

# Financial Capital and Its Role in Today's Economy

D A Dinets<sup>1</sup>, G B Zaorski<sup>1</sup>, A S Merkulov<sup>1</sup>

<sup>1</sup>Irkutsk State University of Communication, Irkutsk, Russia, 664074, Irkutsk, Chernyshevsky Str., 15

E-mail: dinets\_d\_a@mail.ru

**Abstract.** Financial capital has been on the rise since the late 20th century. Prior to the first half of the 20th century, it was mainly used to facilitate the flow of real capital; it greatly contributed to the economic growth by bringing investment beyond equity. In recent decades, financial capital flows have been following their peculiar logic. This paper demonstrates the economic processes that curb economic growth due to the effects of financial capital. Financial capital is objectively on the rise. This paper proposes a stronger state as a regulator of financial capital and markets, which must be able to direct the financial capital to boost the real sector. The goal hereof is to substantiate the need for regulation of financial capital and markets, which will help make them into economic boosters.

## 1. Introduction

Research into financial capital and financial markets is sometimes relevant. On the other hand, its relevance pertains to financial crises; on the other hand, it is associated with the ever-greater role financial capital has had to play throughout the 20th century as well as in the early 21st century. When drafting a business-specific or national economic policy, the rule of finance must be clearly defined. The government determines the economic policy and the tools behind it; it has to choose whether to focus on boosting the financial capital and markets or on the real sector in its broadest interpretation, which includes, for instance, research and development. The goal is not to contrast these priorities but to fuel the financial capital development so that it fuels the real sector and economic growth.

## 2. Materials and methods

Empirical data for this research was drawn from the official statistics provided by the Rosstat, the Bank of Russia, and a variety of statistical studies, data for which had been collected by individual authors. It should be taken into account that due to the high-speed circulation of finance, double counting may occur. Lack of a non-ambiguous definition for statistical purposes means accurate quantification is not possible. However, trend identification is more important for this research than precise quantification.

The methodology is based on dialectics i.e. defining the original concept and sequentially isolating more specific and apparent forms from it. It is assumed that economic trends ultimately determine the economic actors' actions, including economic policy.

This method resolves the long-term dispute between those that deny the state as a rising governing body and those that oppose this trend. This method helps directly stimulate the regular growth of financial capital as a portion of public capital without compromising the real sector. From a dialectical point of view, the growth of financial capital is a trend. The goal is to create such economic

relations that would effectively address this contradiction by using the growing financial capital as a booster for investment in the real sector.

### **3. Literature overview**

Discussion on financial capital started in Hilferding's *Finance Capital. A Study of the Latest Phase of Capitalist Development* (2) released in 1910, and V.I. Lenin's popular opus *Imperialism, the Highest Stage of Capitalism* written in 1916 (13); I.A. Trachtenberg's *Monetary Crises (1921-1938)*, released in 1939, was another major work that discussed the flow of financial capital (25).

Discussions on the problem are summarized in the *History of Political Economy of Capitalism: Essays* (10, pp. 69-83), which covers research papers published from 1900 to the 1980s in detail. It discusses at length the definition of financial capital, its new forms, and the sociopolitical consequences of its advancement. However, trends in the effects financial markets have on economic development as well as the opposition of real and financial sectors are matters not given proper considerations.

This topic is still important for Russian economic literature today. Latest publications on the topic include Yu.A. Danilov's *State-of-the-Art Global Scientific Discussion of Financial Development* (5, pp. 29-47). This paper presents a complete analysis of the last decade of research. Financial markets are given good coverage by international authors. The World Bank studies the issues related to the changing role of financial capital. This is covered in the following papers: Cihak M., Mare D., Melecky M. *The nexus of financial inclusion and financial stability: A study of trade-offs and synergies* (28). Asli Dermiguc-Kunt, Ross Levine. *The Financial Structure Database* Thorsten Beck (30), Demirgiif-Kunt A., Feyen E., Levine R. *The evolving importance of banks and securities markets* (32), Spence M. Growth Commission Background Paper, No. 11. Washington, DC: *World Bank* (33). OECD Department of Economics later began its own analysis of how finance affects economic growth. It has since then helped publish the following papers: Cournede B., Denk O. *Finance and economic growth in OECD and G20 countries* (33). However, some papers call into question the rising role of financial capital (16). Analysis of research into financial capital and financial markets shows that such research is mostly purely empirical, enabled by advanced mathematics. However, this is not enough for pure research. Mathematical methods can neither fully prove nor fully disprove the correlation between financialization and economic growth.

Russia's financial markets are pale in comparison to those abroad, a fact that is often stated as proof of the need for faster financial market development as a precondition of economic growth. Yu.A. Danilov and D.A. Pivovarov cite data on the financial markets and their proportions in a variety of countries. "As at the end of 2014, financial markets had a 8.2% share in Russia, 83% in the US, 49% in the UK, 36% in Germany, 32% in India, 17% in Brazil, and 15% in China." (4) Why is China, where the figure is 15%, is economically above all of these except India? How is India, being at only 32%, outpacing Japan, the US, and other countries?

### **4. Results**

In the 21st century, the real-vs-financial capital ratio is 50/50 (22). Financial capital is on the rise. Public reproduction to an increasing extent seeks to produce finance rather than tangible product. This entails a number of economic and social consequences.

Apparent are the enormous risks in financial markets and the way they affect economic cycles. This gives rise to the problem of public risk management. Financial capital management dates back to the Great Depression of the United States; however, their 1990s policies and D. Trump's financial novels demonstrate a gradual retirement of financial market regulations. Publications on the crisis of 2007 and 2008 mainly state that many authors attribute the crisis to the financial sector, a fact that is hard to deny. Undoubtedly, financial bubbles are a product of financial capital flows; they are the trigger that launches first a financial crisis, then an economic one.

Fictitious capital was a concept widely applied in the 20th century to financial market analysis. It used to mean securities. The concept is no longer valid. However, it explains the processes intertwined

with financial capital on a far deeper level (7). “Fictitious” means that the profits generated by such capital do not originate in the real economy. This, however, contradicts the conventions of today’s economics.

Thirdly, a transition to post-industrial economic development does not mean the government should interfere less with the market. On the one hand, state property is now less significant in manufacturing, and ‘planning’ is not a thing. However, public regulation only takes a different form. What is regulated nowadays is the flow of financial capital. This is due to the fact that financial capital, being a product of real-capital flow, determines the logic of real economic development. Thus, the state rejects its Keynesian participation as a controlling actor and switches to monetary controls.

Financial capital has a role to play as the new foundation of market economy; this role has yet to be understood, whether in Russia or abroad. L.P. Yevstigneyeva’s and R.N. Yevstigneyev’s *Financial Capital as a Systemic Basis of Economy* (8) gives the most in-depth explanation of this turnaround in the methodology of market economy governance. Financial capital management is proposed both to improve the controllability of capitalist markets and to enable sustainable economic growth. However, governments of developed countries have tried to apply this method to prevent economic crises and failed to do so, albeit the crises were somewhat mitigated.

Fourthly, expert opinion is split on this problem. Liberal scientists believe financial markets play an ever greater role in economic growth while also curbing the economic disparity. Others are of opinion that a stronger financial sector leads to less investment in real economy.

Fifthly, the economic world was surprised by the emergence of cryptocurrency, which, with some luck, might affect the financial capital.<sup>1</sup> Cryptocurrency was intended to replace fiat money; however, it only became another financial asset, a highly volatile kind of fictitious capital.

Sixthly, financialization, while being a process with good statistical coverage, still lacks theoretical foundation. Financial institutions have been restructured, a fact evidenced empirically. Lack of in-depth theoretical research on this issue results in different states having different economic policies, often to the point of being contrary. Financial capital flow has long become global, a trend that is effectively at odds with the strengthening of national interests. This contradiction of today’s capitalism is ever more apparent, as global integration is facing the rise of nationalism. The world economy is becoming increasingly volatile, which the very survival of the system being in question.

## **5. Discussion**

Financial capital is defined herein as the flow of monetary capital that follows its own trends and patterns rather than the real capital (18). Moreover, financial capital guides its real counterpart. The process began in the early 20th century and was complete at the turn of the 21st century. Financial capital comprises stocks and debt securities, derivatives, bank assets, insurance and pension fund assets, investment fund capital (IFC), international gold and foreign exchange reserves, and the National Welfare Fund (or similar funds in other countries). Their circulation rate varies.

First, the bulk of stocks or debt bonds does not even reach the market.

Second, insurance providers, pension funds, and investment companies have to reserve some of their assets. Some of the bank assets are frozen in fixed assets while others form mandatory reserves<sup>2</sup>.

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<sup>1</sup> Hayek’s *Denationalization of Currency* was an early work that proved private currency feasible. Small-town currencies were attempted; however, those were not ‘private’. M. Portnoy’s monograph that received minor critical acclaim is one of these few successful scientific monographs today. However, we do not believe it is a breakthrough. Without a solid theory behind today’s money, the prospects of cryptocurrency remain clouded. It should be admitted that in their understanding of the essence of credit money, the authors hereof have failed to advance beyond G. Matyukhin, who successfully furthered the Marx theory of money. G. Matyukhin based his ideas of credit money on the concept of commodity money. (Matyukhin G.G. *Problems of Credit Money Under Capitalism*. Moscow: Nauka, 1977. 226 p.)

Reserve funds do not follow a clear trend, as their dynamics is effectively determined by the control action the state takes in the context of the current economic situation.

Third, the international gold and foreign exchange reserves generate income due to the revaluation of currency and gold; however, these reserves never enter the market in the form of capital. All of this means the financial capital is hard to quantify, whether nationally or globally. No less difficult is the structural analysis and quantification of financial markets. However, its quantitative growth is apparent regardless of the statistical methodology.

Russian statistics are as follows: financial assets totaled 76,322.1 billion rubles in early 2012, 166,872.2 billion in early 2018, an increase of 218.6%. They thus totaled 112.0% GNP in 2012, 167.0% in 2018. The worldwide figure was 335% (485% in the US) in 2010 (27).

Financial institutions are changing their roles. Banks used to be the primary source of credit, with interest rates being their primary source of income; however, things are different today.

Consider the Sberbank of Russia’s statistics as an example of how banks’ role as a source of credit has changed in the Russian economy.

**Table 1.** Sberbank revenue breakdown.

	2013	2014	2015	2016	2017	2018
Net interest income	15.5	21.6	15.3	5.1	7.4	4.6
Net commission income	13.6	22.2	5.7	22.0	14.6	21.0

Source: [https://bf.arsagera.ru/finansovyy\\_sektor/sberbank\\_rossii/itogi\\_2018\\_g/](https://bf.arsagera.ru/finansovyy_sektor/sberbank_rossii/itogi_2018_g/) (21).

This process is observed in most banking systems worldwide. Western banks mainly generate their non-interest income from security transactions. Thus, banks are essentially transforming into organizations that convert temporarily free money into capital. It is no coincidence that H. Gref has stated that ‘bank’ might be removed from the name of Sberbank. Thus, stock and over-the-counter (OTC) security trading will develop faster. A similar process is observed throughout Russia’s banking system (14). More and more international scientists believe that banks have an ever less significant role to play as economic growth boosters. This is due to them being overregulated (34).

A business that used to generate income from its core operations currently has to rely on transactions in financial markets. Major corporations, e.g. in the US, receive ever larger revenue from financial market transactions.

Let us have a quick look into the quantifications of the Western financial capital. The economy is increasingly saturated with financial assets, is infused with financial relations, institutions, and ever more complex financial instruments. Total financial assets rose from 42 trillion US dollars in 1990 to 294 trillion in 2014, or from 195% global GDP to 379% (21). The derivatives market is currently approaching an estimate of \$1.2 quadrillion.

One study of financial capital structures the public capital as follows: 50% derivatives, 20% to 25% primary securities, 10% to 15% trading capital, and 5% to 10% real capital (24).

In financial markets, financial capital transactions are growing even faster. Capital turnover rate is many times higher in financial markets than elsewhere. On the one hand, this makes capital more profitable and attracts capital from other areas; on the other hand, the same trend results in greater risks. Risks boost insurance business. However, while an insurance provider helps lower the risks for a specific capital, the overall risk rises. This results, among other things, in a lower value of capital (6).

Financial capital is important for funding the real sector. One manifestations of this is the total loans issued to non-financial institutions, including in Russia. In Russia, more such loans are granted

<sup>2</sup> As of March 5th, 2019 the mandatory reserve accounts credit institutions had with the Bank of Russia as correspondent accounts (subaccounts) totaled 2,272.8 million rubles with a clear upward trend. It had increased by 217.0% YoY.

than elsewhere. However, this positive indicator is being diminished, as the Russian economy is restructuring itself towards a greater proportion of financial markets.

These processes help raise net investment in the real sector beyond the limits of undistributed profits that businesses have at hand. However, as the financial capital flow has become independent, and the capital itself is growing an order of magnitude faster than the savings of the real sector, most of the profits generated by tangible production flows into the financial market, which reduces the entrepreneurial self-investment capacity. An ever greater proportion of public labor is now in the financial market. Besides, the functioning of this market affects inflation.

First, it alters the interest rate, which in its turn affects the proportion of loans in liabilities, especially in medium-sized and major businesses. Thus, more interest rate charges are included in the cost, which leads to rising prices.

Second, it leads to a greater risk as the financial markets are volatile. As specified above, a stronger financial market means a greater risk. Firms incur direct costs as they need insurance reserves. Of course, risk-related costs are added to the cost of product, which ultimately leads to a higher price.

Third, a considerable portion of financial capital has invaded the trading capital, which has transformed the commodity exchange from trading 'middlemen' into speculative platforms. Commodity exchange used to boost competition, as the supply-demand ratio was the key pricing mechanism. Nowadays, pricing is determined by the financial capital flow logic instead. Consider the fluctuating oil prices that are effectively independent from the supply and demand, rather being set by the stock/OTC market. The same applies to food exchange.

Fourth, financial capital contributes to centralization of capital in the real sector, which accelerates monopolization. Monopolies are created to gain better control over prices, which are rising are a result. All these factors attributable to the growth of financial market in turn contribute to inflation. The Central Bank of Russia's policy seeks to concentrate the banking capital, which contributes to the above trends. In the mid-1980s, the United States had over 18 thousand banks. As at the end of Q3 2013, it had 6,891 banks. Only 5,256 remained in late 2018 (27). Russia has seen a similar trend, going from 1,058 banks as at January 1, 2010 to 473 as at April 1, 2019 (1).

Centralization of financial institutions boosts their importance. Capital is inherently prone to centralization. This feature is apparent in financial capital. This is facilitated by the financial institutions being easily adaptable to centralization, as they only operate with money that only differs in quantity. Financial institutions are easy to merge or acquire. In 2018 alone, a year that was considered lackluster in terms of centralization, financial institutions were the second largest market sector in terms of transactions in Russia: a total of 33 transactions for 6.48 billion US dollars or 15.3% of the market. However, the merger/acquisition process is now in a slowdown. The number of banks has seemingly been optimized for the current pace of the Russian economy. Further mergers and acquisitions are expected in the insurance and pension fund markets.

From 2012 through 2018, Russia saw 192 mergers in banking (1). Besides, assets of delicensed banks were acquired by major banks in a variety of ways. A total of 397 banks were stripped of their licenses from January 1, 2017 to April 1, 2019 (1). As a result, the share of 5 major banks in total assets rose from 55.3% (January 1, 2017) to 61.4 (May 1, 2019) (1). The Bank of Russia has started similar processes with respect to insurance companies, expected to face mergers and acquisitions in the nearest future.

Russia's financial capital (banks) is facing a merger with the real capital, which, all other things being equal, should generally contribute to economic growth. Banks' portfolio in subsidiaries and dependent companies as well as in mutual funds is growing. It rose to 1,640.1 billion rubles in Q1 2019 from 1,548.2 billion in Q1 2017 (1). This is a binary trend: on the other hand, such participation is seen as portfolio investment; on the other hand, when applied to subsidiaries, it becomes direct investment for business development.

## 6. Conclusions

The conclusions are as follows:

- by giving away a considerable portion of its profits to the financial sector, businesses have to raise prices to compensate.
- the merger of banking capital and industrial capital, being an important aspect to the definition of financial capital, leads to greater monopolization, which results in higher prices as well as in a partial loss of public income;
- commodity exchanges being speculative transaction platforms are interested in more volatile pricing for their commodities, which boosts the risks;
- currency exchange rates produced by speculative transactions lead to greater inflation and risks;
- the imbalance of real capital and monetary capital ultimately leads to a monetary crises;
- a nation often faces an unfavorable settlement balance as the global flow of financial capital is speculation-driven;
- as a result of speculative transactions, exchange rates have an opposite effect on inflation;

Analysis of the negative effects financial capital has on tangible production leads to an inevitable conclusion that this trend is inherent in capitalism and its development logic. A capitalist economy is designed not to boost tangible production or improve public welfare. For individual capital, converting the real capital into financial capital is apparently efficient, which hinders the development of public production. Individual capitalists' goals are at odds with the survival of the capitalist system, a contradiction that can only be resolved by a stronger state. Only it will be able to save the system from the centripetal flow of individual capital. With respect to handling this situation, the developed countries' economic policies are limited to either imposing stronger restrictions on the financial markets or removing all restrictions whatsoever. A good example is B. Obama's and D. Trump's financial policy (34). The goal is to find such financial capital and market controls that will transform the gains in the financial sector into investment in the real sector. This will undermine the superiority of non-banking financial institutions. However, the process requires a long-term analysis. Economic growth must be seen in the context of recessions, crises, and risks attributable to the financial sector. Otherwise, the sources of national wealth will be jeopardized. It is the real sector that generates the profit for the financial capital, which justifies governmental regulation of financial capital and its markets to stimulate investment in real sector. Otherwise, the very existence of financial capital will become unsustainable.

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