

Policy Brief

Policies to stimulate investment in the age of financialization in Europe

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Abstract:

Despite increasing profits private investment remained weak in Europe as firms directed their profits to financial speculation (Tori and Onaran, 2017). Not only high dividend payments but also increasing financial revenues of firms due to their surging financial activities crowd out private investment in physical machinery and equipment. Perversely, financial activities do not automatically provide more funds for productive activity. According to econometric estimations by Tori and Onaran (2017) using firm balance sheet data in Europe the rate of investment by the NFCs would have been 27% higher without the rise in interest and dividend payments, and 10% higher without the crowding-out effect of increasing financial incomes. A properly designed public investment and industrial policy also needs to be complemented by a corporate governance reform to reinstate the missing link between private investments and profits. Under the guidance of a macroeconomic policy framework focused on full employment and equality, which helps to define and improve the vector of choices of firms, shareholders themselves could see the long-term stability of the corporation as their main goal once again.

Keywords: Financialization, Investment, Non-financial sector, Firm data, Europe, Financial development

JEL codes: C23, D22, G31

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Despite increasing profits private investment remained weak in Europe as firms directed their profits to financial speculation. Recent research by Tori and Onaran (2017) show that one of the most important reasons behind this missing link between profits and investment is financialization.

Based on the balance sheet data of publicly listed non-financial corporations (NFCs) in Europe, we show that financialization has led to an increasing orientation towards external financing and shareholder value orientation as well as the substitution of fixed investment by financial activity. Both aspects of financialization had a fundamental role in suppressing investment in the NFCs. On the one hand, the increase in financial payments (both interest and dividend payments) have a negative effect on investment. On the other hand, the rise in financial activities in search for short term financial profits crowd out investment in physical machinery and equipment. Perversely financial activities do not provide more funds for productive activity.

According to our estimations, the rate of investment by the NFCs in Europe would have been 27% higher without the rise in interest and dividend payments, and 10% higher without the crowding-out effect of increasing financial incomes.

The growth of the financial markets and intermediaries delinked from the financing requirements of NFCs is incentivizing firms to heavily engage in non-operating (non-core) activities, ultimately leading to stagnant levels of investment. Our results suggest that, even though at low levels of financial development, an increase in financial development has a positive effect on investment in small companies through enhanced resource allocation, in countries with high levels of financial development a perverse effect on investment dominates.

Financial incomes have a positive effect on investment only for the small companies in countries with low levels of financial development, but a significant negative effect in the large as well as small companies in countries with high levels of financial development. It has to be noted that larger companies create the vast majority of capital, and the crowding-out of physical investment of these companies by financial activity is a substantial drag on the investment performance and productivity of the European countries. The crowding-out effect of financialization has not been addressed carefully by policy makers so far, in particular because of the strength of the conventional idea that 'every additional fund is good for investment'.

A process of de-financialization of the non-financial sector is a pre-condition for a stable and vigorous investment performance. This would require an extended regulation of companies' non-operating financial activities along with financial regulation.

Managers' short-termist behaviour and decisions exclusively aimed at maximizing dividends distributed to the shareholders should be disincentivized. What is needed is the provision of an institutional setting for the NFCs that encourage management orientation towards long term growth and, more generally, 'stakeholder value'. This should be addressed in particular in the case of larger corporations.

The focus of corporate governance should be on the destination of the funds. The corporation today is an institution composed of different layers of productive and non-operating activities. Policies should aim at favouring a productive destination of NFCs' internal funds, e.g. higher rate of taxation on profits which are not invested.

Given the negative effect of excessive financial development on NFCs' investment, the policy recommendation for countries with low levels of financial development would be to prevent further de-regulation of financial markets and/or intermediaries in order to avoid the negative effect associated with high levels of financial development.

Last but not least, a wider and renewed fiscal policy can be effective in reversing the financialization-led investment depletion. Alongside the re-regulation of the financial sphere of our economies (both at the macro and at the corporate levels), the reform of a financialized system needs coordinated public investments. In fact, the public sector can act as the catalyst and driver of a new phase in which NFCs' objectives are essentially brought back to productive and stable capital accumulation. The various waves of liberalization and privatisation of large part of the economics systems fostered the emergence of behaviours detached from the objectives of equality and prosperity. The evidence speaks in favour of a vast program of public investment that can provide a consistent and sustainable 'direction' to the private initiative. Under the guidance of a macroeconomic policy framework focused on full employment and equality, which helps to define and improve the vector of choices of firms, shareholders themselves could see the long-term stability of the corporation as their main goal once again.

References

Tori, D., and Onaran, Ö. (2017), The effects of financialisation and financial development on investment: Evidence from firm-level data in Europe, [Greenwich Papers in Political Economy](#), No44