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978-1-108-48234-9 — The Rise of Finance
V. Anantha Nageswaran , Gulzar Natarajan
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More Information

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

[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

[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×.

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[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.

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> 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.

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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.'

and defaults would mount. Pain all around. In short, the capture of monetary policy was an important consequence of the rise of finance. Unfortunately for the world, that led to a pivotal role for monetary policy in setting off a slew of undesirable economic and social consequences post 2008.

The rise of finance had multilayered consequences and the crisis of 2008 was an outcome of these underlying forces that the rise of finance had unleashed.

The third and final part of the book has three chapters. There are some incipient danger signs in some pockets of finance and equally, there are areas where finance has barely registered its presence. As with most things, India presents a picture of contradictions and complexity. Hence, we present that chapter separately. But the lessons that the world has learnt about finance will eventually apply to India too. It neither has to reinvent the wheel nor repeat the mistakes that other nations have made. The advantage of a late-starter is that it can leapfrog over the mistakes that others made in their journey.

We offer several suggestions and proposals on managing, taming and reversing the rise of finance. The ones with the greatest potential for change are to do with monetary policy and banking regulation. As we said before, the Federal Reserve and its leadership over the last 30 years have played a very big role in helping finance rise to its present state of undesirably excessive domination over the economy and, increasingly, over society too. Finance has returned the favour by capturing monetary policy. Monetary policy has to be freed of the considerations of finance. Mind you, these considerations are not and will never be official. If it were so, it would be easier to resist it and change it. It is subterranean. It is insidious.

Reversing the financialization of the global economy requires fixing the prevailing monetary policy framework in America and Europe. Yes, Europe too. Europe was relatively late to the party. It favoured fixed exchange rates and the discipline that went with it. For a long time, capital controls were in vogue in the continent. But aging populations, faltering growth, a broken banking system and a huge debt burden have forced their hand. The European Central Bank (ECB), under Mario Draghi, has enthusiastically embraced America's policy framework. They have to keep their fiscally broken sovereigns with heavy interest rate subsidies. In doing so, they have fallen into the ditch and are still digging. Their policies have created more problems than solving them. Real estate bubbles have popped up everywhere in the continent and zombie companies have been kept alive.

Fixing the monetary policy framework requires fixing not just their economic models and but also their mental models. That explains a separate section on asymmetries and non-linearity in economics and finance in Chapter 6. In the