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**THE FINANCIALIZATION OF THE ECONOMY.
VIEWS FROM THE INSTITUTIONAL PERSPECTIVE**

Summary: In the economic literature the idea of financialization is becoming more and more popular. The main aim of this paper is to look at financialization from the perspective of institutional economics. The nature of financialization as well as its history and manifestations are also presented. In author's opinion, financialization is a manifestation of the next stage of development of the market economy, especially in the most developed countries. Its origins lie in both economic phenomena as well as the socio-cultural, including the area of political life. Economists, regardless to what extent they are convinced of the specific role of financialization, should take into account the consequences of this phenomenon in their academic and research efforts, as well as the needs to integrate considerations regarding the financial sector and the real economy.

Key words: financialization, institutional economics.

1. Introductory remarks

The financial crisis which began on the US subprime mortgage market and then spread to the real economy caused, among others, an increased interest in various aspects of the processes which in the English-language literature are known as financialization. This term does not have an accepted Polish equivalent and each translation, aside from descriptions such as "financial capitalism", does not sound right linguistically.¹

Besides describing the nature of financialization as well as its history and manifestations, the main aim of this paper is to look at financialization from the perspective of institutional economics. The term institutional economics is understood to include old, traditional, as well as historical institutionalism dating back to the traditions of Thorstein Veblen and new institutional economics, which went through a kind of ennoblement in 2009 as a result of Oliver E. Williamson and Elinor Ostrom being awarded the Nobel prize in economics.

¹ Polish literature contains Polish translations such as "finansjalizacja", "ufinansowanie", or (most often) "finansyzacja".

2. Financialization

Özyiir Orhangezi rightly points out that the use of the term financialization is reminiscent of the use of the term “globalization” [Orhangazi 2008, p. 3]. Both terms are commonly used with the latter being certainly more popular, albeit both are equally lacking of an unambiguous, accepted definition.² In all the definitions of financialization, the increasing importance of the financial sector and financial criteria in the functioning of modern economies and society are pointed out. From its traditional role of supporting and complementing the real economy, the financial sector is becoming a dominant participant in economic and social life. Such a general vision of financialization would be difficult to deem sufficient for further analysis. Therefore, it is worthwhile trying to describe it more adequately, albeit by differentiating between the narrow and broader interpretations of financialization.

In a narrow sense, financialization is above all associated with “the increase in the importance of financial activities in non-financial corporations” [Ząbkowicz 2009, p. 25]. This has resulted in changes in income streams which are becoming increasingly dominated by revenues and incomes derived from financial activities and not traditionally understood operational and investment activities.

The narrow interpretation of financialization provided in the previous paragraph clearly constitutes a very important aspect of financial capitalism; however, it does not cover the whole scope of financialization. In a broader sense, financialization is deemed to be a kind of process, whereby the financial domain grows more autonomous with respect to the real economy, or even the former dominates the latter. As part of the financialization process, financial markets and the financial elites have a growing influence on the political economy (at a micro-economic level in firms as well as at a macroeconomic level) as well as on the effects of economic management.³ There is an accompanying opinion that financialization is evidence of a new study of capitalism described as financial capitalism, rent capitalism, bankocracy, or “coupon pool capitalism”.⁴ At last the authors of the most radical concepts understand that financialization is clear evidence of a kind of capitalist “autumn” as well as the evolution of a financial-political complex which with its influences and importance in the fields of economics and politics exceeds the role of the previous military-industry complex.⁵ Financialization and this autumn are also

² It should be noted that for some researchers, financialization is simply a specific word or even a form of globalization or internationalization [see Engelen 2008; Boyer 2005].

³ See Epstein (ed.) [2006, p. 6] and Stockhammer [2004, pp. 720-721]. A broad analysis of the ideology of financialization and its effects on economic growth is contained in Boyer [2000, pp. 11-145]. A broad view of the role of the financial elite in the modern world is contained in Hall [2009].

⁴ For rent capitalism and “coupon pool capitalism” see G.A. Epstein (ed.) [2006]. Consider also Froud *et al.* [2000, pp. 273, 275]. “Bankocracy” is a term used by Robert Gwiazdowski during an interview for the “Przekroj” weekly [see Gwiazdowski 2008, p. 36].

⁵ See Mączyńska [2009, p. 10].

supposed to be linked with the move from democracy to plutocracy, namely to the rule of money and those who possess it.⁶

Financialization leads to fundamental changes in the field of management and ownership, especially in large firms. In the field of ownership, this is linked with the greater role of institutional owners from the financial sector. These owners generally treat their shares in the real economy as one of many periodic and alternative forms of investment and not as long-term ownership and development of the organization in question.

It is not difficult to notice that whilst the narrow interpretation of financialization has a narrow economic dimension linked to the analysis of changes in non-financial institution income streams, the broader interpretation of financialization by definition clearly exceeds analysis typical for so-called mainstream economics. At the same time, the analysis pertains to phenomena which are tied to the traditional institutional analysis and closely linked to phenomena from other areas of society. This is why financialization is increasingly popular amongst economists who are more or less associated with modern institutionalism. Other economists representing those schools which are skeptical or even highly critical towards so-called mainstream economics as well as towards that which by doctrine is tied to neo-liberal ideologies, also accept financialization. Orthodox representatives of mainstream economics treat everything linked to financialization as an indication of certain natural changes in the market economy which do not give sufficient justification for significant paradigmatic revisions or changes to fundamental theories or models.

In the subsequent sections of this paper we will be, above all, referring to the broader discussion of financialization. This is linked to the author's conviction that the latest crises or in fact financialization is evidence of wider and deeper changes occurring in the modern world and that it is not a symptom of certain short or medium term economic disruptions.

3. The historical dimension of financialization

In the modern world and the fields of academia and economic research, there is a clear tendency towards ahistoricism (the only thing that is important is the here and now). That which happened previously has no significant bearing on present events. However, it is the author's opinion (and not simply because of the ever popular concept of "path dependence") that economic and social phenomena should be viewed and analyzed in their historical contexts.

From the perspective of the discussion surrounding financialization in its historical dimension, it is possible to identify two research perspectives. One is based on the view that financialization is a phenomenon with a long history characterized

⁶ The well-known American investor Warren Buffett stated that "The United States is moving toward plutocracy – government of the rich, not by the people"[*Puls Biznesu* 2011, p. 9].

by moments of the financial domain's growing dominance and the associated wealth creation in the face of real economic activities. The background to this type of analysis is associated with Aristotle's differentiation between economics and chrematistics. The essence of the former was to be the increase in wealth through satisfying the needs of the real economy. Chrematistics, however, is linked to the idea of increasing wealth for its own sake through what can be described as financial speculation. Differentiation between economics and chrematistics is tied to the debate regarding the role of money in economic and social life as well as charging interest which was initially also not accepted by Christianity.

The case of Spain in the 16th and 17th centuries is among the many cited historical manifestations of financialization. The influx of precious metals from America, which were used to make coins led to the spread of a kind of faith that money and its circulation could autonomously guarantee success and be a source of wealth and development. The so-called Spanish Crisis of the 17th century quickly showed that neither money or securities and their trading can replace normal activity in the real economy.

Historical manifestations of financialization are sometimes associated with all speculative bubbles (and bursts). Such a broad interpretation can, however, raise questions due to the different nature and sources of speculative activity.

The second and most popular historical perspective regarding financialization links the phenomenon with processes which strengthened themselves in the market economy towards the end of the 1980s. That which clearly defines the fundamental differences between the financialization of the sometimes distant past and its current form is the scope and scale of speculative phenomena as well as (what is very important) the essence of these phenomena. We should agree with Samuel Knafo, who believes that traditional speculation was largely based upon arbitrage. However, modern speculation is more closely tied to the inflation of financial assets and the emergence of financial speculative bubbles [Knafo 2009, p. 130]. The clearest example of the consequences of this second type of speculation is the latest crisis which is rooted in the financial markets and the bursting of the speculative bubbles.

4. Manifestations of financialization

A detailed analysis of various manifestations of financialization are beyond the scope of this paper. A kind of catalogue of the evidence of growing financialization used most frequently in the literature is presented further on.

It would be most appropriate to begin with the role of so-called invisible transactions and the growth of derivative markets. It is estimated that around 75-80% of global financial transactions are not associated with the flow of any goods or non-financial services. The daily turnover on the so-called FOREX market is several times the Polish Gross Domestic Product. Everything that can be described as e-business as well as the digitization of economic and social life has undoubtedly

played a significant role in the growth in the number of invisible transactions as well as the ease with which they can be executed. A new and rapidly growing phenomenon which serves as testimony to the new speculative dimension are ultra-quick transactions which take only milliseconds to complete.

The inflation of financial assets as well as financial instruments themselves are an expression of financialization. The derivatives markets play an important role with credit default swaps (CDS) gaining particular popularity. It is worthwhile noting that the value of the CDS market in 2000 amounted to approx. 0 whilst in 2007, the CDS market was estimated to be worth around 60 trillion USD. The value of the derivatives market was estimated to be in the region of 600 trillion USD. New and evermore complicated financial instruments developed through financial engineering were often not understandable especially for buyers, who were reliant upon the opinions of so-called experts. These experts were generally rating agencies which, as the experience of the latest crisis has shown, were not necessarily diligent and careful when rating these products. The development of the derivatives market, in particular the market for CDSs, also caused a fundamental change in the relationships between debtors and creditors in the real economy. In the case of traditional relationships, should the debtor fall into difficulty, the creditor was generally interested in helping the debtor find a solution. The prospect of the debtor filing for bankruptcy would result in potential problems for the creditor. In the world of the CDS, speculators can bet for/against the bankruptcy of the creditor, which is beneficial for the CDS issuer(s) and broker(s).

Phenomena such as the scale of financial leverage among firms (including the financial sector where leverage in some cases even exceeds 50%) are also classical manifestations of financialization. Additionally, the aforementioned increased level of income from financial activities in non-financial institutions (sometimes exceeding 50%) are also manifestations of financialization.

The role of financial institutions and their overall income within the economy are also evidence of financialization. In the 1980s banks listed on the US stock exchange constituted $\pm 5\%$ of the overall market capitalization and approximately 10% of the profits of all the firms listed on the stock exchange. In 2007, these figures were both 25% and 40%, respectively. Let us remember that in Iceland, which is well known as a country having experienced a financial sector crisis, the value of the Icelandic bank assets was ten times the value of the country's GDP.

Financialization also applies to households and the value of financial assets in their total assets as well as the level of household debt in relation to their income. In 1975 in the UK for example, this amounted to approx 45% of household assets, whilst in 1995 this grew to 61%. This was mainly as a result of the growth in insurance and pension funds. The level of household debt in the UK in 2007 amounted to 150% of income, whilst in the USA this figure was 137%.

The analysis of the changes in management, linked to the spread of the idea of "shareholder value" and the role of financial institutions in firms outside of this

sector, plays an important role in the discussion regarding the manifestation of financialization as well as its causes. The spread of the shareholder value idea led, among others, to the excessive prominence of the whole group of indicators relating above all to short-term profitability in economic-financial analysis and not those pertaining to the long-term stable growth of a given firm.⁷

And finally, “last but not least”, the growing frequency and strength of financial crises is a significant manifestation of financialization. From this perspective, a particularly important role has been played by the latest crisis, which is difficult to definitively class as over.

5. Financialization and historical institutionalism

As has been mentioned previously, in particular during the discussion regarding financialization in a broader sense, referring to significant changes in the way in which the market economy functions is naturally tied to analysis typical for institutional economics. This also applies to the element described as old, traditional, or historical institutionalism. Due to the limitations of the paper’s scope, it is impossible to carry out a full analysis of specific issues. For this reason, this section will be more a catalogue rather than an in-depth presentation of specific issues, as was the case with the section devoted to the manifestation of financialization.

The discussion pertaining to financialization is undoubtedly linked to the problem of human nature, which was a key issue for Thorstein Veblen himself. Of course, in contemporary psychology, the notion of “instincts” is not really used, nor the idea of the predatory instinct underlined by Veblen; however, the idea of greed which was so widely referred to during discussions regarding the latest crisis and its causes fits well in the discussion regarding the nature of man. The Gordon Gecco style of business began dictating for many (especially those in the financial sector) the boundaries which defined what could and could not be done. Adopting this philosophy in essence was tantamount to believing that everything which facilitates the accumulation of wealth is permissible.⁸

The notion of power plays an important role in traditional institutionalism. From the perspective of financialization, this term can be considered in two dimensions. One is the issue of the ties between various levels of political power and the financial sector. The so-called “revolving door” phenomenon is linked with the movement of people from business to the world of politics, including public administration, and then back again in to business thereby simplifying undertaking actions in the interest of the financial sector. It is worthwhile remembering that the most popular

⁷ See Froud *et al.* [2000, pp. 80-110] as well as Williams [2000, pp. 1-12].

⁸ The term comes from the main character from the film “Wall Street” (1987) and the fragment which is often cited today containing the statement that “greed is good.” The Gordon Gecco style of business has become a symbol of achieving financial success at any cost and by any means.

response to the question why the Lehman Brothers bank collapsed and not the other banks, which themselves were not in a better position, is that Lehman had a weaker relationship with the prevailing US administration than the other big players.

In writing about power in its political sense, it is worthwhile looking more broadly at the role of the state in financialization. This is important because particularly radical supporters of the idea of market efficiency are likely to place state intervention in the market at the source of the cause of the latest crisis.

Firstly, the state's regulatory functions are important from the perspective of financialization. The laws and various regulatory bodies dictate to what extent the business environment is conducive (or not) to the expansion of the financial sector. The principles of deregulation and privatization are generally sound and unequivocally create an environment conducive for growth in entrepreneurship and respecting the laws of microeconomic efficiency. The specific nature of capital markets, however, taking into account globalization and the rise of the digital economy, means that deregulation and privatization (in particular limited regulatory supervision) can produce very dangerous consequences.

Secondly, financialization (in the context of the actions of the state) can be considered through its stimulation and utilization by the state. The state, besides economic aims, must also meet certain social goals. If, as was the case in the US, a government tries to realize social aims tied to ensuring the access to such goods as homes through stimulating or forcing loans, then it is directly contributing to the financialization. The US subprime mortgage market developed in part as a consequence of state policies linked to institutions such as Fannie Mae and Freddie Mac.

State's social aims also include ensuring a certain standard of living for those who are no longer economically active. In the face of the ever-increasing problem of ageing populations in the most highly developed countries, even the wealthiest countries are not in the position to meet social expectations in this regard and to ensure the financing of social expenditure including pension funds. Therefore, countries look for different ways to at least in part free themselves of rigid transfer budget expenditure. One way to do this is to develop an alternative to the sources of finance for social security expenditure such as Polish open pension funds. These alternatives to the budget require the development of capital markets and the financial sector which in turn contributes to the growth in financialization.

The problem of governance can also be considered in terms of the relationship between the world of capital and the world of work. From this perspective, one should point to a departure from the so-called Fordist system, to some extent based on the idea of solidarity between the worlds of work and capital, in favour of clear competition between the two worlds (particularly with respect to increasing incomes), which is typical for the so-called neo-liberal age. Data regarding the American economy in particular show the rapid widening of the income gap between the so-called blue and white collar workers, particularly in the case of top management [van Treeck 2009, p. 473].

Financialization is also associated with ideological issues particularly the aforementioned neo-liberalism where the free market has been understood as an unregulated market. Market failures were considered a marginal phenomenon, while all manifestations of state failure were treated as fundamental and inherently destructive for the market. The famous TINA (there is no alternative) as well as political and economical benchmarking (which boils down to copying American solutions) constitutes an important element in the ideology of the economics.

It is difficult to ignore the cultural aspect whilst discussing financialization. Various types of changes accompany the so-called post-modernistic era. Loans which were granted in the past are, today, sold. In turn, mass culture is clearly spreading the vision of a hedonistic way of life in which renting, traditionally very restrained or even frowned upon by economists, is a sign of success and a worthy path to follow.

Ethical changes and changes in religious life are also more conducive to financialization. There is currently an erosion of traditional values particularly in the case of business. An example, albeit not in all cases, is the career of “business ethic” idea. Unfortunately in practice, this ethic is sometimes tailor-made to a specific corporation, where standard ethical issues often take on a new meaning. The old Latin principle of *caveat emptor* (“let the buyer beware”) becomes a fundamental market rule.

And finally the issue of broader social changes taking place under financialization (i.e., in highly developed market economies) can also be included in the analysis and fits within the traditions of old institutionalism. The erosion of social capital,⁹ albeit not to the same extent everywhere, as well as the changes taking place in the younger generation,¹⁰ facilitate the development of speculation and Gordon Gecco business style.

6. Financialization and new institutional economics

As in the case of historical institutionalism, new institutional economics and its instruments fit the analysis of the financialization phenomenon. This undoubtedly pertains to the idea of information asymmetry from the perspective of customer relations and sellers with respect to financial products. We have already referred to the role of rating agencies, which were treated as impartial experts allowing the buyer to minimize risk. Unfortunately, it was the rating agencies which in fact failed in their responsibilities as their various branches were working for both parties in the

⁹ Let us recall that the foundation of social capital is trust. The lower the level of trust the greater the risk when making decisions (including financial ones).

¹⁰ From this perspective it is worthwhile paying attention (as an example) to the observed, increasing belief among the younger generation in the U.S. that problems are largely technical and in order to solve them, we need only make hardware and software changes, or greater ingenuity in the creation of new products and financial instruments.

transaction. They were also, to a certain extent, the victims of asymmetric information with respect to the complexity of financial instruments constructed under financial engineering.

From the perspective of property rights theory, which is important for new institutional economics, it is worth paying attention to the increasing share of ownership in the real economy in the hands of financial institutions, to which we referred earlier. There is a kind of financialization of any and all assets, including those related to human capital. The stakeholders' perspective becomes replaced by the shareholders' perspective (which has been already analyzed) and the idea of shareholder value. This is conducive to activities aimed at the short-term maximization of a listed company's market value and not long-term growth.

Activities linked to finding ways to minimize transaction costs also play an important role from the perspective of financialization. Lean management or outsourcing are very important and useful concepts providing that they do not largely or wholly serve short-term shareholder maximization. Achieving superiority of shareholder perspective compared to the traditional stakeholders perspective leads among others to the replacement of the traditional rule of "retain and reinvest" with the principle of "cut costs and distribute (dividends)" [Stockhammer 2004, p. 727]. Replacing bank employees with financial intermediaries can bring significant financial advantages but can also mean that the middle-man who is rewarded in the form of a commission will take too many risks.

From the perspective of new institutional economics, the spread of rent-seeking, which leads to the violation of the fundamental rules of trust between sellers (e.g., new financial products) and customers, fits well into the discussion. It also results in the old Latin maxim of *caveat emptor* taking on new significant importance [Freeman 2010, p. 165].

And finally, when writing about financialization from the perspective of new institutional economics, it is difficult not to refer to the problem of moral hazard or *ex post* opportunism. This phenomenon boils down to the idea (taken from insurance theory and practice) that the entity enjoying a significant amount of security in essence does not need to try and avoid those threats which its insurance protects them against. The idea of moral hazard is linked to the rise of concepts such as "too big to fail" and "the state as the insurer of a last resort". The latest crisis is an example of the practical functioning of both concepts. Unfortunately, from today's perspective, it is clear that even though there has been much discussion regarding the fact that the term "too big to fail" is a distortion of the principles of a market economy, institutions of this nature are faring quite well. The management of such institutions is expecting the state to fulfill the role of the insurer of a last resort, if required, at the cost of the tax payer. This is especially the case given that the aforementioned principle of "revolving door" also still works.

7. Final remarks

The most important conclusions arising from the present analysis are as follows. Firstly, financialization is a manifestation of the next stage of development of the market economy, especially in the most developed countries. Its origins lie in both the economic phenomena as well as the socio-cultural ones, including the area of political life.

Secondly, the concept of financialization and assigning it a specific role is popular among economists who are skeptical regarding mainstream economics. This is reflected, among others, in the number of references to institutionalist analytic tools during the discussions regarding financialization.

Thirdly, financialization is, for mainstream economics, a technical phenomenon as opposed to a fundamental one and therefore does not require any corrections to analysis tools or the perception of the economy. Finances are, by nature, good and markets are efficient.¹¹ The level of market failure is limited and does not require significant government intervention. Financial crises and various manifestations of financialization are, to a large degree, derived from errors made by states.

Fourthly, in the opinion of the supporters of the special role of financialization, the only entity which can try to limit the associated level of risk is in fact the state. However, for various reasons, the actions required of the state are difficult to take and complete. Moreover, in this case the state is no longer solely an objective/autonomous arbiter.

Fifthly, economists, regardless to what extent they are convinced of the specific role of financialization, should take into account the consequences of this phenomenon in their academic and research efforts as well as the needs to integrate considerations regarding the financial sector and the real economy.

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¹¹ We have to agree with Duncan Wigan that in contemporary economic theory especially theory of finance is based on anti-thesis of J.M. Keynes' comparison of share market to a casino [Wigan 2009, p. 160].

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FINANSYZACJA GOSPODARKI. SPOJRZENIE Z PERSPEKTYWY INSTYTUCJONALNEJ

Streszczenie: W literaturze ekonomicznej coraz większą popularność zyskuje pojęcie finansyzacji. Celem opracowania jest obok określenia istoty finansyzacji, jej historycznego zakresu i przejawów, próba spojrzenia na finansyzację z perspektywy ekonomii instytucjonalnej. W przekonaniu autora finansyzacja jest jednym z przejawów kolejnego etapu rozwoju gospodarki rynkowej zwłaszcza w krajach najwyżej rozwiniętych, a jej źródła tkwią zarówno w zjawiskach ekonomicznych, jak i tych ze sfery społeczno-kulturowej, a w tym z obszaru polityki. Ekonomiści, niezależnie od stopnia przekonania co do szczególnej roli finansyzacji, powinni w swych działaniach w sferze naukowej i dydaktycznej uwzględniać konsekwencje tego zjawiska i potrzebę integracji rozważań o sferze finansowej i realnej.

Słowa kluczowe: finansyzacja, ekonomia instytucjonalna.