

# Analysis of Financialization in the Process of Economic Development

Yifei Li \*

Social Science and Public Policy, King's College London, London, United Kingdom

\* Corresponding author: K21092772@kcl.ac.uk

**Abstract.** Economic development is a top priority for the overall development of modern societies today. Since the financial crisis the position and role of financialization in economic development have received increasing attention. This paper begins with different perspectives to demonstrate the expansion financial industry, elevated status and expanding influence of a country. Financialization affects many aspects of our lives, such as the food industry, housing, and higher education. This paper analyses the root causes of financialization from the perspective of money and capital, and the external factors that give rise to financialization from the perspectives of policy, technology, and Internet information. Financialization can have a positive impact on investment and consumption by mechanisms including wealth effects and channel effects. On the other hand, the development of financialization has largely disconnected monetary and virtual capital accumulation from capital accumulation within the real economy, reinforcing the speculative and fragile nature of finance, and thus adversely affecting the real economy. Financialization development should be compatible with real economy development, to avoid excessive financialization causing harm to the real economy.

**Keywords:** Financialization, economic development, market analysis.

## 1. Introduction

Since the global financial crisis in 2008, the impact of financialization on economic growth has received widespread attention from all walks of life. Since the late 19th and early 20th centuries, the modern financial system, consisting of diversified financial institutions and multi-level financial markets, has been evolving [1]. By the 1980s, the development of financialization in the world had become faster and is affecting the economic development of the world today in different ways [2]. Financialization means the expansion of the scope and status of a country's financial industry about the economy as a whole as countries move away from industrial capitalism [3]. It is characterized by, on the one hand, the rising share of financial profits of the non-financial segment in its overall profits and the rising share in GDP of the financial segment's value added [4]; and on the other hand, the rising share of household debt about GDP and the rising share of non-financial corporations' debt about GDP [5]. This means not only that the financial sector, financial institutions, and markets are becoming more visible in our lives, but also that the number and variety of related transactions and participants have increased, while the intersection of finance with the economy as a whole and other social sector has become rich and diverse [3].

Through a systematic analysis, Zhang Sicheng points out that financialisation can be summarized at three levels, firstly, the financialisation of the pan-financial industry at the macro level, secondly, the financialisation of enterprises at the micro level, and thirdly, the financialisation of commodities at the meso level. On this basis, the logic of "financialisation" had three meanings: first, the rapid development of the pan-financial sector and its gradual dominance at the socio-economic level; second, the fact that the accumulation of profits by real (non-financial) enterprises increasingly came from financial channels; and, third, the increasing financial dimension in the mechanism of commodity trading, to the extent that the determination of the price of commodities became increasingly divorced from supply-and-demand relationships in the real trade. Third, the financial dimension of the commodity trading mechanism is growing to the extent that the determination of commodity prices is increasingly divorced from supply and demand in real transactions, and is replaced by the amount of capital entering the corresponding market, and commodities are not traded

as commodities, but rather ownership of such commodities is treated as a financial asset, which is purchased to resell the ownership at a profit, rather than for the use of the commodities themselves [6].

In recent years, the issue of financialization has become a forward-looking research theme in the field of money and finance, and it is intertwined with political economy and sociology, becoming a topic of wide attention from all walks of life [4]. Nowadays, financialization not only has a pivotal role in influencing the development of the overall economy, but also affects many industries and society, and even penetrates the products and industries that are just necessary for people's lives. For example, the food industry, which is a necessity in people's lives, has been affected by financialization. With the help of different financial sectors, financial players are influencing the way food is produced, distributed, and consumed through their involvement in the various segments of the food supply chain [3]. Similarly, housing is supposed to guarantee security and stability in people's lives and should exist as a fundamental right. However, housing is increasingly seen as being viewed as a vehicle for investment and wealth, and the increasing financialization of housing is highly publicized and controversial [3]. In addition, students' higher education has also been affected by financialization. Today, many universities rely more on tuition fees than on state grants to cover their expenses. This has forced some schools to borrow large sums of money and spend it on building high-end campus facilities and equipment and student hostels to attract more potential students [3]. However, this practice not only leads to a constant spike in tuition fees adding to the financial burden of students, but also requires universities to take on a great deal of financial risk. For example, when the economy is in turmoil universities are likely to suffer heavy financial losses [7]. In the financial crisis in the United Kingdom, the University of Cambridge in Iceland in the bankruptcy of two banks lost 8.5 million pounds and 2.5 million pounds, the University of Oxford lost more than 30 million pounds, 12 universities in the United Kingdom in the investment of a total loss of 77 million pounds [8]. These sectors and industries that are closely related to people's lives are affected by financialization more and more deeply, figuring out the financialization of our lives, financialization has become an important trend in the development of the economy that cannot be ignored.

## **2. Causes of Financialization**

### **2.1. Money Capitalisation and Capital Virtualisation**

Financialization is essentially an economic phenomenon highly related to the capitalization of money and the virtualization of capital. This phenomenon is based on monetization. In modern society, monetization is constantly facilitated by the development of the commodity economy, the continuous expansion of the type and range of tangible and intangible products that money can purchase, and the gradual fixing of its purchasing power. Simultaneously, the market for capital is also developing. Money, with its fixed purchasing power, expands production by way of credit. In turn, production expansion and accumulation expansion led to an increase in the generation of money stocks and started to result in a deeper extension of credit money [2].

With the capitalization of money, money capital accumulates and gradually favors virtual capital. Money capital accumulation is the accumulation of both capital and income owned by the accumulator in the monetary form or indirect claims on money, being the accumulation in the price of the market for this kind of claim [2]. Virtual capital is essentially pre-existing claims or certificates of entitlement to future production [2]. The virtual capital accumulation, however, is the cumulative accumulation of monetary claims or certificates for rights expressed as securities, and is the fantasy capital value of the claims, mostly not claims to actual production [2]. As a result, monetary and virtual capital accumulation has facilitated the virtualization of capital, particularly as financial innovations have continued to give rise to a variety of financial derivatives, which have enabled virtual capital to gain an unprecedented status [2].

This economic phenomenon accompanying monetization, monetary capitalization, and capital virtualization is financialization. The essence is that individuals are becoming more and more

possessive and accumulating capital and income both in terms of currency and virtual capital, which are correspondingly shaped by these mediums. Financialization has led to an increasing amount of capital and income taking shape as monetary claims and certificates of property, with the dominant mode for productive capital accumulation gradually being substituted by the dominant mode for financialized capital accumulation, with the consequent formation of self-expanding, self-recycling mechanisms of financialized capital that enable it to make profits through the continuous creation and trading of financial products [2].

## **2.2. Policy**

The beginning of financialization can be traced back to the 1950s, but it was in the late 20th century that the financial sector began to develop in a real sense. The capitalist economy suffered from a crisis of stagflation in the 1970s and was faced with problems of high unemployment and hyperinflation, which dealt a big blow to economic development [2]. To deal with the crisis of stagflation developed countries adopted neo-liberal economic strategies centred on cutting taxes and deregulation. Such policies have facilitated an expansion of both financial activities and the flourishing of financial markets, and have facilitated the emergence and development of financialization. Financial liberalization policies have reduced the restrictions on economic agents' participation in financial activities, creating circumstances conducive to the accelerated development of financial markets and institutions. The government policy of reducing public expenditure has enabled a stronger hand to be played by financial institutions in the delivery of pensions and health services. Economic globalization processes that have opened up capital markets in various countries have also led to the global movement of financial capital, contributing to the financialization of countries worldwide [2]. Meanwhile, neo-liberal strategies, which favored capital over labor, exacerbated the inequality of the distribution of income and severely affected overall demand. Financialization has become a major instrument for solving the issue of total requirement and supporting the execution of neoliberal policies [2]. At the same time, the government deregulated, and even after the 2008 recession, laws regarding how and how much banks could borrow were relatively lax, thus creating further liquidity [3].

## **2.3. Technology**

New financial technologies have impacted the financial industry significantly, driving it to move to the digital age, they have also accelerated the financialization of the industry. Recently financial innovation driven by the Internet has produced large numbers of new models of various types, which are fundamental and disruptive, making them inherently distinguishable from conventional finance agencies [9]. Fintech is a close integration of financial innovation and legal technology to facilitate the transformation of financing methods, usually in the form of disruptive innovation [10]. Financial Stability Board (FSB) defines FinTech as "technology-driven financial innovation that creates new business models, applications, processes, or products that have a significant impact on financial markets, financial institutions, or the way in which financial services are delivered" [11]. Therefore, it can be said that in recent years the new financial industry represented by fintech has led the human society to progress in the era on the one hand, and accelerated the phenomenon of pan-financialisation of the whole society on the other hand.

## **2.4. Internet and Financial Information**

Thanks to the Internet, more people than ever before have access to financial information and markets [3]. Financial informatization means the systematic collection, processing, analysis, and dissemination of information about the financial sector, a process that promotes the development of the financial sector and the financialization of society. In addition, thanks to the rapid development of the Internet, the analysis results of financial information can be released to every corner of the world, and financial transactions break the limitations of space and time so that the global financial industry is mutually beneficial [12]. This means that with the help of the Internet, financial

informatization provides a good growing ground for the financialization of the country and the financialization of the world.

### 3. Impact of Financialization

Financialization has altered the allocation and accumulation of capital and income, which has unavoidably had a big impact on economic growth. Short-term financial innovations allow excess money to be invested, which facilitates the real economy's ability to borrow money from financial markets. The incapacity of businesses to profit from real estate investments, or more accurately, the incapacity of businesses to find enough real estate investment possibilities that meet their profit targets, is a micro reflection of the real economy's stagnation. As a result, businesses started looking for other places to put their money, and an increasing amount of money started to enter the financial industry. Simultaneously, the government faced significant pressure due to the real economy's stagnation, leading it to adopt a lenient or supportive stance towards the inflow of capital into the financial sector. The government implemented numerous financial liberalization policies under the neo-liberal leadership, which guaranteed the development of finance through policy; additionally, when the growth of finance required novel financial instruments, the advancement of information technology supplied adequate guarantees for them. Large amounts of money capital entered the financial industry on the backs of neo-liberal policies and technological advancement, reaping rewards through the financial market's self-expansion process. At the same time, the financial market's prosperity has made it possible for finance to perform its legitimate duties to a greater extent. Many businesses use the financial markets to raise capital for either real or financial investments. Financial market booms can substantially facilitate corporate financing when there are extremely attractive investment possibilities in the real economy. The financial market offers a location for excess capital to turn a profit, and it is simple for businesses to get the money required for actual investment as long as the boom in the market can continue [2].

In terms of consumption, financialization has resulted in the wealth effect of rising asset values on the one hand, and increased credit availability on the other, allowing low-income people to obtain more credit funds. The financial sector has seen significant capital inflows, which have raised the value of assets in financial markets. Households started to progressively move their money into the financial markets and buy financial assets as the financial markets got more alluring. Simultaneously, a significant amount of cash has been drawn to the real estate market, which shares similarities with the financial market. Households have benefited greatly from the financial market's boom as evidenced by the rising prices of their real estate and financial assets as capital continues to flow in. The wealth impact stimulates a rise in household consumption. Low-income groups now have easier access to loans thanks to the financial market development. The clear trend of the financial market's expansion will result in a gradual lowering of the qualification standards for financial institution borrowers, and increased competition among financial institutions will force them to loosen lending requirements to attract new clients. In response to this, low-income populations now have far more access to consumer credit, allowing them to increase their spending. The likelihood of inter-household comparisons in spending has also increased due to the wealth effect of asset appreciation brought on by financialization, which has further widened the wealth and income differences between households that own financial assets and real estate and those that do not. Such comparative spending has been made possible by the ongoing liberalization of credit markets, with low-income groups increasingly borrowing money to buy things [2].

Due to the short-term boost to the actual economy, it provides and the self-expanding characteristics of the financial sector, financialization can be sustained over time. Long-term negative impacts of financialization on the actual economy are, however, also a result of the financial system's tendency to self-inflate [2]. First of all, the financialization process lowers corporate investment in the actual economy. While financial market growth provides resources for genuine investment, it also lessens the appeal of real investment. Businesses began to use more capital for financial investment

since the return on financial investment was higher than the return on actual investment. The increasing cost of capital uncertainty in the deregulated financial market also encourages non-financial businesses to make financial investments that will yield returns in the near term [13]. Enterprise financial investment is expected to rise, which will help investment returns climb even more. As a result, increasing numbers of businesses have begun to make financial investments. Financial institutions' operations eventually grow unrelated to the real economy and are only concerned with financial speculation. Non-financial businesses are also entering the finance and real estate sectors, benefiting from the increase in asset values.

At the same time, the prosperity of the financial market has resulted in the strong position of finance vis-à-vis the real economy and the financial market has exerted increasing pressure on the real economy. Financial institutions have been demanding higher returns and higher real interest rates have raised the cost of capital for real investment. Along with the "shareholder value-oriented" management philosophy and aggressive takeovers in the stock market, enterprises have continued to use funds to buy back their shares and increase dividends to shareholders to maintain their share prices. These have resulted in a steady decline in the funds available for real investment. Due to the availability of financial investment options and the lack of funding, businesses are eschewing long-term returns on actual investments in favor of quick financial gains. Although physical investment is inherently necessary for economic progress, the financialization process has caused businesses to choose financial investment for quick benefits and reduce physical investment. As a result, the process of financialization substantially impairs the economy's capacity to grow over time and is not favorable to the actual economy's long-term development [2].

Additionally, financialization will eventually exacerbate the income disparity, which will be detrimental to the expansion of consumption. First, rather than relying on the accumulation of tangible wealth, the wealth effect caused by financialization depends on the increase in asset prices. In other words, the financialization of wealth has an "illusory" influence on wealth. This illusion can be seen, on the one hand, in the expansion of financial assets without regard to real output, and on the other, in the fact that a significant portion of the appreciation gained through financial assets is a process of redistribution of wealth and income, which makes it inevitable for financial assets to depreciate when a large number of them must be exchanged for real output. Furthermore, financialization increases household borrowing, which ultimately results in a high debt burden for households and boosts consumption among low-income groups. The increasing amount of interest payments that low-income households must make will expand the real income gap between various groups. A significant contributor to the real economy's stagnation is underconsumption, which can be made worse by expanding income disparities. Financialization can boost consumption through asset appreciation and borrowing to make up for the underconsumption brought on by the large income disparity, which is one of the key ways in which it can support the growth of the real economy. However, growing financialization has made the expanding income gap even worse, which has hurt the long-term growth of the real economy [2].

#### 4. Conclusion

The real economy faced significant challenges as a result of the stagflationary crisis that the capitalist economy went through in the 1970s, which was characterized by high unemployment and high inflation. The capitalist economy saw significant changes starting in the 1980s. Financial institutions' profits have increased quickly relative to non-financial institutions' profits, returns on financial assets now account for a larger portion of national income, financial assets now account for a larger share of societal assets, and financial market interests now dominate corporate management goals. These phenomena show how the capitalist system is increasingly becoming financialized.

Through the expansion of financial markets and a rise in consumer borrowing, the financialization process has the potential to both accelerate the real economy's short-term growth and, to a certain extent, resolve its issues. However, because of the financial system's inherent capacity for self-

expansion, as financialization advances, money will continue to flow from the real economy to the financial sector, widening the real income gap, and generally being inimical to the long-term growth of the real economy. The degree of financialization and the circumstances that the real economy sets up for its growth will determine the long-term effects of financialization on the real economy. When financialization becomes too developed in an excessive way.

To prevent excessive financialization from harming the actual economy, the expansion of the financial sector should be compatible with that of the real economy. The real economy serves as the cornerstone for the development of the financial sector, but to some extent, the financial sector can advance of the real economy and control the real economy's effects through expansion and contraction. However, unrestricted financial growth in stark contrast to the real economy will inevitably exceed its carrying capacity and trigger a financial crisis. Financial liberalization is a trend that is being driven by financial globalization in all nations of the world. However, because real economic development requirements vary from nation to nation, the effects of globalization will be uneven across all nations. The same level of financialization might be good for developed country economies but bad for developing country economies. Therefore, to prevent an excessive development of the financial system in isolation from the real economy, which would reduce the accumulation of real capital and increase the risk of financial crises, the development of financial institutions and financial markets should be cautiously encouraged based on the specific conditions of the development of the real economy.

## References

- [1] He L. History of world finance: from its origins to the formation of the modern system. China Finance Press. 2022.
- [2] Chen X. Guo Y. On financialisation and its impact on economic development. Learning Forum, 2017, 2.
- [3] Charles P. Financialization: Definition, Examples, Consequences and Criticisms. Investopedia. 2021.
- [4] Crotty J. The neoliberal paradox: the impact of destructive product market competition and 'modern' financial markets on nonfinancial corporation performance in the neoliberal era. Financialization and the world economy, 2005, 1: 77 - 110.
- [5] Foster J. B. The financialization of capitalism. Monthly review, 2007, 58 (11): 1 - 12.
- [6] Zhang S. The Logic and Rethinking of Financialisation. Economic Research, 2019, 54 (11): 4 - 20.
- [7] Hou D. Li M. Higher education in countries amid the financial crisis. Research on Education Development, 2009, (3): 13 - 17.
- [8] Anthea Lipsett. Oxford May Lose £30m Tied up in Icelandic Banks. <http://www.guardian.co.uk/education/2008/oct/16/universityfunding-oxforduniversity>.
- [9] Yang D. RegTech: Regulatory Challenges and Dimensioning of Fintech. Social Sciences in China, 2018, 5: 69 - 91.
- [10] Chiu I H. Fintech and disruptive business models in financial products, intermediation and markets-policy implications for financial regulators. J. Tech. L. & Pol'y, 2016, 21: 55.
- [11] Board F S. FinTech: Describing the landscape and a framework for analysis. 2016.
- [12] Cai M. On the Impact of Financial Informatization on the Financial Industry. Economic Horizon, 2013, 16.
- [13] Krippner G R. Capitalizing on crisis: The political origins of the rise of finance. Harvard University Press, 2011.