Financialization Impacts on Economic Equality

Financialization is a trend in which risky financial markets, rather than just financial institutions, make up a significant percent of GDP. Analysts believe this trend is contributing to growing economic inequality.

The financial industry is powerful. The industry includes financial institutions, financial markets, insurance companies, real estate investors, and the wealthiest individuals. Their policies and actions determine things like the direction of the flow of money, the amount of investments in employment growth, the abilities of businesses to startup and grow, and the growth or stagnation of the economy. All of these impacts add up in a way that determines the amount of economic inequality a country experiences. The emerging trend is continued growth in "financialization" in which risky financial markets control wealth, raising deep concerns about the full economic impact of a growing imbalance between a production economy and a financial market.

Shifting from Production to Financial Economy

Nine years after the start of the 2008 financial collapse that triggered a recession, banks and mortgage companies are still settling with the U.S. government. The high risk financial activities, like the buying and selling of mortgage derivatives through financial markets, created economic havoc. It also brought to light financialization in which financial markets and risky financial activities are contributing a larger share to GDP. Despite the creation of the Consumer Protection Agency and regulatory crackdowns designed to discourage these risky activities, financial markets continue to grow and are now estimated to account for 20 percent of GDP in the U.S. The companies making up the industry continue to earn billions in profits, and government settlements for violating laws and regulations are easily paid and shrugged off.

Financialization is the term for the shift from a production to a financial economy in which the financial industry, especially financial markets, gains greater influence over economic outcomes and in the functioning of capitalism. The financial companies and markets control much of the country's capital or wealth and use it to fuel the economy but mostly to drive the greater accumulation of wealth for a small minority that includes top corporate leaders, investors and shareholders, and not all stakeholders. While financial companies and wealthy private individuals are earning enormous surpluses through risk-taking investments,

they are also limiting the ability of businesses to provide goods and services at prices that consumers can afford through wealth control. This creates sluggish consumption leading to a sluggish economy.

When a set of people and companies can control money flows, they have an almost monopolistic power. A good example are small businesses interested in expanding capacity but unable to qualify for bank loans at the same time the lenders are investing in risky financial markets. This gave rise to peer-to-peer lending and crowdfunding in an attempt to bypass the traditional financial institutions. Banks determine how much money flows to businesses. Mortgage companies determine whether people can buy houses or other large assets. There are ongoing arguments for and against financialization, but many experts believe the trend harms the economy and increases economic inequality in several ways.

The Wealthier Get Wealthier

First, large non-financial businesses have been taking on debt rather than issuing equity, and using profits to buy back stock. This raises the return on equity through a reduction in outstanding shares rather than through increased or more efficient production. Since corporate executives are paid with salary and stock, they get wealthier while employee wages stagnate. Employment is reduced in order to drive stock prices up. Wall Street and top executives benefit and income inequality increases. People buy less and pay fewer taxes which in turn impacts the ability of the government to invest in infrastructure improvements. In general, economic growth is held back, perhaps as much as 3-4 percent. In the meantime, financial firms created highly liquid products requiring high risk taking, like options and derivatives, and are not investing in economic growth. They are speculating on short-term returns in order to grow profit, rather than investing in in long-term economic growth. Investments in intangible assets without fixed prices also lack transparency because they make it difficult for government regulators to monitor and makes it easier for insiders to profit.

One of the many issues in this complex problem is government's role in providing incentives for risky investments. The "too big to fail" mantra is really about a government underpinning of support in which financial institutions know they will be bailed out should they get into financial trouble. The government did assist many homeowners who faced foreclosure on their homes, but millions also lost their homes before programs were set up. The reason was financialization in which mortgages were sold as securities in financial markets rather than held by mortgage companies until they were paid off. The financial companies promoted household debt as a way to improve a standard of living despite stagnating wages. In the meantime, most financial firms survived and eventually thrived again by raising fees and resuming risky behaviors.

Opening a Closed Loop

People were surprised when the market meltdown in 2008 did not slow down financialization. The industry members continued to report even higher profits. The income gap between people at the top of society and those at the bottom continued to widen because those at the bottom could not accumulate capital or fully participate in the economy. The financial industry has also extended its reach into developing and underdeveloped economies which moves capital out of the U.S. and into foreign countries. While this may provide some benefits to the needy economies, it also means that governments have less ability to regulate their economies. Countries attracting foreign investors have improved economic fundamentals but at the cost of higher interest rates, slower economic growth and increased vulnerability to changes in international financial markets.

Currently, it is estimated that only 15 percent of market system money makes its way into the "real economy" or production economy. Should financialization continue to grow, more money is kept within a closed loop of financial markets and out of the general economy that benefits the workforce in terms of employment, wages and investments. It has also spawned predatory business like payday lenders, excessive student debt and insurance companies selling policies with little real value to policyholders, like policies on young children. Wall Street has earned a reputation as being greedy, and financialization is one reason for the description.