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THE ROLE OF FINANCIALIZATION IN BANKING SECTOR INSTABILITY
Abstract

The causes of the global financial crisis are observed in the various aspects of the functioning of the financial system. It is pointed out that this was excessive bank lending, the development of modern financial instruments – derivatives, increasing role of securitization process, incorrect ratings of the financial instruments of the credit rating agencies, inadequate macroeconomic policies, in particular monetary and fiscal policies, development of the shadow banking market, increase in systemic risk or changes in the management of financial institutions. However, there is one more problem in the global economy. This is the growing importance of the financial sphere, which has started to affect and determine the real economy. This process, known as financialization also increases the risk of instability in the financial system and the role of banking institutions in maintaining the stability of the whole economy. The main aim of the study is to analyze the importance of the financialization process, which is observed in the global economy, in destabilizing the banking sector. The study also identifies its consequences for the framework of the modern banking sector and the functioning of individual banking institutions.

Keywords: financialization, financial instability, banking sector instability, global financial crisis.

JEL Classification: G01, G21, F65.

Introduction

Financialization might be interpreted as a process in which markets and their participants gaining the more influence on the functioning of enterprises/companies and the framework of financial system. Financialization changes the functioning of the economic system, both at the macro- and microeconomic level. It results in increasing the importance of the financial sector in relation to real sector, transferring the income from the real economy to the financial sector and contributing to the growth of inequality income and stagnant wages.

In intellectual terms, financialization is inspired by the work of M. Friedman and the Chicago-school in modern economics. This doctrine and a neoliberal thought encouraged R. Reagan and M. Thatcher to implement broad deregulatory reforms that have increased the development of financialization. The second stimulus of economies’ financialization, was the collapse of the world monetary system in 1971 and break the link between the main currencies and
gold. Then, governments and central banks have obtained the freedom to issue paper money. There was seen the increasing uncertainty and risk, which contributed to financial fragility, economies’ vulnerability to crises and infections, as well as financial speculation. The third factor in the growing financialization was the excessive financial liberalism, which was intended to lead to financial development, mainly by increasing the share of the financial sector in GDP.

1. The essence of the financialization process

In the last three decades, there have been significant changes in the functioning of financial markets, which might be referred to the example of the industrial revolution – as the financial revolution. They have become the source of significant transformation of the global financial markets. At the same time, they form the basis of a number of economic, political, legal, social, and technological phenomena. Despite their undeniably positive impact on the financial system, they caused (due to their scale, role and development) that it has become more “fragile” and vulnerable to instability. The most important changes in the international financial markets are:

- Globalization – which led to the financial markets integration, causing that they became more open systems of the world economy; its manifestation is the increase of relationships and linkages between economies, financial markets and banking institutions.
- Deregulation and financial liberalization – indicating the removal of restrictions on the banks’ activity and abolition of barriers to transfer capital between countries.
- Disintermediation – a process of gradual reduction of the banks’ role in raising capital for companies.
- Technical and technological progress and the development of new banking products – technical and technological innovations lead to the development of advanced financial engineering instruments, channels of their distribution and risk management methods; the basis of these changes was the rapid development of information technology and telecommunications, and extensive use of the Internet, allowing access to information and reaching out to a wide audience of financial services, affecting to the deepening of the financial market and increase its liquidity.

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Consolidation (mergers and acquisitions) and economic expansion (cross-border) – banks’ business conditions have changed as a result of opening up financial markets for foreign competitors; strong competitive pressure and the need to take appropriate actions to cope with the increasing competition, resulted in a number of mergers, acquisitions and strategic agreements on local and international markets, which were supposed to bring economies of scale.

The current period of the global economy is determined by the following process of financialization. The literature indicates that it was one of the causes of the financial crisis the twenty-first century. Financialization means a situation in which the elite and financial markets gain more and more influence on economic policy and the effects of management. Semantically, it is similar to the concept of “stock exchanging”, “bankokration” or “financial capitalism”. The definition of financialization indicates on the particular and growing role of the financial sphere and financial criteria in the functioning of economy and in economic and social life. Thus, financial sphere becomes a dominant participant of the market, growing over the traditional role of supporting and complementing the real economy. The situation prevailing in the international monetary system since the collapse of the Bretton Woods system, contributed to the development of financialization as an international phenomenon. The multitude of ores systems and the lack of commonly accepted rules of market’s functioning, encouraged and facilitated the participants’ speculation. The more that the traditional speculation was based mainly on the use of arbitration. The modern speculation involves the inflation of financial assets, as well as creation speculative bubbles with a financial nature. Financialization also led to changes in the shape of business cycle, by shortening the cycle and increasing its volatility. In particular, these changes are seen in the periods of prosperity and depression (Figure 1).

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The term of financialization is defined in the narrow and broad sense. In a narrow sense, it is understood as the growing importance of financial operations in the activity of non-financial companies (Figure 2). It is resulted in a change in income streams, where there are increases the share of income from financial activities, in relation to benefits from the traditional operating and investing activities. Financialization – in the narrow sense – is regarded as one of its manifestations in broad sense. In a broad sense, it includes elements typical for tradition of institutional analysis in which economic events are closely related with phenomena from other areas of social life. So that, financialization is a process of financial sphere autonomization in relation to the real economy, and even its superiority over the real economy. Financial markets and elites gain more and more influence on economic policy (in the micro-and macroeconomic meaning), and the effects of management. There is also a view that financialization of the economy is a new stage of capitalism – financial capitalism, rentier capitalism, “clipping coupons” and bankokration. With the refer-

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ence to the Keynesian tradition, this is a “casino capitalism”\textsuperscript{10}, which means a situation when the accumulation of capital becomes a by-product of gambling game and entrepreneurship is mainly based on speculation. Some economists in financialization see the end of capitalism (which does not mean the end of a market economy) and the creation of a financial and political complex, which its influence and importance exceeds the role of the past military-industrial complex\textsuperscript{11}. Supporters of the Marxist tradition, determine the financialization as a monopolist and financial stage of the capitalist economy\textsuperscript{12}. It is also one of the manifestations of the transition from democracy to plutocracy – the world of money and its depositors. According to W. Buffett, nowadays United States aims to plutocracy, where the state is controlled by very rich people, not the general public\textsuperscript{13}.

**Figure 2. Financial sector as a percentage of GDP**


Financialization also leads to significant changes in management and ownership, especially large enterprises (Figure 3). Institutional owners represent so called impatient capital, looking for unconventional profits in the short term\textsuperscript{14}. Owners of the financial sphere treat their part in the real sector as one of its regul-


\textsuperscript{13} „Puls Biznesu” March 23, 2011, p. 9.

lar and alternative forms of capital investment, rather than long-term, development-oriented investments. Shortening the investments’ time horizon has led to excessive exhibition a group of indicators in economic and financial analysis, taking into account the short-term profitability, over the long-term company’s stability.15

Figure 3. Financialization channels

![Financialization Channels Diagram]


2. The impact of financialization on destabilizing banking sector

The changes, that can be observed with increasing role of financialization at the current level of economic development, cause that this phenomenon is seen as a source of a threat for the stability of the banking sector. Economists, such as J. Tobin and H. Minsky, drew attention to the negative elements of financialization. J. Tobin, Nobel laureate in economics in 1981, states that “[...] more and more resources are invested in financial activity, rather than in the production of goods and services, that generates high private profits, disproportionate to its social utility.”16 Financialization has caused a deepening of information asymmetry when it comes to relations between customer and supplier in the sphere of financial products. Highly advanced financial instruments cause that even credit rating agencies that should – on behalf of other market participants – assess the risk of the instruments, fall victim to information asymmetry themselves. In the perspective of new institutional economics, it includes another threat to the stability of the banking sector. This applies to the spread of rent-seeking, which leads to the violation of fundamental rules of trust between seller and buyer of financial products.

A negative consequence of financialization is also a process of asset securitization, which is an off-balance sheet source of funding for banks to improve the indicators, the releasing costly capital and locating it in the other activity and increasing lending activity, without the fear of failure to meet the capital requirements for credit risk. On the other hand, securitization, as a method of managing banks’ credit risk, may bring a serious threat to the whole sector. Banks are able to increase the level of debt, by increasing the scale of their lending activity. At the same time, credit risk – during the issuance of securities based on credit claims – is not redeemed. It is still in the system. It is only transferred to other entities. Therefore, borrowers’ insolvency threatens to the stability of the whole banking sector.

As a result of financialization is restriction of the role of traditional banking institutions as intermediaries in the capital market and increase the liquidity in financial markets at international level17. Modern financialization of the economy is, in fact, the next phase of searching for new methods how to maximize profits in the money form. Referring to capitalism, in accordance with the economics of John Maynard Keynes, it should be thinking about monetary-commodity economy with the relation of: money (M) → commodity (C) → money (M’)18. Not according to the traditional view, where commodity-monetary economy is defined as the relation of: commodity (C) → money (M) → commodity (C’). Because money is a fundamental element of the modern world, and commodities – only way to increase the money resources.

Manifestations of financialization of global economy are therefore considered as causative factors of modern banking sector instability. These are the reasons that were a direct source of destabilizing the conditions of functioning of the sector. Moreover, their escalation turned into the instability of the financial system, and finally the global financial crisis. These manifestations include: the growing role of “invisible transactions” and the development of the derivatives market. It caused the dissemination of a new form of ownership, with no awareness of being a co-owner, and the ownership, which is not accompanied by any rights and obligations. The derivatives’ owner can be even interested in the bankruptcy of the company (rather than a stability) which activity is a source of creation an instrument, or significant events’ volatility, affecting on the valuation of instruments and the possibility of gaining a speculative rent/profits19. It is estimated that approximately 75%-80% of total financial turnover, on a global scale before the crisis, was related to transactions involving derivatives, which were not accompanied by any flow of goods or finan-

18 J.B. Foster, The Financialization of Capitalism, op. cit.
cial services. Significant role is ascribed to market derivatives, in particular credit derivative instruments (Credit Default Swap – CDS). Especially that, the value of the CDS market in 2000 was close to zero. In 2007, the market was estimated for about 60 trillion USD, while the value of the whole derivatives market for 600 trillion USD. CDS market is considered as one of the indicators to measure the risk of instability in the banking sector because it illustrates by the perception of the credit risk of the issuer. The level of complexity of advanced financial engineering instruments have caused that they became illegible to their customers and difficult in terms of quantifying the risks, that accompanied them, even by their creators or experts (such as credit rating agencies).

The significant role of financialization of the global economic in increasing banking sector instability is also seen in growing importance of financial institutions and their incomes in the economy as well as the scale of financial leverage of their activity (Table 1). In the 80s of twentieth century, banks which were listed in the United States, accounted about 5% of the market capitalization and represented approximately 10% of the profits of all listed companies. In turn, in 2007 it was accordingly 25% and 40%21. In Iceland, where three largest banks (Glitnir Bank, Kaupthing Bank, Landsbank Islands) was nationalized during the crisis, leading to the collapse of the domestic banking sector, the value of banks’ assets in 2008 – on the eve of the collapse – was the equivalent of 10 times the country's GDP. This illustrates the significant role of the stability of the banking market for the Iceland macroeconomic stability.

Table 1. Overview of banks with the highest percentage of total assets in relations to GDP in 2008

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<tr>
<th>Name of bank</th>
<th>Country of origin</th>
<th>Asset /GDP ratio*</th>
<th>Total assets (in bln USD)</th>
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<td>ING Group NV</td>
<td>The Netherlands</td>
<td>2,218</td>
<td>1813</td>
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<tr>
<td>Credit Suisse Group</td>
<td>Switzerland</td>
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<td>1058</td>
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<td>Danska Bank A/S</td>
<td>Denmark</td>
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<td>Dexia</td>
<td>Belgium</td>
<td>1,904</td>
<td>900</td>
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<td>United Kingdom</td>
<td>1,707</td>
<td>2437</td>
</tr>
<tr>
<td>Barclays Plc</td>
<td>United Kingdom</td>
<td>1,412</td>
<td>2939</td>
</tr>
<tr>
<td>The Royal Bank of Scotland Plc</td>
<td>United Kingdom</td>
<td>1,282</td>
<td>2669</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>France</td>
<td>1,042</td>
<td>2824</td>
</tr>
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21 Ibid.
Financialization promotes also so called finance democratization\textsuperscript{22}. The development of markets and financial instruments, and the possibilities which offer the securitization process, allow companies even with very low creditworthiness to use a credit for example for purchasing a real estate, which in turn opens the way to further consumer spending, in connection with increasing the value of the acquired property. At the same time, this is accompanied by a high credit risk

\textsuperscript{22} J. Montgomerie, K. Williams, \textit{Financialised Capitalism: After the Crisis and beyond Neoliberalism}, “Competition & Change” 2009, No. 2.
and the risk of collapse of the banking sector, as a result of the borrowers’ insolvency and the decline in value of the property, which was confirmed by the collapse of the subprime mortgages market in the United States.

The stage of financialization, which led to an intensification of modern banking sector instability, were also the actions of particular countries, disrupting the effectiveness of self-regulation market. It was a restriction of financial markets’ supervision and the repeal of *Glass-Steagall Act* in 1999, which prohibited the banks to combine deposit and lending activities with investments. These changes began the period known as a “deregulation of the banking sector”, and therefore a significant liberalization and the abolition of restrictions imposed on the banking institutions. The countries’ macroeconomic policies contribute to these processes. In the monetary policy, it included too long-lasting very low interest rates policy at the beginning of the twenty-first century, which encouraged to take a credit and excessive indebtedness and at the same time to look for alternative forms of capital investment compared to traditional bank deposits (e.g. investments in mutual funds). Fiscal policy has also caused the increasing of instability. On the one hand, it was related to the tax solutions and the abolition of tax progressivity, which resulted that the richest social group invested their excessive income in financial instruments, rather than additional consumption. On the other hand, it was connected with the borrowing needs of the state in order to finance the budget deficit and public debt. These needs lead to the creation of new financial instruments, based on the public debt.

The deregulation of the banking sector caused the explosion of the global banking market. It has began the process of “conglomeration”, during which big financial institutions has formed, and which engaged in operations on several segments of the financial market (Table 2). This was a situation when Systemically Important Financial Institutions (SIFIs) have been established. Their economic and financial standing started to determine the condition of the banking sector. Financial liberalization was continued by the lack of regulation in the derivatives market – *over-the-counter market* (OTC market), where transactions take place directly between market participants, without the mediation of a third party (the stock exchange), made it impossible to control the market and the real risk assessment, created by these instruments.

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Source: Based on Bloomberg data.
Conclusions

Financialization is considered as one of the main causes of modern banking sector instability. At the same time, not the only one. These problems are stuck in the mechanisms of functioning of modern market economy and its capitalist nature, which is associated with the permanent prosperity idea, often associated primarily with the financial dimension. Moreover, the consequences of financialization cause the evolution of the shape of the modern banking sector and activity of banking institutions. Representatives of mainstream economics – neoclassicals, indicate that financialization of the global economy is only a manifestation of the natural changes, occurring in the market economy, and they do not give a basis to a substantial revision of the paradigms and effects which they cause for the financial system, including the banking sector.

Banking sector is considered to be crucial for the functioning of the financial system. However, with the increase of scale of banking institutions activity since the 90s of twentieth century, and especially at the beginning of new century, banking sector also began to determine the condition whole global economy. It has caused that the instability of modern banking sector, the most severe since the Great Depression, quickly spread to other segments of the financial system, and finally caused a recession of many economies in the world. This illustrates that too fast progressing financialization process, without appropriate control of his transformation of national governments, central institutions – central banks and supervisory institutions, international institutions responsible for financial stability may be a significant source of risk of the financial instability phenomenon.

Reference


“Puls Biznesu” March 23, 2011.


