The Problems with Financializing the Economy

Dr Liam Lenten
Dr Jan Libich

Scientia

THE PROBLEMS WITH FINANCIALIZING THE ECONOMY

Article written by Dr Jan Libich of La Trobe University and Dr Liam Lenten of the University of Adelaide

While a well-developed financial system can contribute to economic prosperity, if it grows too large or is inadequately regulated it may actually cause more harm than good – adversely affecting socio-economic outcomes and people's wellbeing. This is one of the key conclusions of a recent survey of the literature in which we document the role of the financial system in society's development. We find that the trend towards financialization, observed over the past four decades, has gradually transformed modern finance from 'hero' to 'villain'.

The Financial System

A financial system is the collective set of institutions, instruments and markets that enable the exchange of funds or resources between citizens, companies, and other parties in a specific geographical area, as well as globally. These institutions include banks, insurance companies, investment funds and others; the instruments include bonds and stocks; and the markets are the exchanges where these instruments are traded.

In 2008, the world was shaken by the Global Financial Crisis. Previously little-known terms such as 'subprime mortgage' and 'collateralized debt obligation' became part of conversations at the dinner table for many. The crisis was preceded by a boom in housing prices and was followed by bank failures and a plummeting stock market. It raised concerns about the effectiveness – or ineffectiveness – of the financial system, encouraging academic economists and policymakers to identify its weaknesses and devise strategies to improve it.

Since then, researchers have produced numerous studies identifying and quantifying the pros and cons of the current financial system. A commonly repeated theme was that the financial sector is now leading the economy in the wrong direction and taking advantage of it, rather than supporting its growth and development.

We set out to shed some further light on these issues and assess the unique characteristics, challenges, and shortcomings of the 21st Century financial system, based on a comprehensive review of existing research findings.

Traditional vs Modern Finance

Our paper highlighted the fact that a well-functioning financial system can boost the economy and people's overall financial prosperity. However, when the financial system is over-expanded, excessively leveraged and poorly regulated, both the economy and individuals tend to suffer greatly.

In our review, we made the crucial distinction between traditional and modern finance. Traditional finance includes well-established and long-standing financial services such as retail banking and insurance. They allow people to borrow against their future income, for example, to buy a house or start their own business. They also connect savers and investors, such as enabling a company to invest in and expand production.

Modern finance, on the other hand, is primarily about active asset management and so-called financial 'innovation'. Its main purpose is risk diversification; for example, by holding different types of assets one avoids 'putting their eggs in one basket'. And modern finance is where financialization, a phenomenon initiated in the early 1980s following the deregulation of the financial system in the United States and elsewhere, occurred.

The Oxford English Dictionary describes financialization as: '*…the process by which financial institutions, markets…*

increase in size and influence'. The observed financialization has been associated with a growth in the financial sector's debt, which in the US increased from just over 10% of all debt in 1980 to one-third at the GFC, as well as a boom in speculative trading activity, including high-frequency trading. As another indicator of its growth, the total volume of global trading in all over-the-counter derivatives exploded from around US$100 million at the turn of the century to over six times that figure by the onset of the Global Financial Crisis.

These trends have been moving an increasing proportion of society's resources away from productive activity that actually creates value, and towards largely wasteful activity that merely redistributes value. Our review documents, based on the literature, that excessive financialization tends to lead to a greater cost of financial intermediation, higher unemployment, lower economic growth and increased inequality. Importantly, it also injects a greater amount of systemic risk into the economy, amplifying boom-bust cycles and making financial crises more likely.

As an example, from 1997 to 2006 house prices in inflation-adjusted terms increased by an astonishing 173% in Ireland. Within the 5–6 years afterwards, they came crashing down by more than 50%. As a result, a significant proportion of the Irish population went into mortgage arrears. The Irish stock market also lost almost 80% of its value within a period of 2 years, and the economy consequently experienced a deep and prolonged recession. Ireland's public debt increased from 25% to 120% of GDP over the 2008-2013 period, primarily due to the government's bailouts of private banks that the taxpayer was on the line for.

The global stock market boom during the Covid-19 pandemic, as well as the subsequent major correction in 2022, are also relevant examples of the havoc excessive finance can impose on society. In relation to that, serious concerns for regulators have emerged around the extent that financialization has caused 'financial dominance'. This term refers to the financial system inhibiting central bankers' ability to conduct monetary stabilization without the possible unintended consequence of amplifying the very business cycles they are trying to iron out.

The Way Forward

Unfortunately, the adverse effects of financialization have not been sufficiently discussed and debated in the public sphere, let alone rectified in the policy arena. However, it is not all bad news, as potential reforms exist that could alleviate many of the vagaries of modern finance. An acknowledgment of the global financial system being broken is a vital first step.

In our review paper, we discuss in detail various policy measures that could help return modern finance from villain back into hero. The key is implementation of well-designed global regulation, including cryptocurrencies, because more stringent locally imposed controls tend merely to redirect the perverse financial activities elsewhere, leading to an international race to the bottom. The 'revolving door' problem at financial system regulators also needs to be addressed.

Removing implicit government guaranties to too-big-to-fail financial institutions would reduce the moral hazard issue and systemic risk. Financial transaction taxes should also be applied globally to discourage excessive active asset trading. Other areas of desirable policy reforms include fractional reserve banking, redesigning reimbursement schemes at financial institutions to encourage a longer-term focus, credit rating agencies, market transparency and improving people's financial literacy.

Without robust action, modern finance runs the risk of remaining a villain in perpetuity. Pushing these reforms through is likely to become even more challenging in the future, due to the financial sector's growing influence over politicians and regulators. The time to act is now!

Meet the researchers

Dr Liam Lenten
School of Economics and Public Policy
University of Adelaide
Adelaide, SA
Australia

Dr Jan Libich
La Trobe University
Australia
VSB-TU Ostrava
Czech Republic

Professor Liam Lenten is an Adjunct Senior Lecturer at the University of Adelaide. He holds a BEc from La Trobe University, a Master of Commerce from University of Melbourne, and a PhD in Economics from La Trobe University. Before he started working at the University of Adelaide, he was a Senior Lecturer at La Trobe University for over two decades. Over the course of his career, Dr Lenten has published countless papers and has been interviewed by media outlets as an economics expert. He has also received several important honours and awards, including the Executive Dean's Teaching Award and the 2019 Research Excellence Award from La Trobe Business School.

CONTACT

E: llenten91@gmail.com
W: www.linkedin.com/in/liam-lenten-7744651; https://twitter.com/llenten; https://scholar.google.com/citations?user=L5wAhkcAAAAJ&hl=en; https://www.researchgate.net/profile/Liam-Lenten

Professor Jan Libich has been a Lecturer and Senior Lecturer at La Trobe University since 2005. He is also affiliated with the VSB-TU Ostrava. He received his PhD in Economics from the University of New South Wales in Sydney. Dr Libich is the author of a book on economic policy, co-author of leading economics textbooks and has published over 40 academic papers in economics journals such as the *Journal of Public Economics*. He has presented his research at well over 100 seminars and conferences, including influential policy institutions such the International Monetary Fund and ten central banks. He has also been the recipient of many research grants, honours and awards, for example a Citation for 'Outstanding contribution to student learning' from the Australian government.

CONTACT

E: j.libich@latrobe.edu.au
W: https://scholars.latrobe.edu.au/jlibich

FURTHER READING

J Libich, LJA Lenten, 'Hero or Villain? The Financial System in the 21st Century', Journal of Economic Surveys, 2022, 36(1), 3–40. https://doi.org/10.1111/joes.12437