

**Introduction**

Banking, whatever its form may be, is an integral part of economic activities since the classical ages. However, during the course of the time, the methods and techniques of this industry has become so developed and sophisticated that banking is an indispensable part of not only firms but also all individuals in modern times. The most important feature of banking in the 21<sup>st</sup> Century is, although financial services seems in the heart of the economies, their disassociation and independence from the industrial capital. Hilferding ([1910]1981) defines this era as financial capitalism. This sophisticated structure of banking and financial services are the main source of rapid development of industrial countries in the one hand, and also the biggest financial and following economic disasters in these countries on the other. The big crash of 1929 originated from a big collapse in the Wall Street. Additionally, the last crisis of 2008 began with a meltdown in financial assets in the US and the UK. Experiences in the last three centuries show that uncontrolled and unregulated financial institutions may give more harm to their hosting economies than the wealth they created by their complicated techniques and instruments.

Probably the most important transformation in the last century is the turning industrial capitalism to financial capitalism (Dembinski, 2009). Gilpin (2001) also identifies industrial capitalism after the 30 years following the World War II. Financial capitalism begins to take the place of industrial capitalism in the middle of the 1970s. Although financialization exists in both financial and industrial capitalist periods, it changes its patterns in the mid 1970s. During the Post World War II era, financialization mainly funds the development projects both in the US and war weary Europe. In this era, financialization coexists with industrial capitalism. With Hegelian terminology, it exists in itself within the industrial capitalism. However, beginning with mid 1970s, in the Carter and Reagan administrations namely, financialization enters an era which exists for itself. This character of financialization becomes more visible in the second term of President Reagan (Tarhan, 2015). Therefore, an assessment of financialization requires first to distinguish in and for itself periods of this process, and then to evaluate the capital flows between the developed core and the developing periphery. Locating

the sources of financial needs or disabilities of developing countries also consists of an integral part of these analyses to understand the feasibility of financialization, and shadow banking for these countries.

## **1. Securization and Financialization**

The two big crashes of 1929 and 2008 occurred in and around the financial services. The most blamed parts of these financial services during the crises are securization and financialization operations. Unlike the 1929 crash, these two kinds of operations of financial services are organized under an unofficial framework of shadow banking in the latter crisis. Having created a more wealth than the real economy can afford, during the economic booms the shadow banking system is not the main source of complaints. However, when the events go wrong and economies face with contractions shadow banking worsens the situation by even more contractions and bankruptcies in financial services. Therefore, the purpose of this section is to define main characteristics of securization and financialization.

### **1.1. Securization**

The simplest form of securization is to issue securities in financial markets in order to raise debt (Feeney, 1995). This is the primary securization and banks' balance sheets are not affected by these operations and they reestablish their financial statements in a more liquid form. Consequently, by selling securities banks enhance their liquidity levels and continue their lending processes. Otherwise, they had to raise their liquid funds by increasing their deposit portfolios which is over dependent on non bank economic conditions such as marginal propensity to save of their customers.

Securization is one of the financial innovations used by banks to improve their financial abilities alongside the certificate of deposits (CDs), money market mutual funds (MMMFs), and repurchase agreements (RPs or Repos) between the 1960s and 1990s (Sevic, 1999). However, this era has not witnessed a major global economic catastrophe stemmed from the financial services due to the effective regulations over the banking industry in the US and the UK, with the exception of

savings and loans crisis in the US. On the other hand, the provisions of securization provided necessary tools for a bigger form of this process in the structure of financialization during the 1990s and 2000s which brought the great meltdown of 2008.

## **1.2. Financialization**

The base of the financialization is secondary securization. Banks realize secondary securization by holding their existing loan assets in a pool and turn them into securities, and sell them to investors in capital markets. By these transactions they remove asset from their balance sheets (Feeney, 1995). Financial industry has invented indigenous tools in order to create more liquidity in the financialization process. Therefore, financialization is in fact a generalized form of securitization, and inevitably coexists with globalization (Lavoie, 2013) as the domestic markets reach to their consuming limits. Due to its almost limitless liquidity creating capacity, financial industry overshadowed the industrial capitalism during the 1990s and 2000s, and caused a massive deindustrialization in the US and the UK. Thus, with this transformation, the financial sector of the US and the UK divorced from their long term companion, the commerce and industry, and turned into an existing for itself entity (Giron and Chapoy, 2013).

The primary innovative products of financialization process can be sorted as asset-backed securities (ABS), mortgage-backed securities (MBS), residential mortgage-backed securities (RMBS), asset-backed commercial paper (ABCP), credit default swaps (CDS), and collateralized debt obligations (CDO) (Gorton and Metrick, 2009). The most distinguishing feature of financialization shows itself in operational and legal realms. As a rule, these securization transactions are realized outside the regulated traditional banking system, and this system is called as shadow banking. The whole process of financialization can be expressed as the domination of a financial markets and institutions over the real economy. In the end, this domination transforms the whole economy from industrialization to financialization (Palley, 2007). As a consequence of this process, beginning with the early 1980s, the US economy turned into a consumption driven economy.

However, much of the US consumption has been financed by an unsustainable debt burden of its consumers during this epoch (Hein and Truger, 2013).

## **2. Shadow Banking in The Developed Core**

The legal systems of the US and the UK provide almost limitless contract opportunities for individuals and firms. In addition, with Glass-Steagall act in 1933, the US authorities broke the ties between the banks and securities firms, and created legal privileges for the latter by keeping them outside the official obligations of traditional banks. Securities firms, or investment banks in other words, are monitored by the US Securities and Exchange Commission (SEC) from 1934 onwards. However, SEC's monitoring has not created much effect over the transactions realized by the investment banks due to the non-breakability of mutual and/or multilateral contracts under the provisions of the Anglo-Saxon legal code. Consequently, almost all shadow banking transactions have been realized with special legal entities known as special purpose vehicles (SPVs).

### **2.1. The Structure of Shadow Banking**

SPVs are legally created firms in order to perform certain financial activities and contracts in the form of securitization. SPVs are almost fictitious bodies which have no spatial entity or personnel. They are controlled by sponsors or the agents of the originator firm. Because of their legal nature, they are immune to the bankruptcy and taxation (Gorton and Souleles, 2005). In this system, banks provide credits to their customers and receive deeds against these transactions. In the second stage, banks transfer these loans to SPVs, and receive securitized bonds and cash. In the third stage, SPVs sell these securitized bonds to MMMFs, and receive cash. MMMFs sell these securitized bonds to their retail customers as shares. MMMFs hedge themselves against the probable losses with repos. In order to do that MMMFs deposit certain amounts in initiating banks and receive assets as collateral (Gorton, 2010).

## **2.2. The Outcomes of Shadow Banking**

Main purpose of the Glass-Steagall act was to break the banks' ties with the securities markets in order to prevent banking industry from putting their customers' money in risky investments. During this regulation primary cash sources of the US banks were deposits. The only remaining area for the US banks in order to attract more deposits was to make innovations in these accounts such as checking accounts or NOW (negotiable order of withdrawal) accounts. On the other hand, the rapid growth of financial markets during the Carter and Reagan administrations forced later administrations to remove the barriers between banking and capital markets. This barrier was finally removed during the Clinton administration with the Gramm-Leach-Bliley Act in 1999. Consequently, after having suspended over a century, interrelations with commercial and investment banks were re-established (Adrian and Shin, 2009). These newly implemented ties not only gave the way for big scale shadow banking, but also shifted the financial hub from banking to capital markets. Taking into to the account of unlimited freedom in individual contracts and the absence of government intervention, the shadow banking system can be considered as the purest form of capitalism.

## **3. Shadow Banking and The Developing Semi-Periphery**

For itself stage of the developed countries' financialization goes parallel with the developing world financialization. Since the lack of regulations or proper control over shadow banking activities in the US and the UK, the mass volume of funds created by financial services are also uncontrollable. Therefore, the primary role of financialization in the semi-periphery is to create a niche for the surplus or shortage of the developed core's funds (Tarhan, 2013). Consequently, beginning with the early 1980's, developing periphery becomes more vulnerable to the destructive effects of sudden capital in and outflows.

### **3.1. The Spread of Financialization Through The Semi-Periphery**

During the Cold War period allies of the US and the other developing countries in the Western bloc have been financed directly by the US government or its

agencies. Most important element of the aid system has been the military assistance of the US government. In this period developing countries were heavily relied on the cheap military surpluses of the US army, so that they could restricted their scarce funds to development projects. However, with the Reagan administration, these transfers have come to an end, and consequently developing countries have had to allocate more shares for their defense budgets. This process has made them more deprived for foreign funds to finance developmental projects (Tarhan, 2014). The end of government to government loans and military aids has made developing countries involuntary customers of the international capital markets. Therefore, 1980s are the settlement years for emerging economies with international capital markets.

Due to the lack of adequate domestic capital markets and legal framework, most emerging country banks realize their securitization operations in world financial centers with big investment banks. Dramatically, in many cases, the assets controlled by these investment banks are far larger than the applying countries' annual GDP. Therefore, terms and conditions of these dealings are subject to the more powerful party's will, or dictation (Duménil and Lévy, 2001). Contrary to the expected outcomes, developing countries' securitizations' are short termed, and fall short of the necessities of long term development projects. Thus, short termed capital inflows to the emerging markets discourage the long term development projects, and encourage the short term commercial and/or land development projects.

### **3.2. Shadow Banking and Semi-Periphery**

Developing countries have different institutional arrangements comparing to the developed countries. First important difference stems from judiciary structures of the former countries. Unlike the developed countries, legal structure of developing countries does not support unlimited market or contract freedoms. Thus, government controls and regulations over the economy in these countries are stronger than in the developed core countries. In an era of financial globalization this legal structure discourages or makes impossible financial innovations in developing countries. Consequently, providing the capital controls do not exist or

discouraged by the international financial authorities such as the International Monetary Fund, financial capital flee from these countries to the more liberal countries. Further, the state structure of these countries does not comply fully with the requirements of financial capitalism since the lack of the rule of law. In most cases, developing country state structures comes in the form of a predatory state which hinders the transformation of individual wealth to productive capital in the markets (Levi, 1988). Additionally, predatory taxation also discourages foreign investors and foreign direct investments in developing semi-peripheral countries.

Huang (2007) explains basic differences between the developed and developing countries with their cultural structures towards the markets. Huang sorts these differences in rigidity, individualism, objectivity, relationship, merit, time, and influence fields. As developed countries more rigid in following the rules, developing countries are more flexible in this field. Developed countries are principally individually focused, but in developing countries groups are more important than the individuals. Developed country individuals tend to avoid subjectivity, and focus on their tasks. On the other hand, in developing countries, individuals are more subjective and relation oriented. While promotions are based on merit in developed countries, developing countries give priority to social relations in promotions. Because of these institutional, legal, political, and cultural differences, a full integration of developing countries with the developed markets has not yet been fully accomplished.

This failure reveals some positive and negative outcomes for developing countries. First, because of these sorted reasons, shadow banking has not been institutionalized in these countries. Therefore, banking industry of developing countries realize their securization operations with the investment banks of core countries. However, this tendency poses some negative and positive implications. Negative ones are the over dependency on foreign funds and foreign financial institutions, and the short term nature of available funds. Positive side of the situation is that developing countries have an access to foreign capital markets.

**Conclusion**

Securization is an integral part of modern banking systems. Without securization, it would be impossible for banks to renew their loanable portfolios. However, latest crises have shown that unlimited securization, ending with a total financialization, have devastating effects on both industry in particular, and in whole economy in general. Moreover, securization and following possible financialization have different effects on developed and developing economies. Therefore, this study suggests that it is crucial to distinguish the state of an analyzed country in order to reach a verdict about securization. Securization, if clearly monitored, may be useful for developing semi-peripheral countries to realize their development projects. In order to do that securitizing agencies should be differentiated from the traditional banking system to block the spread effects of possible financial crises into the traditional banking industry. Second, monitoring agencies, like central banks, treasuries, or inspection authorities should be chosen carefully and integrated with each other with well-defined jurisdiction borders.

Rules and regulations for developed economies may consist of different sets of criteria. As widely accepted, heavily regulated financial markets cannot easily create financial disasters. However this claim ignores the political power of big financial companies. As 2008 crisis has showed that power of financial conglomerates easily offsets the power of political parties or other interest groups. As long as this picture stays as reality, a total financialization of an economy cannot be stopped or controlled by the state authorities. This is the basic dilemma of today's US economy. In this case, the only unknown progress in this economy is the timing and scale of the next crisis. As a sum, this study suggests a more democratic participation in economic decision making processes, and more regulation and monitoring in financial services. Regulation and monitoring may not be the only panacea for prospective financial crises; however, they may reduce the scale of these catastrophes.



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