Changing topographies of financial markets in the current era: preliminary thoughts

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The puzzle

- Where have all the financial markets gone in the study of comparative capitalisms?
- Increasing focus on local institutions, firm and productive enterprises as (relatively) autonomous from finance and analysable with limited reference to finance issues, e.g. Translearn.
- Contrast with:
  - The centrality of finance in the current crisis
  - The dominance of finance in global policy making
  - The rise of financialisation as an area of study
  - The previous centrality of finance in theories of comparative capitalism

Contextualizing the puzzle: structure of the paper

- The initial comparative capitalisms model of the role of finance
- Globalization and financialization; beyond the national model and the impact on firms
- The implosion of the financialization model – where now?

Back in the day: the early comparative capitalism models

- In initial formulations, finance played a central role in understanding different forms of capitalism
- Contrast between capital market based forms of financing, bank based forms of financing and state managed forms of financing was seen as key to understanding how firms developed capabilities and competitive advantage.
- Finance was a central part of the institutional configuration in particular contexts – setting up path dependencies and complementarities with other institutions.
- National financial systems were relatively closed off from each other due to different histories, structures and regulatory regimes.

What changed with finance? The global context

Increased flow of financial resources around the global system precipitated by 2 main factors:

- growing global imbalances between savings rich economies (China, India, oil rich states) and debtor nations (especially the US)
- Shift under neo-liberalism
  - deregulation of capital markets and capital movements
  - Expansion of private pensions and away from state provision

Created a Wall of Money seeking investment outlets

Follow the money!

- Flowed through key intermediaries – the large investment banks – and key locations (London, New York) in the search for profitable outlets
- Led to a rebalancing of portfolios away from traditional investment fund management characterised by index linking into the search for high return assets
- Search for new asset classes through more activist and risky investment strategies which gave higher returns to banks (as fees were higher) and to investors
  - New actors: hedge funds, private equity
  - New instruments: securitization, derivatives, special investment vehicles (SIVs)
- Maximizing tax advantages through forms of regulatory arbitrage
- Created asset price bubbles and debt fuelled expansion within the context of a macroeconomic stability managed through newly powerful and independent central banks led by Greenspan and the Fed – the ‘Great Moderation’
- Speculative financial bubbles and crashes, at country level (Asian Financial Crisis, Russia, Argentina etc.), sectoral level (dot.com) were to be managed through monetary policy.

Disembedding from dependence on the national financial system: the emergence of the financially strategic firm

- Firms can go elsewhere for capital
  - International venture capital
  - International IPO
  - International listings of stock and shares facilitating access to local financial markets
  - International bond issues, e.g. Yankee bonds, Euro-dollar bonds
- Firms can use international financial markets to maximize the value of their working capital in their Treasury function
- Firms can hedge risks (currency risk, credit risk, commodity price risk, interest rate risk) through derivative markets.

Response of comparative capitalisms approach

- Comparative capitalism studies have focused on financialisation from the point of view of the changes in ownership arising from this process and in particular the impact of international investors
- Debate has looked at
  - Continued significance of national patterns of corporate governance
  - Whether having international owners changes company strategy
  - How this impacts particularly on labour relations
  - This has led to an argument that the tight linkage between the form of capital provision and the form of labour relations has to be recast – there can be relative autonomy between the two.

Capital Market financialization

- Financialization (market financialization) and its impact through bonds, hedging and treasury has been less discussed
- Arguably this is (a) the most widespread form of financialization and (b) the most consequential for economic activity and firm strategies more generally.
- The emergence of **the financially strategic firm** embedded in international financial markets rather than in national financial systems.

Disembedding Financial institutions from national financial systems

- The push to financial strategizing clearly impacts on the financial institutions themselves and is pushed forward by them
- In an era of declining margins on traditional money transmission, retail lending products and standard fund management activities, new sources of profits have emerged;
  - access to wholesale money markets (as a way of increasing margins),
  - access to fee income (for advice, underwriting bond issues, prime brokerage for hedge funds)
  - income from proprietary trading in fixed income, equities and derivatives.
  - Income from alternative asset classes – hedge funds
- This had an attraction to (almost) all banking institutions in the period up to 2007.

Which banks made these moves?

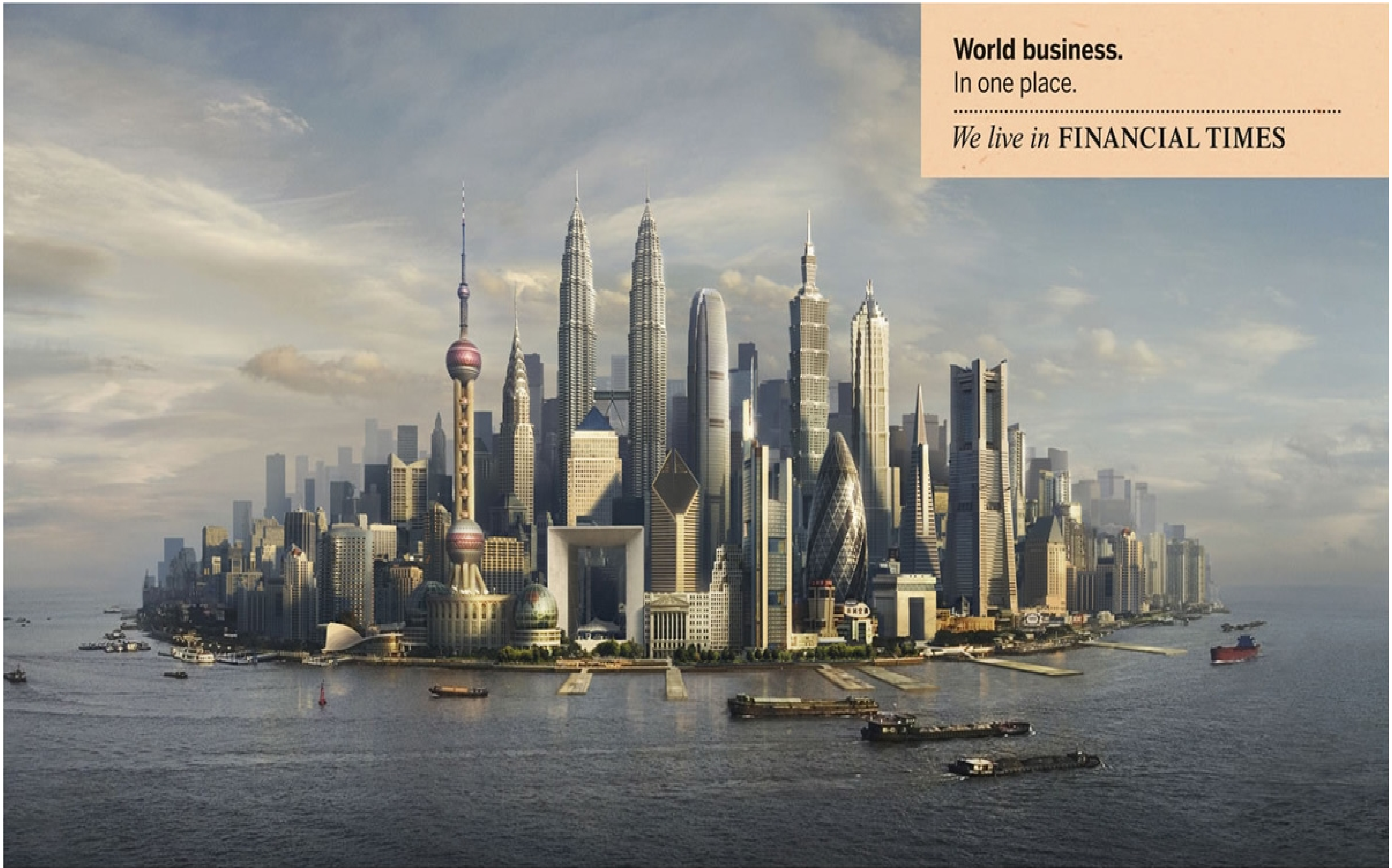
- Some regulatory restrictions (e.g. Basel II and some antional restrictions) though in general a weak regulatory regime which allowed the expansion of a shadow banking system with no effective regulation (e.g. hedge funds, SIVs)
- Generally, however, assets have been available in particular locations if banks want to access them and want to accept the risks, disciplines and costs associated with them;
  - Capital: through wholesale money markets
  - Skills and know-how: through cosmopolitan labour markets
  - Back office and systems skills: through specialist suppliers and sub-contractors
- More likely to happen where banks have demanding shareholders and/or ambitious senior managers and weak constraining/regulatory forces.
- When everybody was winning in the financial markets, it was hard for any bank to resist and not participate in some limited way, e.g. German Landesbanken, Chinese banks etc.

Tilting the financial world towards London and New York

- New York and London are the places where the assets to make this model work are most readily available
- Overseas banks set up operations there to enter these markets.
- Their home base funnels clients into these markets.
- They also compete against each other for any business that is available
- Creates a stratified system of global centres, regional centres (networking local clients into the global centres) and local centres (again may be variously linked through regional centres into the global centres).
- Regional centres may be emptied out of their international banking capability e.g. Amsterdam

Banks and clients

- Banks worked hard to sell the ‘benefits’ of the new system to corporate clients, creating the possibility of new gains for the financially strategic firm.
- They accessed new products primarily through a presence in New York and London even if they are selling them through local branches in regional and/or local centres.
- Banks competed in the global and regional centres for these new forms of business
- ‘National’ financial systems were no longer strongly bounded by national borders.
- They are networked into broader financial flows and processes.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Consequences of these changes for firms: New forms of financial flexibility and financial performance

– Wider range of funding sources that could be customised for different purposes – different forms of corporate bonds and short term borrowing – easier to secure funding to grow into new business areas
– Ability to shift risks through hedging and in theory predict and control costs (associated with currency, commodity and interest rate risks)
– Wider range of earning opportunities through financial processes, ranging from gaming on the money markets through to borrowing in order to provide loans to customers (e.g. as in car industry, housing, airplane manufacture etc).
– Many firms took advantage of this, disembedding their Treasury function from their national base and placing it in London or New York

Consequences of these changes for firms: stock market discipline

- **Where ownership had become more financialized – the discipline of the stock market**
  - Mergers and acquisitions
  - Downsizing and spinning off parts of the firm
  - Reducing capital held in order to push up profits and redistribute to shareholders, making firms more dependent on bond markets as possibilities of internal financing are reduced

Consequences of these changes for firms: New forms of vulnerability and discipline

- **Where firms were more market financialized – the discipline of the bond market**
  - The role of credit agencies
  - The importance of steady revenue streams
  - The role of covenants and their consequences

- **Overall Increased dependence on stability of global financial system**
  - High levels of financial liquidity
  - Low interest rates
  - Ability to live with rising levels of corporate endebtedness
  - Stability to hedging process
  - High levels of leveraging making firms increasingly dependent on credit conditions (and hedging against adverse credit conditions – the rise of credit default swaps which became a major multiplier of the credit crunch)

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The paradoxical effect of financialisation

- The process speeded up the restructuring of firms and industries, and in particular contributed to disaggregating the large Chandlerian firm
- Because credit was easily available, the system did not lead necessarily to closure of productive resources
- Instead these could be ‘rescued’ by new owners – MNC, PE, MBO – reorganized and recapitalised usually under a regime of debt with limited equity – the growth of the highly leveraged firm.
- What became important was whether the local unit had the capacity to attract these new owners through its own networks and proactive strategizing and the capacity to service the debt incurred in these restructuring processes.

Financialisation, institutions and firms

- Market financialisation facilitated the disintegration of the large firms and the ability of local productive units to engage with globalization and MNCs in a proactive way.
- In this sense it reinforced institutional difference and did not destroy it.
- However…..

New disciplines and new vulnerabilities

- It did this through a new form of disciplinary regime centred
  - not on traditional distinctions of bank versus capital market funding
  - but on the new model of financialisation where the firm became much more embedded in financial relations than it had previously.
- This created a new form of vulnerability and a new form of contagion between the financial and the wider economic system that had not been present since the 1920s and 1930s
- Further the system was inherently unstable as it was built on a speculative bubble and increased asset prices that presupposed high levels of credit and liquidity; once these conditions faltered so would the whole system.

The current crisis: the banking roots

- A crisis of liquidity and over-endebtedness, following unsupportable increases in asset values
- Banks have insufficient capital to cover their potential and actual losses
- Hedging instruments incapable of dealing with this level of instability, effectively exacerbating it
- Banks will not extend credit

The broader consequences

- Losses in the banking sector and in property assets
- Rising unemployment
- Falling wealth
- Crashing consumer markets
- Impact on manufacturing firms of reduced credit and falling demand
- Creating a vicious circle of falling GDP, catching firms and countries whether they were highly financialised or not, e.g. impact on Germany and Japan.

The end of financialization and the financially strategic firm?

- Financial markets have suffered a massive legitimacy crisis.
- The model of financial acumen and the intellectual capital on which the system was based has been destroyed for the foreseeable future.
- The option of becoming a financially strategic firm has disappeared.
- There will be less credit available to oil the wheels of dynamic processes of restructuring
- The conditions for financial markets are going to be much more highly regulated than previously – the shadow banking system will decline, certain products (OTC CDS) will disappear, securitization will be remodelled etc.etc..

De-financialisation and de-globalization

- Financial institutions have fallen back to dependence on their home governments to prop them up
- This is linked to increased requirements to focus on the needs of the home economy and the debate over protectionism
- Likely to lead to a retightening of relations between finance and industry inside national contexts
- This will be complicated in the EU context by the rules of the market – not clear whether this level may become a significant actor in reforming the system.
- The re-emergence of national systems? Need to look at how these relations are being reconstituted and the impact of this on firms and financial institutions/markets.

Conclusion

- The relationship between finance and production is central to understanding dynamics of capitalism
- The phase of financialisation did fundamentally affect that relationship in ways which we are only just understanding
- However that phase has ended and now we need to look at how the finance/production interface is going to be reworked again.
- Most likely that is going to involve de-financialisation and de-globalization and a reemerged role for the state and linkages within national contexts.