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Revisiting conventional wisdom: does financialization have to leave sovereigns subordinated?*

Anna Ząbkowicz**, Sławomir Czech***

Abstract

The financialization process is considered to leave debtor states critically dependent on international financial capital, which may then exercise indirect power over government policy, to the point where the state becomes a hostage to financial markets' 'state of confidence'. Such relations between the state and internationalized capital are perceived to come with two strings attached, as the state listens to financial markets because it is in debt and must settle accounts while still requiring external financing; and as financial deepening or credit is considered a vehicle of economic growth. It is the contention of this paper that conventional wisdom as to the correctness of debtor-state behavior in the above circumstances is open to challenge.

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** Jagiellonian University, Cracow, anna.zabkowicz@uj.edu.pl.
*** University of Economics, Katowice, slawomir.czech@ue.katowice.pl

1. Introduction

Financialization has been observed as a rapid increase in the share accounted for by the financial sector (i.e. finance, insurance and real estate) in profits and investments, as compared with the real economy. It is a development first registered in the US at the beginning of the 1980s, and continuing since. At the heart of the process lie changing patterns of accumulation, in which more and more capital is allocated to bring income from the ownership of and/or trade in financial assets (via dividends, interest, share buybacks, etc.), while the drawing of profit from production and goods turnover is losing importance steadily (Krippner 2005).

None of the above could have happened without the specific underlying cause that is a huge expansion in credit. And that was in turn a consequence of liberalization policies concerning purely financial transactions and resulting in soaring cross-border flows of internationalized capital (see Epstein 2005). When going into debt, non-financial corporations became increasingly exposed to takeovers at the hands of either competitors or creditors. Leverage of financial institutions also rose to unprecedented levels prior to the crisis (Colander *et al.* 2009), and, due to leveraged operations on financial assets (including bond and equity trading, foreign exchange, contracting in commodity exchange, etc.), banks, brokerage houses and other financial firms have gained in size and power very markedly (Brenner 2002; Crotty 2005, 2009; Krippner 2005; Palpacuer 2008).

The above processes gathering pace were accompanied by levels of mortgage credit for households that famously skyrocketed in the US (Crotty 2009), as well as in many other economies in the 2000s; and, last but not least, by increases in states' levels of indebtedness to record levels, in full-fledged market economies hit by the recent crisis.

In the recent literature on financialization, most of the research can be seen to focus on three distinct areas of the phenomenon, i.e. the new regime of accumulation, the new pattern of corporate behavior entailing shareholder value maximization, and the financialization of everyday life (see van der Zwan 2014 for a comprehensive literature review).However, it is also possible to find a growing body of literature on the political economy of financialization, which takes account of the changing position of the state in financialized economies, as well as macro outcomes of this process (cf. van Treeck 2009).

The present paper relates closely to the latter stream of research, concentrating on the power relations that emerged in the new financialized global economy regime. Our focus is thus different from the mainstream of research, which is centered on the macroeconomic link between finance and growth. A large body of literature is concerned with financial development and/or depth which are defined, roughly speaking, by the size of private credit as a fraction of GDP.[1] While the cen-

[1] Financial development is a much broader concept than financial depth (for discussion see Torre *et al*. 2011).

tral role of credit, i.e. leverage, indicates a close relationship with financialization, the latter denotes a quite different perspective, since it is mostly about trading in financial assets rather than consumption and investments. Moreover, financialization has substantial consequences for the sphere of political and economic power. We are therefore paying attention to the macro-effects of financialization, but exclusively those of an economic and political nature. We deal with sovereign debt in the context of political consequences that influence the balance of power, with the issues of private debt being considered in terms of political legitimacy derived from GDP growth.

For the above reason, the conclusions drawn here may seem to fly in the face of the consensus existing among macroeconomists, yet their questions are different than ours. For instance, questions as to whether debt-financed consumption or the deepening of financial markets are desirable (which are undoubtedly of central importance when economic growth and financial volatility are at stake), cease to be the main concern of research from a political economy perspective.

Nevertheless, the body of macroeconomic literature provides extremely useful evidence which we do employ in our analysis as we seek to review both econometric research results and empirical evidence, with a view to defining the position of the state in the bargaining process with creditors in the circumstances of financialization.

Our starting point is the observation that, in the circumstance of soaring cross-border flows of internationalized capital and relatively easy access to credit, numerous sovereign states commenced with a rapid accumulation of debt. Whatever the reasons underpinning policy of this kind, the effect was for the sovereignty of states involved to become potentially limited, due to growing dependency on the financial markets. In this situation, there was a danger of the democratic obligations of states being pushed into the background as the interests of the financial markets needed satisfying. Defaulting on debt has thus been perceived widely as a severe political error.

Additionally, as there is a substantial body of literature claiming that financial deepening is actually beneficial to economic growth, reasonable policymakers might be expected to express a welcoming attitude to the extension of financial markets.

Drawing on the latest research, the work detailed in this paper seeks to point to the serious flaws in this picture of power relations seemingly leaving the state in a position subordinate to that of the financial markets. It is our contention that the negative consequences of defaulting on debt are often overestimated, while the positive impact of financial development on growth is by no means obvious. We argue that the position of the state as regards financial markets is thus safer than it seems to be according to conventional wisdom, which claims that debts must be paid back regardless of circumstances, and that leveraged wealth as a rule contributes to economic growth.

The remainder of this paper organizes our work into a second section that elaborates further on the indebted state's position; a third section that focuses on the consequences where public debt is defaulted on; and a fourth section discussing the literature on finance and growth, as well as the wealth effect. A fifth and final section offers conclusions.

2. The trapped state?

In this paper, we deal with states understood as political entities with governments elected in democratic processes and with established institutions favouring general social and economic welfare. Unlike in the era of closed national economies, states under the modern global economic configuration have lost several attributes of sovereignty, for example through economic and political integration, as in the European Union. However, in the circumstances of ongoing financialization, a debtor state may further be thought to become critically dependent on international financial capital. Two dimensions to this dependence are worth scrutinizing, given that both relate critically to the issue of economic growth. One strand of analysis argues that it is financialization which has overt responsibility for the 2008−2009 crash, with all the further consequences this had in terms of permanent loss of employment, reduction in public goods and poor GDP growth (Freeman 2010; Stockhammer 2012). This argumentation stands in opposition to mainstream macroeconomic analysis of the finance and growth nexus which, notwithstanding important nuances, has built a consensus around perceived positive effects of financial development on economic growth (as first highlighted in the seminal paper of King and Levine 1993).

From the first perspective, financialization due to growth recession may be the subject of an indirect link with indebtedness, a rise in sovereign debt included. This reflects the manner in which financialization contributes to unequal income distribution and the repression of productive capital accumulation, and thus potentially exerts negative impacts on aggregate demand and growth (Dodig, Hein, and Detzer 2015). Due to its contractive effects, it contributes to further accumulation of public debt. This situation exposes states to a benchmarking regime and contest for financial markets' benevolence.

Second, in line with the other perspective encompassing the optimistic message in finance-and-growth literature, private debt (or credit) creates a potential for wealth-based and debt-financed consumption and GDP growth.[2] Thus easy credit access along with the wealth effect have been perceived by governments as con-

[2] The linkage between wealth effect and credit expansion has lately been so strong that some scholars suggest that 'it is misleading to speak of a wealth effect, rather it should be called a credit access effect' (Stockhammer 2013).

tributors to well-being and associates of electorate's support.[3] This enchantment could even be sustainable, provided credit was delivered continuously by a hierarchical international banking system.

In this context, indebted states seem to be trapped as they try to satisfy the conflicting interests of domestic and global actors. They should address the expectations of the former, which provide them with political legitimization, yet they feel obliged to listen to the latter for reasons of financial dependency. The exchange between the state and domestic actors concerns the provision of public and social services in return for votes and public support. However, if it is to meet voter expectations, the state needs to be solvent financially, and so debts need to be sustainable. Alas, when the accumulation of debt begins to threaten the financial stability of the state, the interests of voters suddenly find themselves in opposition to creditors' interests. As Tomz and Wright (2013, 22) put it: 'when governments appropriate funds to service the foreign debt, they are making a political decision to prioritize foreign obligations over alternative goals that might be more popular with domestic constituents'. A likelihood thus appears that the outlays for public services may be dramatically constrained for the sake of paying back creditors, with this in turn translating into a shrinking capacity to meet the expectations of voters and other domestic actors. A risk of social discontent arises, but the fear of a state's creditors having their 'state of confidence'[4] shaken often prevails over the obligations toward society. Politicians are afraid of leaving the financial markets discontented, because that could escalate into political and economic crisis. Thus international financial capital can exercise indirect power over government policies, with the state thus becoming a hostage to the aforesaid 'state of confidence'.

In the face of such received wisdom, this paper seeks to put into doubt the inevitability of the above positioning of the state, on the basis of the recent body of relevant literature. In the argumentation that follows, we perceive the relations between the state and internationalized capital to have two strings attached. First, the state listens to financial markets because it is in debt and must settle accounts, while still requiring external financing. And second, financialization is perceived as a vehicle underpinning economic growth, due to the positive influence finance

[3] By contrast, Dodig, Hein, and Detzer (2015) claim that for most countries, apart from four major external-surplus-economies, it appeared to be the way of compensating the contractive effects mentioned before. Alas compensation via credit-driven consumption boom even more aggravates indebtedness and dependency on external financing.

[4] We borrow this concept from Michał Kalecki, who in his famous paper on full employment (Kalecki 1943) mentioned that a 'state of confidence' is a very promising way of keeping governments in check by 'captains of industry'. He remarked that capitalists had 'a powerful indirect control over government policy: everything which may shake the state of confidence must be carefully avoided because it would cause an economic crisis. […] The social function of the doctrine of 'sound finance' is to make the level of employment dependent on the state of confidence' (p. 325). Analogous mechanism works today.

exerts in deepening growth and increasing the so called wealth effect, since the 1990s at least. These two channels of influence constitute a stick and carrot strategy. The stick is the threat that, in the face of growing public debt, attempts to have this rescheduled, or to negotiate in the matter of a default, will cause a severe economic downturn and isolation on financial markets leading eventually to a state's financial collapse. The carrot is in turn the promise of positive effects of spreading financialization on economic growth and development. The first case would mean politicians taking the blame for letting the state go bankrupt, while the second would bring them votes and popularity, for wise decisions and the following of prospective political vision. In other words, failures to service public debt and/or constrain financialization can be perceived as grave mistakes leading to the collapse of public finances, and/or a lost chance for economic growth. However, as we intend to show, evidence in support of such claims is mixed and rather weak.

3. The cost of sovereign debt default revisited

A state's position as set against foreign creditors is rather more uncomfortable than creditor-debtor relations normally are. It does matter who the creditors are, and in what currency debts are denominated. Domestically-related financial institutions are identified more readily, and the range of sensible arguments and common interests upon which cooperation may be based seems far wider than is the case with international agents. Also households tend to be benevolent creditors, who rather do not exert pressure on the state (as in Japan). However, few states remain in this comfortable position, as normally creditors who control access to capital are indeed transnational agents. Currency is another factor determining dependence. For instance, persuading a national/central bank (e.g., the Fed in the US) to increase the monetary base or even buy out government bonds seems far easier than asking a foreign issuer (e.g., the ECB) for the same thing.

However, governments do default on external debt, and – while debt restructurings are normally a sign of distress among less-developed countries − they do also happen in the developed countries, as historical records show (Aguiar and Amador 2015). According to the dataset on debt restructuring among developing countries since the 1950s, the number of incidences amounts to 600, with most of these carried out post-default (Das, Pappaioannou, and Trebesch 2012). Defaults are likely to happen in waves; and widely known cases of multi-country debt crises include the Great Depression, and the Latin American crisis of the 1980s. Governments' defaulting practices are by no means a marginal phenomenon.

There are a couple of factors that make a government's position under default special. One cannot imagine that contemporary creditor-related countries would use military intervention to enforce debt contracts. There is also little evidence for a state's assets being seized after a default, since sovereign debt is typically not backed by any collateral, and only rather few attachable government assets are located beyond national borders. However, even when locations are indeed in foreign jurisdictions, legal principles such as sovereign immunity do tend to protect sovereign assets (Das, Pappaioannou, and Trebesch 2012, 50). Thus sovereignty appears to be a privilege in the context of pay-back demands. On the other hand, it increases the willingness of potential creditors to lend. Lysandrou (2013) has recently argued that investors are nowadays quite tied to government bonds, due to the virtual lack of alternatives. In post-crisis times, private assets have lower profitability-to-risk ratios than government bonds, when it comes to the safe, long-term allocation of capital. And − contrary to the famous supposition of Reinhart and Rogoff (2009) − it is also incredibly difficult to designate a threshold of public debt beyond which a real threat to a state's financial stability begins to be posed (Lysandrou 2013; Nersisyan and Wray 2010).

The circumstances mentioned above must not be ignored as position of the state vis-à-vis internationalized capital is deliberated. Indeed, they quite obviously make governments' positions more solid than those of any other debtor or type thereof.

Conventional economic wisdom affecting the behavior of debtor states and protecting the interests of international financial agents says that debts must be paid back in line with a schedule, no matter what the costs. This was the official position of the IMF and other creditors during the international debt crisis of the 1980s, and it has been the line of argumentation pursued during the debt crisis of recent years. This imperative holds valid, not only for moral reasons, as it is the financial stability of states that is here at stake. If the repayment conditions are not met, the state will bear severe consequences of an economic and political nature. This is thus addressed to countries indebted to foreign creditors as a kind of pragmatic 'iron rule' advocated in their own best interest.

The counter-default argumentation along financial stability lines follows as below. Firstly, default on external debts can endanger domestic financial-sector stability and contribute to a credit crunch at home, because of complex links between foreign and domestic agents within the financial sector. Governments cannot repay their debts selectively, discriminating between foreign and domestic creditors (Broner and Ventura 2011). For instance, since bonds are traded *inter alia* on secondary markets, it is hard to trace who owns the debt; therefore the government would find it hard to repay locals at the expense of foreigners. It is presumed that default on external debt strikes, not only at foreign creditors and bondholders, but also at banks, insurance companies, and pension funds operating domestically, to the extent that governments would be wise to resist any such temptation. It is indeed true that debt restructurings such as in Russia in 1998 have contributed to banking-sector distress, and thus caused bank failures and runs (Das, Pappaioannou, and Trebesch 2012).

However, the power of this argument depends on how intense the links between foreign and domestic actors on the sovereign debt market really are. In fact, these can easily be over-estimated, as the recent case of Poland suggests. The post-2008 turbulence on international financial markets and consequent distress experienced by a few European parent-companies invoked concerns that they would try to rescue their balance sheets at the cost of their banking subsidiaries in Poland. Profit transfers abroad or total capital withdrawal from Poland might have provoked financial instability in a country where ca. 70% of assets in the banking industry are owned by foreign banks. However, this possibility never became a reality. In this case, the links between domestic and foreign actors emerged as a harmless one, from the point of view of domestic financial stability.

A second argument often raised is that the various costs arising out of sovereign default can be unsustainable to a government. These include increased borrowing costs, exclusion from capital markets, losses in terms of output and trade, a drop in FDI flows and private sector access to credit, negotiation costs and fees (Das, Pappaioannou, and Trebesch 2012). In this reasoning, finance-sector implications are regarded as costs borne by a country, rather than political risks facing private companies. In theory, costs to the state arising from a default are known and discussed widely. However, in reality, the said costs of restructuring and default incurred by governments are not so obvious and straightforward, and evidence for their existence is mixed (Tomz and Wright 2007; see also Aguiar and Amador 2015 for a survey of recent findings on sovereign debt default and overhang). In addition, costs arising out of sovereign defaults are not evenly certain for both parties, i.e. the state and its creditors. When the time comes to count, it emerges that it is creditors who can easily estimate the amount of losses they will have to bear when a debtor defaults. Despite differences in definitions, all measures of creditors' losses in the present value of their claims to be found in Tomz and Wright (2013, 17), give similar quantitative results, i.e. a ca. 40% market 'haircut'.[5] In sum, the risk borne by a defaulting government in terms of costs seems to be vague while haircut of its creditors seems to be rather obvious.

Surprisingly enough, then, in the light of these findings creditors might appear in a relatively weaker position than the debtor-country despite it being the latter on which analysis is normally focused. Hence arguments against sovereign default with a financial-stability argument to the forefront should not be taken for granted; evidence is mixed as to how high the costs might be, and even whether some of them will actually arise at all. On the other hand, haircuts for private creditors and bondholders may be estimated with relative ease. Hereby we are *not* saying that

[5] We do not refer here to financial-sector implications in the form of banking-sector distress and financial-sector instability which needs a separate deliberation. We mean creditor losses in a sovereign default, in accounting terms.

states should default, or that the costs of defaulting are trivial. Indeed, far from that. But the point is that governments in critical fiscal situations should not feel intimidated by the allegedly grave consequences of potential defaulting or debt renegotiation. They seem to have important arguments in hand when the confrontation with creditors comes.

4. The weakening finance and growth nexus

The second channel by which to exert pressure on governments (or in fact offer a juicy carrot) relates to the positive impacts of financial development on economic growth that occur thanks to financial deepening and the wealth effect. The general consensus among scholars in this very area was established in the 1990s, in the aftermath of such studies as King and Levine (1993), Pagano (1993), Levine (1997), and Rousseau and Wachtel (1998). The approach in question seemed to offer a foundation for the conventional-wisdom view that the development of finance may become an engine of economic growth. With time, the perspective on this relationship became much more nuanced. Scholars admitted the importance of financial institutions, but called for more detailed studies that would expose both positive and negative consequences of the growth of finance, and reveal the transmission mechanisms in more detail (Easterly, Islam and Stiglitz 2000; Wachtel 2003). Others have pointed to the shortcomings of the methods used to establish the finance and growth nexus (Manning 2003; Colander et al. 2009), and stressed the influence of other factors (institutional, political, regional, etc.) on growth that could only with difficulty be separated from the financial factor (Manning 2003; Demetriades and Law 2006). And finally, after the recent financial crisis, the former consensus became somewhat shaky after it was established that the positive link between finance and growth has its limits. For example, Rousseau and Wachtel (2011, 286) conclude by reference to panel data for 84 countries that 'the finance-growth relationship that was estimated with data from the 1960s to the 1980s simply disappeared over the subsequent 15 years'. Thus excessive financial deepening does not seem to promote growth – a conclusion confirmed by Arcand, Berkes and Panizza (2012), who establish that the positive relationship between financial depth and economic growth exists in countries with small and intermediate financial sectors, but with growth affected negatively once a certain threshold (private sector credits reaching 100% of GDP) has been passed. As we may see, the former conviction characterizing this strand of research – as regards the positive effects of growing finance on the performance of national economies – becomes nuanced. Doubts especially concern the wealthiest countries that have experienced the financialization processes to the greatest extent.

Consequently, the argument that the further extension of financial markets will bring more economic growth has lost much of its weight. The process revealed in this short review seems to be summarized effectively in a 2015 statement delivered in the Presidential Address to the American Finance Society from Luigi Zingales: 'There is no theoretical reason or empirical evidence to support the notion that all the growth of the financial sector in the last forty years has been beneficial to society' (Zingales 2015, 3).

A particular issue well worth mentioning in this context is the so called wealth effect, which combines rising indebtedness with an increase in the wealth of asset holders. The logic underpinning this phenomenon seems quite straightforward: credit expansion serves as leverage for purchases of various assets, be they stock, houses or consumer goods. In effect, rising demand causes prices to rise as well. This in turn fuels the propensity of consumers and firms to spend on goods and assets, because rising prices of financial assets (houses or shares) contribute to rising wealth of owners. And last but not least, when expenditure by the private sector increases, so does the level of satisfaction of voters. Thanks to this process politicians can perceive financialization as an attractive factor gaining them political support, and therefore assume automatically that there is also a positive effect on the real economy.

However, the positive impact of the wealth effect on consumption, and thus on GDP growth, has been undermined by recent research which yields highly inconclusive and sometimes even contradictory results. On the one hand, Carroll, Otsuka and Slacalek (2006) and Case, Quigley and Shiller (2011) provide evidence based on the US economy that the wealth effect does have a positive and significant impact on aggregate consumption that is much stronger for real estate than for other financial assets. On the other, Calomiris, Longhofer and Miles (2009), also drawing on US data, find that housing wealth has a negligible effect on consumption, in times of either economic upturn or downturn. Interestingly the results for the euro area seem in some respects to be the reverse of those found for America. A study by Sousa (2010) shows that it is financial wealth that has the leading impact on consumption, whereas the effect of housing wealth is nil, and not significant, and not even by any means strong. Moreover, he argues that it is the exposure to financial markets that probably causes increased volatility of consumption. Even if the positive causation between rising wealth and consumption exists, increased consumption at times of stagnating mass incomes is a cause of rising household debt, which further adds to the instability of national economies. In the event of bust, the positive effect of GDP growth during the prosperity phase may be abolished. The gains can thus be negligible in the long run, and only add to uncertainty (Stockhammer 2012). As the above review demonstrates, the wealth effect cannot be relied on as a certain and unproblematic source of long-term, sustainable economic growth.

5. Conclusions

Financialization is a relatively recent phenomenon. It started in 1980s and has since displayed an impressive upward trend continuing through to the present day. However, to date the effects of financialization have usually been analyzed in terms of macroeconomic outcomes and new managerial practices. The literature on the finance and growth nexus that blossomed in the 1990s may have contributed to the conviction that financial development plays a major part in economic growth and is consequently a desirable process. Similar hopes were tied to a particular case of finance-led growth, i.e. the wealth effect, which was supposed to bring higher consumption levels thanks to the rise in value of financial assets. However, a darker side of financialization was and has been rising indebtedness on the part of the states. With easy access to credit and rising liquidity of markets, financialization offered conditions favourable to the accumulation of public debt, whatever the underlying reasons.

In this paper, the focus has been on another side to financialization, concerning its impact on the balance of power in the political-economic order. In the face of the rising economic power of financial markets, the state has seemed to move into a trap position of being forced to choose between the interests of political constituencies and financial-market creditors. The state's subordination to financial markets has apparently been built upon two main pillars. The first of these consisted of rhetoric as to the fatal consequences of defaulting on accumulated debts; while the second concerned the lost opportunity for economic growth based on financial development and the wealth effect. However, the scholarly evidence reviewed in this paper indicates that these arguments may have lost much of their weight. It seems that governments have enough margin to become more resistant to the standard financial stability argument, and at the same time have more reasons to be resistant to potential growth and wealth arguments. As a result, we believe that the picture of the trapped state deserves renewed debate with a view to the state's position in the current matrix of power relations being reformulated.

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