The abuses of financialization[1]

Note written by Jacques de Larosière

The research – which I have been doing for a long time and which has resulted in a new book to be published in autumn 2022 – is on the subject of the abuses of 'financialization'.

The notion of financialization can be defined as the extension of the role of finance in the functioning of the economy and in determining the cycle.

I will try to clarify this phenomenon, touching on its historical development, its current state and its consequences on our societies.

To better understand the subject, we can refer to some simple but significant data. It has been calculated that over the last 20 years, the growth rate of credit has been, on average, twice as high as the growth rate of the real economy, whereas in "normal" historical periods, the two rates have generally kept pace.

This phenomenon has allowed governments to borrow more and more to finance current account deficits (deficits that should never be covered by borrowing since, by definition, they are permanent losses that are not creditable and must be repaid).

But "financialization" does not only affect public debt. It concerns all economic agents: households and companies.

1. Before describing the current importance of the indebtedness that characterizes our world, let us try to understand the history, the genesis of this phenomenon

I think it can be stated without question that the trend towards systematic indebtedness dates from the end of Bretton Woods. A brief historical review is in order. The so-called "Bretton Woods" system, created under the aegis of the United States in 1944, consisted of an exchange rate discipline:

- In relation to the dollar – the system's central currency – the other currencies should maintain a fixed link and not diverge by more than 1%.
- These countries could only devalue with the prior authorization of the International Monetary Fund and on condition that they implemented a 'conditionality' negotiated with the IMF.
- In return for the advantage derived from its central position, the dollar was subject to a gold convertibility obligation in the event that foreign central banks wished to dispose of the dollars they had accumulated.

The Bretton Woods system was therefore more than an agreement on exchange rate fixity. **It was a means of enforcing economic discipline by the member states.** Indeed, if a state wished to pursue a more expensive policy than the system average, *i.e.* if it wished to increase its budget or balance of payments deficits, it was quickly called to order. Indeed, the unavoidable devaluation of such a state's currency required a formal devaluation, which was only allowed if the IMF ensured that the state in question would return to "the right path".

This system worked fairly well until the late 1960s. But with the rise in US public spending as a result of the welfare state and especially the Vietnam War, the US was faced with a dilemma: to finance the war through taxation or borrowing. It chose the second option and its dollar debt skyrocketed – very quickly, its gold stockpile was no longer sufficient to ensure the conversion of dollars into gold. And on 15 August 1971, President Nixon unilaterally decided to end the convertibility of the dollar. The fixed exchange rate system collapsed and was followed by the general floating of currencies.

Many economists at the time welcomed the advent of floating exchange rates.

The constraint – the fixity of parities – which limited the freedom of economic policies had finally given way. Each state could now freely choose its optimal economic growth policy.

But what was not realized in 1971 was that the world was about to enter a very dangerous process of indebtedness, and then of over-indebtedness. With the freedom of capital movements and the extraordinary inventiveness that would characterize financial innovations, recourse to debt became the rule and the 'leverage' of the system exceeded the limits of the imagination.

Under the Bretton Woods system, each state was responsible for its currency and the stability of its external value. When the system collapsed, no one was responsible anymore.

It was the market that decided the value of currencies at any given time. The end of the system effectively opened the floodgates to international debt and consigned the notion of economic discipline and cooperation to oblivion.

2. A few figures enable us to measure the extent of the phenomenon of financialization

Global debt – as calculated by the Institute of International Finance – has reached dizzying heights.

It now stands at 300 trillion dollars (1 trillion = one thousand billion) or 360% of world GDP. These are figures that have never been observed in peacetime.

1. Speech delivered on June 9, 2022 at a dinner organized by the Cercle du Nouveau in Paris Monde at the Centre Interallié

They translate into an over-indebtedness of economic agents, whether governmental or private. This means that our financial system is:

- Overexposed (in terms of repayment capacity)
- And therefore vulnerable (the more a system is overexposed, the more an economic slowdown – even a modest one – can lead to defaults and, by extension, to financial crises.

3. What are the dangers and challenges presented by this massive indebtedness? debt?

I see three major drawbacks.

3.1 Overexposure of the global system increases the risks – and severity – of financial crises.

This phenomenon has been amplified by the fall in interest rates that has been instituted by the extremely accommodating monetary policies pursued over the last two decades.
It should be recalled **that policy rates – those set by Central Banks – have been negative (in real terms) for more than 20 years.**

This low interest rate environment has not only encouraged debt, but has also degraded its quality:
Indeed, when rates are very low (or even zero or negative) the concern of many fund managers is to seek yield, whatever the risk.
As a result, loans to low-rated companies (such as those rated BBB, the lowest investment grade) now account for more than half the market. As the debt of these borrowers increases, so does the likelihood of default crises.

McKinsey has shown that the global balance sheet of our world has tripled in 20 years (which is unprecedented and out of all proportion to GDP growth). This balance sheet now represents $1.540 trillion, or 18 times the world's GDP.

3.2 Low interest rates and abundant credit are accompanied by a decline in productive investment.

This observation does not seem obvious. On the face of it, one might expect very low interest rates to favour investment projects.

But the reality is quite different: it is since rates have been low that the decline in global productive investment has been observed. The stock of productive capital has in fact fallen over the last 20 years by 2.5% of world GDP, which is considerable.

It is here that we must refer to Keynes' fear of the "liquidity trap". Keynes was certainly in favour of low interest rates, but, he added, "not too low". Indeed, when savings are no longer remunerated (or even when they are taxed in the case of a negative rate), investors' attitudes change. Since the remuneration of savings disappears, it is more rational to keep one's funds in the most liquid form possible, rather than to invest them in risky productive investment projects. While we are at it, the saver who is no longer remunerated has an interest in remaining liquid.

This increase in the most liquid part of financial savings characterizes the current situation, particularly in Europe, and explains the disaffection with long-term productive investment projects.

An economy cannot prosper when productive investment is lost.

3.3 The current paradigm is based on the rise in asset valuations for the benefit of privileged social categories.

For the past 20 years, the rise in asset prices (real estate or stock markets) has represented ¾ of the increase in the global balance sheet.

Thus, in the United States (where the trend in relation to the average has increased), 87% of the growth in the value of balance sheets has been the result of increases in valuations and not of the added value created by investment.

This paradigm shift – the shift towards higher valuations at the expense of real growth and wages – has worrying consequences:

- Systems that favour the wealthiest 10% – those who benefit from valuations – to the detriment of the great mass of the population lead to a formidable social fragility;
- Fundamentally, such a system – which penalizes productive investment – does not make it possible to finance the immense ecological transformation projects that are indispensable.

In the environment of quantitative monetary ease and low – or negative – interest rates maintained by central banks for more than 15 years, the valuations of financial assets have soared, allowing equity holders, in particular, to make gains above normal remuneration ("operating returns").

It is understandable, in these conditions, that investors have given priority to making quick profits on valuations rather than committing themselves (without remuneration) to financing risky long-term projects.

This observation is important. An economy cannot function in the long term and for the good of all if investors' choices are oriented (notably because of monetary policy) towards immediate speculative opportunities and gains on valuations, rather than towards long-term growth prospects.

Let us not delude ourselves: if the stock of productive investment has declined over the last 20 years (by nearly 3% of world GDP, which is considerable), it is largely because real investments – risky, medium – and long-term investments – have been discouraged because of zero or even negative returns, in favour of liquid investments, which are certainly non-remunerative, but risk-free.

For 20 years, debt has exceeded investment.

Over the period from 2000 to 2020, the increase in debt – in the broadest sense – has far exceeded investment.

It has been calculated (McKinsey) that on average 4 dollars of liabilities (debt and the like) had to be brought into play to create 1 dollar of net investment during this period.

Even if there are strong disparities between countries in this area, the fact remains that this multiplier of 4 indicates a considerable leverage effect – a historical record – which can only raise concerns about the sustainability of this debt in the future.

As much as it is normal to go into debt to invest, it is also dangerous to see financial commitments swell well beyond investment needs. This is a sign of overexposure to debt, particularly in terms of financing current expenditure and public sector deficits and property speculation.

If we look at the ratio between value and production (net worth/GDP) we see that before 2000 this ratio was generally stable (the rise in this ratio, sometimes observed in the past, was mainly due to real estate). But since 2000, both net worth and real assets have been growing – and consistently – faster than GDP.

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So, we need to return to simpler and more fundamental truths:

Don't believe that always borrowing more and creating more money will solve structural problems. Structural reforms must be undertaken where the nature of the problems requires it and care must be taken not to weaken our financial system:

- Remunerating savings – and in particular those who wish to invest in the long term – according to the conditions of supply and demand;
- Do not allow an economic system to persist where ¾ of the activity is translated into valuations for a small minority.
- Restore work to its fundamental role of social and economic transformation and avoid wage stagnation;
- Promote the development of human capital and corporate equity and abandon the traditional focus on debt;
- Reflect on what could be improved by the reform of the international monetary system, which should be based on greater discipline and genuine economic cooperation.

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Ultimately, it would be imperative to:

1. **To revive productive investment**, the orphan of this narrative, and to do this we must refrain from administratively setting (or "guiding" the market) long-term interest rates at zero and accept to let the market remunerate savings in the medium and long term – according to supply and demand – without which there can be neither productive investment nor productivity gains.
2. **To put an end to "moral hazard".**
   It is important to understand that the laxity of monetary policy has led to an extraordinary development of what is called "moral hazard".
   The more a system gets into debt, the more fragile it becomes because imprudent borrowers risk defaulting. To counter this risk and the risk of a market collapse, central banks have felt obliged to provide over-indebted agents with an implicit guarantee intended to limit the losses incurred by these borrowers in the event of a crisis following a market downturn.
   This implicit guarantee – which does not involve the payment of any insurance premium by the beneficiaries – has played a key role in the phenomenon of overindebtedness described in my book. It encouraged operators to take more and more risks since the public authority was in fact insuring them. This moral hazard – ethically shocking because it transfers to the nation the cost of the risks taken by some – has considerably encouraged the phenomenon of financialization that I describe.
3. **To establish more social justice**, whereas financialization has, in fact, arbitrated in favour of the privileged 10% at the expense of employees.
   Maintaining the current paradigm, as revealed by the "global balance sheet" described in this book, will never allow our country to modernize or recover. It must therefore be changed: stop the crazy progression of money creation and debt, encourage the development of equity rather than debt, and accept that the most privileged pay their share of a fairer and more efficient economy.

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You may be surprised that I have not mentioned inflation which, after a long period of absence – due in particular to the effects of low wages incorporated into imports from emerging countries accessing international trade – is noisily reinviting itself to the world economic scene.

The current very high inflation (8% price rises over a year) has many causes: rigidities in production chains (following in particular the restrictions on globalisation introduced by the USA some time ago), the intensity of the recovery in demand after months of sanitary confinement, the rise in commodity prices and, in particular, the surge in energy and raw material costs, the effects of the war in the Ukraine, and the resurgence of the pandemic in China...

But let us not forget that inflation, whatever its causes, is always fostered by excess money creation. When the money supply increases for a long time much faster than production – which is exactly the phenomenon described in this book – we always end up with a rise in prices. This is what is known as the "quantitative money equation", which was formulated by the French economist Jean Bodin in 1558 and which has remained accurate ever since. It continues to provide the explanation behind today's inflation. Some may be tempted to say that inflation will at least relieve the debt burden on borrowers.

This is another illusion produced by the proponents of financialization. Inflation is never a solution: at most it is a terrible admission of failure. It is, in the end, a tax that impoverishes the vast mass of the population by reducing their purchasing power. A shameful tax that is not submitted to Parliament and that is supposed to erase the mistakes of those who allowed it, or even prepared it.

I do not wish any country to go down the road of "stagflation" – for which we have paid the price for more than twenty years – and which cumulates all the negative effects of the phenomenon: impoverishment and instability.