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Financialization and the Monetary Circuit: A Macro-accounting Approach

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Abstract

This paper aims to cross-breed the standard monetary circuit accounting model with elements from the Post-Keynesian literature. The goals are: (i) to analyse the implications of credit-based household consumption fed by capital asset inflation for the soundness of a pure credit-money economy of production; and (ii) to provide a more sophisticated description of the working of modern financial systems than the one grounded in the usual 'bank-based vs. market based' distinction.

This article is part of the following collection(s):

The Monetary Circuit

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Notes

[1]We abstract for the moment from the repayment of interest to the banks. Following Zezza (2012), hereafter it is implicitly assumed that the 'financial period' (starting with the creation of bank loans and ending with the paying off of the debt) is longer than the 'production period' (i.e. the time corporations need to sell output to both wage-earners and banks). This allows us to treat interest payments consistently.

[2]If households do not hoard deposits, then even the sums paid by corporations as interests on bonds flow back to the corporate sector.

[3]A corporation might buy back its own shares in order to sustain the price of shares, to adjust the liquidity of its balance sheet, or to distribute income to its owners in the form of capital gains.

[4]For a heterodox perspective on interest rate targeting by the central bank, see Brancaccio & Fontana (2013).

[5]For a Minsky-Kalecki simulation model derived from this accounting framework, see Passarella (2012b).

[6]In this case, the only reason for purchasing equities is to realize capital gains.

[7]Herein lies a difference with respect to the traditional TMC. For Graziani (2003), while interests paid on securities are never a real cost to corporations (apart from a possible 'income effect'), interests paid on bank loans represent a real subtraction from corporate profits. However, in a fully consistent macroeconomic approach: (i) the corporate sector as a whole can, theoretically, always realize its own autonomous

investment plans and hence the resulting profits; and (ii) the financial-banking sector can always successfully compete with households in the 'commodity' market by setting the rates of return on deposits and loans. Thus, bank interest payments are a subtraction from household real income, rather than from the corporate one. Nevertheless, for the sake of simplicity, in the rest of the paper we will continue to assume that banks use all of their retained earnings to purchase equities.

[8]It is a simple matter to demonstrate that this method leads to results that are equivalent to cost-plus pricing.

[9]This suggests that implementation of an expansionary monetary policy by the central bank via the reduction of interest rates may have a 'crowding out' effect on traditional banking activity unless it is offset by a strict regulation of the financial services industry.

[10]One might be tempted to think that asset inflation can have only microeconomic effects but no macroeconomic consequences, since capital gains realized by some units (either households or corporations) offset capital losses suffered by others. However, this is not true whenever: (i) there is asymmetric information, so that agents realizing capital gains react more quickly than agents suffering capital losses; (ii) capital gains and losses entail a redistribution of income among different sectors; or (iii) bank loans are linked to the value of assets, allowing agents to realize capital gains immediately.

[11] Figure 2 shows that, if the stock buyback is 'internal' to the corporate sector, then the households sector cannot draw from the financial market the liquidity it needs to pay off its bank debt. However, households can easily keep renewing their bank loans, as the price of financial assets (and hence their wealth) keeps on increasing, thanks of the inflow of corporate saving. The same goes for the corporate purchases of financial assets from banks and other financial entities. By contrast, to the extent that corporations repurchase their shares from households, the latter will be able to pay off part of their debt, but at the cost of 'de-accumulating' their stock of assets, with the risk of a debt-deflation crisis. Data seem to indicate that the two hypotheses describe two different phases of the actual process of financialization. On the one hand, the financialization of western economies (which started at the end of the 1970s) has been associated with a tendential fall in the proportion of investment financed by new issues. On the other hand, the equity-to-investment ratio decreased during the upswings (mainly because of the stock repurchases of the non-financial corporate sector) and

increased after the crises associated with the Wall Street crashes of 1987, 2000 and 2007 (Passarella, 2012a; Ryoo, 2010).

[12]Government sector deficits financed through the issue of money represent an additional source of funds for the private sector. The same goes for balance of payments surpluses. In the Euro Area, the financial condition of countries marked by external surpluses may be easily likened to that of corporations depicted in Figure 2, whereas the situation of deficit countries can be likened to that of the household sector. In both cases, behind the appearance of sustainability, there are increasing imbalances between sectors or countries, which are bound to lead to financial fragility and to crisis.

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