Foreword by
Y. V. Reddy

THE RISE OF FINANCE

CAUSES, CONSEQUENCES AND CURES

V. Anantha Nageswaran

Gulzar Natarajan

Advance Praise

'Financialization, defined as growing scale and profitability of the finance sector at the expense of the rest of the economy, is a relatively new term in the lexicon of economics. In this timely, well-researched and thought-provoking book V. Anantha Nageswaran and Gulzar Natarajan not only examine the causes and the consequences of financialization but offer specific policies that can help reduce its negative impacts on the real economy. The authors break new grounds by linking central banks' policies with the increased financialization of national economies, offering India as a case study of how smart financial deregulation could be a force for sustainable economic growth in emerging economies. Anyone who wants to understand the roots of increasing inequality and instability in the global economy must read this book.'

Hossein Kazemi, Michael & Cheryl Philipp Distinguished Professor of Finance and Director of CISDM Isenberg School of Management, University of Massachusetts

'Anantha Nageswaran and Gulzar Natarajan's work is a courageous and comprehensive commentary on the reasons, ramifications and possible response to the excessive financialization and financial market liberalization that characterized the global economy over the last quarter century or so. The authors lament that the world has not learnt the right lessons from the recent global financial crisis, the major manifestation of unbridled financialization by re-emphasizing and reinforcing, through painstaking analysis and new perspectives, the thesis that beyond a point financial sector growth can have inverted U-shaped effect on the real economy and the society.

They provide a strong critique of the role of the major central banks led by the Federal Reserve in fostering and furthering financialization leading to misallocation of resources away from the real economy to the financial markets, excessive risk taking and speculation, bourgeoning indebtedness, cycles of booms and bursts with serious economic and social costs and spillovers effects of cross-border flows on emerging countries. Their singular focus on price stability under the inflation-targeting framework to the detriment of the financial stability and the consequences of the unconventional monetary policy with potential for stoking the next financial crisis have been subjected to sharp scrutiny in the book. Authors have unhesitatingly suggested policy choices like using capital-flows management and stricter macro-prudential measures by the central banks, curbs on banks' capacity for asset creation in sync with the need for 'boring banking', ending the craze for debt pile-up, restraints on central banks' put option for the rescue of the

financial assets and overarching imperative of building consensus for safe and sustainable financial system.

In a separate section on India the authors provide a somehow different perspective that India suffers from too little rather than too much of finance and hence has to focus on institutions and innovations for financial sector deepening and broadening while remaining on guard against potential for excessive speculation in certain areas and disproportionate financialization.

This bold and brilliant book is a must-read for all those who are concerned with a fragile financial future of economies and societies.'

Harun R. Khan, former Deputy Governor, Reserve Bank of India

'An iconoclastic but persuasive account of the excessive financialization that has come to dominate and distort advanced economies over the past three decades. *The Rise of Finance* is a comprehensive, painstakingly researched and documented account of all that has gone wrong as the finance-dominated advanced economies struggle to emerge from the North Atlantic Financial Crisis. An immensely readable, accessible and valuable contribution that will be a must-read for laymen, finance aficionados, market participants, researchers, academics and policymakers alike. Coming from practitioners and teachers of finance, their bold nostrums for a radical overhaul of the global financial and monetary systems deserve a serious hearing.'

Rakesh Mohan, Senior Fellow at the Jackson Institute for Global Affairs, Yale University, and Distinguished Fellow at Brookings India

'Anantha and Gulzar have tackled an important issue in this book – the financialization of the world economy and its consequences. Is financialization a case of the tail wagging the economic dog? Why is it a risk to macro-stability and what should be done about it? The book explores options and remedies. Agree or not, it is a must-read for all breeds of economists – academic, financial and policy-maker.'

Sanjeev Sanyal, Principal Economic Adviser, Government of India

The Rise of Finance

Financialization, or the disproportionate importance of financial considerations in economic decisions, has been a defining feature of the economic history of the last 30 years. The wave of deregulation that accompanied the neoliberal agenda in the US, aided by the dominance of the US dollar and the American economy, has resulted in the globalization of finance.

The current instability in the world economy provides a window for a radical overhaul of the global financial and monetary systems. Measures such as simple capital adequacy rules for banks, acceptance of capital flows management, measures to discourage debt accumulation, anti-trust action, and replacement of elements of the neoliberal framework are crucial in realizing and effecting that change.

This book examines the rise of financialization globally while charting its drawbacks and prescribing suggestions for a definitive overhaul of the structure. Bringing together various strands of the latest research and evidence generated in recent years, empirical analysis, and views of reputed experts in the field, it presents a counterpoint to the canonical frameworks of analysing financial market dynamics and financial globalization. It proposes a revision of the current monetary policy paradigm to correct its excessive focus on equity markets and their 'wealth effect', embrace a more symmetric response to the economic cycle, and a mandate to focus on financial stability as much as price stability.

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The Rise of Finance

Causes, Consequences and Cures

V. Anantha Nageswaran
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Foreword

The developments leading to the global financial crisis and experiences with policy responses have led to an inconclusive but fundamental rethinking on the practice of public policy. We know that the intellectual framework that prevailed before 2008 was not sustainable. We are yet to agree on what the new normal should be, except that money and finance are critical, though one part, and that excess finance is injurious to health. But right sizing finance cannot happen if the attention is confined to finance. We are in search of new balances not only between finance and real economy, but also between state and market, between national and global, and between old global economic order and evolving new one.

It is often argued that the ongoing financial crisis reflects excessive belief in the efficiency and self-correcting mechanisms of markets. It is, therefore, argued that the state should be empowered so that the balance between the state and the market is restored. Consequently, the policy prescriptions are essentially in the nature of creating a strengthened role for state, broadly defined to include intervention in the functioning of markets by the public policy.

It is possible to argue that the recent financial crisis represents the failure of both the market and the state. The apparatus of the state, in particular the independent central banks and regulators, seem to have failed to discharge the duties assigned and deliver the outcomes that they had assured. There are sufficient grounds to believe that the crisis is a result of the capture of the governments by the markets, especially by the financial institutions and financial markets. In other words, it can be argued that the crisis was caused by not a mere failure of regulators but a capture of the regulators and the governments by the financial markets. This plausible explanation of the crisis warrants an entirely different dimension to the traditional debate of state versus market. The debate may have to focus on the relationship between the state and the market in each country, on one hand, and the relationship between the nation states, national financial markets and international financial markets, on the other. At the same time, the role of large non-financial corporates cannot be ignored in the analysis.

The corporate sector seems to have developed a larger-than-life identity of its own but is not necessarily maintaining continuity of individual identities

as corporates. The mergers, amalgamations and takeovers of corporates have become common and thus the corporate identities are fast changing. However, the corporate sector as a whole has developed a global domination and a global presence. Their influence over politics is now no longer necessarily through a national government, but cuts across several countries. The managements of corporates seem to have developed their own spheres of cross-country influence and interests. More importantly, some of their institutional capacities often exceed that of some national governments.

Technological developments are constraining the capacity of the individual nation-state to exercise its power of intervention in the economic activity of individuals or corporates that it was able to do in the twentieth century. Technological developments have a tendency to make cross-border movements economical and hence can undermine the instruments available for the nation-states. At the same time, the consequences of cross-border movements on a nation's population have to be often managed by the state. It is possible that globalization of business, especially finance, has been premature relative to the globalization of public policy or globalized governance.

In the past, finance was viewed as powerful but mainly as an enabling part of the real politics and real output or employment. In recent years, the financial sector has acquired a life of its own, with capacity to influence politics not only at a national level but also in terms of relations between nations, and equally in terms of the influence of the financial sector over the real sector. A possible disconnect between the real sector and the financial sector may also be emerging. For instance, currently while the financial markets seem to have rebounded globally and are thriving, employment and growth appear to be lagging behind, particularly in developed countries. It is not clear whether the booming financial markets are in anticipation of a definitive surge in real output and employment globally.

The common elements in the narration of events that led to the current financial crisis indicate that there has been close cooperation between the financial conglomerates and the ruling elite; that there has been competition for resources among these constituents within each country; and that these forces resulted in contagion in different degrees to different countries. Thus, there have been different strategic elements of cooperation, competition and coordination between state and market, nations and supra-nations, financial and non-financial corporates.

Interestingly, the surging public debt of many countries in recent years may place the sovereign at the mercy of the financial markets that were bailed out by the sovereign in the first place. How will these be resolved? In any case, the path towards the new normal is not only a political process but also one in which business—big business—especially the financial sector, plays a major role.

Optimal level and role of finance is, thus, not merely a question of regulation and supervision. Just as the influence and impact of finance has spread well beyond its initial role of provision of funds to enterprises, determining its optimal role, size, power and influence in the future requires an examination of the motivations and incentives of various players and institutions that finance touches. The authors of the book, V. Anantha Nageswaran and Gulzar Natarajan, have brought out these multiple dimensions and oft-overlooked areas relating to the future of finance. They have embarked on this intellectually demanding and, yet, ambitious task with courage, conviction, open minds and scholarship of considerable depth and breath.

The story of India may not fully fit into this narration as far as the role of finance is concerned, but it is part of the pattern in link between politics and business.

During the independence movement, there were observable links between indigenous business and policies. Post-independence, politicians and big businesses continued to be distinct and a dynamic mutually reinforcing on occasions and restraining each other at other times existed. The position seems to have changed rapidly after the reforms of 1991. Politics and business were merged in India. Many businessmen have joined active political life while many politicians turned to business as an additional occupation. Some people comment that the regime of gentlemen-politicians has been replaced by businessmen-politicians or politician-businessmen. Further, after the onset of the process of economic reform, there have been large elements of deregulation and liberalization, but the role of the government continues to be dominant in a significant way in the area of access to natural resources, privatization of public enterprises or disinvestment and public–private participation in physical infrastructure and possibly social infrastructure such as education. More importantly, public policy in India under the reform period seems to have created a conducive atmosphere for rapid growth by being business-friendly but not necessarily market-friendly. Public sector banking and, in fact, dominance of public sector in finance may be the institutional link between politics and business embedded in government.

In India, banking dominates finance and public sector dominates banking. Finance in India thus becomes an extended arm of politics. It provides extra-budgetary resource to the government. It also provides the largest source of fiscal gains, taxes, next only to taxes on energy. It enables decisions outside direct parliamentary accountability. Hence, the debate on excessive financialization in India has far larger political economy dimensions than in other countries. It has lesser global finance dimensions. The challenge for India is to move towards optimal market-based financialization from repressive political patronage–based financialization.

The authors had taken upon themselves the ambitious task of bringing together empirical evidence pertaining to this complex reality from multiple disciplines,

thought processes and sources and have succeeded in weaving them together into a cogent narrative, culminating in a set of interesting and bold recommendations. The value of the book lies in its departure from simplistic prescriptions or predominantly scholarly exposition, but focusing on pragmatism derived from both theory and practice.

Readers will find in this book insights and observations that are not readily available in the plethora of literature being churned out on the subject of bloated global finance in need of re-orientation.

24 September 2018 **Y. V. Reddy**

Prologue

As the Clinton presidency entered its final year in 2000, America removed the last vestiges of control on the financial services industry. The Commodities Futures Modernization Act was passed, paving the way for an explosion in the creation of financial derivatives. The Glass–Steagall Act that separated commercial banking from investment banking was repealed, enabling the creation of financial conglomerates.

The new millennium began with the collapse of the Internet and technology bubbles in the United States and elsewhere. The NASDAQ composite index crashed from 5,300 points to around 1,300 points. Then, there was 9/11. Surprisingly, the US economy endured only a brief and mild recession. In December of that year, China joined the World Trade Organization (WTO). In the United States, the Federal Reserve lowered the federal funds rate to 1.0 per cent. From 2002, a global economic recovery ensued, notwithstanding the invasion of Iraq in 2003, in search of weapons of mass destruction.

America pursued simultaneous wars in Afghanistan and Iraq. Government spending rose rapidly, and consumer spending even more so. The US dollar weakened but foreign governments, led by China and oil-producing nations, bought American debt copiously. Interest rates stayed low despite swift and big increase in government and private debt. Prices of commodities, including crude oil, boomed. Real estate prices boomed everywhere. Millions, including those with no income, no jobs and no assets, became homeowners, as lending standards were continuously diluted by successive governments. Securitization of mortgages happened at an unprecedented pace. New over-the-counter financial derivative contracts such as credit default swaps (CDSs) were created in the trillions. It all ended in 2007 as mortgage borrowers began to default and the real estate boom ended in America. The malaise soon spread to the rest of the world through financial channels. It climaxed with the collapse of Lehman Brothers, a big name on Wall Street. The world economy teetered on the edge of collapse.

In response, monetary policy turned unconventional. Unprecedented measures were adopted. The Federal Reserve set its policy rate – the federal funds rate – at 0 in December 2008 and held it there for seven years. In addition, the Federal

Reserve targeted long-term interest rates through asset purchases. The Federal Reserve 'printed' money. It was called quantitative easing (QE). The balance sheet of the Federal Reserve went from USD 898.61 billion nearly a month before the collapse of Lehman Brothers on 15 September 2008 to USD 4.516 trillion on 14 January 2015. In many countries in Europe, central bank policy rates turned negative. That is, commercial banks had to pay interest to leave money in their accounts with the central banks.

Part A | The Causes

1 | Introduction

In 2015, ethicist Dirk Philipsen wrote a book on GDP – gross domestic product. The book was titled *The Little Big Number: How GDP Came to Rule the World and What to do About it*. Katy Lederer,[1] who reviewed the book for the *New Yorker*, quotes this gem from the book:

> … a pill-dependent smoker who, on the way to his divorce lawyer, crashes his oversized car into a school bus because he is texting about an impending derivatives trade.

Philipsen has used this extreme example to make the point that GDP makes no distinction between ethical and unethical activities. All of the above boost GDP but do little to boost economic welfare or well-being. Yes, it includes the derivatives trade.

A piece of news from *Financial Times* in June 2018 proved that Philipsen was not exaggerating. A financial market trader, running a hedge fund inside the private equity firm Blackstone, used to take positions in credit default swaps (CDSs) (an insurance contract that compensates the owner if the borrower defaults on payments – interest and/or principal repayment – on the bond on which the insurance was bought). Nothing exceptional. Hedge fund managers and traders routinely do this. The difference was that he then used it to lean on the companies that had to make the payment to miss payments or delay them such that they constituted a technical default. His CDSs would then pay him out the compensation. Few days later, the companies would make their delayed payments to bondholders. In one of his last trades, he did the opposite. He sold CDSs to other hedge funds on a company that looked very likely to default on its next payment and collected premiums from those who

[1] Katy Lederer, 'The End of G.D.P.?' *New Yorker*, 9 September 2015, available at https://www.newyorker.com/business/currency/the-end-of-g-d-p- (accessed on 8 June 2018).

bought the CDS. Then, the company was lent enough money such that it did not default on the payment. The insurance was for nothing. Those who bought the CDS lost their premiums! Several months later, the company defaulted and filed for bankruptcy. This is the equivalent of fixing matches in sports. We are also reminded of *Almighty*, a novel by fiction writer Irving Wallace, in which a newspaper owner would begin to create news-stories and make them happen so that his newspaper could be the first one to report the exclusive breaking news!

What was this trader's strength? Apparently, he used to pore over hundreds of pages of bond or loan documents for details that others would miss. 'Once he identifies chinks in the wording of particular clauses he plots a way to construct trades using derivatives on whether a company will default on its debts, which would lure rivals to take the other side.'[2]

Did his extraordinary diligence contribute to economic growth or quality of life of the people? It only left a trail of bitterness and howls of protest at the blatant unfairness of it all even though nothing illegal could be established.

Close on the heels of this big report in *Financial Times* came the news that the Australian financial regulator was charging Citibank and Deutsche Bank with criminal misconduct when they underwrote the share issuance of ANZ Bank. Reportedly, they had held back on certain number of shares from being available for sale and did not disclose that. Both the banks are contesting the charge. But financial regulators are not known to press criminal charges lightly.[3] Separately, from another news,[4] we learn that previously unreported court documents reveal that American prosecutors were aware of high-level executive involvement in SocGen bank in France and directed the rigging of the London Interbank Offered Rate (LIBOR). None of them were personally prosecuted or extradited to America to face trial. So, none went to jail either.

By now, if you think you have an idea of where the book is going, then you are wrong. This book is not a chronicle of personal or institutional misconduct by financial institutions over the years. We have nothing more to add to what

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[2] 'The Mystery Trader Who Roiled Wall Street', *Financial Times*, 4 June 2018, available at https://www.ft.com/content/5e23e516-5cdc-11e8-ad91-e01af256df68 (accessed on 8 June 2018).

[3] 'Former Citi and Deutsche Bankers Charged in Australian Cartel Case', *Financial Times*, 5 June 2018, available at https://www.ft.com/content/851bfcf6-68a5-11e8-8cf3-0c230fa67aec (accessed on 8 June 2018).

[4] 'SocGen Executives Ordered Libor Rigging, US Prosecutors Believed', *Financial Times*, 8 June 2018, available at https://www.ft.com/content/05dfb112-6a53-11e8-b6eb-4acfcfb08c11 (accessed on 8 June 2018).

Raghuram Rajan, former governor of the Reserve Bank of India (RBI), had said in a speech about five years ago:

> No wonder bankers today, and unfortunately, have a social status somewhere between that of a pimp and a conman.[5]

1.1 The story of this book

This book tells the story of how finance came to dominate economies, our lives and the evolution of societies disproportionately heavily from the 1980s. Of course, as will be seen later, it was not the first time it had happened. Finance had been dominant before, and on those occasions too, it had caused grief. Our purpose in this book is not to present a history of finance from its origins. Ours is a more recent tale.

In the wake of the Great Depression of the 1930s that followed the 'Great Gatsby' decade of the 1920s, the Roosevelt administration had taken several steps to improve the lives of the people. Social security was introduced (the Social Security Administration [SSA] was founded on 14 August 1935) as was Deposit Insurance (the Federal Deposit Insurance Corporation [FDIC] was founded on 16 June 1933) for bank deposits. Interstate banking was prohibited and interest rates on deposits and loans were regulated. Post World War II, the Bretton Woods Agreement was concluded, which created a system of stable exchange rates with the US dollar as the global anchor currency. Stock market tickers did not run continuously below the morning breakfast television shows in America.[6]

The world economy, led by the United States of America as the leader of the victorious Allied nations, recovered nicely from the ravages of war. Reconstruction and catch-up growth were state-led and were low-hanging fruits. Households held bank deposits and pension funds bought bonds to hold until maturity as the coupon on them was deemed adequate compensation against inflation. Compensation in the financial sector (see Chapter 3) was no different from the rest of the economy and trading derivatives was not easy. Not too many financial innovations happened in any case. Stock broking commissions were too high and analysts' research reports on stocks were not

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[5] Raghuram Rajan, 'A Step in the Dark: Unconventional Monetary Policy after the Crisis', First Andrew Crockett Memorial Lecture, 23 June 2013, available at https://www.bis.org/events/agm2013/sp130623.htm (accessed on 8 June 2018).

[6] Wikipedia informs us that the first fully automated stock ticker to appear on television was in 1996 (https://en.wikipedia.org/wiki/News_ticker).

the equivalent of sales promotion literature and retirement planning was not a gamble on stock market returns. Emerging markets (EMs) were a long way off from emerging as a viable and promising asset class. There was West and then the rest. Financial and banking crises were rare. Banking was boring. Then, it changed.

It all began as America fretted about the too successful Germany and Japan and about the spread of communism to faraway shores. It entered the costly Vietnam War and also began running a loose monetary policy with a view to making American exports competitive. The Bretton Woods arrangement soon unravelled in the 1970s. Without the anchor country guaranteeing price stability, there cannot be a fixed exchange rate regime. Arab nations flexed their oil muscle; mullahs took over Iran and they held America hostage. Oil prices became a big factor in economic growth and the decade of the 1970s was a decade of stagflation for the West.

As economic growth opportunities were exhausted, the West had to find other ways to maintain economic growth. Financial liberalization was the next growth driver and academic studies played a catalysing role in placing it at the centre of economic activity. The economy was no longer the dog that wagged the finance tail. In ordinary terms, one can say that the 'rise of finance' or *financialization*[7] is the process by which the tail wagged the dog or finance became the dog!

The facts[8] are staggering:

> Credit market debt and market value of equities in America were 212 per cent of GDP in 1981 and 514 per cent of GDP in 2014.
>
> The balance sheet of the Federal Reserve exploded from USD 200 billion to USD 4.5 trillion. Call that a 23× gain.
>
> According to Forbes, Warren Buffett's net worth was USD 2.1 billion back in 1987 and it is now about USD 73 billion. Call that 35×.

---

[7] These two terms will be used interchangeably throughout the book. To us, it means one and the same.

[8] These facts are based on a blog post by David Stockman, the former Director of the Office of Budget Management under President Ronald Reagan: 'The Warren Buffett Economy: How Central-Bank-Enabled Financialisation Divided America', 7 August 2016, available at http://www.zerohedge.com/news/2016-08-07/warren-buffett-economy-how-central-bank-enabled-financialization-divided-america (accessed on 14 May 2017). We have updated the figures using FRED database of the Federal Reserve Bank of St. Louis for as many of the bullet points as possible. We cannot vouchsafe for their accuracy.

During those same years, the value of non-financial US corporate equities rose from USD 2.3 trillion to USD 23.6 trillion. Call it 10.3×.

During those same years, credit to the private non-financial sector rose from USD 5.9 trillion to USD 28.0 trillion. That was 4.7×.

Nominal GDP rose from USD 4.9 trillion to USD 18.6 trillion during the same 29-year period. That was 3.8×.

The value of corporate equities rose from 46 per cent to 125 per cent of GDP during that 29-year interval.

Wage and salary disbursements paid to employees (from gross domestic income data) rose from USD 2.26 trillion to USD 8.2 trillion over the period. That is 3.6×.

Then comes the median nominal household income. That measurement increased from USD 26,000 to USD 565,000 over the period. Call it 2.2×.

Then comes the real median household income (2015 dollars). That measurement increased from USD 52,000 to USD 565,000 over the period. Call it 1.2×.

The median nominal income of US families increased from USD 31,000 to USD 71,000 over the period. Call it 2.3×.

The real median income (2015 dollars) of US families increased from USD 618,000 to USD 707,000 over the period. Call it 1.14×.

The sum of aggregate labour hours supplied to the non-farm economy by real people rose from 185 billion hours to 240 billion hours during those same 29 years. Call it 1.27×.

The average weekly wage of full-time workers in constant 1982 dollars was USD 330 per week in 1987 and is currently USD 340. Call that 1.03×.

This book tells the story of how this happened and more. What or who caused this? What are its consequences? What is the cure? Yes, we consider the rise of finance to such staggering levels as a disease that the world is suffering from. We suggest some therapies. Others have suggested them too. We do not claim originality. But we think that the more they are discussed and their circulation greater in public domain and discussions, the better are the chances of their acceptance. Of course, this sounds somewhat naïve. Reforms and regime shifts are neither voluntary nor are they products of intellectual persuasion. Crises and revolts are the likely parents. The crisis of 2008 was an opportunity. But financiers and their godfathers dug their

heels in. Temporarily, they have succeeded. The more things changed, as a consequence of the 2008 crisis, the more they have remained the same. In 2018, the Federal Reserve relaxed the capital requirements for eight systemically important financial institutions (Chapter 6). Therefore, it might take another bigger crisis to force end the dominance of finance that has been the feature of nearly the last four decades.

We are aware that the stakes are more than about finance. It is also a clash between the interests of capital and labour. It is not a mere coincidence that the rise of finance has gone hand in hand with the decline of labour unions and labour share of income not just in the US but in several other developed nations as well. The dominance of the West over the rest has also been bound up with the rise and success of capitalism of which finance is a crucial component. So, we realize that taming and reversing the rise of finance is not just a simple matter of making banking boring again. It may come to redefine the course of capitalism in the twenty-first century and reshape the global power balance between the West and the rest. After all, with aging populations, the West has relied considerably on debt to deliver economic growth. Finance has ferried global savings to the shores of the America so that it could consume and grow. While Germany is different, the rest of Europe needs global capital to help them honour their pension, social security and health care promises to their public. If the genie of finance is put back in the bottle, the collapse of the western model might follow in short order. They know that and consequently they did not allow the crisis of 2008 to upend the financial edifice they had carefully constructed over the previous three decades.

At the same time, change has to come because the rise of finance has meant the rise of debt mountains around the world – debt in the hands of governments, businesses and households. As debt climbed, interest rates have plumbed. Strange as it may sound, that has happened since the 1980s. Without that, such vast and rapid debt accumulation would not have transpired, nor would it have been possible to service them. But interest rates cannot go much lower. All interest rate bullets had been fired to stave off the consequences of the last crisis and there has been resistance to reloading the policy guns. Consequently, the world finds itself saddled with much more debt in 2018 than it did in 2008. In the process, it has woken up to another problem that has grown silently if unsurprisingly: glaring, persistent and pervasive income and wealth inequality.

It should not be surprising because when capitalists got the better of labour in the 1980s, labour share of income began to fall. As capitalists managed to retain their dominance, it kept falling. Debt goes and on favourable terms where

there is collateral. That is, assets facilitate debt growth and debt facilitates asset growth. It is a convenient marriage. In contrast, the working class relies on debt, available at not-so-favourable terms, for survival and for smoothing out consumption from one period to the next. As a result, the household net worth distribution is skewed and is disproportionately in the hands of the top deciles of the population. The rest are managing with less savings in banks that earn them nothing. It does not look like a sustainable state of affairs to us.

In 2011, Wolfgang Streeck wrote:[9]

> More than ever, economic power seems today to have become political power while citizens appear to be almost entirely stripped of their democratic defences and their capacity to impress on the political economy interests and demands incommensurable with those of capital owners. In fact, looking back at the democratic-capitalist crisis sequence since the 1970s, one cannot but be afraid of the possibility of a new, however temporary, settlement of social conflict in advanced capitalism, this time entirely in favour of the propertied classes now firmly entrenched in their politically unconquerable institutional stronghold, the international financial industry.

Changing this is far more urgent and important than preserving the existing pecking order between nations of the West and aspiring powers of the East. It is a humane thing to do. That requires stopping the rise of finance and plotting its decline. This book is a small effort in that direction.

1.2 The questions we seek to answer

This book answers three questions: What caused the rise of finance? What are its consequences? What can cure it? The first part examines the causes and it is also a chronicle of the rise of finance. But the chronicle is only brief for we are more interested in examining and presenting the consequences of its rise and in proposing cures that would cap and reverse its rise. The second and third parts of the book deal with them. The reader may notice that 'cures' is a play on the word 'curse'.

The story of the twentieth century was a tale of two halves – a bloody first half and a peaceful second half. The second half of the second half witnessed

[9] Wolfgang Streeck, 'The Crisis in Context: Democratic Capitalism and Its Contradictions', MPIfG Discussion Paper 11/15, Max Planck Institute for the Study of Societies, October 2011.

the rise of finance. Such a phenomenon which quickly became global has to have multiple causes and actors who helped it along. We will take the risk of being accused of oversimplification but we will say that the Federal Reserve and Alan Greenspan, its chairman from 1987 to 2006, emerge as the biggest creators and champions of financialization. The institution, under his leadership, seeded it and nurtured it and safeguarded it. He handed the baton over to Ben Bernanke in 2006 who ran with it faithfully. The Federal Reserve and its leadership are the prime forces that propelled financialization and its globalization. America's leadership in the non-Communist world and unipolar position after 1990 ensured that the rest of the world had to accommodate and accept the rise of finance, willingly or otherwise.

In the quarter century between 1990 and 2015, that is, in a period of 300 months, the Federal Reserve had either been lowering the federal funds rate or kept it on hold for a total of 240 months. Yes, 80 per cent of the time. When it raised the federal funds rate by 25 basis points in December 2015, it was doing so for the first time in 114 months. Monetary policy decisions of the Federal Reserve were central to the extraordinary wealth accretion to financial traders, fund managers and executives and to the rewards that investors and other participants collected from speculative activity in financial and other asset markets. That is why for David Stockman financialization is the process by which the Federal Reserve monetary policy over the last quarter century to three decades rewarded financial speculators at the expense of mainstream America. This may be sensational but also true, even if only partially.

The Federal Reserve enabled the rise of finance not just through its conduct of monetary policy but also through the intellectual contributions made by its leadership on issues such as deregulation, budget deficits and social security. Their larger-than-life roles influenced opinion formation in the media, society and the US Congress. The importance of the US economy to the rest of the world influenced opinions and financial sector evolution globally too. We are convinced that reversing financialization or de-financializing America and the rest of the world would require a change of heart or a different philosophical outlook towards finance at the Federal Reserve. That is where it has to begin. But it is not going to be easy. In the aftermath of the crisis of 2008, Alan Greenspan expressed some remorse for his role in the deregulation of the US financial industry, in his memoirs. He admitted that his faith in the self-regulating capacity of the financial markets had been misplaced. But by the end of his testimony, he had largely retracted his confession.

1.3 Why did we omit the crisis of 2008?

Some readers might be surprised that the book does not have a chapter dedicated to the crisis of 2008. After all, it was the Wile E. Coyote moment for finance and it was global. Then, why are we silent on the crisis of 2008? We are silent not because the crisis is now 10 years old, that it is time for the next one and that it made more sense to us to discuss why the conditions for it are in place rather than doing a post-mortem on the last one. After all, many have already done that. Although these explanations have more than a kernel of truth, they only partially explain our silence. A more important reason is that we see the crisis of 2008 as a symptom, an apparent manifestation of underlying causes that were themselves the consequences of the rise of finance. Chapters in Part II of the book deal with consequences of the rise of finance.

The extraordinary rise in executive compensation in finance, which then spread to non-financial sectors, is one of them. A related phenomenon is the misallocation of human resources in the economy. Much talent flowed to finance where it created far too much private gains and too little social gains. Just remember the fund manager in Blackstone who knew how to read the arcane details of bond covenants and set up profitable trades for himself and his firm. Then, there is inequality of income and wealth.[10] The most important consequence of the rise of finance was the changes it wrought to the monetary policy framework in the world.

In the 1980s, central banks went from targeting the quantity of money and credit to setting interest rates to target inflation. That was a momentous change – one that mistook price stability for financial stability and sacrificing the latter in the process. This important change in the monetary policy framework then spawned a series of subsidiary consequences: sustained growth in debt, which, in turn, meant that monetary policy had to support asset prices for assets represented collateral to debt. It meant that monetary policy had to become predictable and transparent to financial market participants and speculators. If they were surprised and if asset prices fell, debt burdens would be hard to service

[10] We must record here that Wolfgang Streeck thinks that inequality is not so much the consequence of financialization as it is a cause of it! In his widely cited essay 'How Will Capitalism End?', in the *New Left Review* in 2014 (May/June), he wrote, 'As Keynes would have known, concentration of income at the top must detract from effective demand and make capital owners look for speculative profit opportunities outside the "real economy". This may in fact have been one of the causes of the "financialisation" of capitalism that began in the 1980s.'