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The Importance of the Financial Sector and Its Impact on Economic System in the United States in Years 1970–2010

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Abstract: Capitalism is an economic system which is subject to dynamic and continual changes. In the history of market exchange of goods and services a few of factors can be enumerated which had considerable influence on the whole socioeconomic system. These include the industrialization of the production process, the introduction of the production line, the growth of international trade and the information revolution. Financialization of economy is another factor that has a huge impact on today's capitalism. A huge increase in turnovers value on the financial markets has been observed since the early eighties. Already in the early nineties the whole financial sector, together with financial corporations, became very significant in the American economy. That was when the profits of the financial sector exceeded the profits of the manufacturing sector. This article is based on the descriptive method and presents the growth of relevance of financial sector in the United States of America which took place in the years 1970–2010. This phenomenon has a huge impact on the contemporary capitalism. The author strives to answer the following question in the recapitulation – what is the impact of the changes described above on the efficiency and competitiveness of the whole socioeconomic system?

Introduction

"Speculators may be harmless when they are like the foam on an even stream of enterprise. But the situation becomes serious when enterprise should be a foam at the vortex of speculation. When the country accumulation becomes a byproduct of the gambling, the results are always devastating. The success of Wall Street as an institution whose proper social purpose is to track

the management of investments on the highest future profitability can not be truly considered as one of the outstanding achievements of liberal capitalism" (Keynes 1956, pp. 202–203). This is probably the most frequently cited excerpt from John Maynard Keynes's works which conveys his worry about the future of capitalism. The increasing importance of the financial sector worried Keynes as early as in the mid-thirties of the 20th century. The source of his concern was the attitude of people and institutions which contributed to the increase. The stock exchange and financial markets, besides investment capital delivery, already then had high speculative potential. The danger of stock mentality proliferation and the threat of permanent destabilization of the global economy convinced J. M Keynes of the necessity of global financial market adjustment. It resulted in the foundation of adjustable exchange market system in Bretton Woods (Kowalik 2005, p. 43).

The Bretton Woods system was the proper solution in contemporary circumstances. The objectives which it set, i.e. the international stability and full employment in the members countries, were fulfilled. "By imposing that constraint in the context of a system of reasonably symmetrical reserve constraints and an expectation that countries would aim at full employment, Bretton Woods contributed significantly to the stability, and therefore to the longevity, of the post-war boom" (Williamson 1985, p. 78). The depletion of the potential for further working of adjustable exchange market system from Bretton Woods came at the beginning of the seventies of the twentieth century. As a result, there was broad liberalization of international economic relations, and thus, assignation of exchange prices shaping to global markets.

The release of exchange rates and general liberalization of international economic relations has led to the increase of importance of the financial sector in modern economies. This increasing importance is so large that it has changed its character, which greatly influences the whole modern economic system. J. Żyżyński writes: "(...) the last decades of the twentieth century, since the collapse of the Bretton Woods system, were the period with numerous crises of a different character, in fact caused by the financial markets which had become a special sector of the world economy, characterized, on the one hand, by the obvious nervousness, and on the other hand – by successive pressures on the alienation and acquisition of dominance over the real sphere" (Żyżyński 2006, pp. 527–528).

This dynamic and significant change in the economic system raises questions about its validity and consequences. The aim of this paper is to estimate the growth of the financial sector in the United States between 1970–2010 and attempt to determine its impact on the working of the U.S. economy. It seems to be a very important issue in today's world because many authors argue that the recent global crisis was caused by the financial sector.

Financialization – the notion

Several terms have been used to refer to the phenomenon of a significant increase of the financial sector in the economy. One of them is financialization which is used by J. Żyżyński and determines the “overproportional growth of the financial sphere” (Żyżyński 2009, p. 172). T. Kowalik argues that this phenomenon is not financialization but financiazation[1]. He says, however, that both definitions are not adequate to the phenomenon described here. He claims that the problem is not only the rapid growth of the financial sector but also the instability of contemporary economies (Kowalik 2009, p. 70). Kowalik argues that the best notion for today’s capitalism is “casino capitalism”. It includes the increasing influence of spectacular and unrestrained growth of speculative capital” (Kowalik 2005, p. 45). The American enterprises concentrate on short-term horizon of acting. They focus on stock operations and the current account. It is called short-termizm, and this is the main allegation towards American enterprises. R. Dore perceives the whole issue more widely. He writes about “marketization plus financialization” as processes typical for the twentieth century American economy (Dore 2002, p. 3). All of these concepts relate to the increasing scope of the market and the growing importance of the financial sector in today’s economy. In order to convey contents of that notion and understand the aforementioned phenomenon, it is worth citing J. Toporowski’s sentence: „in an era of finance, finance mostly finances finance” (Toporowski 2003, following: Kowalik 2005, p. 45).

It is not the aim of this paper to settle which of the above-mentioned terms best reflects changes taking place in capitalism. However, due to the presence in the English literature, the term “financialization” will be used hereafter in this work.

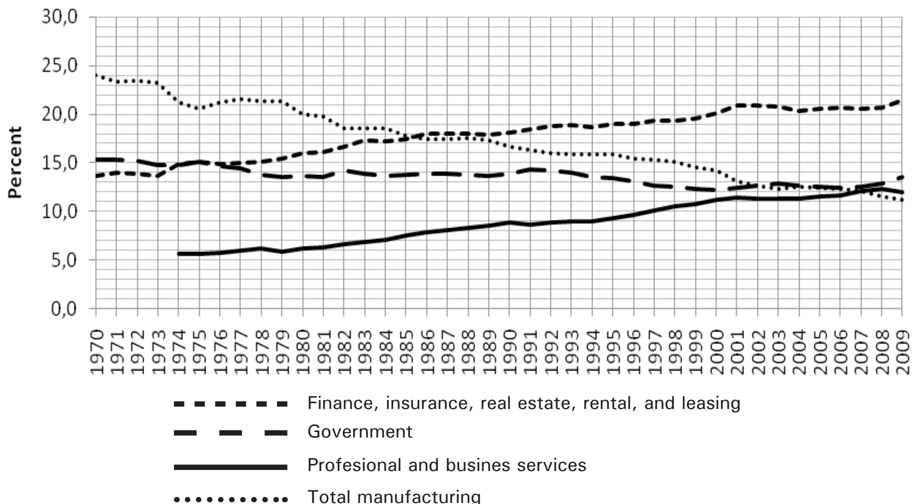
Financialization of American economy – manifestation

Already at the beginning of the nineteenth century, Werner Sombart claimed that “all over the world there is no other country where the masses would be so drawn into the speculation mode as in the United States, there is no other country where people would benefit from the capitalism fruits so commonly” (Sombart 2004, p. 39). But the real boom in the development of financial markets occurred later, namely when the deregulation of trade and capital flows in the seventies and eighties.

[1] Polish: *finansjalizacja* (Kowalik 2009, p. 70).

The process of increasing the importance of the financial sector in the U.S. economy has real symptoms. One of them is the share of the widely understood financial sector in the gross domestic product over the past 40 years. Figure 1 shows the four industries of the U.S. economy with the highest share of GDP in 2009. There are: 1. Finance, insurance, real estate, rental, and leasing; 2. Government; 3. Professional and business services; 4. Manufacturing[2]. The widely understood financial sector steadily increased its share in the United States GDP. In 1970 it amounted to 13.7% in 2009 – 21.5%. At the same time you can see that those industries for which the financial sector should be a source of capital, had an increasingly smaller share in GDP generation. The share of industrial production dropped from 24% share in 1970 to 11.2% in 2009.

Figure 1. Percentage share of selected economic sectors in GDP in the United States in years 1970 – 2009 (in current prices)



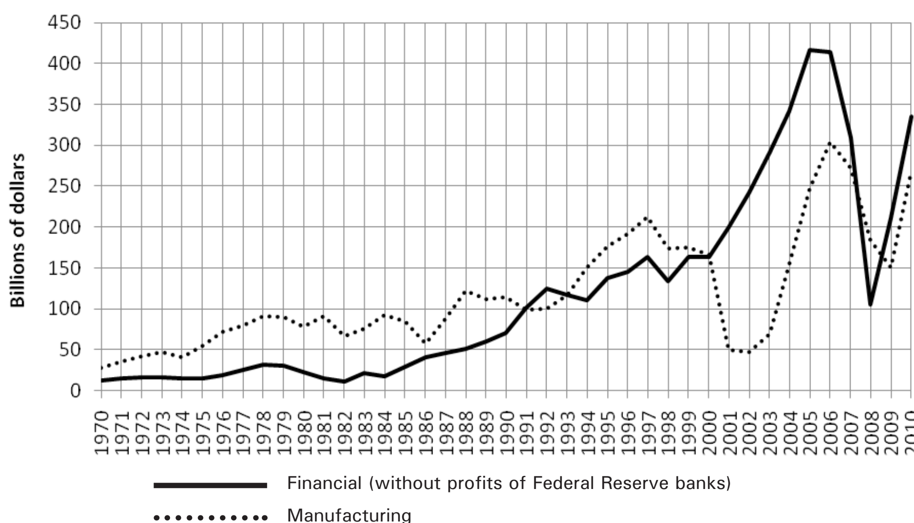
Source: own study based on Economic Report of the President, 2004, 2006, 2001.

Figure 2 provides similar conclusions as the previous one. It presents the profits of enterprises in the financial sector and corporate profits in the industrial

[2] The secondary sector comprises data both for durable and non-durable goods. Other industries are: wholesale trade; retail trade; transportation and warehousing; information technology; educational services, health care, and social assistance; arts, entertainment, recreation, accommodation, and food services; and other services, except government.

sector. In the early nineties, for the first time the financial sector generated higher profit than the industrial sector. Since 2001, when financial firms produced a profit of 199.1 billion dollars, and industrial enterprises in the amount of 49.7 billion dollars, the financial sector almost always (except for 2008) earned higher profits than the industrial sector. The financial sector returned 334.6 billion in 2010, and its profit was higher by almost 25% than that obtained by the industrial sector.

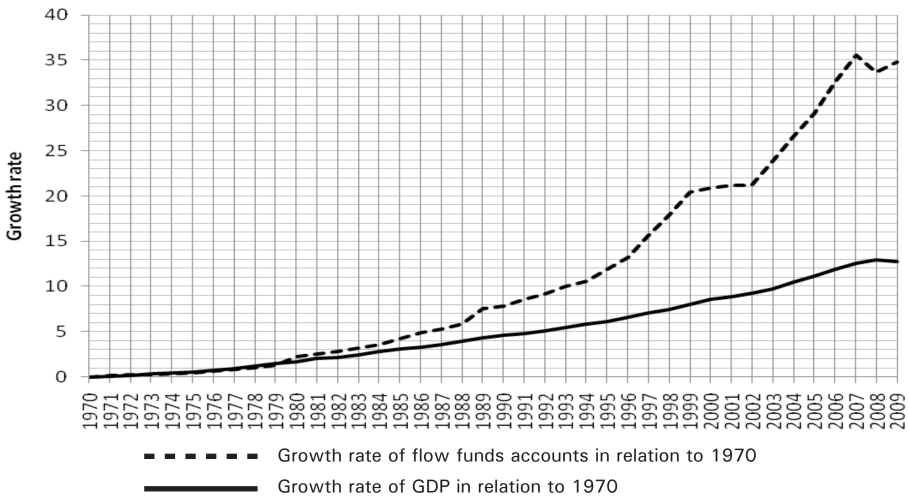
Figure 2. Corporate profits of the financial sector and industrial sector obtained in the years 1970–2010 in billions of dollars



Source: own study based on Economic Report of the President, 2011.

Figure 3 shows, in turn, the growth rate of value of financial assets flow and the rate of GDP growth compared to 1970. At that time there was an disproportioned increase of financial assets flow value in relation to GDP. The value of financial assets increased by nearly 35 times, when the GDP grew only by almost 13 times.

Figure 3. The growth rate of financial flows in the American economy and the GDP growth rate in relation to 1970, in billions of dollars in the years 1970–2010



Source: own study based on Statistical Abstract of the United States (various yearbooks).

Table 1 shows another phenomenon in a shorter time horizon, which indicates an increase in the financial sector. It presents the nominal value of the transactions of options and instruments such as futures deliveries in the past twenty years. The first column shows the nominal value of transactions in 1990 and in the years 2000–2009. The second column shows the growth rate of the value of the transactions. At its peak, i.e. in 2008, the value of the options and futures instruments transactions were more than 46 times higher than in 1990[3]. The phenomenon accelerates significantly in 2004 (an increase of 76% compared to the year 2003).

[3] Nominal GDP increased over this period of less than 1.5 times.

Table 1. The transaction value and the growth rate of the options and futures deliveries transactions value

Year	1990	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Transaction activity in option exercise and futures deliveries (in billions of dollars)	48	233	224	209	282	495	995	1611	2211	2264	1574
Growth rate of option exercises and futures deliveries in relation to 1990	-	3,85	3,67	3,35	4,88	9,31	19,73	32,56	45,06	46,17	31,79

Source: U.S. Census Bureau, Statistical Abstract of the United States (various yearbooks).

Table 2. The growth rate of average number of shares trading on the American market and the value of shares on sale on the Chicago Board Options Exchange

Year	1976	1980	1985	1990	1995	2000	2005	2009
Growth rate of average daily shares in relation to 1970	0,83	2,87	8,41	12,52	28,83	88,83	175,81	251,50
Growth rate of sales of stocks on Chicago Board Options Exchange in relation to 1975	0,50	3,67	5,33	12,50	16,83	54,00	51,33	110,17

Source: U. S. Census Bureau, Statistical Abstract of United States (various yearbooks).

Table 2 shows the growth rate of the average daily number of shares which were traded on the New York Stock Exchange and the growth rate of sales value on the Chicago Board Options Exchange. Both of them indicate dramatic rise in relation to the base year, as well as the growth rate of U.S. GDP, as shown in diagram 3. The average daily number of traded shares on the New York Stock Exchange was more than 250 times greater in 2009 than in 1976. The growth rate of sales at the Chicago Board Options Exchange in 2009 was over 110 times higher than in 1975. The rate accelerated significantly in the last decade

Where's the problem?

According to the definition, a crisis in the United States ended with the beginning of 2010. "However, this is an intellectually and politically unacceptable

simplification to identify the contemporary crisis with the temporary drop in production. [...] Unfortunately, the crisis continues, it goes far beyond the narrowly understood area of reproduction (Kołodko 2010, p. 117). Kołodko argues that the sources of the crisis resides in the financial sector and its isolation from the real economy.

Why would the overdeveloped financial sector be harmful to the economy? Because the internal feature of the financial market is great opportunity to speculate. The financial sector is an essential element of the developed capitalist economy. Its overgrowth, however, causes the situation in which instead of being a provider of capital and mechanism by means of which the market makes optimal allocation, it has taken care of itself. The turnover and operation in financial markets have become an aim, not the means to develop real economy.

The theory says, quite extensively, why the financial markets may be harmful to the whole economic system. It lists seven key manifestations of market failures in financial markets (Stiglitz, Jaramillo-Vallejo, Yung Chal Park 1993, pp. 4–9):

- monitoring – there is a common requirement to ensure reliable information about the solvency of financial institutions and information about the management of these institutions;
- externalities of monitoring – there is possibility of negative externality between lenders;
- externalities of financial disruption – the entire economic system bears the costs of disruptions of the financial system;
- missing and incomplete markets – for example the prevalence of credit rationing;
- imperfect competition – limited competition in the banking sector in most countries;
- Pareto inefficiency of competitive market - complete set of markets, and exogenous information are not always achieved assumptions;
- uninformed investors – (it is not a market failure in a formal sense) requirement to disclose information about products.

This is the theoretical basis for explaining the financial markets failure. They show the inevitability of improper operation of financial markets.

The ideology which is to blame for bringing about the changes, which consequently leads to a disproportionate increase in the financial sector, is neoliberalism. Kołodko writes: “In the value sphere, neoliberalism leads to looking at almost everything from a financial perspective, because under that doctrine, it is advisable and worth trading in everything that can be profitable, also expectations” (Kołodko 2010, p. 121).

Conclusions

Financialization of the U.S. economy is not an isolated phenomenon. This process involves the whole world, not only the developed economies. Therefore, the solution called for by various economists refer to the whole world, not only to the economy of the United States or other individual countries.

The literature describes frequent attempts to fix the systemic errors of neoliberal policies which can be described as ideological because their prescriptions are referred to way of thinking and understanding of economic phenomena. Kolodko proposes the new pragmatism and new state intervention, consisting in an interdisciplinary approach combining cultural, geographic and historical science, management science and the science of networks. He says that it is necessary to abandon all attempts at universalistic conception of growth seeking which could be applied in all countries and would give guaranteed results. Based on common knowledge from economic history, geography and culture of the area (country) it is necessary to formulate pragmatic and individual solutions for each country separately (Kołodko 2008, pp. 315–318).

The solutions formulated by other economists can be classified as macroeconomic solutions, since they call for holistic, global countermeasures, such as the creation of international institutions to enable global coordination of economic policy. It would be a top-down reform of economic systems through global institutions and agreements. Joseph Stiglitz is proponent of such changes. He advocates for the regulation of the financial system and bank system to protect ourselves against enormous force of destabilization which is carried by the "hot money" and against macroeconomic instability exported to other countries (Stiglitz 2006, pp. 210–212). Dariusz Rosati also postulates more oversight and regulation to the financial system (Rosati 2009, p. 349). Kaczmarek claims that introduction of global bank or international monetary system to regulate global market could be necessary (Kaczmarek 2009, pp. 183–190). It should be noted that there is a considerable distinction between regulations and restrictions (constraints) of the financial market. It is not about obstruction of access to financial markets, e.g. to limit competition. The necessity to intervene in the financial sector steams not always from positive effects which the increase of the financial market could induce in the real economy and its inherent weaknesses (Honohan 1992, for Kulawik 1997, p. 710).

In conclusion, we should pay attention to another possible solution to the problem which can be considered as microeconomic. The microeconomic solution - because it would result from the competitive mechanism. Apparently, the issue of property rights is appropriate to the regulation of financial markets. The regulations prescribed by the theory of property rights do not restrict competition but set tough rules that enhance competition. As a result

the situation on the market is more predictable. The introduction of regulations consistent with the theory of property rights was not introduced by the international rounds of negotiations because it wasn't necessary to persuade countries to implement them. As soon as it was noted that the implementation and observance of property rights is beneficial for the economic development, their introduction has simply become favorable. There may be a similar situation with financial market regulations - if the regulation of financial markets leads to greater stability of economic system that serves the real economy, bringing them to life may simply be beneficial.

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