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

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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.

V. Anantha Nageswaran is Dean of the IFMR Graduate School of Business at Krea University, India. He has published *Economics of Derivatives* with T. V. Somanathan (2015) and *Derivatives* (2017) with T. V. Somanathan and Harsh Gupta.

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V. Anantha Nageswaran and Gulzar Natarajan have co-authored *Can India Grow?* published by the Carnegie Endowment (India) in 2016.

The Rise of Finance

Causes, Consequences and Cures

V. Anantha Nageswaran
Gulzar Natarajan

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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.