The growing dichotomy between real and financial sectors

Roy Trivedi, Smita

National Institute of Bank Management

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Smita Roy[2]

Abstract

The paper contends that the economic growth process around the world has seen a growing dichotomy between real and financial sectors in the last four decades. There has been a marked stagnation in the real sector with falling growth and productivity levels, worsening physical investment and employment growth and dwindling saving rates. In contrast, the financial sector has seen a huge appreciation in financial assets and growing income from ownership of financial capital. The paper highlights the paradoxical coexistence of real sector stagnation with financial sector explosion.

Keywords: Real sector stagnation, Financial sector dominance, Economic crisis.

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[2] *Smita Roy, Faculty Research Associate, National Institute of Bank Management (NIBM), Kondhwe Khurd, Pune-411048. E-mail: smita@nibmindia.org, akshmita@gmail.com.

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Introduction

In the last few years the world economy has faced arduous challenges on an unprecedented scale. The year 2008-09 saw the world facing the worst possible recession since the Great Depression. The 2007 subprime crisis that hit the United States economy soon snowballed to a world-wide financial crisis and culminated finally in the global recession of 2008-09. The impact of the global recession of 2008-09 has been widespread, prolonged and devastating. According to the World Bank *Global Economic Prospects* (2010), global output contracted by 2.2 percent in 2009. While growth rates improved in 2010 and 2011, the pace of recovery remains highly uncertain. Importantly, the World Bank *Global Economic Prospects* (Ibid) pointed out that the surge in capital flows in late 2009 (though they remain much lower than their 2008 levels), if sustained, could reinflate some of the asset bubbles in stock, currency, and real estate markets among developing countries. In contrast to the recovery in bond and equity markets, cross-border bank lending however remains weak as global banks lay stress on consolidation and deleveraging in an effort to rebuild their balance sheets.

Food and fuel prices have been on the rise since 2006. The United Nations Report (2009, p.3) suggests that about 125 million people have been pushed into extreme poverty following the rise in food prices since 2006. The World Bank *Global Economic Prospects* (2010) suggests that the crisis will leave an additional fifty million people in extreme poverty in 2009 and some sixty-four million more in poverty by the end of 2010 relative to a no crisis scenario.

While the severity of the economic crisis has hit the world economy hard, the premonition of the crisis was there for a considerable time. It is contended in the paper that the world economy has seen a paradoxical growth process in the last four decades with an increasing divergence between the real and financial sectors of the economy. There has been pronounced real sector stagnation with falling growth and productivity levels, worsening physical investment and employment growth and dwindling saving rates. In contrast, the financial sector has seen a huge appreciation in financial assets and growing income from ownership of financial capital. This paradoxical development is highlighted in this paper.

The economic scenario of the post-Fordist era

The Post-Fordist era economic scenario presets some sharp contrasts. On one hand, we see a stagnating real sector while on the other hand there is an exponentially growing financial sector. Economic theory assigns to finance a crucial role in fostering economic growth. Finance is believed to be the oil that lubricates the production process. While financial development is crucial for economic growth, it cannot act as a substitute for production of physical goods and services. Finance as a complement to real production activities can nurture growth but when the financial sector grows by itself beyond the needs of the real sector it suggests a speculative bubble. The economic growth process unfolding in the present decade in one in which the financial sector has assumed a life of its own. It is no longer constrained by the needs of the real sector nor is simply the complementary factor encouraging real sector growth. This is evidenced in the exponential growth of the financial sector even while the real sector has continued to stagnate amidst falling growth and productivity and declining physical investment the financial sector. This paradoxical dichotomy between the real and financial sector is a distinct feature of the Post-Fordist era the main features of which is underlined below.

Dwindling growth and productivity levels

The Post World War II decades or what is oft called the 'Golden Age of Modern Capitalism' was characterized by high growth rates and productivity in most nations. However, a striking development since the late 1970s is the fall in growth rates. Maddison (2001, pp.125-126) estimated that the growth of Gross Domestic Product (GDP) fell from an average 4.91 percent to 3.01 percent from 1950-73 to 1973-2001, while per-capita GDP fell from 2.93 percent to 1.33 percent for the same time period. Again, except for a few Asian countries this alarming fall in growth rates was noted for most countries of the world. As shown in Table 2.1 below, growth rates of both GDP and per-capital GDP in major regions have registered declines in the post 1970s period. Western Europe has seen a fall in GDP from 4.81 to 2.11 percent and a similar fall from 4.03 to 2.98 is noted for Western off-shoots (the United States, Canada, Australia and New Zealand). Japan has seen a pronounced fall in growth rate from 9.29 percent to 2.97 percent and for Eastern Europe growth rates have turned negative to -0.56 percent. A similar fall in per-capita Gross Domestic Product has been noted for Western

Table 1 Growth of GDP and per capita GDP *(Annual average growth rates)*				
World and major regions	**GDP**		**Per-capita GDP**	
	1950–73	1973-98	1950–73	1973-98
Western Europe	4.81	2.11	4.08	1.78
Western Offshoots	4.03	2.98	2.44	1.94
Japan	9.29	2.97	8.05	2.34
Asia (excluding Japan)	5.18	5.46	2.92	3.54
Latin America	5.33	3.02	2.52	0.99
Eastern Europe & former USSR	4.84	-0.56	3.49	-1.10
Africa	4.45	2.74	2.07	0.01
World	4.91	3.01	2.93	1.33

Compiled from Maddison (2001), Ibid, Table 3–1a, p.126.

and Eastern Europe, Former USSR (Union of Soviet Socialist Republics), United States, Latin America and Japan as seen in Table1 below.

Maddison (2001, p.23) further pointed out that a third of the world's population in counties of Africa, Eastern Europe, Latin America and parts of Asia have experienced stark fall in incomes. While in Africa there has been no advance in per capita income in the past quarter century, in Eastern Europe and the former United States average per capita income in 1998 had fallen to about three-quarters of that in 1973. Similarly, in Latin America and in many Asian countries, income gains have been a fraction of what they were in the golden era. While 'Resurgent Asia[3]' growth rates and per-capita incomes have registered a phenomenal rise since the 1970s as pointed out by Maddison (2001, pp.142-146), they have been marred by constant crisis since the late 1990s.

China and India has in the last decade managed to achieve very high growth rates. However, the reduction of poverty and lessening of income inequality have been far less impressive. Bardhan (2010, p.6) has pointed out that the most impressive growth rates for China came in the period from 1973-1993 even though foreign trade and foreign investment increased only after the 1990s. The impressive growth in the 1973-1993 period is more attributable to internal factors rather than globalisation. Again, for India, Bardhan (Ibid) has contended that it is far from clear whether it is economic reforms of the last two decade that is responsible for the high growth rates achieved by the country. While reforms have made the Indian

[3] Resurgent Asia comprises of fifteen countries, i.e. China, Singapore, Hong Kong, Taiwan, South Korea, Malaysia, Thailand, Pakistan, India, Sri Lanka, Philippines, Indonesia, Bangladesh, Burma and Nepal. Maddison (2006), Ibid, p.146.

corporate sector competitive, ninety-four percent of the Indian labour force works outside this sector. Again the rate of decline of poverty has not accelerated in the post reform period, i.e. 1993-2005. In fact, for both the nations currently seen as the economic super-powers, inequality and consequent social discontent are seething below the surface. As Bardhan (Ibid) says –

> …those who envisage "billions of new capitalists" in China and India do not realize that hundreds of millions of poor people in both countries are currently scrounging a living from tiny family enterprises of extremely low productivity, and they don't have access to credit, marketing, and infrastructure or the basic skills and education and risk-bearing capacity that can make a capitalist enterprise possible (Bardhan, 2010, p.7).

The fall in growth and productivity levels has certainly been the most pronounced for developed nations. Several studies (Nordhaus,1982, 2004; Cullison, 1989; Wolff, 1997; Kozicki, 1997; Gordon, 1995, pp.141-145) have shown that there was a fall in both labor and total factor productivity levels during this period in different Organisation for Economic Cooperation and Development (OECD) nations compared to the preceding 'Fordist' era .Wolff (Ibid) pointed out that the annual rate of growth for labor productivity for the entire United States economy fell from 1.8% per annum for the period 1958-67 to 0.9% per annum for the period 1967-77 and further to 0.7% per annum in 1977-87. Total Factor Productivity growth for the entire economy fell from 1.5% per annum in 1958-67 to 0.3% per annum in 1967-77, showing no recovery in the period 1977-87 (Wolff, 1997, p.8). Cullison (Ibid, p.11) has shown that the same trend has been noted in all major OECD nations.

Stagnating real sector and 'jobless growth'

Eatwell and Taylor (2000), Panchmukhi (2000) and Crotty (2000) pointed out that there has been a marked stagnation in real wages and falling employment in the present era. Crotty (Ibid, p.6) pointed out that the unemployment rate in OECD countries increased from 3.2% in 1960-73 to 5% in 1973-79 and further to 7.2% in 1979-89, falling marginally to 7.1% in 1989-95. Crotty (2000, p.29) further gives evidence that the real compensation growth in nineteen developed countries (not including the United States) (after rising rapidly through the early 1970s), fell to 1.2% a year in 1979-89 and again to 0.7% in 1989-96. Alarmingly, the unprecedented technological progress following the Information Technology revolution was accompanied by a widening wage inequality (Greenwood, 1997, p.3). Panchmukhi

(2000, p.6) characterized this period as '***jobless growth***' highlighting the stark fall in employment in industrialized countries.

Moreover real sector investment declined sharply after the 1970s. Crotty (2000. p.6) have presented calculations of the annual rate of growth of world real gross domestic investment based on World Bank data. The annual rate of growth of world real gross domestic investment stayed at 7.0% from 1966 to 1973 at the end of the Golden Age. It then fell sharply to 2.2% from 1974 to 1979; rose modestly to 2.8% from 1980 to 1989, then fell again to 2.7% from 1990 through 1996. Evidently, investment growth was especially sluggish in the developed world. The average annual growth rate of real gross capital formation for Organisation for Economic Cooperation and Development (OECD) countries fell from 6.3% in 1960-73 to1.5% in 1973-79. It improved somewhat to 2.4% in 1979-89, falling again to1.5% in 1989-95.

Dwindling savings and rising indebtedness

The falling investment in real sector in Organization for Economic Cooperation and Development (OECD) nations is coupled with declining household saving rates in these countries. As pointed out by Harvey (2004), net household saving ratios have been declining for the Euro area, United States and Japan over the 1990s and early 2000s.

Table 2 Household Saving Rates in Select OECD countries

(Percent of Disposable Household Income)

Year	1990	1995	1999	2002	2003	2004	2005
Net Savings							
Australia	8.2	6.4	1.9	-2.3	-3.3	-2.6	-1.1
Canada	13.0	9.2	4.0	3.5	2.6	2.9	1.6
Japan	13.9	11.9	10.0	4.9	3.9	3.5	3.9
United States	7.0	4.6	2.4	2.4	2.1	2.1	0.5
France	9.4	12.8	12.1	13.8	12.7	12.6	11.8
Gross Savings							
United Kingdom	8.0	10.2	5.3	5.0	4.9	3.7	5.6

Compiled from OECD Economic Outlook 83Database, Annex Table 23

Table 2 shows Household Saving Rates for select OECD nations over the period 1990 to 2005. As may be seen, household savings rates have fallen drastically over this period for most of these countries.

Again, Household debt has increased to record levels in a number of OECD countries. Girouard, Kennedy and André (2006, p.6) show total household borrowing, as a proportion of GDP, has increased considerably – debt levels ranging from below forty percent of GDP in Italy to above hundred percent in the United Kingdom, the Netherlands and Denmark. Stockhammer (2008, pp.6-8) have pointed out that most European nations have experienced rising debt ratios since 1995 as shown in Table 3. Van Treeck (2009, p.474) have shown for the United States there has been a fall in savings rate coupled with a rapid increase in both household wealth and indebtedness since the 1970s.

Table 3 Household Debt in select OECD countries

(*Percent of disposable income)*

Country	1995	2000	2005
Germany	97	111	107
France	66	78	89
United Kingdom	116	118	158
United States	93	107	135
Japan	113	136	132

Note: (a) Data for Denmark, Spain and Japan refer to 2004 rather than 2005.
(b) Germany refers to West-Germany before 1991
Compiled from: Stockhammer, 2008, Ibid, p.21.

The explosive financial sector growth

On the financial side, again, the single most key factor affecting the developments over this period is the unprecedented growth of financial markets, and consequent financialisation. The world economic order has been characterized by an enormous growth of financial markets and commodities since the 1980s. Demirguc-Kunt and Levine (1996, p.1) has shown that between 1982 and 1993 stock market capitalization grew an average 15 percent a year from $2 trillion to $10 trillion. A disproportionate amount of this growth was in emerging stock markets. For emerging markets, stock market capitalization increased from three percent to fourteen percent in the same period. Schmidt (2002, p.17) has pointed out that there has been an increasing globalization of the financial markets, with international bank lending increasing from $265 billion in 1975 to $4.2 trillion in 1995. Private capital flows that were insignificant in 1960s increased to $890 billion in net new issues of international loans and bonds in 1997. Moreover, there has been the rise of a new-more demanding and powerful, institutional investor in this decade. Institutional investors (mainly pension funds, mutual funds and insurance companies) expanded by seventeen percent between 1981 and 1991 to reach $3500 billion in Europe and expanded by fifteen percent to reach $6400 billion in North America. Even more surprising is the growth of the second-generation financial commodities, which have little basis in real sector activities. Bank of International Settlements (BIS) (2009) statistics show that there had been an astounding growth of the amounts outstanding of over-the-counter (OTC) derivatives since the late 1990s. Aptly, Crotty (2007, p.4) has named the present age as the 'Golden Age of Finance'.

'Financialisation' and its consequences

Evidently, a defining character of the growth scenario since the 1970s has been the increased importance of financial sector of the economy relative to the non-financial sectors termed in economic literature as the 'financialisation' of the economy (Van Treeck, 2009, p.467; Stockhammer, 2004, p.720). Stockhammer (2004, p.720) includes in the process broadly "the globalization of financial markets, the shareholder value revolution and the rise of incomes from financial investment". 'Financialisation' by shifting the balance of power to the owners of financial capital in the corporate world has had a crucial impact on corporate governance and labor relations. 'Shareholder value revolution', defined as the increased dominance of shareholders over management and workers in corporate governance, leads to a corporate restructuring and shift in management priorities (Stockhammer, 2004; Van Treeck, 2009). Moreover, as Lazonick and O'Sullivan (2000, p.18) point out a high dividend payout ratio leads to a shift to a policy of 'downsize and distribute', as opposed to a strategy of 'retain and invest' that has been traditionally favored by managements.

There has been an increasing gap between manager wages and blue-collar wages. Piketty and Saez (2003, pp.31-32) have shown that wage inequality for the United States economy, as measured by top fractile wage shares, started to increase since the 1970s. The top one percent share increased from 5 percent to 7.5 percent from 1970 to 1984. From 1986 to 1988 the top shares of wage earners increased more sharply with the top one percent share jumping from 7.5 percent to 9.5 percent. From 1988 to 1994, top wage remained somewhat constant, but increased again from 1994 to 1998, with the top one percent wage share increasing from 9 percent to 11 percent.

Van Treeck (2009, pp.469-470) has also highlighted two well established stylized facts that provide evidence of the fact that the shareholder revolution has indeed curbed the managements desire to accumulate physical capital— first, there has been an increase in firms' dividend payout ratio along with a strong positive correlation between the availability of internal sources of finance and physical investment and second, there has been a declining, role of the stock market for providing investment finance to firms.

Stockhammer (2004, p.11) has shown that over the past two decades, in fact, the financial investments of non-financial businesses have been increasing resulting in a slowdown in

Table 4 Gross capital formation in select OECD Countries

(as percent of GDP)

Country	1960-73	1974-79	1980-89	1990-99
France	23.8	24.2	21.7	19.6
Germany	24.6	21.2	20.8	22.5
Canada	21.8	23.5	21.7	18.9
United Kingdom	22.4	20.1	18.5	17.1
United States	18.4	19.4	19.2	17.7

Note: Compiled from Navarro, Schmitt & Astudillo (2004), Ibid, p.150

accumulation of physical assets. In the major economies (Germany, France and the United Kingdom as well as the United States), the investment to profit ratio has shown a clear declining trend. Again, there has been increasing evidence that gross fixed capital formation as percent of Gross Domestic Product (GDP) in major industrialized countries fell since the late 1970s (Navarro,V., Schmitt, J. & Austudillo, J , 2004, p.150). This is shown in Table 4.

A closely related development has been the rise in rentier incomes over this period. Power,

Table 4 Rentier Income Share (Not Including Capital Gains) in Select OECD Countries, 1960-2000

(Decade average percent of GDP)

Country	1960s		1970s		1980s		1990s		Decadal Change	
	R*	NF*	R*	NF*	R*	NF*	R*	NF*	R*	NF*
Australia	6.67	12.66	7.92	8.10	14.50	5.24	12.97	7.91	88.40	-26.76
France	—	—	6.24	6.39	10.62	5.97	21.19	11.07	155.0	23.25
Japan	9.00	11.96	12.30	9.02	14.27	9.91	11.22	8.25	19.70	-12.54
UK	3.97	14.82	6.33	13.45	10.85	15.83	14.16	15.95	143.0	16.19
USA	14.81	11.31	22.47	10.65	38.26	12.18	33.49	9.97	92.40	0.89

Note : R*= Rentier Income Share, NF*= Non-Financial Income Share
Decadal changes are over 1960s/1970s and 1980s/1990s
Source: Compiled from Power *et al*, 2003 (Table III.1.1 p.6)

Epstein, and Abrena (2003, p.70) have shown that rentier shares increased dramatically in most countries between the first two decades and the second two decades of the period from 1960-2000. Table 4 complied from Power *et al*. (Ibid) shows the Rentier Income Shares for the period 1960-2000 for select OECD Countries clearly shows this trend

The tremendous growth in the derivatives market also underline the accumulation of financial capital. Crotty (2007, pp.6-7) has pointed out that large financial institutions have raised profits by taking larger risks that all more often located off-the-balance sheet, trading in an increasingly complex set of derivative instruments. They have been able to achieve high margins on much of this business by selling the bulk of their products over-the-counter (OTC) rather than on exchanges, thus insulating the profit margin from destructive competition All this point to the massive accumulation that have taken place. The Federal Deposit Insurance Corporation (United States) reports that in 2006, the seven largest commercial banks held 98% of the industry's derivatives.

Not surprisingly, over-the-counter (OTC) derivatives have grown at an astounding pace since the 1990s. In 1992, the notional amount of global OTC derivatives was $25 trillion, which had reached $72 trillion in mid 1998; by mid 2001 it was $98 trillion and in mid 2006 it was $370 trillion. Credit default swaps increased from $180 billion in 1996 to $2 trillion in 2002 and further to $20 trillion in 2006. Again, OTC interest rate derivatives increased from $70 trillion in 2000 to $262 trillion in 2006 (Crotty, 2007, pp.31-32). The unprecedented growth of financial commodities underlines the tremendous accumulation process set up in the economic system. This growth in financial assets has come despite the stagnation in the real sector which makes it all the more significant. It evidently points out this accumulation of financial commodities has little basis in real sector growth and surely is not catered for real sector investment. Finance today has far surpassed any need of the real sector and assumed an extraordinary growth process of its own.

Financial sector explosion, crisis and the real sector slowdown

The economic scenario of the last four decades is also distinctive if we consider the frequency of crises that has affected the world over this period. The trend that began with the collapse of the par value system in early 1970s was followed by the oil-price crises, EMS crisis of 1992-93 and the Tequila crisis of 1994-95. The string of crises continued with South-East Asian crises of 1997, the Brazilian crisis of 1998-9, the "Dot-com Bubble" crash in 2000, United States sub-prime crises of 2007-08, to the global recession of 2008-09. As

Bordo, Eichegreen, Kingebiel and Soledad (2000, p.27) and Panchmukhi (2000) have pointed out the frequency of financial crises has evidently increased in the current period. Eatwell and Taylor (2000, pp.5-6) has also underlined the fact that the new international financial order that emerged since the 1980s, is not only characterized by an enormous volume of trading in financial assets, but also a financial system that is more and more susceptible to financial fragility.

The financialisation of the economy has a significant impact on the real sector stagnation. Stockhammer (2004) has shown that financialisation over the last two decades has resulted in slowdown of physical asset accumulation and increasing financial investments by non-financial businesses. Further, the shareholder revolution has led to a reduction in the growth desired by the firms, as shareholders are keener on raising profits as opposed to managers who focus more on growth. As shareholder revolution includes a market for corporate control (including the possibility of firing managers and performance related pay-packages), management becomes keener to adopt policies closer to shareholders objectives of increased profitability leading to lower real sector investment activity, for the low profit rates in real sector in most industries most of the time, and with existence of by excess capacity.

In identifying the causes on the 2008-09 crises, Baily & Elliott (2011) pointed out that the financial meltdown witnessed has an origin in the asset price bubble brought about by newer kinds of financial innovation that helped to mask risk and supervisors and regulators who failed to curb excessive risk-taking. While securitization process was seen as a solution to the problem of balance sheet management by banks, this process itself had a key role in creation of more and more complex financial instruments and led to financial markets turning more risky and opaque. Eatwell and Taylor (2000, pp.99-100) pointed out that while derivatives are meant to hedge risks and promote the flow of private capital, they are perfect vehicles for speculation, besides helping to escape regulatory safeguards, circumvent accounting rules and evade taxation. Dodd (2002) has shown that derivatives played a key destructive role in the 1997 East-Asian crisis. They not only made the economies more susceptible to crisis, but also hastened and intensified the downturn once it started. Thus, the increasing financial crisis and fragility during this period has a basis in the finance-dominated economic regime that has emerged. Moreover, the heightened instability of global financial markets has significantly increased the incidence of banking and currency crises, which culminated to serious recessions in the areas in which they occur (Crotty, 2000, p.30).

Conclusion

The analysis in the above sections clearly has shown that one of the key aspects affecting the economic scenario over the last few decades is the unprecedented expansion of financial capital. It is this accumulation that is reflected in the expansion of financial markets and commodities, appreciation of financial assets and rising rentier shares. The analysis of financialisation in literature gives evidence that the accumulation of financial capital has also had a major impact on the real sector. Financialisation and shareholder revolution has not only led to slowdown of physical capital accumulation that is crucial for attaining real growth; but also led to a deterioration of labor relations, employment and real compensation. In fact, we can identify the accumulation of financial capital as the underlying feature that has impacted the developments of the present epoch.

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