

## **Financialisation, Speculation and Instability**

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Instabilities and inequities, as can be related to the widening spread of financialisation in different parts of the world economy, make it relevant to further analyse the origin and implications of the related changes brought in by financialisation. The all-encompassing nature of a financialised economy, as described in this volume, is marked by the prevalence of financial assets which offer returns at levels higher than those on similar assets which are backed by real activities. While linked to the risks as perceived, the higher returns on investments in those assets provide an impetus to agents in markets to hold them as a greater proportion of their respective portfolios.

Section I of this chapter outlines the theoretical principles in mainstream economics which have been guiding the official policy prescriptions that are conducive to financialization as well as the resulting micro-level investment strategies. It contrasts assumptions of rationality and calculability with the Keynes-Minsky school of thought that highlights the uncertainty of the future and irrationality of financial markets. Section II examines two particular instances of the greater uncertainty and irrationality of financial markets under financialisation, with reference to corporate investments and speculation in commodity markets, in advanced economies as well as emerging economies. The results have been economic stagnation and accumulating instabilities. A brief conclusion reiterates the need to understand financialisation as a global driver of instability and uncertainty and the need for policies to hem in deregulated financial markets.

### **Mainstream economics and the question of rationality versus uncertainty**

Tracing back the origin of financialisation, one needs to pay attention to the deregulation of financial markets in different parts of the global economy which started off during the mid-1970s of the last century. The added degree of uncertainty, in the new climate of deregulation, contributed much to generate

additional risks in the conduct of business in markets. Uncertainty-related risks in deregulated markets generated the need for instruments to manage the unknown prospects related to financial assets. Such situations led to the invention of hedging instruments in the market as covers against enhanced risks. Financial instruments, innovated as derivatives, consisted of forwards, futures, options, swaps, and the likes. All of those were contracted on the basis of what is described as the “underlying”, which relied on such financial assets as are originally backed by physical assets, currency, commodities, or even real estates. Instruments as above, clubbed with financial assets which are *not* backed by physical assets, constitute the essential components of the financialisation process (examples of financial assets mentioned above include those transacted in the secondary stock markets). Risk-adjusted returns on those financial assets have been usually higher than those backed by physical assets. We recall here that deregulation of the financial markets has generally been responsible for the relatively higher rates of returns on financial assets as compared to those backed up by real assets. With the spread of financialisation, there has also emerged in the market professional agents who manage risks to sustain and maximise returns in the face of uncertainty. However, as critics point out, such strategies which try to balance risks with returns do not necessarily materialise.

Investments in both the hedging instruments and in the financial assets transacted in the secondary market tend to rely on the principles underlying mainstream economics which guide investment decisions. The theoretical frame which underlies such prescriptions assumes “rational choice” on the part of economic agents, thus *ruling out uncertainty* in the decision-making process. Agents operating in markets are assumed to rely on an ergodic probability function, in terms of which the future is intractably linked to the past and weights attributed to past events continue to determine the probabilities of outcomes in future (Sen 2018). An essential aspect of models, as above, is the strict assumption that all agents in markets are able to *calculate* probability, which rules out uncertainty. Conclusions derived from such a framework obviously do not stand up scrutiny to guide investment decisions in the real world as long the latter is assumed to be bereft of uncertainty. Contrary to what is postulated in the rational expectations approach (which underlies the mainstream doctrines advocating financial deregulation), capital markets hardly serve as an informational/signalling agency in the economy (Shackle 1974, cited in Sen 2003: 25). Thus, operating in the free financial markets and relying on instruments like derivatives does not necessarily contribute to efficiency in the financial sector or to material growth in the real economy.

It may be recalled here that the multiplicity of financial investments relying on derivatives, while originating from the same base in terms of specific spheres of real activities (or “underlying” activities), do not expand the base itself. Instead, these amount to a piling up of claims which in turn are linked to the same set of real assets. In terms of the standard convention related to national accounts, capital gains/losses are reckoned as pure transfers which are not included in GDP computations. Finance in its gyration under financialisation thus becomes increasingly remote from the real economy; in the meantime, financial innovations and financial assets proliferate within the economy, to hedge and insulate financial assets in the presence of uncertainty.

Limitations of mainstream formulations in framing investment decisions have been evident in the frequent failures of the financialised strategies in achieving their targeted goals of maximising returns and minimising risks. Instead, there have been recurrent financial crises which have shaken the basis of the deregulated financial system. A classic example indicating the failures of the financialisation process is the subprime crisis of 2008 in the US economy and the effects it had on the world economy as a whole.

Questions have been raised in the literature on the methodology behind mainstream investment decisions, especially on grounds of the limiting assumptions which include the ergodic notion of probability subject to a normal distribution function. It may be mentioned here that the possibility of numerical calculation of probabilities had been subject to criticisms much earlier by Keynes (1921). Attacking the utilitarian and cardinal (or statistical) notions in the frequency theories of probability, Keynes deviated from such quantitative estimations. Instead, the probability relations, as defined in Keynes’ *Treatise*, rather spelt out the “*degree*” of belief related to actual observations relying on knowledge (Bateman and Davis, 1991).

Keynes’s take in the *Treatise* on objective observations was subsequently replaced by Keynes himself with subjective faculties, largely under the influence of Frank Ramsay, a contemporary philosopher-mathematician. With this, decision making by individuals was described in the *General Theory* (Keynes 1936) as guided by “animal spirits”, or a subjective faculty on part of individuals having a “spontaneous urge for actions”; and this was despite the fact that knowledge is never complete about “uncertain” events (Keynes 1937).

Uncertainty-related notions of probability have been further advanced in the post-Keynesian literature as “fundamental uncertainty” which relates to “... the un-knowability of the future” (Dunn 2008: 8). As it has been observed, the reason lies in the fact that economic outcomes related to the future may be changed by the current actions on part of individuals, groups and/or governments themselves, with outcomes often out of sight on the part of those responsible for such changes (Davidson 2003; Scazzieri 2011).

Such interpretations of uncertainty and probability relations in a changing world fit in well with Keynes’ famous observation “About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know” (Keynes 1937, 235–6). It is also relevant in this context that investment decisions by individual agents, influenced by the prevailing business sentiments in the market, are considerably shaped by actions on the part of *others* who operate in a similar manner in the market. The pattern is akin to Keynes’ metaphor of a “beauty contest”, where opinions are formed on the basis of what other (judges) consider to be most beautiful. Neither rational judgements, nor the probability calculations, as in the prescribed models of investment decisions, are thus tenable in situations as above.

### **Financialisation, Instability and Stagnation**

Investment strategies under financialisation are subject to strong preferences in markets for short-term financial assets which offer high returns as compensation against the risks. Those assets, however, often fail to achieve the targeted goals. An explanation can be found in the limitations of the investment strategy in terms of the ergodic notion of probability and its numerical assessments as discussed in the previous section. As for the current manifestations of financialisation in markets, investment strategies continue to ignore the critiques of the mainstream forecasting models on probability calculations, with much of current-day business practices continuing to rely on models based on a predicted normal distribution function of probability.

With businesses always subject to uncertainties and with hedging devices failing to ensure steady returns on financial assets, it is normal to expect instability in the investment climate generated under financialisation. In addition, with speculation providing incentives to hold short-term financial assets, which offer prospects of capital gains as well as higher returns, tendencies are naturally there on the part of agents in the market to allocate a smaller proportion of their portfolio as investments on assets backed by real activities. This clearly signifies possibilities of an impending stagnation to come about in business and tendencies of instabilities therein. A drop in the growth rate, as comes about, would have a negative impact on wages and employment as well.

Financialisation helps to raise the share of financial assets in portfolios held by agents in markets. This is because, as pointed out earlier, deregulation usually makes financial assets relatively attractive, with offers of better returns as well as of potential capital gains. As a consequence, financialisation is bound to provide incentives to various agents in markets to invest more on financial assets, with a resulting rise in their share relative to the remaining assets in portfolios.

### *Corporate Behaviour*

Looking at the related literature in the context of both advanced and the emerging economies one comes across attempts to analyse corporate behaviour under financialisation (Crotty, 1990; Stockhammer 2005–6; Hein 2012; Sen and Dasgupta 2018). Corporates, while following their primary target of maximising shareholder value by investing in high-risk short-term financial assets, also pull large financial flows to derivative markets to provide hedges. As it has been pointed out, corporate behaviour has been subject to “shareholder value-orientation” (Stockhammer 2005–6), which can be held responsible for a “growth-profit trade off” in business decisions of corporate firms (Crotty 1990). The consequences amount to short-termism at the cost of growth with long-term investments.

We spell out the notion of “shareholder value orientation” with a reference to the post-Keynesian theory of firms (Crotty, 1990; Organzi, 2006; Hein, 2012; Stockhammer, 2005-06). The latter rests on their institutional setting which includes shareholders, managers and workers. The decision on the part of corporate firms to use a share of their profits on investment depends on the relative weight of the above three major cohorts within firms in shaping such decisions. As for the respective interests, the shareholders remain interested in high profits and rising share prices, the workers in output growth with employment, and managers in high profits and share prices which would add to their performance-related receipts. Dwelling on the sequence as a “shareholder revolution” which lends greater power to shareholders, it is not difficult to explain why firms, led by managers, adopt a business strategy which caters less for long-term investment as compared to those which help share prices and profits in the short term (Stockhammer 2005–6; see Erturk 2019, in this volume).

A pattern as above has been empirically verified in the literature by using data for advanced economies (Stockhammer2004; Orhangazi 2006; Van Treeck 2008). The statistics reveal a rising share of interests and dividends in profits as distributed by the non-financial corporate firms. This also reflects the on-going tendencies under financialisation of corporate capital to hold an increasing share of profits as investments in financial assets. The latter is largely a result of the shareholder–manager alliances which promote short-term profits as against long-term growth in business activities. Treating the rising share of dividends and interest in the deployment of corporate income as the indicator of an underlying short-termism in corporate investments, those studies come to the conclusion that such outcomes, largely related to financialisation, have been responsible for a simultaneous drop in both investment and accumulation by firms. Observations, as above, point to steady declines in investment out of profits in the major advanced economies. The pattern is similar to a Minskyan paradigm where uncertainty in deregulated capital markets generates short-termism in investments. It is possible to trace the above argument in Minsky’s characterisation of “money manager capitalism” as the new stage of contemporary capitalism in which “... total return on the portfolio is the only criterion used for judging the performance of the managers.....It makes a long view a luxury....The stated aim of financial manager is to maximise the value of the investment of the holders of its liabilities” (Minsky1996).

With financialisation generating the climate for “shareholder value orientation”, as described above, it can be a logical corollary that financialisation has caused a slowdown in accumulation. Moreover, there emerges a distinct pattern in the distribution of corporate profit income across different stakeholders engaged with the firms, especially with its rising share distributed as dividends and interest payments. A large fraction of profits generated by corporates thus reach out to the “rentiers” who live on the income they earn from past savings.

Developments, as above, provide an indication that preferences for short-term investments, as reflected in the corporate decisions in advanced countries, are negatively associated with real investment (Hein 2012: 125). This counters the view that the rising rentier income-shares in corporate profits earned by corporates may generate a “finance-led-growth” in the real economy, unless of course, the rentiers have a consumption propensity which is higher than that of the national average, which is unlikely (Boyer 2000: 111–15). As already pointed out, in the process, corporate firms invest an increasing portion of the profits earned on short-term financial assets which have no links with the real economy; which include the high-risk financial assets as well as the derivative products for hedging, transacted in secondary stock exchanges (Stockhammer 2005–6: 197).

A similar conclusion has been arrived at in a more recent empirical analysis on US firms during 1970–2013 (Davis 2017). The study points at tendencies prevailing among firm managers inhibiting fixed investments, an outcome which results from the shareholder value norms which are closely followed by the large corporates. The study also finds tendencies among the large firms for large-scale repurchasing of their *own* equities, thus contributing further to the respective proportion of financial assets in their portfolios. Attention is also drawn in the paper to the prevalence of leveraged financing on the part of the corporates, thus working further as a deterrent to new investments on fixed capital. As we will point out later, propensities to borrow not only add to further liabilities in future, but also make for Minskyan Ponzi financing when fresh loans are used to service the outstanding debt (see Sotiropoulos and Hillig 2019, in this volume).

There exist empirical evidences that financialisation has been responsible for a slowdown in accumulations. As pointed out in a study on the distribution of GDP in the OECD during 1960–2000, financialisation and shareholder orientation of firms, as above, have gone in with the “rising share of interest and dividends in profits of non-financial business”, confirming the emergence of rentiers who live on past rather than on current activities (Epstein and Power 2003: 229–48).

Attention paid to the emerging countries reveals similar behaviour on the part of corporate firms in India, a major emerging country (Sen and Dasgupta 2018). Decisions about investing large shares of their earnings from profits on short-term financial assets are generally influenced by the growing state of uncertainty, which is the driving force behind speculation under financialisation. As with investment patterns in advanced economies, the majority of those short-term assets offer high returns despite being risky. Dwelling on the sequence which lends greater power to shareholders who easily win over the managers, it is not difficult to explain why corporate firms in India, led by managers, usually adopt a business strategy which caters less for long-term investments and more to those which help share prices and profits in the short term. The pattern runs parallel to the statistics in the major advanced economies in terms of the steady decline in the ratio of investment to profits (see also Karwowski 2019, in this volume, on variegated financialization in emerging economies).

Data on corporate investments in India as available from India's central bank (Reserve Bank of India Bulletins: 1990-2017) indicates that there has been a steady *rise* in the *share* of financial components in aggregate assets held by the Indian non-financial corporates in the decades preceding 2011–12. The proportion of securities (financial and industrial) in total assets held by those corporates, as reported by the RBI, has been moving up, from 21.83 per cent in 1992–93 to 46.83 per cent in 2010–11.

Data available on changes in asset shares in India from firm level Prowess data sources of the Centre for Monitoring Indian Economy (CMIE) also indicates a continuous decline in physical assets between 2005 and 2011. The two sources of statistics share a common pattern which reflects the declining share of physical assets in portfolios held by the non-financial corporations (NFCs). Evidently, changes as above suggest a pattern where investments in the real economy assume a lower priority for the non-financial corporates in India's private sector.

Data as above can also be explored further to highlight the sources of funds used by the Indian corporate firms. It can be observed that there has been a rising share of funds from sources which are external to firms, consisting of equities and borrowings—the latter from both domestic and overseas sources. Since the onset of the global financial crisis of 2008 there has been a continuous decline in the contribution of equity-finance and of internal reserves as sources of funds to corporate firms. The situation has led the firms take resort to additional borrowings. Shares of borrowings in total liabilities of the firms, according to Prowess sources, at respective levels of 35.9 per cent in 2008 and 39.6 per cent in 2013, have continued to rise since then. The pattern seems to indicate an easier option of financing on the part of the corporates, *which was to meet up liabilities with borrowings*. Moreover, one can notice a drop in domestic as opposed to foreign borrowings, largely facilitated by the liberalised norms for external borrowings (see Bonizzi et al. 2019, in this volume).

It is important to notice here that at the firm-level, the large share of resources procured from borrowings and reserves are effectively in use to manage the “current liabilities” which comprise dividends, interests and related payments. With borrowings contributing further to current liabilities, as above, one here observes a Minskyan Ponzi mode; with fresh borrowings used to meet the current liabilities related to borrowings and the sale of equities in the past (Wray:



2011). Such situations will erode the respective asset bases of individual firms as there has been no investment in fixed capital and an accumulation of additional liabilities to meet current liabilities.

As in the advanced economies, corporate non-financial firms in India too seem to be following a path of short-termism in the face of uncertainty under financialisation. This considerably dampens the prospects of further investments in physical assets, reflecting a familiar Minskyan situation where uncertainty in deregulated capital markets under financialisation generates instability and short termism. To quote Minsky, “for Ponzi units, the cash flows from operations are not sufficient to fulfil either the repayment of principle or the interest due on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stock lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes. A unit that Ponzi finances lowers the margin of safety that it offers the holders of its debts” (Minsky, 1992; see Sotiropoulos and Hillig 2019, in this volume). Proclivities, as above, also exist on part of the Indian corporates to invest in short-term financial assets rather than in the long-term physical economy, an aspect which provides the core of the explanation for the stagnation in the non-speculatory real segment of the economy. Instances as above are available in our recent study on corporate investments (Sen and Dasgupta, 2018).

### *Speculation, Derivatives and Commodity Markets*

As with the financial markets with trading in equities or currencies, use of derivatives has been common in other markets as well which include those for commodities. The major reason behind the use of the derivative instruments has been the volatility in global commodity prices. Since the beginning of the present century, such prices have been subject to multiple swings, starting with a prolonged boom which pulled up the all-commodity price index from 56 in July 1992 to 219 by July 2008. The global crisis that followed pushed the index down to 100 by October 2008. Volatility was evident with the quick reversal in prices and the index peaked again to 210 by April 2011. Commodity prices were subject to sharp downturns within a few years and the index touched 92 by 2016. The recovery that followed led to newer heights of the index around 120 by January 2017.<sup>1</sup> Futures trading as hedging devices was much in use in the context of the volatile commodity prices. As it has been claimed, the practice has been held responsible for upward pressures as well as instability in those prices (Sen and Paul 2010).

Explanations of the volatilities in global commodity prices, in terms of the tapering of the Quantitative Easing (QE) by the US Federal Reserve as well as the rising import demand from China (UNCTAD 2013: 30–39, 50), need also to recognise the significant presence of financial investors in commodity futures markets. As pointed out in an UNCTAD study,

A particular feature and a “new twist” to the recent boom is the increasing presence of financial investors in commodity futures markets ... during the 2000s, investment in commodity index funds has been heavily concentrated in the buy (long) side of those markets, and such a substantial influx of investment gives rise to futures price bubbles. These, in turn, affect spot prices by altering price expectations and providing incentives to hoard—a phenomenon never evident before (UNCTAD 2013: 30).

In principle, futures contracts in commodity markets are considered to transfer price risks from market participants of physical commodities in spot markets to agents who are ready to bear risks with speculative interests. Advocacy of future trading is linked to reduction of risks, both for buyers and sellers by minimising uncertainty and thereby reducing the transaction cost. Also, future trading in commodities is considered to allow risk sharing among various participants like the farmers and the trader. However, it is assumed that the role of the future contracts in “price discovery” can work only with access to full information in the market and with the absence of big players in control of the market (Sen 2010).

With continuing volatility in the global commodity markets, questions have often been raised as to whether commodity futures have been effective in fulfilling their role in terms of “price discovery” and “risk transfers”. It has also been pointed out that such claims can be fulfilled provided the participants of the commodity market have access to insider information which usually lies beyond public domain (UNCTAD 2011: 119). It can, however, be pointed out that even then information relating to other asset markets is bound to remain incomplete. Under such circumstances, future trading in commodities would fail to achieve much of the expected results—either in terms of price discovery (i.e., futures prices charting the path for spots) or in terms of risk transfers to those who are willing to bear risks in trading. With interconnected markets in terms of trading as well as investment decisions, more often it is the financial investor who manage multiple markets, not only by virtue of the large positions they usually command but also by managing portfolios across those markets, which include those for equities, currencies and real estates.

Use of futures trading has been quite common both in advanced as well as developing countries. One can here refer to the commodity market in India, a major emerging economy where futures trading has been in practice since a long time. As elsewhere, futures trading has not reduced the volatility in commodity prices in the country. By 2008, the persistent boom in commodity prices, especially related to food grains, led to public concerns and the appointment of an official committee to deliberate on commodity futures trading in the country (Sen, A., 2008). Contesting the claim that futures trading has

been beneficial for managing risks and discovering prices, the committee set limits in providing hedging facilities universally to all commodities in the market. A genuine case for futures trade, as the committee suggested, needs to rest on providing benefits to farmers who produce the traded commodities. Qualifying the majority report, the chairman of the committee pointed at the rising international commodity prices as a major factor behind the rise in spot market prices for agricultural products, thus dispelling the claim that the futures trade has been a major factor behind price increases in India.

However, as argued in a study on future trading in India's commodity markets (Sen and Paul 2010), while the global stock market downslides were matched by similar downslides in both global equity and commodity prices in 2008, there was not much of a drop in the movements in food prices in India. The reason may be the continuing use of the forward and future contracts as tools for speculation in these items. It can also be related to typical portfolio reshufflings on the part of the financial investors who turned to the commodity markets of India in the wake of the 2008 global financial crisis. Further, the same study also makes the point that futures trading in agricultural goods, especially in food items in India, has neither resulted in price discovery nor less of volatility in food prices. Instead, the steep increases in spot prices for the major food items are matched by a granger causal link *from future to spot prices* for commodities on which futures are traded. The sequence disproves the basic idea of having future markets as devices to stabilise movements in spot prices. Moreover, while there have been limited attempts in India to control future trade in some sensitive food items, the continuing rise in prices for essential staple food items like rice, wheat, pulses, and oilseeds has often led to an urgency of deliberating on the related issues (Clapp 2014).

However, the fact remains that with financialisation under deregulated markets, little efforts are there to regulate the pace of futures trading and the speculation and related hikes in prices that have resulted. As an example, prices of essential food items in India are still within the ambit of futures trading. Summing up, futures trading in India in agricultural goods, especially in food items, has neither resulted in price discovery nor a reduction of volatility in food prices. Nor are there significant effects in terms of farmers fetching higher prices in the market, as pointed out by the last official committee in India on futures trading. With the opening of cross-border trade, commodity prices in India have been guided by the upward movements in prices in international markets, which again are largely driven by financialised future trading. Instead, futures markets in India seem to have provided new avenues of speculation to traders as well as financiers, as has happened elsewhere. Thus, the use of the derivative instruments under financialisation, in the context of global commodity markets seems to have failed to bring in the much acclaimed "market efficiency", for growers as well as consumers in emerging economies like India.

## **Conclusion**

With financialisation affecting corporate investments as well as commodity trading, the result is a crippling effect on economies' productive capacity and the availability of resources along with a disproportionate increase in rentier income earned from speculation in the economy. The web of financialised operations also extends further, importing greater uncertainty and speculation into real estate (Aalbers 2019, in this volume), currency markets, insurance, and other areas of activity where money circulates through trade in securitised assets. With globalisation and the related ease of deregulated financial flows, the pattern of financialised activities, though different in scale, are similar in the advanced economies and the emerging economies like India. The trade in securitised assets even extends to the livelihoods of very poor people, whose income streams, generated in the informal economies of countries like India, have become the basis of the global microfinance industry (Mader 2015).

Concluding, one needs to bring back here the need for regulation, both in the financial market as well as in future markets for commodities and the credit market, to bring back some semblance of a coordination between financial and real activities (see Dow 2019, in this volume).

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<sup>1</sup> <https://www.indexmundi.com/commodities>, retrieved on 31<sup>st</sup> June 2018