investor gap

Another distinctive feature of the NC growth model is that it also generates an investor gap. This time, the relevant gap is between favourable economic conditions, such as low interest rates and easy credit, and the perceptions of investors, which remain negative.

Before we discuss this gap in detail, it is important to note that it does not tell the whole story about low real investment. On the one hand, there are also objective factors, such as the nature of new technologies and relative prices in the NC, that do not favour real investment. This is well captured by Summers in particular, in his discussion of debt-financed investment:

> **Ponder that the leading technological companies of this age—I think, for example, of Apple and Google— find themselves swimming in cash and facing the challenge of what to do with a very large cash hoard. Ponder the fact that WhatsApp has a greater market value than Sony, with next to no capital investment required to achieve it. Ponder the fact that it used to require tens of millions of dollars to start a significant new venture, and significant new ventures today are seeded with hundreds of thousands of dollars. All of this means reduced demand for investment. (2014a, p.69)**

He recalls, moreover, that new technologies also involve a substantial reduction in the relative price of capital goods: 'Cheaper capital goods mean that investment goods can be achieved with less borrowing and spending, reducing the propensity for investment.' (ibid.)

On the other hand, if the expansion of financial markets in NC does not lead to greater real investment, this is also due to the behaviour of financial intermediaries. While appearing to stabilize the economy by favouring the systematic reduction in interest rates -- something that in principle comes close to the realization of the euthanasia of the *rentier* advocated by Keynes to tame capitalism -- financialization instead turns finance itself into a more speculative business. As many have noted, low nominal rates stimulate risk-seeking by financial institutions, with the decline of traditional banking – meaning that less lending to firms and households -- and more off-balance operations, trade in security and bonds speculation, higher leverage ratios (or Ponzi finance) (see e.g., Lapavitsas and Powell, 2013; Simon, 2015). Indeed, as Mazzucato and Wray conveniently stress, 'securitization had turned patient and local finance into highly impatient global finance.' (Mazzucato and Wray, 2014, p.51)

However, these remarks do not contradict the existence of the investor gap: there is no doubting that, in general, credit conditions remain easy in the present context, and changing investors' perceptions induced by the trends of NC play an important part among the causes of low real investment. One notes, for example, that, by influencing their perception of space, globalization stimulates enterprises to invest abroad. Moreover, by influencing their perception of time, the new technologies generate larger and faster information flows, thus increasing uncertainty about future scenarios. Below I place the emphasis on how investors' perceptions are influenced by financialization.

First, financialization stimulates a new perception of value which influences negatively firms' real investment because it generates 'higher' and 'safer' returns than those that could be derived from investment in the real sector.

Second, these returns are 'higher' because financialization implies the creation of ever more complex financial assets (further removed from underlying real assets and thus even more difficult to value than previous ones),[14] which greatly favour the determination of asset prices on the grounds of a pure 'internal' market assessment (guided by formal models). These prices tend to be 'validated' ex-post by policy moves -- such as the current historically low interest rates ensured by quantitative easing -- due to the interconnectedness of the financial sector and policy.

Third, financial returns are 'safer' than those obtainable in the real sector. The point is that while financial institutions operate under the insurance granted by bail-out strategies, which lower the risk of bankruptcy, non-financial corporations do not normally have such an insurance.

Fourth, for both reasons, in NC financial returns set a benchmark for returns in the real sector. In particular, the so-called 'fundamentals' of the real sector, such as profits, are driven by financial returns, rather than the other way round. Non-financial corporations' investment seek to converge round this benchmark both

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by turning themselves to financial activities -- indeed, large corporations are now much more focused on financial activities with respect to their traditional core business[15]-- and by seeking to shape the productive process by following the principle of shareholders' value maximization.[16] This leads them to penalize investment in R&D, new technologies and new plants, as well as in wage levels and work conditions. They use financial resources not to make new investment but to eliminate competitors.

Fifth, non-financial business firms may be unable to achieve the exogenous benchmark return set by financial markets. The logic of aggregate demand is that real returns may be low due to low investment caused by financialization.

4.4. The general trust problem

While for standard theorists the lack of trust is due to institutional failures -- such as policy moves raising the moral hazard problem or the fact that institutions turn extractive rather than inclusive (e.g. Acemoglu and Robinson, 2013, Johnson, 2013) -- the Keynesian perspective advocated here underlines the fact that the trust problem is endogenous to the economy. More specifically, all NC trends make conventions more fragile and bring about not only significant shifts in agents'

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perceptions but also a worsening of the collective trust problem, which further undermines the drivers of aggregate demand.

There can be no doubting, for example, that, by causing joblessness, the new technologies and globalization make a large contribution to weakening collective trust (in particular, the erosion of social capital in the shape of 'national' identity or ties).

Below I focus on how financialization contributes to this problem. By bridging the consumer gap, financialization apparently favours stability. However, if one considers that consumers' aspirations are 'impossible' to realize (given the creation of ever new desires in NC) and that the indebtedness of individual households cannot grow forever, their greater dependence upon debt offers only a temporary and partial solution to the gap and ultimately raises their 'unhappiness' or frustration, which weakens the trust background underlying conventions and makes consumption more fragile, more dependent upon the 'state of the news', a bit like investment in the past. Moreover, consumers' unhappiness is clearly stimulated by their feeling that they are treated unfairly as debtors. They mistrust the financial world -- where fraud and false accounting go hand in hand with the fabulous pay rises and bonuses earned by top managers -- and are deceived by the asymmetric behaviour of governments apparently ready to save banks but quite incapable of saving homeowners. As Johnson (2013) puts it:

What happened from 2008 to 2009? A few big banks received very generous amounts of

support from the central bank and the government ... But … the same kind of support was not provided to homeowners ... we have exacerbated the moral hazard that was already lurking in our financial system. Looking at this arrangement, it is no wonder that so many people are angry … the Tea Party... represents a deep breakdown of the most fundamental but also most precarious trust in our society – trust in economic and political fairness.

The tendency of consumption to become more unstable in NC naturally affects negatively investment, as underlined by the 'normal' accelerator effect. This worsens the investor gap -- highlighting the vicious circle created by financialization (low investment -- lower interest rates -- more intense financialization -- still less investment), hence the general trust problem. Strictly speaking, the very existence of the investor gap is a measure of the enterprises' lack of trust that undermines investment decisions. All NC trends combine to make it more difficult for enterprises to estimate expected returns on investment. However, it is clear that financialization greatly contributes to this estimation problem, and, more in general, to the collective trust (or 'unhappiness') problem underlying the gap between GDP and welfare. Suffice it here to make two remarks. First, by stimulating firms' short termism -- their defensive move in the face of their estimation problem -- financialization weakens collective confidence by encouraging social irresponsibility of investment (i.e. disregard for work conditions, the ecological wealth of the planet or so called Living Capital, see e.g. Kurtzman, 1993). Secondly, by influencing both the consumer and investor gaps, financialization may be held responsible for the cumulative effects that such gaps tend to have on collective trust: what we might call 'trust trap'.

4.5. Stabilization mechanisms and the 'trust trap'

One implication of the analysis carried out so far is that the NC tends to generate a structural lack of aggregate demand and high unemployment as well as low quality of jobs for most, in contrast with the promises of the 'new economy' or 'society of knowledge'. While contributing to shift the engine of private demand growth from wages into asset price inflation and borrowing, financialization is ultimately unable to solve the demand problem in NC. Strictly speaking, it is bound to make it worse, especially as a result of the trust trap, i.e. the vicious circle between the consumer and investors gap it generates. Moreover, financialization may also contribute to lower exports for western countries, due to the growing volatility of financial markets and exchange rates, as well as the faster transmission of financial and real disturbances across countries produced by the combination of all the NC trends.

One key feature of NC is the absence of adequate stabilization mechanisms to counter this private demand problem. In principle, the trust trap could only be broken by rising public expenditure for accumulation or welfare purposes, i.e. by a kind of Keynesian environment, such as that of MC. However, the logic of NC drives governments' policy in the opposite direction, thus undermining the prerequisites for sustained levels of growth. Indeed, while in MC there was a monotonic increase in this kind of public expenditure, the NC is characterized by a retrenchment therein, due to the existence of a number of constraints. Among these, an important part is played by

the performativity of mainstream economics, crucially stimulated by financialization itself.

The paradigm of efficient-market theories -- their performative nature -- has succeeded in influencing not just the growth of financial markets but also the economy at large by stimulating thinking whereby economies can be shaped like the benchmark of perfect competition and the demand problem can be simply ignored by systematically tracing the causes of dramatic events, such as the Great Recession, to 'structural' problems in individual markets or government or institutional failures. More specifically, according to standard theory governments should stick to conceptions of orthodox finance -- i.e., seek to balance their budgets, especially for fear of 'market punishment', and should reduce welfare expenditure (in particular, for pensions and health), while lowering tax for the rich and firms (e.g., Van der Zwan, 2014).

It is important to note, however, that another crucial constraint to the rise of public expenditure for accumulation or welfare purposes is the very nature of the financial system in NC, namely its interconnectedness, which potentially lead governments to face what they now regard as the most dramatic challenge: namely, the meltdown of financial markets, an event which would be capable of worsening the fundamental trust trap underlying NC.

To avoid this scenario, governments feel they have no other option than to accommodate almost whatever arrangements or conventions the financial system may choose to adopt at any given moment in time. Bail-out strategies setting a

floor to asset prices and ruling out the 'discipline' of capitalism within the financial system are simply the recognition of this kind of political impotence.

A similar accommodating, last-resort defensive stance characterizes the conduct of monetary policy. While inflation-targeting still represents the formal goal pursued by central banks, in a world with no inflation these banks' true goal is the stability of the financial system, which they prepare to pursue by promising to do 'whatever it takes' -- for example, by engineering new massive injections of liquidity-- to achieve it. However, central banks too are bound to fall into the trust trap. On the one hand, low interest rates granted by ever new forms of quantitative easing do not favour real investment (on the contrary, they may well reduce it by widening the investor gap). On the other, in the absence of inflation, central banks cannot readily go back to 'normal' monetary policy for fear of destroying market trust.

Conclusion

A few key conclusions follow from the analysis of this paper. First of all, I underline the fact that the so-called New Normal is due to the growth model implied by New Capitalism (NC). This model is based on a higher degree of interconnectedness between key trends, including financialization, which plays a

major role in bringing about greater instability (i.e. a low aggregate demand) and constraining policy moves.

Secondly, low aggregate demand is explained in terms of the interconnectedness between key objective trends and agents' perceptions of such trends, which accounts for shifts of the demand drivers, such as the propensity to consume and invest.

Thirdly, this distinction between objective trends and agents' perceptions allows one to provide a consistent account of the growing gap between an objective indicator of economic performance, such as the GDP, and agents' 'happiness' with NC. On these grounds, one can understand better the role of 'negative factors' such as financialization. In particular, the latter -- while raising current GDP, though not as much as it could (i.e. it partially crowds out real growth directly, for example, by setting too high a benchmark return for real investment) – undermines future GDP growth indirectly through the consumer and investor gaps and their interaction.

Fourthly, in NC there is no adequate stabilization mechanism capable of addressing this GDP/unhappiness gap. Indeed, due to the basic interconnectedness of the NC, governments cannot avoid falling into the trust trap. Both bail-outs and quantitative easing are 'necessary' accommodating policies that, while restoring confidence temporarily, end up by favouring the

further growth of financialization and the performativity of standard theory, which are at the root of the low demand problem. By saving financial institutions and putting a floor to asset prices, they ensure the ex-post validity of the financial paradigm as a driver of both real sector dynamics (undermining private demand) and of orthodox economic policies addressing the low aggregate demand problem in ways -- i.e. in terms of structural market reforms and cuts to public expenditure for welfare and accumulation -- that tend to aggravate it even further.

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FOOTNOTES

[1] There is no generally agreed definition of financialization in the literature. It is a multi-dimensional concept that can be defined in different ways according to the emphasis placed on specific issues, such as a new regime of accumulation, shareholder value orientation and how finance affects people's everyday life. For an overview of the relevant literature concerning these issues and the most significant definitions of financialization, see e.g. Argitis and Pitelis, 2008; Lapavitsas and Powell, 2013; Sawyer, 2016, van der Zwan, 2014. For the purposes of this paper, focusing on macroeconomic issues, I adopt a broad definition encompassing most of these dimensions. In particular, as I stress below, financialization means *acceleration* of financial transactions, growth of the stock of financial assets relative to GDP, and growth of financial incomes compared to non-financial turnover, assets and incomes. For indicators of financialization, see e.g. Sawyer, 2016, section 1.

[2] The current growth regime has been labelled in many different ways in the literature. For an overview, see e.g., Sawyer, 2016; Togati, 2016; van der Zwan, 2014.

[3] See, for example, the authors quoted by Lapavitsas and Powell, 2013.

[4] **To a large extent, this is the product of the process of externalization of production (especially from industrialized countries to emerging economies), involving the 'fragmentation' of productive processes in value chains formed by thousands of suppliers and sub-suppliers, with inevitable heavy restructuring, job losses and weakened trade unions.**

[5] **'neoliberalism… helped shape the ideal of society as a kind of universal market (and not, for example, a polis, a civil sphere or a kind of family) and of human beings as profit-and-loss calculators (and not bearers of grace, or of inalienable rights and duties). Of course the goal was to weaken the welfare state and any commitment to full employment, and – always – to cut taxes and deregulate. But "neoliberalism" indicates something more than a standard rightwing wish list. It was a way of reordering social reality, and of rethinking our status as individuals. Still peering through the lens, you see how, no less than the welfare state, the free market is a human invention. You see how pervasively we are now urged to think of ourselves as proprietors of our own talents and initiative, how glibly we are told to compete and adapt. *You see the extent to which a language formerly confined to chalkboard simplifications describing commodity markets (competition, perfect information, rational behaviour) has been applied to all of society, until it has invaded the grit of our personal lives, and how the attitude of the salesman has become enmeshed in all modes of self-expressio*n. (Metcalf, 2017, emphasis added).**

[6] **For a more complete discussion, see e.g., Togati, 2006; 2016.**

[7] **As Mazzucato and Wray note, for example, 'Minsky … moved beyond cyclical analysis to the analysis of the transformation of an economy over stages or epochs—an evolution that results from changes of expectations and behavior, that itself changes the environment in which economic agents must operate (which induces further behavioral changes).' (Mazzucato and Wray, 2014, p.12).**

[8] **One instance is provided by Hein's analysis of financialization. He notes, for example, that, by increasing shareholder power, it 'has imposed *short-termism* on management and has caused a decrease in management's *animal spirits* with respect to real investment in capital stock and long-run growth of the firm and increasing *preference* for financial investment, generating high profits in the short run.' (Hein, 2012, p. 2, my italics).**

[9] **'The idea that economic crises, like the current financial and housing crisis, are mainly caused by changing thought patterns goes against standard economic thinking. But the current crisis bears witness to the role of such changes in thinking. It was caused precisely by our changing *confidence, temptations, envy, resentment and***

illusions --and especially by changing stories **about the nature of the economy.' (Akerlof and Shiller, 2012: 4, my italics).**

[10] **As already noted, this influence has not been neglected in the literature. As shown by the above quote, Hein, for example, correctly refers to 'short-termism' and industrial firms' 'increasing preference for financial investment'. Similarly, Stockhammer (2012) holds that financialisation has changed the behaviour of economic actors, i.e. businesses, banks, financial investors and households, who now tend to act more like financial investors who try to optimise their portfolios and have a preference for liquid assets (2012, p.46). However, these authors do not carry out a systematic analysis of such perceptions and regard them as mere psychological features rather than enduring conventions driving the Keynesian propensities in a long-period analysis, such as the one provided here.**

[11] **Indeed, not only has consumption in the NC gone much beyond mere subsistence levels as in the first waves of mass production after the Second World War, but mass production also goes hand in hand with customization. It is one thing to sell a fridge or a cell phone for the first time, another to induce consumers to change the 'old' version they currently have for a new, better one. Today highly sophisticated marketing studies are geared toward pushing consumers to buy ever new versions of their durables as fast as possible in order to keep up with rapidly changing lifestyles.**

[12] **There are many signs that a debt society is more fragile than relatively less financially sophisticated societies: 'With the development of total financial deregulation over a lot of countries emerged a specific regime characterized by low inflation, low growth and high incomes inequalities. Under this regime credit has been used and misused to soften otherwise unbearable social tensions. This led to a huge accumulation of debt in an economy becoming day after day more and more insolvent and ultimately led to a large credit crisis.' (Sapir 2013, p.30). More specifically, Sapir underlines that credit expansion was 'a response to a change in the social situation: the disappearance of the middle-class and the resurgence of a true Veblenian world dominated by the Leisure Class.' (ibid., p.16). On the link between household spending, consumer debt and rising economic inequality, see Cynamon and Fazzari, 2016.**

[13] **For analysis of this shift, see e.g. Palley, 2012, 2013; Sapir, 2013; Yokokawa and Dymski, 2013.**

[14] **Strictly speaking, due to the greater weight of intangibles, real assets themselves are also more difficult to value.**

[15] **In particular, as noted by Muller, in the U.S. and many other western countries. 'There is … a tendency towards *profit financialisation …*, which means two things: first, increasing profitability of the financial in comparison to the non-financial sector (intersectoral profit financialisation); second, the growth in the share of … profits stemming from financial transactions …' (2013, p.9); see also van der Zwan, 2014, p.104.**

[16]**In more general terms, financialization 'crowds out' entrepreneurship because financial sector 'values' tend to predominate in society as a whole, both in cultural terms (i.e. the social prestige attached to jobs in this sector) and economic terms (e.g. artificially highly paid jobs in this sector). For both reasons, the financial sector tends to attract the best talents.**