Financialization constitutes a particular ordering of economic arrangements. That statement challenges the way economists usually talk about the economy, because it challenges the view that the economy is a natural order.

The perspective in this book is that the economy is made, not found. By that is meant that economies are shaped by choices societies make about laws, institutions, and economic policies. Such a perspective inevitably takes the analysis into the realm of political economy. Fully understanding financialization is no longer just a matter of formal macroeconomic analysis, but also involves understanding the political and sociological dynamics that explain those societal choices. As shown in Chapter 11, this significance of political economy is clear with regard to the Federal Reserve and its conduct of monetary and regulatory policy.

Figure 12.1 illustrates the political economy triangle, which shows how the economy, ideas, and politics and economic policy interact to impact each other. The economic structure determines economic outcomes, including the distribution of economic power, wealth, and income. That enables the economic winners to influence politics, economic policy, and ideas. The control of politics and policy influences the structure of the economy, and it also influences ideas by privileging some and
suppressing others. Ideas in turn infuse politics and economic policy, and they influence the economy and economic outcomes by impacting behaviors, laws, and choice of institutional arrangements. Financialization can only be fully understood by recognizing the significance of the triangle.

12.1 Economic policy and financialization

Chapter 2 described the main economic developments in the era of financialization – including the increased relative size of the financial sector; the increased reliance on debt finance; the shift in the distribution of income toward profit and interest; and increased income inequality, with the bulk of income gains accruing to upper-echelon households.

Analytically, the key feature of the era has been severing of the link between real wage and productivity growth. This severing coincided with the inauguration of a new growth model. In the pre-financialization era, before 1980, wages drove demand growth. After 1980, however, demand growth was driven increasingly by asset price inflation and borrowing.

The pre-financialization growth model can be described in terms of a Keynesian virtuous circle, as shown in Figure 12.2. Wage growth drove demand growth, which promoted full employment. That in turn encouraged investment, which drove productivity growth, which in turn drove wage growth. The key features of the model were full employment and a tight link between wage and productivity growth, both of which features have been abandoned in the era of financialization.

Economic policy played a key role in overthrowing the Keynesian virtuous circle growth model, and the new policy paradigm can be described as a neoliberal box, which is illustrated in Figure 12.3. Workers are boxed in on all sides by a policy matrix consisting of globalization, labor market