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Financialization and its impact upon the developed economies

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Summary. Financialization is a multidimensional process that has originated in the developed economies at the beginning of the 1980s. In a broad sense, financialization is understood as a process of autonomization of the financial sphere or even obtaining the supremacy over the real economy. The emergence of an era of neo-liberalism, reflected in the processes of globalization and loosening of regulatory framework, contributed to the fast development of financialization. Financialization has had an impact upon the governance systems in corporations. It resulted in marked change in the goals of managers who became primarily oriented on short-term profits and increase of stock price. Another consequence of this process has been growing interest of non-financial companies in developing financial activity that has started to provide increasingly high contribution to companies' profits. The negative aspect of financialization of company activities has been, in many cases, inadequate investment in tangible assets.

Introduction

The origin of the term "financialization" is not clear. The first usage of it is usually attributed to Philips (1993) who defined financialization as a process of permanent and growing separation of the financial sphere of the economy from its real counterpart. Since the beginning the 1990s the term has been increasingly used throughout the economic literature. In its original and primary interpretation, financialization refers to the transformation of the economic system of developed countries, the essence of which is the dramatically growing role of the financial system. In a broad sense, financialization is understood as a process of autonomization of the financial sphere or even obtaining the supremacy over the real economy. The purpose of this article is to present the key

concepts of financialization and analyze the consequences of it for the economy as a whole as well as for corporations and individuals.

1. Financialization – definitions, measures and causation

Financialisation is a relatively new term, which covers such a range of phenomena that it is difficult to define precisely. Financialization is a complex term, containing several different dimensions and aspects. As a consequence, there is no single definition of financialization. For instance Krippner (2005) looks at the return on financial assets as a rising share of profits of non-financial institutioins. Other scholars analyze the growth of financial service providers since the 1980s with a particular focus on the increasing size of financial services relative to other sectors of the American economy (e.g. Witko, 2016). Others highlight the emergence of a finance culture in the United States as households actively embrace financial strategies as a means to manage their consumption, indebtedness, and saving (Fligstein, Goldstein, 2015). The most-cited definition of financialization comes from Gerald Epstein. He defines it as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies" (Epstein, 2005, p. 3)

In a general sense, financialization refers to the transformation of the relationship between financial markets and non-financial corporations. At the firm level, financialization is "a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production" (Krippner, 2005, pp. 174–175). Additionally, distinction should be made between three main dimensions: (1) financialization of objectives refers to the implementation of shareholder value norms, whose consequence are ane an increase of the financial flows to from non-financial corporation to the financial sector; (2) financialization of investment refers to the increasing share of financial assets owned by non-financial firms; and (3) financialization of operations refers to the development of financial activities and relationships offered to customers and/or imposed on workers and suppliers, by non-financial firms (Baud, Durand, 2011, p. 4).

Most scholars agree the process of financialization started in the 1890s, however Faziano et al (2016, p. 1) put forward a thesis that it started at the beginning of 20th century and can be decomposed to four subperiods:

- since the beginning of the century until 1933, i.e. until the beginning of New Deal program in the US, introduced to overcome the great crisis,
- intermediate period from 1933 until 1940,
- the golden age of capitalism 1945–1973,
- since 1973 until today.

The rapid growth of the financial sector since the 1980s has been the most significant change to the American economy in the post-war period. Over the past thirty years, the share of national income generated by the financial services industry has increased

by more than fifty percent, rising from less than five to more than eight percent of GDP. The US economy was not the only one to experience dramatic growth in financial services. Other countries, including Switzerland, Great Britain, Canada stand out for increasing share of their economies devoted to finance. During this period the financial services sector has grown enormously. This growth is apparent whether one measures the financial sector by its share of GDP, by the quantity of financial assets, by employment, or by average wages. The growth of the financial sector is also evident in the growth of financial claims and contracts, including stocks, bonds, derivatives, and mutual fund shares. Much of the growth of finance is associated with two activities: asset management and the provision of household credit.

Financialization is evident in two broad measures of economic activity (Oatley, Petrova, 2016, p. 4). The most direct measure of financialization is the value added by the financial services industry, i.e. value added by credit intermediation, the management of securities, and insurance. By this measure, the contribution of financial services to the American economy expanded by more than 50 percent between 1980 and 2007. A second and indirect measure of financialization is evident in data on the source of corporate profits. Profits generated by financial activities rose from 20 percent to 50 percent of non-financial corporate profits between 1980 and 2010. Both measures point to the same conclusion: financial activity began a rapid expansion in the late 1970s and the early 1980s. Davis and Kim (2014) note that this growth marks a fundamental discontinuity between the immediate post-war period, which was primarily driven by industrial production, and the current era, in which finance assumes a much larger role.

Typically, scholars argue that financialization has been the consequence of globalization and deregulation (Tomaskovic-Devey, Lin, 2011; Witko, 2016). Thus deregulation fundamentally shifted the basic structure of the economy to favor the financial sector (Tomaskovic-Devey, Lin, 2011, p. 543). The new regulatory framework, designed to reverse the decline in the rates of return to capital that occurred in the 1970s, removed obstacles to financial activity and refrained from regulating new financial products. It has lead to exponential growth of markets for derivatives and other financial innovations. As a consequence, it stimulated financial investment over physical capital investment and unleashed speculation, borrowing, and trading with securities (Witko, 2016, p. 356).

2. Financialization – economic theory perspective

There is a widespread view that the emergence of an era of neo-liberalism and contributed to the fast development of financialization from the beginning of the 1980s (in the dominant capitalist economies). According to Harvey (2005), “neoliberalism is in the first instance a theory of political economic practices that proposes that human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights,

free markets and free trade". The neoliberal theory is rooted in the works of authors such as Fama (1970). Liberalization parallel to globalization opened foreign markets. It meant the elimination of restrictions on the transit of goods and capital. This process was set in motion in the 1980s and is ongoing. This new paradigm gave rise to important transformations in different spheres of the financial sector:

1. The creation of financial assets and capital movements between different countries was liberalized. In addition, there was a progressive substitution of public regulation by the self-regulation of the markets. These factors have encouraged the development and growing complexity of the financial system.
2. Within the business area, the vision of business became more short-term and the approach to incentivizing managers changed, depending more on short-term company results and on the evolution of share prices. Therefore, companies acted consistent with the image they projected in the market, seeking short-term stock market revaluations rather than investments that would bear fruit in the longer term.

According to economic theory attributes there are many benefits to liberalization for those economies that implement it:

- liberalization produces a growth in competition and in the scope and depth of the markets, thereby increasing efficiency and causing a reduction in interest rates, both of which benefit economic growth,
- companies can profit from a greater diversification of risk and from greater possibilities of access to financing,
- financial entities improve their solvency and operations are more transparent.

The negative aspect of liberalism is that it tends to increase instability.

3. Financialization of the economy – impact upon corporate governance

As a consequence of globalization, which has been influenced by neoliberalism and driven by liberalization and deregulation, the economic environment in which businesses operate, experienced a marked change. One of the important aspects of it have been changes in the corporate governance system. Corporate governance is defined as a system through which companies are managed and controlled. As such, it involves a series of relations between the different interested parties in the company and those that manage it, and it encompasses contracts, processes and mechanisms for decision making that attempt to ensure that the management applied in the company by the managers is in alignment with the objectives of the shareholders and other interested parties.

Thus, corporate governance oriented toward protecting the rights of shareholders is reflected in the Principles of Corporate Governance published by the OECD in 2004. It consists of six principles intended to provide the basis for companies to develop good practices of corporate governance. Within the six principles, there is an emphasis on the protection of shareholders, situating them as a collective whose rights must be defended

as a priority. Shareholders are at the center of the ownership structure of the companies because of their right to make decisions based on their vote. Moreover, as their pay fluctuates in accordance with returns on equity, they ask for increased profits from the companies.

This approach to corporate governance favors institutional investors. They invest a big part of the capital they manage in shares and do so following the criteria to obtain increased profits. Therefore, if companies want to count on the support of the shareholders in their shareholder base, they must direct their governance towards the objectives that the institutional investors wish to achieve.

Along with the financial globalization and financialization of the economy, there has been an unprecedented growth of institutional investors that affect corporate governance. Investment funds, pension funds and insurance companies have significantly expanded since the early 1980s, and during the following decades. Institutional investors have a significant presence in the shareholder-base management corporations, thus giving shareholders the power to influence the governance. Because the main objective of financial governance in the financial sector could be aligned with the maximization of short-term shareholder value, and considering the objective of institutional investors, the way in which the alignment of managerial actions was approached evolved in parallel with the main objective.

Following the postulates of agency theory, the administrators to whom owners delegate management are considered to have different interests and perspectives on risk than those of the owners (shareholders). The former are less willing to assume risk because all of their human capital is invested in the company, unlike the shareholders, whose investment portfolios have been diversified. There are many ways to align managers' actions with shareholders' interests. With respect to corporate governance, important are manager incentives, out of which, over the last decades, the stock options are increasingly the most common one. This form of remuneration is intended to commit managers to increase the share market value because doing so will increase their remuneration. In other words, their incentives influence their interest to increase the company's value in the market, which coincides with the goals of the shareholders.

This system of incentives has numerous weakness from the perspective of long-term interests of the companies however it works to the advantage of shareholders and managers:

It did not ensure that the levels of managers' salaries were matched by their performance. In fact they were markedly asymmetrical. When the entity increased its profit, higher remuneration was received by the managers, but when the entity registered losses, this was not reflected by a decrease in salaries. Moreover, immediate results were rewarded, neglecting any evaluation of the risks incurred to achieve them. This has led to greater risk taking by the entities and undue remunerations for the managers.

The system was not properly supervised by the shareholders' general meeting as it was not capable of ensuring that the defense of company interests was guaranteed over the long term (Bratton, Watcher, 2010).

The managers benefitted from an even greater moral hazard than that of the shareholders because they profited from all the rises in stock prices but were not affected at all when the price dropped, as they held options rather than shares.

4. The impact of financialization upon (big) (retail) companies

From the beginning of the 1990s until the first decade of 21st century, leading retailers became highly specialized firms and experts in global supply, production and sales strategies. Despite of that they experienced a slowdown of their growth in domestic markets, Surprisingly, they have generated an opposite, i.e. upward trend in return on equity (Baud, Durand, 2011). Moreover, the share of profit distributed to shareholders reached a historical high in the most recent period.

One way of explaining this phenomenon is internationalization of trade. The late 1990s witnessed a powerful wave of retail internationalization. Leading retailers from Europe and the USA entered new markets, especially in developing countries. This expansion accelerated as the firms experienced a slowdown in their domestic sales.

On the other hand, the end of 1990s marked the beginning of the rise of financial investment by retailers. This shift towards more financial investment to the detriment of tangible investment has contributed to the continuation of a very high fall of the rate of tangible asset from 18% at the beginning of the 1990s towards less than 10% in the 2000s. This evolution towards more financial investment and a slower accumulation of tangible assets is consistent with the literature on financialization, which points out that firms have diverted a growing proportion of their incoming cash flows from investment in fixed capital.

The increasing role of shareholders and the development of a market for corporate control have led to a substantial transformation of management behavior in order to satisfy the cash payments required by impatient financial markets. In essence, the orientation has changed to short-term performance and increasing stock price.

This new behavior is detrimental to real investment in two kinds of mechanisms (Orhangazi, 2008). First, increased payments to financial markets in the form of interest payments, dividend payments and stock buybacks may hinder real investment by reducing internal funds and shortening the planning horizons. Second, increased financial profit opportunities may diminish real investment because firms will prefer to invest in financial assets and activities. Additionally, in a business environment characterized by a high level of uncertainty, the preference for liquid assets tends to increase.

The acceleration of financialization in the first decade of 21st century reflects the long-term strategy of substitution of operational activities and investment by financial activities and investment. In the period of rising markets – as was the case between

2002 and 2007, and between 2009 until 2017 – financial investment offers managers the opportunity to generate incomes and satisfy impatient shareholders. For instance, Sears in the third quarter of 2006 earned more than half of its net income from form risky investments in derivatives.

In the early 1980s non-financial institutions started to develop financial activities that were generating increasingly high profits. For instance, non-bank commercial corporations such as GM, GE, Sears and other big retailers began to create structures that either accepted deposits (money market mutual funds) or made commercial and consumer loans (mortgage finance companies and credit card companies). Financial investments and the development of financial activities have provided firms with new sources of income and profits.

Conclusions

Systemic transformation of mature market economies comprises three fundamental elements: first, large non-financial corporations have reduced their reliance on bank loans and have acquired financial capacities; second, banks have expanded their mediating activities in financial markets as well as lending to households; third, households have become increasingly involved in the realm of finance both as debtors and as asset holders. As a consequence, non-financial companies have become increasingly involved in developing financial activities. It contributed to higher profits, however at the expense of investments in tangible assets and domination of short-term perspective parallel to negligence of long-term strategic goals.

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FINANSJALIZACJA I JEJ WPŁYW NA GOSPODARKI ROZWINIĘTE

Słowa kluczowe: finansjalizacja, neoliberalizm, nadzór właścicielski

Streszczenie. Finansjalizacja jest wielowymiarowym procesem, który rozpoczął się w rozwiniętych gospodarkach na początku lat osiemdziesiątych. Ogólnie finasjalizacja rozumiana jest jako proces autonomizacji sfery finansowej względem sfery realnej czy nawet zyskiwania dominującej roli. Pojawienie się doktryny neoliberalizmu, przejawiającej się między innymi w redukcji poziomu regulacji gospodarki oraz globalizacji aktywności firm, przyczyniło się do szybkiego rozwoju finansjalizacji. Proces ten znalazł swoje odzwierciedlenie również w formach sprawowania nadzoru właścicielskiego (*corporate governance*). Motywatory determinujące zachowania zaczęły kierować ich uwagę na decyzje sprzyjające wzrostowi zyskowności firm i wzrostowi wyceny rynkowej firm w krótkim horyzoncie czasowym. Skutkowało to ograniczeniem, w wielu przypadkach, niezbędnych nakładów na modernizację i rozwój aktywów trwałych. Zyski z aktywności firm produkcyjnych czy handlowych na rynkach finansowych firm zaczęły dorównywać zyskom z działalności podstawowej.

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