IPPR

REPORT

Mathew Lawrence

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IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

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NEW IDEAS
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ABOUT THE AUTHOR

Mathew Lawrence is a research fellow at IPPR.

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SUMMARY

An effective financial sector is vital to the UK's future prosperity. Yet too often finance is divorced from the real economy, prone to generating macroeconomic instability and remote from the concerns of society. Moreover, the design of the financial sector has not only led to the misallocation of capital. 'Finance capitalism run amok', in the words of Thomas Piketty, also distributes power in a way that entrenches unjustifiable inequalities of influence and reward. These inequalities threaten the strength of our economy and the vitality of our democracy.

The process driving these shifts – financialisation – is arguably the most important structural change in British capitalism in the last 30 years. Financialisation is defined for our purposes as the 'increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies' (Epstein 2005). The rise in the scale, scope and profitability of financial activity relative to the size of the UK's economy in this period is well known. For example, the balance sheet of the UK banking sector grew from 40 per cent of GDP in 1960 to 450 per cent in 2010 (Davies et al 2010), with predictions it will reach as high as 900 per cent by 2050 (Wolf 2013a); the proportion of pre-tax profits of financial corporations as a percentage of total UK pre-tax profit rose from 7 per cent to nearly 35 per cent from the mid-1980s to 2007/08 (Lapavitsas 2013); while the total amount of financial assets and liabilities of the UK rose from four to five times yearly national income to 20 times by 2010 (Piketty 2014). The consequences of financialisation more broadly, both positive and negative, are also well understood.[1]

The purpose of this report is therefore not to add greatly to this literature. Instead it is to set out a number of principles for 'definancialisation', for rolling back the socially useless aspects of contemporary finance and advancing in their place the many creative and productive forms of finance the UK undoubtedly possesses and could nurture better. In particular, our goal is to establish policies that reassert democratic influence over the banking and 'shadow banking'[2] systems, especially over the production and allocation of credit, which gives financial capitalism its power. By doing so, we want to reanchor finance in the real economy, as a productive servant of society, not a promiscuous master.

From crisis to stasis: the economic and democratic costs of inaction

The financial implosion of 2007–08 should have been used as a 'provocation to rearrange the place of finance in our economic lives' (Unger 2008). Instead, six years on from a financial crash that cost British society the equivalent sum of fighting a major war (Haldane 2012a), too little has changed. Financial crisis has ossified into relative political stasis.

This is not to suggest there has been no change. The new rules created by Basel III, the new requirement of financial institutions to create 'living wills', and the outcome of the UK's Banking Commission are all examples of significant improvements in the financial ecosystem. More examples could be cited. Nonetheless, the crucial set of interlocking institutional arrangements in the financial sector that led the global economy to the precipice remain incompletely addressed: the under-regulated privileges bestowed on banks by their right to create and channel credit privately

1 See for example Dolphin 2013.

2 Shadow banking refers to non-bank financial intermediaries within the financial system, who offer many of the same services as traditional banks but do so outside of the same regulatory framework.

while operating with inadequate equity ratios, corporate governance structures that embedded systemically risky incentive structures, the implicit subsidies for banks that are 'too big to fail', and the unconstrained ratcheting upwards of private debt levels.

As a result, contemporary policy debates are either inadequate or focus on treating the consequences of our financial system rather than changing its underlying structures. They are inadequate in the sense that, despite limited reform, banks 'too big to fail' operating in the UK in 2011/12 benefited from an implicit public subsidy worth an estimated £65 billion through artificially lowered operating costs, little lower than before the crash (IMF 2014a).[3] Yet these banks poorly serve the real economy, with net lending to UK businesses falling for almost seven years, even as mortgage and financial lending has recovered strongly (BoE 2014a). At the same time, the focus of policy is misplaced, because policies such as taxing banker bonuses, while justifiable, do not address the root cause of why the banking sector generates such high pay – it is estimated that 30–50 per cent of the difference in wages between the financial sector and the rest of the economy is due to economic rent[4] (Philippon and Reshef 2012, Philippon 2008). This is problematic because rent extraction is not a neutral process: it occurs at the expense of the wider economy.[5] Radically reducing economic rent in the financial sector must therefore be central to any long-term programme of reform. To do that, the banking sector must be reoriented away from short-term, speculative activity and towards its basic, essential functions: managing the payment system, providing appropriate levels of liquidity, and directing credit to the productive and socially useful parts of the economy to create sustainable value.

For the circulation and accumulation of capital in the financial system has become increasingly detached from productive investment, in a process of 'accumulation for accumulation's sake'. This has generated enormous returns and political power for the holders of large financial capital without providing a reciprocally strong benefit for the rest of society. This is bad for our financial ecosystem and the wider economy. However, it also underpins another crucial effect of financialisation: the hollowing out of democratic sovereignty, which has occurred as the longstanding tension between powerful financial interests and the social rights of citizens has been resolved increasingly in the favour of the former (Streeck 2011, 2014; Piketty 2014).

Indeed, this report argues that one of the most worrying long-term consequences of financialisation is this reduction in the capacity of democratic states to meet the demands of their citizens over the demands imposed on them by financial and corporate institutions, institutions which are themselves increasingly unbounded by the responsibilities imposed upon them by confident social democracies in the postwar period (see Offe 2013). In this way, financialisation has been central to the creation of what Colin Crouch has termed our era of 'post-democracy', in which democratic rules exist but are increasingly limited in application (Crouch 2004). Thomas Piketty has also underscored in meticulous detail how, without countervailing interventions, the dynamic of financialised capitalism generates stark inequalities that unpick the bonds of a shared common life necessary for meaningful, active citizenship (see Piketty 2014). Deep, fundamental reform is therefore required to reconcile the dynamics of our economy with the integrity of our democracy.

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3 For Europe as a whole, it was estimated that banks 'too big to fail' received a subsidy in that period equal to $300 billion. Similar research from the Federal Reserve Bank of New York has shown that the five largest US banks paid on average 0.31 percentage points less on A-rated debt than their smaller peers (Santos 2014). http://www.newyorkfed.org/research/epr/2014/1403sant.pdf

4 Economists define rents as excess returns that accrue as a result of positional advantage in a market, for example as a result of exploiting a monopoly, or patent rights, or information not available to other participants in the market. Economic rent is any payment to a factor of production in excess of its opportunity cost, extracting wealth rather than adding to it.

5 For example, since financial markets are a zero-sum game, if hedge funds make better than average returns, then other investors must be doing worse than average. Information asymmetries in the over-the-counter (OTC) derivatives markets allow informed dealers to extract high levels of rent, even while providing a valuation service to their clients (Bolton et al 2011).

Addressing financialisation: principles for reform

A serious charge is therefore made against the UK's financial system: that it not only misallocates capital but also distributes power in a manner that is antithetical to a sustainable, flourishing democratic life and a vibrant economy that ensures broad-based prosperity for all. Our response is therefore framed by two animating ideas.

First, the financial system is a vital utility and the flow of credit to the real economy an essential public good which should be guided by and made accountable to democratic institutions. However, this does not mean we believe rigid, explicit targets should be set. Rather, an overarching framework should be established to ensure that credit is better directed into expanding the productive capacity of the economy. Currently, nearly 90 per cent of outstanding loans in the economy go to fund either financial companies or property deals (Wolf 2013a). In future, it would be preferable to see a more even balance between sectors, with much more credit financing non-financial production than at present.

Second, we believe that there are limits to regulation, necessary though it is.[6] Instead, as Roberto Unger has articulated, we should aim to change 'piece by piece and step by step, the institutions that relate finance to the real economy, if we are to recover from the present crisis in a way that helps us avoid future crises' (Unger 2008). This will require building or reforming institutions, both public and private, that are better able to create and sustain equitably shared growth. Our current set of arrangements too often embeds the reverse: the proceeds of growth are narrowly shared while it is losses that are widely socialised.

These two core arguments build on IPPR's previous report in this area, *Don't bank on it: The financialisation of the UK economy* (Dolphin 2013). As with that report, we recognise here the UK has vital comparative advantages in many areas of financial activity, such as insurance, asset management and primary equity issuance. We believe that what we propose will actually help those sectors to prosper. Nonetheless, our earlier report found that particular types of financial activity were too large to justify their current status, especially the relative profits made in the banking and shadow banking sector and the pay such profit levels support. It should be stressed that this concern is not due to their size per se, but rather that their growth is supported by increased rent extraction.

Our recommendations therefore build on previous IPPR suggestions, including establishing a British Investment Bank and Small Business Administration to address longstanding financing gaps in the economy, the organisational separation of retail and investment banking activities, and a wide-ranging financial transaction tax (designed in a way that minimises tax avoidance). In addition, what is required is structural reform to address the deeper institutional arrangements that underpin financialisation. By doing so, our recommendations should help to build a financial system that operates without subsidy, where rent-seeking is limited, and where the relationship between finance and production is substantially tightened.

With that in mind, this report is structured as follows. First, we explore the nature of financialisation, the processes driving it, and its consequences. We then turn to why further reform has not occurred post-crisis, and, as a corollary, why we believe change remains possible. Finally, we recommend a series of steps to address the fundamental drivers of financialisation and reassert democratic interests over the financial system.

6 For a detailed discussion of the potential and limits of regulation, see Haldane and Madouros 2012.

Proposals and recommendations

1. Targeting credit at the productive economy

First, democratic and publicly accountable institutions should set overarching frameworks to help guide the quantity and type of credit created to ensure it is better targeted at increasing the productive capacity of the UK economy.

Currently, it is estimated that between 95 per cent to 97 per cent of credit in the economy is created by private institutions (McLeay et al 2014) and, as we have seen, goes primarily to support property deals and financial companies. This helps to explain some of the UK's underlying economic weaknesses, including its low investment-to-GDP ratio (159th in the world), its poor productivity rates (21 per cent below the G7 average, a 20-year low) (ONS 2014a), and its skewed housing market. Reversing these ratios over time will help to reanchor finance in service of production, leading to more stable, sustainable, productivity-driven growth. We therefore set out in detail the proposed mandate, mechanisms and forms of democratic accountability the Bank of England should be given to pursue a policy of credit guidance. To support this, we also set out ways to multiply and diversify public financing of production, end the tax bias in favour of debt, and reform macroprudential targets so that the credit system better supports the economy's productive potential.

2. Reassert the public interest in the financial system

If the credit system is a vital public good, an effective financial system is equally vital to a healthy economy and society. Critical aspects of the system – the organisation of the monetary system, how potentially destabilising financial products are regulated, the operation of credit-rating agencies and the inadequacy of equity ratios –currently serve the public interest poorly and require reform. We therefore propose a set of steps designed to address the constitutive elements of the financial system.

2a. Establish a Monetary Commission to investigate the UK's monetary system

The vital importance of the credit and money system is veiled in contemporary debates despite its crucial role in shaping the nature of the financial system, the dynamic of economic growth and the interplay of wider social relations. Tellingly, for example, the recent, lengthy Parliamentary Commission on Banking Standards almost entirely ignored the issue. This is despite the fact that the dynamic of our credit system was central to precipitating the most recent crash and creating the UK's lingering debt hangover. To avoid these mistakes in future, our monetary system should be 'unveiled'. A Commission should be established to examine how effectively our credit and money systems serve the public interest. In doing so, it should examine radical proposals related to the monetary system, including the potential for the Bank of England to provide central banking services directly to anyone who wants them, not just banks (see Gruen 2014); the possibility of transitioning to alternatives, such as the 'Chicago Plan' of 100 per cent reserve banking and the issuance of debt-free money (see Benes and Kumhof 2012); the potential for money-financing the deficit; and the future of 'alternative' currencies. Similarly, the payment system is crucial to the smooth functioning of the economy yet its oligopolistic ownership structure and opaque operation hinders financial innovation and entry by new financial institutions, and imposes disproportionately high costs on small and medium-sized businesses (SMEs) (OFT 2013). A holistic review of how the system operates should also be included. While none of the suggested alternative models are without flaws, nor is the current system, and a thorough examination of the UK's monetary, credit and payment system is long overdue.[7] Even if these alternative models are not necessarily recommended, a thorough review will help to provide greater clarity about the design and operation of the UK's monetary system and how it can be effectively fine-tuned.

7 The last time the UK's monetary system was examined in depth was the Macmillan commission in the aftermath of the Great Depression. Ernest Bevin and John Maynard Keynes, among other historically significant figures, sat on the commission.

2b. Strengthen equity ratio requirements to remove the implicit public subsidy to banks
Despite recent reform, banks 'too big to fail' operating in the UK received £65 billion in implicit public subsidy in 2011/12. This subsidy exposes the taxpayer to undue risks, distorts economic activity, embeds systemic fragility, and promotes overleveraging via debt instead of equity. One effective way to address this is by raising the equity ratio requirements for banks. Admati and Hellwig have persuasively argued that banks can operate successfully with equity ratios of 20–30 per cent of total assets and continue to effectively service demand for credit (Admati and Hellwig 2013). Indeed, successful banks such as Handelsbanken already do so (see Treanor 2012). This is substantially higher than the Basel III rules, which require banks to only hold 6 per cent of tier 1 equity (up from 4 per cent required by Basel II) and 4.5 per cent of common equity (up from 2 per cent).[8]

Given the fragile state of the UK economy, a 30 per cent ratio is too high at this point in time. However, as a start towards a more secure financial system, we believe the required ratio of equity to total assets should be raised. In particular, the amount of tier 1 capital that banks should be required to hold should be raised to 10 per cent by January 2018 for banks operating in the UK. To ensure the potential impact on lending rates is limited, there should be a tapered phase-in period, with equity requirements increasing each year as we approach January 2018, starting at a base requirement of 7 per cent by January 2016, 8 per cent by January 2017 and 10 per cent by January 2018. As in a similar programme recently announced by the US Federal Reserve, banks that fail to reach these targets on time should be subject to strong restrictions on the dividends that they can pay shareholders and on the bonuses that they can give to their senior staff (see Federal Reserve 2014). An assessment in 2018 as to whether equity ratios should be raised further is also recommended, to consider whether the stability of the banking system has improved and whether the scale of implicit subsidies has been substantially reduced.

2c. Create a Financial Product Board to approve new UK-traded financial products
A Financial Product Board should be established within the Bank of England's Prudential Regulation Authority tasked with supporting the PRA's statutory objective of promoting the 'safety and soundness of financial firms and the wider financial system'. This body would conduct a thorough and prompt review of new financial products – for instance, within the derivatives market – to assess whether they are systemically sound, especially when traded in significant volume.[9] Given the implications of mass financial trading for the soundness of the economy, new financial products should be approved before they can be traded in UK regulated markets. We also believe there is a case, in due course, for an equivalent body at a European level. More widely, greater international cooperation is needed to limit the potential for the 'offshoring' of systemically risky trading. Given the UK's importance within the international financial system, there is a strong case for it to lead the drive for increased cooperation in 'reshoring' offshore trading centres.

2d. Establish an EU credit-ratings agency funded by the financial transaction tax
A reliable credit-ratings system is an essential intermediary for the effective functioning of financial markets (Davies 2013). The clear failure of the three dominant global credit-ratings agencies to accurately assess risk and uncertainty was therefore integral to the financial crisis of 2007–08. Yet despite this and other mis-assessments since, there is no competition or large-scale alternative to the 'big three'. We therefore recommend the creation of a public credit-ratings institution to assess the creditworthiness of major European financial institutions, both public and private, and provide a 'public option' to complement the major ratings agencies

8 Tier 1 equity ratio is a comparison between a banking firm's core equity capital and total risk-weighted assets. Common equity is the amount that all common shareholders have invested in a company.

9 A potential organisational analogy for the governance model of the Financial Product Board could be the Medicines and Medical Devices Regulatory Agency, which is responsible for ensuring the soundness of all medical products used in the UK.

and to improve financial market signalling. To operate at an effective level, it should have an EU-wide remit and should therefore be funded out of the estimated €30 billion a year the EU's financial transaction tax is estimated to raise (EC 2011). However, given the political implications of debt rating, especially during sovereign debt crises, it is vital for the credibility of the institution that it is independent and removed from political pressure. We therefore recommend, subject to review, that the agency should operate independently from both the political and bureaucratic processes of the EU, with an autonomous governance structure.

3. Invest the gains of financialisation to help fund public expenditure

Financialisation is a process deeply embedded in how our economy operates. Boldness of intent must therefore be matched with a recognition that change will be painstakingly achieved. Consequently, as reform takes root, a British Future Fund should be established at the same time. This fund would act in a similar manner to a sovereign wealth fund, owning assets and equity on behalf of the nation and investing the proceeds to meet the long-term needs of the country. It should, therefore, be regularly capitalised by hypothecating certain financial operations that are central to the process of financialisation, for example by applying scrip taxes to companies or individuals in certain circumstances.[10] In this way, social accumulation of the proceeds of financialisation can in time help to directly fund vital future public expenditure. The fund, by owning equity rather than seeking to tax it, would have a strong, sustainable base for funding public investment, based on the public ownership of financial capital. It would operate with its own board and with due separation from party political interference in its investment decisions, though with a democratic mandate to support the fiscal strategy of the government of the day.

Conclusion

This represents an ambitious agenda. Ranged against the wealth and power of organised finance, hope for such ambitions might seem remote. However, a useful comparison might be drawn between today's financial system and the Catholic Church on the eve of the Reformation: two imposing cultural, intellectual and social systems that claimed a totalising logic, vastly powerful, whose elites spoke and operated in a vernacular beyond the understanding of ordinary people. Yet arguably now, as then, the hierarchy imposed by excessive financialisation is shallower than imagined and deep-rooted change is possible. This report is, of course, no *Ninety-Five Theses*. However, it is hoped that it can help to set out clear principles and policies for a still urgently needed financial reformation.

10 That is, taxes paid with shares not cash. For example, a scrip tax could be applied during mergers and acquisitions or on bonuses.

INTRODUCTION

> *'A Klee painting named Angelus Novus shows an angel looking as though he is about to move away from something he is fixedly contemplating. His eyes are staring, his mouth is open, his wings are spread. This is how one pictures the angel of history. His face is turned toward the past. Where we perceive a chain of events, he sees one single catastrophe which keeps piling wreckage upon wreckage and hurls it in front of his feet. The angel would like to stay, awaken the dead, and make whole what has been smashed. But a storm is blowing from Paradise; it has got caught in his wings with such violence that the angel can no longer close them. The storm irresistibly propels him into the future to which his back is turned, while the pile of debris before him grows skyward. This storm is what we call progress.'*
>
> Walter Benjamin, *Theses on the Philosophy of History*, 1940

Like Klee's angel, the UK remains trapped by the debris of the financial crisis. We cling to the basic institutional design that caused the crash, and remain caught in the debt hangover that was its consequence, even as we are propelled forward into an unstable economic future. Banks remain too big to fail, our credit system too distant from the real economy; corporate governance structures continue to incentivise excessive leverage and systemically risky behaviour, and we rely too heavily on unsustainable debt levels to ratchet up growth.

This set of interlocking institutional designs were crucial in driving the process of financialisation – an example of Benjamin's 'storm of progress' – that led to the crisis and which has marked one of the most important structural transformations in British capitalism in the last 30 years. Yet, six years on from the crash and despite efforts at reform that have in certain cases made genuine progress, the underpinnings of financialisation remain in place. The purpose of this report is therefore simple: to outline a set of institutional reforms that can reassert the democratic public interest over the financial system. In doing so, the aim is to help make finance a productive servant of society, not a promiscuous master.

Financialisation is defined for our purposes as the 'increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies.' (Epstein 2005) While this definition is neutral, there is a growing recognition that the scale and nature of financialisation in the UK is problematic, displayed through a variety of symptoms. For example, in 2011/12, banks 'too big to fail' operating in the UK received an implicit subsidy estimated at £65 billion (IMF 2014a). Such high implicit subsidy helps to account for the large-scale rent the sector receives at the expense of the wider economy, estimated to be worth as much as 25 per cent of the share of national income.[11]

What's more, this occurs even as the financial sector poorly serves the real economy. For example, net lending to UK businesses has been falling for almost seven years, with businesses actually repaying banks over this time as a sum total

11 Epstein and Jayadev (2005) examined rentier income in a number of countries between the 1960s and 2000. In analysisng this income, which they defined as the return to holders of financial assets plus the return to owners of financial firms, they found the UK share had risen from 6.8 per cent to 24.5 per cent in that period. They attributed this to higher real interest rates, financial liberalisation, greater economic openness and a weakening of the power of organised labour.

(BoE 2014a). Yet, in the last year, gross mortgage lending increased by 33 per cent to £11.6 billion (CML 2014). Financial trading by banks and shadow banks has also continued to soar, even though the volume of high-frequency trading and the accompanying levels of liquidity are, at best, often only tangentially related to supporting the real economy (Turner 2014, Lewis 2014). For example, from April 2010 to April 2013, the daily turnover in global foreign exchange, much of it based in London, increased by 47 per cent to more than US$2.7 trillion, in spite of global economic fragility (BIS 2014).

Beyond these narrow measures, a wider review suggests that the financial sector as currently organised actually helps to generate macroeconomic instability, particularly by inflating of regular asset bubbles via potentially dangerous levels of leverage. In doing so it lowers long-term growth rates, heightens a whole range of inequalities, and crowds out manufacturing. For a full account, see IPPR's previous report, *Don't bank on it*: *The financialisation of the UK economy* (Dolphin 2013). Furthermore, the financial sector does so in a way that strengthens the power of extractive elites within society (Acemoglu and Robinson 2012).[12]

The particular focus of this report is therefore on setting out proposals to reform the fundamental institutional designs that govern how the banking and shadow banking sector operate and which allow these problems to take root. Our remit is, therefore, not to focus on those sections of the financial system, such as insurance or asset management, that do not propel financialisation. Nor do we focus greatly on the minutiae of corporate governance reform, although we support important efforts to throw 'grit in the wheel' of the UK's mergers and acquisitions regime (Sainsbury 2013), to temper the damaging short-termism of our capital markets (Kay 2012a), and to rein in and make more responsible remuneration in banking (Hutton 2010). Instead we focus on the underlying generative structures of financialised capitalism: the endogenous creation of money by banking and shadow banking institutions and how that credit comes to be allocated in a way that is often unrelated to the real economy (Ingham 2009). It is these that create the dynamic of financialisation and, without addressing them, inevitably all other reforms aimed at achieving some level of 'definancialisation' will fall short.

How do we intend to do this? Chapter 1 begins by exploring the concept of financialisation before tracing its historical evolution and summarising its consequences. As Ann Pettifor has argued, '[financialisation] reflects a dense web of changing power relationships, not just economically, but also politically, socially and culturally – with power generally shifting from labour and democratic institutions to capital and non-democratic bodies, enacted by a coalition of largescale capital holders and the state itself' (Pettifor 2013a). Understanding the complex, dynamic nature of financialisation is therefore critical to framing an appropriate response.

In chapter 2 we examine why no deep programmatic response to excessive financialisation has been pursued in the wake of the crisis. It is important to understand why this has not occurred, particularly as the financial crash was caused by a combination of factors integral to the process of financialisation: high leverage, weak risk management hand-in-hand with disproportionate rewards, extreme maturity transformation, and incomprehensible levels of complexity, all operating in an interconnected, unbalanced global economy.

This is not to say that no serious reforms have been enacted in response to these issues. Nonetheless, the response has been muted when set against the scale of the upheavals generated in the financial sector, the impact this has had on living standards, and the challenges the sector continues to present to the stability and health of the wider economy. Understanding this modesty of ambition is therefore

12 For a summary of the concept of 'extractive elites', see http://whynationsfail.com/blog/2012/5/1/who-are-the-extractive-elites.html

important to any future reform agenda. We examine three of the main explanations as to why reform has remained incomplete: the argument that the state has been an explicit partner in the financialisation of the economy; the relationship between the financial lobby and policymaking processes; and the role of increasing debt levels in restricting the potential for different future political possibilities.

In the remaining chapters, we turn to what we believe should be central to any reform agenda: a reassertion of the public interest within the financial system, particularly to ensure the banking system better supports the non-financial economy. In chapter 3, we recommend implementing a policy of credit guidance regarding the quantity and type of credit created, in order to tighten the relationship between finance and production. As a corollary, we argue in chapter 4 for a reassertion of the democratic interest in the financial system via institutional reform of the monetary system, upping the equity ratio banks must maintain, and changes to the role of powerful intermediaries such as ratings agencies. Lastly, we recognise that financialisation will not be easy to reverse, and so alongside these other reforms we recommend in chapter 5 that, as part of a multipronged approach to definancialisation, the UK should adopt an innovative public capital ownership strategy. In particular, a sovereign wealth fund-style British Future Fund should be established, managed at arm's length from direct ministerial intervention but tasked with helping to fund future public expenditure through the social accumulation of the proceeds of financialisation.

Grounds for optimism

Taken together, these reforms aim to address the fundamental drivers of financialisation and reassert the democratic interest over the financial system. Yet, before we move on to examining the forces of financialisation and potential responses, it is reasonable to ask why we believe it is possible to reverse the momentum of financialisation at all. From the 'Big Bang' in 1986 onwards, the British story is one of governments across the political spectrum accepting the decline of British manufacturing and embracing finance as an area of comparative advantage. Moreover, the urge to reform the finance sector has dissipated, particularly with the passage of the Financial Services Act 2013 (Stephens 2014). Indeed, despite the 2007–08 financial crash being rooted in excessive leverage, unsustainable levels of private debt and the bursting of a housing bubble, the UK's return to growth in the past year or so has been based on rapidly inflating a housing bubble, debt-fuelled consumption and increasing flows of credit into mortgages and financial intermediation. The UK's policy attitude towards banking and its relationship to the British economy therefore at times appears akin to Samuel Beckett's famous dictum: 'Ever tried. Ever failed. No matter. Try again. Fail again. Fail better.'

To stop us 'failing' again, and repeatedly, the imperative is to definancialise. How, then, are we to build the social and political coalitions necessary to achieve this, given past failures? Reform will need to be driven by a majoritarian, pluralistic coalition that recognises that excessive financialisation imposes large costs on the public, both fiscally and democratically, while undermining the effectiveness of UK businesses. An alternative vision must be rooted in the productive, creative potential – social and economic – of a UK that is better supported by effective, accountable and responsible forms of finance. Effort is therefore required on multiple fronts: an assertion of utility value over exchange value in the creation and allocation of vital public goods like housing, which otherwise too often tend to be powered by speculative bubbles; new strategies and institutions for dispersing economic power far more widely in the economy, for example by promoting employee representation on boards, or through broad-based profit-sharing or new collective capital ownership strategies (see Lawrence and McNeil 2014); greater care over the stewardship of value, for example by making highly leveraged takeovers more

difficult; and, above all, a focus on building a majoritarian coalition committed to deep reform that supports new ways of owning, producing, consuming and financing.

The lineaments of such a movement are already emerging. Whether in the rapid rise of peer-to-peer lending, new forms of democratic finance such as Abundance Generation or Trillion Fund,[13] the growth of complementary currencies (see Naqvi and Southgate 2013), or the success of banks such as Handelsbanken that focus prudent investment on productive concerns (see Wilson 2013), the roots of change are in place. These new actors, together with those from other groups currently poorly served by the financial system, such as new SMEs and start-ups (Lent 2012), trace the outline of a potent coalition for reform. For ultimately, if deep-rooted reform is to be successful, it cannot simply rely on change through legislative order; it must also build the capacity, platforms and institutions capable of creating a more inclusive, productive financial system.

Our recommendations therefore aim to support this by addressing the fundamental drivers of financialisation, specifically by reasserting the democratic interest over the financial system. In doing so, with due effort and patience, Walter Benjamin's 'angel of history' might be rescued from the debris of the recent past and set on the path to a more prosperous, equitable future.

13 See https://www.abundancegeneration.com/ or https://www.trillionfund.com/ respectively.

1. WHAT IS FINANCIALISATION?

Financialisation as a concept has intertwining definitions. For our purposes, Gerald Epstein's expansive definition is a useful anchoring point: 'Financialisation means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies' (Epstein 2005: 3). This definition captures three key interrelated aspects of financialisation, which in some form most authors place at the centre of the process of financialisation: the growth of the financial sector in size and complexity, the increase in financial activity as a source of profit, and the increasing 'financialisation of everyday life'. Importantly, this process has occurred across multiple actors at different levels of analysis, from the global finance to the individual household, via families, corporations and national economies (Casey 2012). Any definition of financialisation as a phenomenon is also typically bound up with the related rise of a neoliberal political economy in which private capital accumulation has been increasingly driven by the liberalisation of financial markets, extensive privatisation programmes, the weakening of organised labour, and the assertion of shareholder sovereignty over that of other stakeholders.

In terms of size and complexity, financialisation is partly defined by the growing scale of financial activity as a share of GDP. This has been a marked trend over the past 30 years among developed economies, particularly the United States and UK, whether in the volume of financial transactions or the increase in gross value added (GVA) of the financial sector (Dolphin 2013). It is also evident in the growing relative size of that sector. In the 1960s, for example, the assets of UK banks amounted to around 40 per cent of GDP, but this had increased 10-fold by the end of 2012, and could – according to Bank of England governor Mark Carney – rise to a staggering nine times GDP by 2050 (Wolf 2013a).

However, for many it is not just the increasing scale of the financial sector but the changing nature of financial markets that is the central feature of financialisation (see for example Foster 2008). Those who take this view point in particular to the decline in bank lending, particularly lending to the non-financial sector of the economy, relative to the rapid growth of capital markets, financial trading and new financial instruments in the last 30 years. For example, the total value of foreign exchange traded each year ballooned from 11 times the size of global trade value in 1980 to 73 times that in 2011, the value of oil futures trading grew to ten times the value of physical consumption and production by 2013, and interest rate derivatives trading grew from nil in 1980 to be worth over $390 trillion in mid-2009 (Mulgan 2013). The staggering rise of financial activity relative to production is neatly summarised by the fact that, at the peak of the outstanding over-the-counter derivatives market in 2008, it was worth 'the equivalent of everything produced on earth for the previous 20 years' (Duncan 2009).

Moreover, the pace of acceleration in trading has not declined since the crash of 2007–08. A survey by the Bank of International Settlements shows a significant pick-up in global foreign exchange market activity during the period of the global recession, with over $5.3 trillion per day traded in 2013, a 35 per cent increase from 2010, itself an increase of 20 per cent from 2007 (BIS 2013). Similarly, the outstanding over-the-counter derivative market has increased dramatically from its pre-crisis peak, to $710 trillion in December 2013 (BIS 2014).

Another indicator frequently posited as central to the process of financialisation is the increasing share of total profits in the economy received by financial corporations (see for example Krippner 2011, Freeman 2010). Undoubtedly we have seen over the past 30 years a dramatic increase in the share of total profits accounted for by the financial sector, most evidently in the US, where its share rose as high as 45 per cent before 2008 (Reed and Himmelweit 2012). The UK has experienced a similar if slightly less dramatic increase, with finance's share of total profits rising five-fold over three decades, to over 22.5 per cent by 2009 (Dolphin 2013). As Krippner has argued, then, financialisation represents a 'pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production' (Krippner 2011).

Still others have argued that the defining feature of financialisation is the increase in debt it facilitates, in particular the debt of private households (see Palley 2007). While Palley's argument centres on developments in the American economy, his analysis of financialisation is particularly relevant in the UK, as household debt here is 'higher – relative to disposable income – than in any other major advanced economy, and probably higher than anywhere else in the world' (Dolphin 2013). In this regard, financialisation is argued to be part of what Colin Crouch (2009) has termed 'privatised Keynesianism': an attempt to maintain aggregate demand through a policy of supplementing stagnant wage growth with growing private debt levels. The UK provides a dramatic example of this: UK household debt grew from 15 per cent of GDP in 1964 to 95 per cent by 2008, the highest among the G7 states (Turner 2014).

The creation and accumulation of debt is also given central emphasis by Michael Hudson (2012), who claims financialisiaton is a process by which economies become increasingly focused on rentier activity, siphoning economic surplus into new debts and claims on society's output. Collectively this process has been called 'accumulation by dispossession', whereby the financial system seeks to 'constantly reproduce itself to maintain and increase profitability by looking for new asset seams to turn into collateral' (Harvey 2005). In this way, financialisation is viewed as the process by which capital formation is no longer intended to maximise productivity but instead to generate as much interest, fees and capital gains as possible for the creditor (Epstein and Jayadev 2005). This line of argument also stresses the effect of the monetarist turn in the late 1970s, begun before Reagan and Thatcher came to power, which reinforced an era of lower inflation and high real interest rates, strengthening returns to financial asset-holders.

Linked to this general rise in debt is the embedding of financial activity into social relations, and for some this is another strand in the definition of financialisation (see for example Lapavitsas 2013). Arguably, this is not a new insight. It was Marx, after all, who argued that capital, in order to maximise profit, seeks to enter the private sphere of the household, thereby transferring welfare responsibilities from public institutions to private households supported by new forms of private debt. What, however, distinguishes financialised capitalism from earlier forms is its international character, linked to the collapse of the Bretton Woods settlement in the 1970s. This aspect is stressed by authors such as Nelson Barbosa-Filho (2005). By this analysis, financialisation is a type of capitalism more akin to that seen in early globalisation of the late 19th century, in which London served as a financial *entrepôt* for the world, than it is to the post-war Keynesian economic model of managed demand in a mixed economy.

Finally, the rising economic importance of finance has, many have argued, also translated into increased political power, with policy increasingly weighted in favour of the financial sector. Definitions of financialisation are therefore increasingly coupled with accounts of rising political inequality (for examples, see Streeck 2011, Piketty 2014).

By any definition, then, financialisation represents a mesh of interrelated changes in the nature of capitalism, marked in particular by the rising dominance of financial activity within the economy, both in profit and scale. This occurs simultaneously at a global, corporate and household level, with significant consequences for the political, social and economic organisation of society and the social relations within it, with power gravitating away from the labour force and democratic institutions and towards the holders of large-scale private finance capital.

What causes financialisation?

Financialisation has been one of the most important structural transformations in developed capitalist economies, particularly the UK and US, in the last 30 years. Historical accounts of this process typically claim that, at a structural level, the stagnation experienced by developed economies during the late 1970s accelerated efforts to increase levels of credit and financial activity within the economy as a means to generate growth (see Sweezy and Magdoff 1983, Lapavitsas 2013). As overall growth rates slowed towards the end of the decade, capital increasingly shifted from funding production in the real economy to circulating in financial activity. Thus 'the old structure of the economy, consisting of a production system served by a modest financial adjunct' still evident in the middle part of the decade increasingly gave way to 'a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on top of the underlying production system' (Sweezy 1995). Increasing debt levels effectively 'brought forward' future resources to compensate for decreasing growth and productivity in the present.

This structural analysis might be linked to the argument made by Giovanni Arrighi (1994) that financialisation is driven by historical cycles of accumulation, whereby great but fading economic powers enter a crisis phase and turn to finance as their productive advantage over economic rivals recedes. In this interpretation, Arrighi mirrors the argument of the historian Fernand Braudel, who claimed that financialisation had heralded the autumn of various superpowers throughout history. He pointed to the rise of the City of London in the 19th century, for instance, which occurred just as Britain's imperial and manufacturing pre-eminence began to fade. Similarly, Arrighi argued that the American-led capitalist system of the late 20th century had entered a similar stage in the historical cycle. From this perspective, financialisation reflects the cycle of capitalist development interacting with imperial geopolitics, bringing first a stage of material expansion before later turning to financial activity as a means to maintain capital accumulation. That's to say, whatever profits and 'growth' might result, financialisation is an indicator of deeper faults – it is the canary gone quiet in the mine.

Others argue that the dominant shareholder-oriented corporate governance structure of British capitalism has helped to fix capitalist societies on a path that privileges financial over non-financial economic activity. By this view, financialisation reflects corporate governance codes that have locked corporations into 'path dependencies' in which they are incentivised to 'financialise' their activities (Davis 2005, Hutton 2010). The short-term drive to maximise shareholder value under market pressure has gradually reoriented firms from seeking profit by investing in long-term production to focusing on rapid trading in financial markets. Emblematic of this is the fact that General Electric now makes more profit from its GE Capital division than it does from all its manufacturing divisions combined (Pylypczak 2014). This realignment of priorities has made the short-term revenue and profit potential of financial activity far more attractive – and safer to justify to shareholders – than non-financial activity. As Gerald Davis (2005) argues, corporate governance's emphasis on the shareholder has meant we have moved 'from a social system orbiting around corporations and their imperatives … to a market centred system in which corporations themselves – along with households and governments – are guided

by the gravitational pull of financial markets.' This trend has been reinforced by the coupling of extravagant financial remuneration with short-term share performance, often unrelated to long-term value created. However, while undoubtedly important, corporate governance alone appears too narrow as a conception of political economy to fully explain the turn to finance.

Other, complementary explanations stress the role of private banking institutions in creating and allocating excessive amounts of credit, which flowed into credit and asset bubbles (primarily housing) rather than into investments in new assets or facilitating increased sustainable productivity (Shiller 2000). This is exemplified by the words of the former Citigroup CEO Charles Prince, who, when questioned on the eve of the crisis whether speculative behaviour on the part of major financial institutions resembled a gigantic bubble detached from underlying value, replied: 'As long as the music is playing, you've got to get up and dance' (Nakamoto and Wighton 2007).

This trend was strengthened by gradual global liberalisation of capital flows in the 1970s and 1980s, following the collapse of the Bretton Woods system of fixed exchange rates (Dolphin 2013). More recently, Ben Bernanke, former chairman of the US Federal Reserve Bank, has suggested that a 'savings glut' – a tremendous increase in the flow of capital from China and oil-producing countries into the US between 2003 and 2007 – contributed enormously to the bubbles that preceded the recent financial crisis and in the process deepened financialisation. Other influential commentators, such as Dean Baker (2014), have also stressed the importance of trade imbalances and savings gluts to the rapid growth of the financial sector. The role of global trade imbalances, not just in China but in other major export-driven economies such as Germany and Japan, compared to consumption-led economies such as the UK or US, therefore does seem to be of vital importance in any explanation of why and how financialisation has occurred (see Borio and Disyatat 2011).

'Stability is destabilising'

Hyman Minsky (1919–96), a heterodox post-Keynesian American economist, argued that the mainstream belief in macroeconomic 'equilibrium models', where market economies are stable in the absence of exogenous shocks, was wrong. Instead, in his 'financial instability hypothesis', he argued that financial markets can produce economic crises endogenously, without external forces. Why he believed this was pithily summarised in his phrase 'stability is destabilising'.

By this he meant that financial markets go through three distinct stages. First is the stable 'Hedge' phase, where borrowers and lenders are cautious. The second 'Speculative' phase sees loans being made against which the borrower can on average only afford to pay the interest; these loans are made in expectation of capital appreciation, brought about by the relative stability of the 'Hedge' phase. Finally, in the 'Ponzi' phase, a belief in ever-rising asset prices creates a euphoric financial market, and loans are against which the borrower cannot afford to finance neither the interest nor the principal if asset prices do not rise at the expected rate. Crucially, the sense of stability in the financial system at the beginning of a cycle internally generates the momentum towards a destabilising, Ponzi-style phase.

In this final phase, if asset prices fall, or fail to rise at the expected pace, a so-called 'Minsky moment' occurs, when there is a rapid realisation that the accumulated debt contracts will never be repaid, sparking a fire-sale of assets, in turn driving prices down even further, whereupon a financial crisis becomes an economic crash. This description neatly captures the dynamic that led to the events of 2007–08. Moreover, not only did Minsky effectively diagnose the speculative, destabilising dynamic of liberalised credit markets that drive financialisation, his remedies – a tighter regulatory system that leans against the over-accumulation of private debt – also have substantial merit, and will be reflected in later chapters of this report.

For further details, see *Stabilizing an Unstable Economy* (Minsky 1986).

Finally, it is important to stress, as shall be explored in greater detail later, financialisation was not simply a product of private financial markets developing of their own accord, in opposition to a regulatory state. For as Karl Polanyi argued, changes in political economy are embedded in a far wider constellation of social and political forces – and financialisation is no different. By this view, the process is intimately bound up with the rise of 'neoliberal' political economies, in which the state was an active partner, with reform marked by cultural, political and social choices. Greta Krippner, for instance, expertly shows how financialisation occurred in part because of a deliberate choice by policymakers and politicians to 'de-democratise' decisions concerning resource scarcity in the late 1970s, with the resulting turn to monetarism and the market to allocate resources reflecting a depoliticisation of distributional questions – questions which democratic actors had managed to postpone answering, to varying degrees of success, since the 1960s (Krippner 2011). Seen through an historical lens, the deregulation of financial markets and their prodigious growth in the following decades was a response to the fraying of the post-war economic consensus.

Similarly, an influential group of scholars led by Wolfgang Streeck and Claus Offe argue that financialisation is part of an ongoing attempt to delay the 'crisis of democratic capitalism' – the tension between the conflicting demands of financial markets and that of citizens empowered by democracy. In this account, the crisis was first evaded by a turn to inflation in the 1970s, then by allowing rising public debt in the 1980s which 'for a while acted as a functional equivalent of inflation', and then, when the pressure on public debt accumulation grew too intense, by encouraging and facilitating growing private indebtedness (Streeck 2011). In this argument, the crisis of 2007–08 is taken to be the private debt-driven model of financial capitalism reaching the limit of its attempts to escape the political dilemmas imposed by economic scarcity. Regardless of how accurately this analysis captures the dynamic of financialisation, it remains an imperative that finance is reformed to sustain a recovery built on the creation of value and sustained productivity growth over an unsustainable, overly financialised future.

Why tackle financialisation?

IPPR's earlier report, '*Don't bank on it: The financialisation of the UK economy* (Dolphin 2013), presented a detailed ledger of the positives – of which there clearly are some – and negatives of financialisation. However, it concluded that the degree to which financialisation has occurred in the UK is problematic and should be reversed. This report builds on that finding. Similarly, it follows that report in arguing that definancialisation is not about selecting an arbitrary set of figures to aim at. Rather, the marker of success is changing a set of behaviours and outcomes which the financial system currently produces: rent-seeking, detachment from the real economy, destabilising negative externalities. To achieve that, however, it is important to have a better sense of the problems that are caused by financialisation.

The scale of financialisation has generated very significant negative externalities, most noticeably in the continued implicit subsidy of banks that are 'too big to fail'. Moreover, while that subsidy continues at roughly £65 billion a year (IMF 2014a), when banks do actually fail, too often the cost is explicitly socialised. For example, in the aftermath of the financial crisis, the National Audit Office estimated that 'the total outstanding support explicitly pledged to the banks … is £456.33 billion' – equivalent to 31 per cent of GDP at the time (NAO 2011). Andy Haldane, the executive director of the Bank of England responsible for financial stability, went further, suggesting that if the indirect costs of recurring banking crises were recouped in their entirety from those responsible, the cost would be greater than the total market capitalisation of the largest banks (Haldane 2010). The banks literally could not afford to save themselves.

Financialisation has also been associated with dramatically increased macroeconomic volatility, with larger and more frequent asset bubbles as well as deeper and longer recessions. For example, Caprio and Klingebiehl (1999) have demonstrated that, while there have been well over 100 banking crises in the past 50 years, their number and magnitude have accelerated during the period in which financialisation has intensified. Moreover, the contemporary financial system, by facilitating larger credit and asset bubbles, has led to post-crisis recoveries that are slower and more drawn-out than those experienced prior to 1970, especially as post-recession debt hangovers have become progressively larger.

Nor has this necessarily come in return for more efficient capital allocation. As Tony Dolphin argues, echoing the critique of many:

> *'The financial sector's primary role should be to allocate capital in the most efficient manner but there are parts of the economy, such as small businesses, which are starved of the capital they need, while lending within finance has reached extraordinary levels.'*
> Dolphin 2013: 48

Evidence previously presented in this report bears this out. Indeed, there is 'no evidence that a much bigger financial sector, relative to the rest of the economy, has led to an improvement in resource allocation or to better returns for savers and investors' (ibid: 2) nor is there evidence for a positive relationship between sustainable GDP growth and growth in the financial sector relative to the rest of the economy (Turner 2012, 2014; King and Levine 1993; Haldane 2012a, 2012b).

Moreover, financialisation has entrenched the sector's capacity to extract rent,[14] which is now estimated to account for up to 50 per cent of the wage differential between finance and the rest of the economy (Philippon 2008). The existence of oligopolies, information asymmetries and a widespread lack of transparency – all of which is reinforced by the institutional underpinnings of the financial system as a whole – reinforces this capacity for rent-seeking. Indeed, Epstein and Jayadev (2005) found a substantial and sustained increase in rentier income shares from the 1980s onwards, attributing it to higher real interest rates, financial liberalisation, greater economic openness and a weakening of the power of organised labour. One result is that financial intermediation in the UK accounted for 15 per cent of total economic profits in 2008, up from just 1.5 per cent in 1978 (Haldane 2010).

Another result is that the process of deepening financialisation has been associated with increasing inequalities in income. For example, Bell and Van Reenen (2010) have shown that the share of income going to those in the top 0.1 per cent of the income scale almost trebled between 1985 and 2009, while the share going to those in the top 0.5 per cent more than doubled. More pertinently, between 1998 and 2008, approximately 60 per cent of the increase in the top decile's income share (and also in that of the top 1 per cent) went to workers in the financial sector – and almost entirely in the form of bonuses. Thomas Piketty (2014) shows that the sharp concentration of income in developed economies in the past 30 years cannot be wholly explained by the rise of finance – other important structural factors are in play. Nonetheless, the evidence does suggest that the rising economic power of finance relative to the rest of the economy has had a strong and distinctly inegalitarian effect.

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14 Economists define rents as excess returns that accrue as a result of positional advantage in a market, for example as a result of exploiting a monopoly, or patent rights, or information not available to other participants in the market. Rentiers are 'those who benefit from control over assets that the economy needs to function and who, therefore, grow disproportionately rich as the economy develops' (Hudson and Bezemer 2012: 6) Economic rent is any payment to a factor of production in excess of its opportunity cost, extracting wealth rather than adding to it.

For example, while it is a difficult claim to prove entirely given the nature of the data, [15] financialisation has been associated with dramatically increased wealth inequalities. For example, the Gini coefficient for financial wealth[16] in the UK has recently risen to 0.92, with nearly a quarter of households now having total debts that exceed their physical and financial assets (ONS 2014b). In short, financialisation has helped concentrate economic power. This is not simply a moral concern, though it is clearly that. Rising inequality also contributes to macroeconomic instability, as households take on excessive levels of debt in an attempt to maintain living standards. For example, Kumhof and Rancière from the IMF (2010) have recently made the argument that inequality and the build-up of debt it induced was pivotal in precipitating the recent crisis.

Financialisation also tends to contribute to the structural and spatial reshaping of the economy. In particular, one argument regularly made is that the rise of finance has typically coincided with a decline in manufacturing as a share of the economy (see Berger 2014). There are complex reasons for this, but certainly in the UK – where manufacturing as a share of total output and in terms of employment numbers has been in long-term decline – history suggests that the economic dominance of the financial sector has likely played a contributing role in manufacturing's decline, even if productivity increases account for the majority of job losses in the sector. Perhaps more pertinently, capital is typically geographically concentrated, and in the UK 'over half the contribution of financial services to UK gross domestic product comes from London and the South East' (TheCityUK 2012), further exacerbating existing regional imbalances.

In sum, while the financialisation of the UK economy has brought some benefits, it has also helped to embed economic rent-seeking, entrenched multiple, interlocking inequalities, increased macroeconomic instability, and loosened the relationship between finance and the real economy. In doing so, the cumulative and most significant effect might well be the hollowing out of democratic power. For, as Piketty and Streeck among others have argued, the circulation and accumulation of capital in 'financial capitalism run amok' has increasingly meant that the contest between the social rights of citizens of democratic states and the demands of large-scale international capital holders has been settled in the favour of the latter. Power has become increasingly financialised, private and narrowly held. In the words of Wolfgang Street, if financialisation deepens further then:

> *'There seems a real possibility of a new, if temporary, settlement of social conflict in advanced capitalism, this time entirely in favour of the propertied classes now firmly entrenched in their politically unassailable stronghold, the international financial industry.'*
> Streeck 2011

It is this threat posed by financialisation to the democratic fabric of our society that animates this report and its recommendations.

15 For an excellent summary of the challenge, see Reed 2014.

16 As a component of total wealth, alongside property wealth, physical wealth and private pension wealth.

2.
WHY REFORM OF FINANCE HAS THUS FAR 'FAILED'

In the wake of the financial crisis a radical overhaul of the architecture of the financial system was widely predicted. Yet while some significant reforms have been undertaken, ambition has not matched outcome. If a reform agenda is to succeed in the future, it is therefore important to understand why this has been the case.

One argument is that financial services, because they continue to represent a major competitive advantage for the UK economy and a significant source of tax revenue, should be left unreformed. As an illustration, in 2011 the financial and insurance services contributed £125.4 billion in gross value added (GVA) to the UK economy, or 9.4 per cent of total GVA (Broughton and Maer 2012). However, explanations centred on basic economic calculus have received widespread consideration. It is therefore worth examining the interlocking social, cultural and political strengths of the financial sector, which have arguably also helped to limit the scale of reform.

An in-depth examination of this nexus of forces behind the rise of financialisation is beyond the scope of this report. Nonetheless, by appraising the relationship between state action, political lobbying and debt accumulation, it is possible to gain a better sense of the complexity and influence of contemporary finance. In doing so, it can point towards how best to achieve further reform in the future.

Financialisation and the state: an intimate relationship

The state has been a key partner in the financialisation of the economy. Contrary to popular conception, the neoliberal turn that ushered in financialisation was not hostile to the state in its totality. Rather, it was reliant on state action but in a manner often radically different from that which it performed during the Keynesian postwar era. Gretna Krippner, as has been noted already, has persuasively argued that the 'de-democratising' of decisions on questions of economic scarcity was rigorously pursued by the central state from the 1970s onwards, which in turn saw private financial institutions increasingly acting as economic intermediaries. Similarly, Mirowksi and Plehwe have claimed that monetary strategies were dramatically reformed in this period in an attempt to galvanise the turn to finance (Mirowski and Plehwe eds. 2009). The state was also a crucial actor in deregulating the financial markets and liberalising tax regimes while simultaneously weakening the power of organised labour, which had traditionally served as a check on the power of organised finance. In short, financialisation was embedded into the UK's political economy by explicit state action (Gamble 2009).

More recently, the implicit support for heavily leveraged banks, which was made explicit during 2007–09, underscores the increasing intertwining of large financial institutions with the modern state. Addressing this concentration of economic and political power therefore requires reasserting democratic interests not simply over the financial sector but also over the organisation of the state itself.

The influence of organised finance

Any examination of the apparent invulnerability of financialisation in the wake of the financial crash must take into account the intertwining of the economic power

of finance and its political influence. For, as John Kay (2012b) has argued, the financial services industry is one of the most powerful, organised political forces in the western world today – if not the most powerful – and it uses that power to protect its interests. In terms of EU lobbying, for example, recent estimates show that the financial industry outspent other public interests by a factor 30 to one (Finance Watch 2014). Such expenditure brings benefits: when the 'troika' (the IMF, European Commission and European Central Bank) negotiated the terms of the Greek debt settlement in 2012, the International Institute for Finance, a lobby group representing 450 private banks, was an active participant – as Colin Crouch notes, this was 'a privilege not extended to any member of Greek civil society' (Crouch 2013: 19). The level of access and potential influence this implies suggests a shift in our notion of authority – or, as Wolfgang Streeck puts it, financialisation is arguably creating 'a new form of sovereign – the people and the market with balance of power rapidly shifting towards one' (Streeck 2012).

Similarly, the financial sector is a source of significant funding for all mainstream political parties, while the City of London Corporation has a privileged position in lobbying, including having one of its representatives sit in parliament. It is this organisational power that underpins Martin Wolf's claim that certain reforms, such as moves to raise equity ratios, have faltered not because the proposed reforms were bad for the wider economy but due to banks' lobbying (Wolf 2013b).

The extent to which this type of political inequality has become a fundamental aspect of the modern financialised economy matters because, as Kay again argues, among other things:

> *'Economic growth is held back by industries where established interests are so powerful that disruptive innovation can be staved off for ever. Financial services is probably one.'*
> Kay 2012b

As a result, it is plausible that the power of the corporate lobby – and, arguably, finance most of all – undermines the market economy and democratic policymaking by subordinating 'general and widespread interests to those of a privileged few' (Crouch 2013: 47). Internationally, it is a similar process working on the relationship between finance and political decision-making that led Streeck to claim that:

> *'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 upon the political economy interests and demands that incommensurable with those of capital owners.'*
> Streeck 2011

Regardless of the true extent of this process of political capture, what a brief analysis of the political influence of the financial sector suggests is that those interested in reform must reject notions of an *apolitical* economy; politics is not exogenous but central to the shaping of a market economy and how it distributes reward and influence. Presently, organised elite interests within the economy – including in the financial sector – operate in a way that accumulates and protects power. Any response must therefore reassert the *political* aspect of 'political economy', recognising that institutions which influence the nature and effectiveness of our financial system are social in origin, not natural and immutable. We should therefore not accept as fate the institutional inheritance of the UK's past political economy; democratic politics can, by patient, programmatic reform, reshape the institutions of our financial system so that they better serve the public interest.

Debt and the foreclosing of the future

The era of financialisation is strongly identified with rising levels of indebtedness. For example, the UK's total debt – public and private – is now equivalent to 484 per cent of GDP (Peston 2014), more than doubling from just under 200 per cent in 1987 (PWC 2010). This has important political and economic consequences for, as Will Hutton argues, 'credit and debt are intimately related to power' (Hutton 2010: chapter 12). As debt levels have risen, it has shifted power towards creditors at the expense of the indebted, while acting as a hidden mechanism of accumulation, as resources are redistributed from debtors to creditors.

Debt 'brings forward' future resources to the present. If it is directed at increasing the productive potential of the economy, this process can be vital to stimulating growth and innovation. However, it also ensures that future productivity gains are at least partly indebted to repaying creditors, representing 'a constant drag on efforts at social and economic renewal' (Davies 2013). Financialisation encourages a dramatic accumulation of debt contracts in the present, contracts which have a strong hold on what is possible in the future. In a very real sense, then, financialisation forecloses potential futures. For, as Davies puts it, if contemporary politics is animated by the tension between, on one hand, the potential of futures not yet made – and capable of being brought into being by democratic action – and, on the other hand, capitalist institutions, which reserve the right to control the future for those who view it 'via the logic of investment' (ibid), then one reason efforts at reform often fall flat is the sheer weight of debt already in circulation.

As a consequence, then, part of the challenge in definancialising our society is to determine how to maximise the potential of political institutions to bring about different possible futures. Into this space fall, at the most radical end, ideas such as targeted debt jubilees (see Graeber 2011), alongside more conventional efforts to ensure debt is targeted at generating a more productive future, not simply a more constrained one.

The potential for change

These are significant challenges. Nonetheless, as a beginning, any response must be grounded in a recognition that financialisation is not an ineluctable process. As Crouch argues, the way the economy is organised – and the dominance of finance within it – is a deeply political outcome, 'driven by human choices that gratuitously intensify the process' (Crouch 2013). Politics can, over time, begin to undo what it has previously made. However, this is not the same as suggesting that financialisation can be overcome by a 20th-century model of politics, where centralised parties support an individual decision-maker who legislates change. Reversing financialisation will not be achieved by relying on the individual political bravery of political leaders, particularly in an age when traditional models and sites of political leadership are under severe pressure. Instead, reversing a process driven by deep structural causes requires a deep structural response. As a result, more positively, it is an agenda to be advanced as much by nurturing a broad-based democratic politics as by actions within a more traditional, hierarchical model of change.[17] With this in mind, we now turn to the decisions and steps that such a broad-based democratic politics could take, collectively, to reassert the public interest over the financial system.

17 Jeremy Gilbert has recently explored what this more horizontal, grassroots politics could mean in practice and how it could be better supported (see Gilbert 2014).

3. TARGETING CREDIT AT THE PRODUCTIVE ECONOMY

Credit is a vital public good. Banks therefore have a unique economic privilege and monopoly power, in that they create and allocate 95–97 per cent of the money supply (McLeay, Radia and Thomas, BoE Quarterly Bulletin 2014). Yet they have little accountability in how they discharge their role as custodians of the money supply, nor do they perform that role as effectively as they could in relation to the wider economy. Indeed, the assumption that, left to its own devices, 'the financial system will create an optimal quantity and mix of credit' has been disproven (Turner 2014). Most new forms of credit do not go into generating sustainable returns through new business investment or productive capital formation, as is classically assumed. Instead, it often circulates by funding overly speculative asset trading, financial transactions or consumption. While some of this is useful, the extent to which credit used for these types of activity dominate over credit going to GDP-enhancing transactions or non-financial activities is problematic.[18] An unregulated credit system therefore suffers from a fallacy of composition, with an inherent collective tendency to endogenously create 'too much of the wrong sort of debt' (Turner 2010).

This has profound implications for the economy. In particular, it causes two economic problems central to the dynamic of financialisation: macroeconomic instability caused by unsustainable asset inflation, and the divorce of finance from the real economy. **To tackle this, we believe that the remit of the Financial Policy Committee of the Bank of England should be changed to include an additional, clear mandate to guide the quantity and type of credit in the economy, reanchoring credit growth in GDP-enhancing transactions. It should also have clear, public lines of democratic accountability and strong mechanisms to achieve its goals**.

The state is already implicitly involved in insuring the credit system: a public-private partnership already exists and underwrites the financial system. The question is therefore not whether it should be involved at all – it already is, as a guarantor – but how democratic influence can be better brought to bear in shaping the system so it more effectively supports the equitable creation of sustainable value in society.

Key challenges

However, before we turn to setting out how this should function, we will examine the two key challenges the new system must overcome.

Asset inflation leads to financial crisis

One of the best predictors of a financial crisis is sustained, excessive credit growth beyond the rate of nominal GDP growth (Arcand, Berkes and Panizza, 2011; Schularick and Taylor 2012). In particular, systemic risk is increased when credit

18 GDP-enhancing transactions include credit to manufacturing industries, construction, the non-financial service sector, mortgage credit to fund new homes and sustainable consumer credit. Non-GDP-enhancing transactions include credit to non-bank financial institutions, bank-to-bank credit, credit to financial or property-holding companies, and credit used to purchase existing property assets. In short, not all bank credit creation is used for GDP transactions: asset and financial transactions do not contribute to GDP. Any measure of the quantity of credit therefore needs to be split into two streams: credit for GDP transactions and credit for non-GDP transactions. For further details see Werner 2012.

going to support either financial activity or asset purchases – in the expectation of continued price appreciation – grows at a quicker, sustained rate than the growth rate of credit that is used to invest in the productive capacity of businesses to generate sustainable returns through new products or productive capacity (Werner 2009, 2011). Indeed, the quantity and use of financial credit (as opposed to credit invested in the real economy) was central to explaining the UK's four most recent financial crises (Dolphin 2013). For example, bank balances trebled between 2000 and 2007, with the growth in financial credit flowing predominantly to financial trading, mortgage credit or commercial property deals (Casey 2012). This process did not result in consumer price inflation. However, the quantity of credit created and how it was used significantly inflated asset prices, which in turn resulted in unsustainable debt contracts centred around the housing market, particularly in the US. Widespread default on those debt contracts followed, which prompted a wider economic crash. Moreover, this process of creating unsustainable debt contracts has been magnified by financialisation, as the locus of profit-making has shifted from investing to create new productive assets to investing to maximise rent-seeking activity, boosted by bidding up equity prices and encouraging excessive financial speculation.

At root then, an under-regulated private credit system typically creates too much credit for financial companies or property deals relative to the amount it creates to support GDP-enhancing transactions in the non-financial economy, as the former is often a swifter way to maximise profit in the short term. A credit system geared towards supporting financial and property trading consequently typically inflates asset bubbles that, if unchecked, can result in financial instability. This is not an aberration but rather one of the central contradictions of capital: banks make profit through selling, managing and insuring debt, so they have a structural incentive to increase the volume of it, regardless of the wider, potentially destabilising effects that might generate (Harvey 2014). Therefore controlling the quantity and use of newly created credit is critical if you want to tame boom and bust asset cycles, which usually have wider macroeconomic implications. Given that the OECD and the Bank of England have recently repeatedly warned that the rapidly inflating housing market, driven by the growth of mortgage credit in excess of wider credit growth in the economy, threatens the stability of the recovery, this remains a very pressing concern.[19]

Sustainable, GDP-enhancing activities are starved of credit

In the current financial system, capital too often circulates without an effective attachment to the real economy, moving in investment circuits predicated on continually rising asset prices as opposed to investing in creating sustainable economic returns based on increasing the productive capacity of the economy. For example, business lending is negative in net real terms (BoE 2014a), while from 1998 to 2008 – when credit was growing rapidly in the economy – bank lending to 'productive business' as a share of total lending fell 30 per cent to 10 per cent, 'mainly because bank lending to other financial firms and property development ballooned' (CRESC 2009: 64). Partly as a result, the UK's investment-to-GDP ratio is now ranked 159th in the world, below that of Mali, Paraguay and Guatemala, among others (Economist 2013). This helps to explain the UK's poor productivity performance, with the average UK worker currently 21 per cent less productive than the average G7 worker (ONS 2014a).

Meanwhile, since 1980, an abrupt change in the pattern of new equity issuance and new credit market borrowing of non-financial corporations in the US and the UK has occurred. Due to the rise of share buybacks, dividends and equity-related bonus packages, the sharemarket, rather than being a positive net source of finance, has become a net drain, as more money has gone out to shareholders than

19 See Guardian 2014 and Kollewe 2014 respectively.

has been invested inwards or raised through it (Palley 2007). That is, the value of extractive activities facilitated by a key part of the financial sector has exceeded the total amount of investments *into* businesses. Another indication of the detachment of finance from production is the fact that, in developed economies, upwards of 90 per cent of capital expenditure by firms is now funded from their own retained earnings (Unger 2009; Mayer 2013). Evidently, financialisation has not led to a more pluralistic, broader system of financing production. Indeed, as one felicitously titled work would have it, the financial system often appears to be *profiting without producing* (Lapavitsas 2013).

This detachment of credit from sustained productive investment is deeply problematic because there is substantial evidence that directing credit to the real economy is central to achieving sustainable growth and reducing the risk of macroeconomic instability. One study, covering 77 countries over three decades, found a very strong, robust correlation between the proportion of total credit issued to non-financial firms and transactions, on one hand, and rates of growth and physical capital accumulation on the other (King and Levine 1993). Similarly, Calza et al (2006) found that ensuring the majority of loans reach the real economy is central to achieving a sustainable increase in GDP, although they did not identify any particular 'golden ratio'. In several studies, Richard Werner also found that focusing credit on sustainable, GDP-enhancing transactions is critical for economies to achieve superior medium- to long-term economic growth (Werner 2009, 2011). Two long-running, multi-country studies in the eurozone and the US also found that focusing the supply of credit on non-financial enterprises has a significant positive effect on real economic activity (Cappiello et al 2010, Driscoll 2004).

Moreover, the circulation and private accumulation of capital that the UK's current private credit system enables is a critical cause of the rise in levels of wealth and income inequality western societies have experienced. For example, the overall inequality of financial wealth in the UK has risen over time to a stark 0.92 on the Gini coefficient, with a quarter of the country having negative net financial wealth, while in the period 2010–12 the total aggregate wealth of the richest 20 per cent of households was 105 times greater than that of the least wealthy 20 per cent of households[20] (ONS 2014b).

Therefore, if the UK wants to tackle its tendency to generate housing bubbles, make its financial system more equitable and stable, and start to address its weak productivity performance, it must tighten the connection between credit growth and increased productive investment, with more finance going to support the non-financial economy. What is required in practice is a rebalancing of the quantity and use of credit created so that it does what the theory presumes it should: invest in capital formation that builds the productive capacity of our economy so that it is capable of generating higher sustainable returns for the common good.

Building a credit-targeting system

How then should a credit-targeting system operate? First, the remit of the Financial Policy Committee (FPC) of the Bank of England should be changed so that it is given the mandate to monitor and where necessary guide the growth and type of credit in the economy. Crucially, this should encompass both the banking and the shadow banking sector. Addressing only one half of the banking system is likely to result in credit creation and allocation simply migrating to the unregulated half.

There are two essential elements which will underpin a successful system of credit monitoring:

20 In comparison, the wealthiest 20 per cent of households had 92 times more aggregate total wealth than the least wealthy 20 per cent of households in 2008/10 (ONS 2014).

1. a clear, positive remit
2. powerful mechanisms for achieving the set targets.

The remainder of this chapter addresses each of these key elements in turn.

Establishing a clear, positive remit

The FPC should monitor the quantity and type of credit created in the economy in order to maximise the stability of the financial system and ensure broadly shared, sustainable growth. In particular, it should track two key measures of credit balance and act if the amount or type of credit fails to meet the target.

1. **The rate of growth of bank credit for non-GDP transactions within the UK should be controlled so that it does not exceed the rate of growth of overall bank credit in the economy**. Experience suggests that a key indicator of a likely impending bank crisis is a sustained rate of growth of credit for non-GDP enhancing transactions that is above the rate of overall credit growth in the economy or above the nominal GDP rate. If the growth rate of non-GDP enhancing credit does rise above the overall level of credit growth within the economy, the Bank of England, working in concert with the government, should have the power to restrict the growth of bank credit to non-GDP transactions in the economy. Below we identify some of the tools that might be used to achieve this.
2. **A rolling target should be established to tighten the link between the financial system and credit flowing to GDP-enhancing transactions rather than non-GDP transactions.** As noted previously, the proportion of credit issued to GDP-enhancing transactions, and non-financial firms in particular, is intimately linked to rates of growth and physical capital accumulation. While it would be inappropriate to set a specific target in this report, it is apparent that the current ratio, where less than 10 per cent of outstanding credit goes to funding non-financial, non-property related activity, is inadequate. At the very least, the Bank of England should seek to guide credit to steadily balance the ratio of credit in the economy. Currently, of the £2.4 trillion in outstanding loans borne by UK residents, financial institutions received 34 per cent, households 43 per cent (secured on dwellings), and real estate and construction 10 per cent – the entirety of the rest of the economy received less than 10 per cent. Within that, manufacturing received only 1.4 per cent of total loans (Wolf 2013a). This split is too focused on the property market and is unlikely to be most effective at generating sustainable productivity growth. To correct this, over time, a much greater proportion of credit created must be channelled towards GDP-contributing transactions than is currently the case. The government should work with the Bank of England to set the target. The alternative is leaving the UK banking system as it currently is: 'a highly interconnected machine whose principal activity is leveraging up existing property assets' (ibid).

Alongside these two key targets, an overarching set of principles should be applied in seeking to guide credit flows in the economy. Such principles should stipulate, for example, that targeting should be:

- closely related to other objectives of monetary policy related to the non-financial economy
- able to account for future changes and fluctuations in the non-financial economy
- exercised via those instruments that the Bank of England has under its direct control
- based on readily available data published on a regular basis, including both data that is produced *by* the Bank of England specifically for this purpose and data that is published *for* the Bank of England to support or aid credit guidance.[21]

21 Adapted from Friedman 1982.

Of course, we also acknowledge that such a targeting regime is necessarily imprecise and that any set of targets should be dynamic and responsive to wider economic conditions, though generally leaning against excessive credit growth. In creating such a system, the Bank of England and the government would need to move cautiously to begin with and learn from best practice internationally, whether from Europe or east Asia, in implementing guidance. Nonetheless, it is better to have a slightly 'messy' but more realistic view of credit and its influence upon the economy, and to act accordingly, than to have a theoretically perfect but practically unhelpful model of credit creation and its link to economic performance. In short, credit policy should be guided by Minskyian realism, not neoclassical certainty.

Identifying powerful mechanisms for the Bank of England to achieve its targets

To fulfil its mandate, the Bank of England will be required to better monitor credit in the economy. This was something that the bank did previously and, although it is not collated effectively for the purposes of providing credit guidance, much of the necessary data is still collected. As a result, there would be almost no cost to introducing this monitoring requirement.

Focused on the two key measures outlined above, then, the Bank of England should guide the credit system towards meeting quarterly quotas (see boxed text below). While the mechanisms to achieve this should be subject to extensive consultation and rigorous testing, we set out in this section a set of tools that we believe would be effective. Given the relatively low costs involved in analysis, the key challenge is to identify the best way to monitor and guide the supply and use of credit in the economy.

The first set of mechanisms relates to the macroprudential role of the Bank of England in shaping credit creation. The second set targets the growth of consumer credit, especially mortgages, something on which there has been considerable policy movement recently. The final set relates to changes in banking behaviour, including suggestions to multiply and pluralise different forms of finance, including a greater role for public finance in investment. Together, these mechanisms should be used to fulfil the new credit monitoring and guidance mandate.

Macroprudential targeting

Consumer price inflation (CPI) is too clumsy a target for controlling the quantity and quality of credit within the economy. The endogenous effect of the flow of particular categories of credit, particularly for property transactions, means that unstable asset price inflation can occur without registering in traditional inflation metrics. We therefore believe, to better support the guidance policies of the FPC, the Monetary Policy Committee (MPC) should have its remit revised so that it targets not just CPI but also stability in wider asset price inflation, in as much as this should remain even and broadly in step with CPI. There is something clearly out of sync in the economy when interest rates have been sustained at an ultra-low 0.5 per cent, CPI hovers at 2 per cent, and UK house prices have increased by 9.9 per cent in the year up to April 2014, up from 8.0 per cent in the year to March 2014 (ONS 2014c). The current inflation target is failing to rectify this situation and indeed may be exacerbating matters. The general aim of this reform should therefore be to treat the monetary system and the wider economy more holistically.

In targeting asset price stability, the MPC should work closely with the Bank of England's Financial Stability Committee to ensure credit growth does not generate systemically risky asset bubbles. Interest rates are an important tool but they are insufficient on their own to meet this target. Therefore, other means to guide the consumer credit market are also necessary, especially regarding mortgage credit.

Consumer credit guidance

The Bank of England should monitor the amount of private bank credit that is used to fund mortgages. If total credit in the mortgage sector exceeds the new credit guidance mandate – especially if the growth rate of bank credit for mortgages exceeds the rate of growth of overall bank credit in the economy – the bank should restrict credit growth flowing to mortgages and property transactions. Depending on the circumstances, this could involve either slowing down the rate of growth of mortgage credit so that it is more closely in sync with total credit growth in the economy, though the total amount of lending would continue to rise, or it could mean reducing the total amount in real terms. It could do this by imposing maximum loan-to-value or loan-to-income ratios on new mortgage arrangements. Any such policy should be targeted and timely, and be able to take account of the business cycle and to act counter cyclically if necessary to maintain wider stability.

Interestingly, there is growing momentum within the financial sector to rein in excessively risky consumer or mortgage credit. For example, the IMF's recent report on the UK argued that loan-to-income or loan-to-value ratios may be required if recent measures to ensure financial stability within the housing market were not effective enough (IMF 2014b). This follows the Bank of England's recent introduction of new mortgage affordability tests. Our outlined reforms would simply reinforce the wider policy dynamic (see also BBC News 2014).

Under any such changes, access to schemes such as the Coalition government's 'Help to Buy' would be much more limited and available only to low- to middle-income households, if indeed it was not cancelled entirely. Loan-to-value ratios of more than 100 per cent – commonplace in the run-up to the financial crisis – would face a similar fate. In any event, the governor of the Bank of England's recent announcement restricting loan-to-value to 4.5 times the borrower or borrowers' income suggests movement in this direction is underway (BoE 2014b). More concrete policies of this nature would help to prevent banks loosening credit in a way that leads to the formation of unstable asset bubbles (Hanauer and Beinhocker 2014).[22]

Credit monitoring in practice: meeting quarterly quotas

Once a policy of credit guidance was introduced, the Bank of England should require banks to meet quarterly quotas concerning the growth of total credit outstanding and the credit outstanding in each of the subcategories of credit. This is data which is already collected and on which banks have to report to the Bank of England on a monthly basis at present, and would be divided into GDP-enhancing and non-GDP transactions.[23]

Bank credit for GDP-enhancing transactions, subdivided into:

- mortgage credit to households
- consumer credit
- other credit to individuals
- credit to the manufacturing industry
- credit to the construction sector
- credit to the non-financial service sector
- R&D and education
- other categories

Bank credit for non-GDP transactions, subdivided into:

- credit to other banks
- credit to non-bank financial institutions
- credit to financial or property-holding companies
- other categories

22 The corollary of this policy would be the need for a much greater expansion of public forms of housing stock, shared ownership and more secure, decent forms of renting – for ideas and steps to achieve this, see Cooke, Lawton and Pearce 2014.

23 For a more detailed discussion of how a credit guidance regime would work in practice, see Werner 2012.

With a credit guidance policy in place, the Bank of England should be able to restrict non-GDP enhancing credit flows while setting positive year-on-year percentage growth targets for credit that supports GDP-enhancing activity. This GDP-enhancing form of credit could be further supported either by public investment, for example through a British Investment Bank (see Dolphin and Nash 2012a).

In enacting a policy of guidance, the FPC should operate transparently and with accountability to the democratic process. We therefore recommend that its chair should appear before the House of Commons Treasury select committee every quarter. Moreover, the Bank of England should work with the government of the day to review and where necessary revise the targets and mechanisms of the credit-monitoring regime, ultimately guided by democratic mandate.

The final set of changes focuses on incentives within the banking sector that influence or affect decisions about credit.

Changing behaviour within the banking sector

The tax bias in favour of debt over equity finance should be removed. Our tax system presently favours interest payments over dividend payments. Consequently, the fragility of the financial system is increased, as banks are encouraged to use debt rather than equity to finance investments (Myerson 2013). This in turn ratchets up reliance on credit creation, encouraging excessive leverage to boost returns. We therefore follow the Mirrlees review (2010: 424–425) and the LSE Growth Commission (2013) in arguing that the treatment of equity and debt finance should be equalised.

The LSE Growth Commission argued that ensuring equality of treatment between equity and debt could deliver long-run increases of 6.1 per cent in investment, 1.7 per cent in wages, 0.2 per cent in employment, and 1.4 per cent in GDP. There are numerous options for doing this, including introducing an 'allowance for corporate equity' (ACE)[24] within the corporate income tax regime to level the playing field. However, the focus here is less on the specifics of a proposal or its fiscal implications than on ensuring a full and rigorous debate is had politically about how best to equalise the treatment of equity and debt which would help with a wider credit guidance policy.

Aggregate maturity transformation should be reduced. Maturity transformation – where banks borrow money on shorter timeframes than they lend money out – is enabled by the modern fractional banking system. It occurs both on and off bank and shadow bank balance sheets. It can have clear economic benefits, including increasing liquidity by creating greater synergy between payments services banks provide and intermediation by lending out credit, though these are not unlimited (Carlin and Soskice 2013 chapter 5 and 6).

Typically, though, the higher the level of maturity transformation that occurs, the greater the leverage and volume of credit in the economy as a share of GDP and the greater the exposure of the lender. This in turn potentially increases the volatility and risk involved. Moreover, this risk is often borne by the public, while the benefits are reaped privately. Therefore, steps should be taken to reduce the aggregate level of maturity transformation by increasing the equity ratio required for banks to operate (see chapter 4 for more details) as well as a tighter liquidity regime designed to reduce systemically risky levels of leverage. This could, for example, involve requiring banks to hold higher buffers of highly liquid assets so they are better able to withstand market shocks, or more frequent and transparent reporting of liquidity

24 As the Mirrless review (2010) argues, the idea of an allowance for corporate equity is to 'provide explicit tax relief for the imputed opportunity cost of using shareholders' funds to finance the operations of the company'.

levels by major lenders, something which would provide an early signal of financial distress. These rules should be devised in concert between the Treasury and the Bank of England and be sensitive to the macroeconomic cycle. While there is a trade-off in terms of the loss of some levels of liquidity, it would help build a more stable financial system that operates with lower, more sustainable levels of leverage and without the high levels of finance-focused credit growth that occurs at present.

Public banking: multiplying and diversifying finance
These reforms should ensure that it is more profitable for private banks to invest and lend to the real economy rather than to engage in excessive financial or asset trading. However, alongside changing the incentives for private banks, there is also a case for changing the wider structure of the banking and credit market by carving out a much larger public role in financing investment and development.

For example, IPPR's report *Investing for the future* (Dolphin and Nash 2012a) set out how a state-owned, profit-making British Investment Bank could help to address two aspects of our economy that have been neglected by our financialised credit system: a tendency to invest less in infrastructure (as a share of GDP) than comparable countries and a shortage of financing, particularly long-term financing, for small and medium-sized businesses (SMEs). An initial capital injection of £40 billion over four years, could, if the bank was able to raise £2.50 on the financial markets for every £1 of capital, create a balance sheet of £140 billion after four years.[25] This would be a significant investment vehicle specifically mandated to finance parts of our economy that currently receive little support from the UK's credit system. In doing so, it would help to achieve the Bank of England's mandate of rebalancing the use of credit within the economy. Moreover, public banks in the US, Brazil and Europe have all been shown to have performed effectively over the long term at supporting the real economy, in particular by having a high proportion of their credit going to support GDP-enhancing as opposed to non-GDP transactions (EAPB 2013).[26] With this in mind, we strongly reiterate our support for a public investment bank of this kind.

To further rebalance the quantity and quality of credit created, and where in the economy it is flowing to, the government should also consider licensing new banks specifically targeted at supporting the non-financial sector of the economy. Clear limits on the types of activity and funding the bank could undertake would be required to ensure their capital was focused on supporting the real economy. A network of regional banks would be one possible way to achieve this, based on the German KfW system as an obvious example, with its network of banks mandated to support businesses within a specific geographical area. To help stimulate this, the government should set clear medium-term targets for the number of new entrants into the domestic banking market – which currently operates largely as an oligopoly with very few new entrants in the past 100 years (OFT, 2010) – with both national and local government and the Bank of England tasked with fostering a more diverse sector, both in terms of the number of banks, the types of lending institutions and the ownership structures of banks, within the next Parliament.

Beyond banking specifically, there is also a clear case for pluralising and strengthening the institutional ecology of finance in the UK to help it reconnect with the real economy. On the micro scale, this includes the rise of peer-to-peer lending and the growth of 'alternative' currencies, as well as the potential of non-profit community development corporations, community land trusts or community development financial institutions. In all these cases there is scope for greater support from government, both local and national, as well as business and civic society.

25 For full examination of the options for funding a British Investment Bank, see Nash and Dolphin 2012a: 22–29.

26 For US case studies, see the Public Banking Institute: http://www.publicbankinginstitute.org/

At a wider scale, there is a growing consensus on the need to devolve substantive economic authority to cities and regions, which opens up the potential to experiment with how finance is organised locally (see Lawton et al 2014). There is also clear role for greater public involvement in financing production, not just through a British Investment Bank but also through regional development funds, nurturing cooperative development funds or more effective use of public pension funds as sources of 'patient' long-term capital (see Lawrence and McNeil 2014).

Finally, as previously described, financialisation has not led to greater financing of innovation or risky forms of production; capital is typically risk averse, seeking safe returns over the uncertainty of investing in the unknown. There is therefore also a case for great public investment in early-stage financing, mimicking private venture capital funds by funding innovative forms of production, extending access to productive capital and technologies beyond the economic vanguard. In doing so, public banking would institutionalise what Roberto Unger has called 'vanguardism outside the vanguard' (Unger and Wood 2014). The corollary is that there should be a greater return to the public purse for that investment, with such a body taking an equity stake to ensure decent returns for public risk (see Mazzucato 2013).

One option to establish this kind of public investment would be to resurrect the UK's old 3i investment vehicle[27] to institutionalise business finance for start-ups which are either too small to raise capital from the market or too risky to access long-term capital from the banks. Similarly, SITRA in Finland or the Small Business Innovation Research Program or DARPA in the US, which invest in risky but high-potential companies the private market will not support, are both effective investment institutions of a sort that the UK's financial ecosystem lacks (Connell 2013) Interestingly, a detailed recent analysis by Nesta suggests as little as £150 million of public investment could establish such a body and make a substantial difference to the market (Westlake and Pierrakis 2009).

More research into the fiscal implications of such schemes is required. However, what is clear is that anchoring credit into the real economy will require a more diverse financial system, which in turn requires a stronger role for public investment. Credit guidance therefore is about more than the setting of frameworks to shape the allocation of credit; it is also about institutional innovation focused on binding finance more tightly into the real economy.

27 3i was the eventual outcome of the 1931 MacMillan committee report which identified a 'MacMillan gap' in the British economy: a chronic shortage of long-term investment capital for small and medium-sized businesses. It recommended the formation of a company 'to devote itself particularly to these smaller industrial and commercial issues'. Over time, 3i (from 'Investors in Industry', formerly the Industrial and Commercial Finance Corporation) became the UK's leading venture capital body, prior to its flotation in the 1990s and subsequent fragmentation as an effective investment vehicle.

4.
REASSERTING THE PUBLIC INTEREST OVER THE FINANCIAL SYSTEM

As financialisation has advanced, the gap between the interests of finance and those of wider society has widened. Tightening that relationship, by reasserting the public interest over the financial system via democratically mandated and accountable institutions is therefore a critical part of definancialising the UK. The following recommendations focus on aspects of the contemporary financial sector that have systemic influence and which currently poorly serve wider economic and social ends: the monetary and payment system, the equity ratio of financial institutions, the derivatives market and the role of critical intermediaries like credit-ratings agencies.

Establish a Monetary Commission

The UK has not effectively examined how its money and credit system operates since the Macmillan commission in the 1930s. Yet in that time the nature of money and the scale of credit has changed significantly. Moreover, how credit is created, circulated and accumulated has vital consequences for the UK's economic and social wellbeing, something increasingly recognised in mainstream debate (see Wolf 2014, Pettifor 2013a). For as Geoffrey Ingham argues, the money system has a dual nature: it 'is not only infrastructural power, it is also despotic power' (Ingham 2004: 4. We therefore need a much better understanding of the nature and role of money and credit if we are to shape the monetary system to best support economic and social wellbeing.

We therefore recommend that **an in-depth parliamentary commission should be established to investigate the role of money and credit within the economy**. This should be a coda to the Parliamentary Commission on Banking Standards, which reported in 2013 and, tellingly, ignored the role of money within banking. The new Monetary Commission should consequently examine how the money system currently operates and the distributional effects it creates, particularly during a period of sustained 'abnormal' monetary policy, as the UK has experienced over the past half decade or more; how effectively it supports broad-based, sustainable growth; and how the UK could potentially support a more democratic money and credit system in future.

Against these overall objectives, there are a range of particular areas the commission could choose to investigate.

Fundamentally, it should investigate credit creation in the UK economy and its part in creating imbalances of economic power. What impact does the banks' power to create money have on entrenching unequal economic power within society, given that most new money enters the economy through consequential debt contracts that favour the creditor, who has been privileged with the right to create credit in the first place? Is this system of credit creation arranged so that it effectively supports the real economy, given that currently so much credit circulates within the financial system without any connection to production?

The creation of money 'out of thin air': the elastic production of money

The particular institutional form of capitalism has evolved periodically since capitalism emerged as the dominant economic mode in the 19th century. Contemporary capitalism has three major institutional aspects: the market (where exchange takes place), private production (resulting in commodities for exchange), and a monetary system for producing bank-credit money (facilitating exchange). Of these aspects it is the capacity of banking institutions to finance production through 'money-capital in the form of newly created bank money that uniquely specifies capitalism as a form of economic system' (Ingham 2009: 53). The elastic production of money – what Ann Pettifor (2013b) memorably terms the 'power to create money out of thin air' – underpins financialisation, giving capitalism both its immense productive potential but also its tendency to damaging instability. Moreover, the power of private banking institutions to create or control credit embeds inequalities of power and reward into wider economic and social relations.

How is money 'created out of thin air'? According to the Bank of England:

> *'Banks do not act simply as intermediaries, lending out deposits that savers place with them, and nor do they "multiply up" central bank money to create new loans and deposits … Commercial banks create money, in the form of bank deposits, by making new loans.'*
>
> MacLeay et al 2014

The book *Where does money come from?* also explains the process:

> *'New money is created by commercial banks when they extend or create credit, either through making loans or buying existing assets. In creating credit, banks simultaneously create deposits in our bank accounts, which, to all intents and purposes, is money.'*
>
> Greenham et al 2011

Economic commentator Martin Wolf (2013c) concisely summarises the implications of money creation for macroeconomic theory and banking reform as follows:

> *'Private institutions create credit as a by-product of their lending.*
>
> *The state uses its ability to create fiat money to back such private money.*
>
> *The monetary and financial system is a complex public-private partnership.*
>
> *The creation of purchasing power ex nihilo by banks also creates debt.*
>
> *The new purchasing power will add to actual spending in the economy, creating booms in consumption or investment.*
>
> *The new credit may also leverage up existing assets.*
>
> *The central bank may fail to stabilise this system by stabilising the prices of current goods and services. Indeed, the policies chosen to stabilise inflation in goods and services may even destabilise prices of assets.*
>
> *In this case, the long run consequence of policies aimed at keeping inflation up might even be deflation.*
>
> *A system in which the liabilities of risk-taking private institutions are believed to be the safest form of purchasing power is unstable and prone to panic and collapse.*
>
> *New technologies and financial innovations allow the financial system to create new forms of credit and money, particularly if the old ones are tightly regulated.*
>
> *The state cannot and will not allow this system to collapse.*
>
> *This is an economy in which balance sheets, financial institutions and the central bank play central roles.*
>
> *None of this has anything at all to do with a barter economy in which credit and money are mere veils.'*

This process has wider macroeconomic effects given banks, when they can create credit and private money, tend to produce quantities of both credit and private money that is either sub-optimally large or contributes towards economic instability. By this view, the financial crisis was the result of a failure to 'constrain the private financial system's creation of private credit and money' (Turner 2012). The privilege bestowed on banking and shadow banking institutions to endogenously create and allocate credit is therefore central to the dynamic of financialisation.

Second, the commission should examine Nick Gruen's proposal (2014) that the central banking services of the Bank of England should be offered not just to commercial banks but directly to citizens as well. This could include simple savings accounts, through the National Savings and Investments (NS&I) system, or guarantees for well-collateralised mortgages.[28] Currently, commercial banks provide these services but at a high cost, backed by subsidies and with the unique advantage of being able to access the infrastructural power of the Bank of England directly. The commission should examine how to open up access to this power, as a way of fostering a more pluralist, democratic and socially innovative financial system.

Today, the payment systems market is a similarly closed shop. A recent review of this market by the Office of Fair Trading (OFT) concluded that it suffered from a number of structural problems driven by the interaction between strong network effects and the ownership of the key payment systems by the large, incumbent banks. In particular, the way that various payment systems – such as Bacs, LINK, C&CCC and CHAPS – operate currently acts as a major barrier to entry into the banking and credit market, inhibits transparency, limits consumer responsiveness, undermines innovation and acts a source of economic rent. In short, the concentration of ownership has led to a poor deal for consumers, retailers and small- to medium-scale financial providers (OFT 2013). The Monetary Commission should therefore examine how the FCA's new regulatory regime for the payment systems[29] should act to ensure that all consumers and businesses can access an open, competitive payment system and that financial start-ups, such as new forms of democratic finance, are able to plug directly into existing systems. In this regard, an important announcement was made in the 2014 budget concerning the powers the FCA will have in regulating the payments systems market, which will include a power to address the ownership of payment systems.

The new commission could investigate the potential to use 'money-financing' to help fund part of the fiscal deficit, based on new money creation from the central bank, rather than debt-financing it via additional issuance of bonds or through additional taxation. Without committing a priori to recommending its use, the commission could explore under what circumstances money-financing might be used to manage the public finances, what its potential benefits could be – for example, it tends to not crowd out private spending, compared to funding expenditure via raising tax levels – and what its downsides might be, such as its potential inflationary impact. Despite any such fears, money-financing is an option worth more serious examination, especially in this period when conventional monetary policy has failed to generate a rapid or broad-based recovery.

Similarly, the commission could also examine the possible impact of transitioning the UK's monetary system to an equivalent of the 'Chicago Plan' of 100 per cent reserve banking and the issuance of debt-free money, as the IMF has recently explored (see Benes and Kumhof 2012). This would involve a radical change in UK monetary policy as there would be no private money created, only that derived from public debt or money issued from the Bank of England – as such, it would bring significant positives and substantial negatives. For this reason, we are not recommending that such a system is enacted. Nonetheless, as with money-financing the deficit, investigating the Chicago Plan in greater detail would help to clarify the dynamics of financial instability and assist policymakers in thinking through with greater clarity how to avoid financial crises and foster a more effective financial system.

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28 Gruen gives the example of a residential mortgage for less than 60 per cent of the value of the collateral.

29 The regulatory role will be managed by the Financial Conduct Authority, a responsibility introduced in the Banking Reform Act 2013 and expected to be fully operational in 2015. The author would like to thank Chris Hewett for his advice on the UK's payment system.

On a more micro level, the commission should examine what role new forms of currency – crypto-currencies and 'local currencies' – can play in the future in terms of broadening out the financial system. Interestingly, this would also build on recent policy work undertaken within the Bank of England (Naqvi and Southgate 2013). The key distinction between these types of currency and traditional fiat money is that typically no group or individual can accelerate the production of money, ensuring a stable rate of value is sustained within the currency circuit. According to the Bank of England among others, the growth of these complementary forms of money and credit is expected to continue, and so it is important to consider how the monetary system can best accommodate them.

This list of investigative avenues is not exhaustive, and certainly none of these ideas is without flaws. Yet nor is the status quo, and a thorough examination of the UK's monetary system and its impact on economic effectiveness and democratic power is therefore long overdue. Indeed, financialisation has partly been driven by the nature of our credit and money system; any attempt to reverse it therefore must take much more seriously the creation and circulation of money and credit within our economy as dynamic agents rather than neutral pawns.

Raise minimum equity requirements

A reformed system in which banks are required to hold higher equity levels would start to undermine the current operating model of banks which is based on very high leverage, extreme indebtedness and fragile debt sources that threatens macroeconomic stability. In doing so, it would also curb the growth of debt, helping to contribute towards any ongoing credit guidance policy (as outlined in chapter 3). Moreover, it would radically curtail the implicit subsidy presently received by banks that are 'too big to fail'. Currently this is around £65 billion a year in the UK, exposing the public to unnecessary risks, distorting economic activity, building fragility into the system, and promoting leverage via debt over equity as a business model, with an implicit subsidy underwriting much of their profit.

The minimum amount of tier 1 equity held by banks and shadow banking institutions should be raised to 10 per cent by January 2018.[30] By boosting the amount of equity required by banks, reform would help to shift risk on to investors and off of the general taxpayer. It would also ensure a more resilient system, as banks would have a larger cushion to cope with any operating losses. Similarly, requiring banks to have higher equity levels reduces the scale of leverage achievable, which in turn reduces instability and potential contagion within the banking system.

To ensure the potential impact on lending rates is limited, there should be a tapered phase-in period, with equity requirements progressively increasing each year to January 2018. Building from the current Basel III base of 6 per cent tier 1 equity, banks and shadow banks should be required to hold 7 per cent tier 1 equity by January 2016, 8 per cent by January 2017 and 10 per cent by January 2018.

This could be achieved by banks either retaining more of their earnings or by raising equity through selling more shares between now and 2018. As with the newly announced US Federal Reserve policy, if a bank fails to reach these targets on time, severe restrictions should be placed on their right to issue dividends or bonuses until they have reached an adequate equity ratio (see Federal Reserve 2014).

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30 Will Hutton and Paul Nightingale (2011) have an excellent summary of the different terms: capital requirements address balance between debt and equity in how banks are funded while liquidity requirements relate to the type of assets a bank holds. Equity is the amount of a debtor's assets in excess of debts to which they are liable. Leverage reflects the multiple between equity and liabilities and is a measure of safety net.

Any such ratio target should be simple, with an emphasis on ease of compliance and understanding, avoiding excessively complex risk weighting of capital ratios. The Basel III requirements, for example, allow banks to appear far more secure than they really are, based on imperfect analyses of the tradeoffs involved (see Admati and Hellwig 2013). Similarly, as the Parliamentary Commission on Banking Standards (2013) concluded, the UK's current equity ratio system is based on a fallible concept. For example, by official measures, between 2004 and 2008 the riskiness of the portfolios of UK-headquartered banks fell dramatically, precisely the opposite of what was actually occurring (Wolf 2012). Instead, targets should include all bank exposures, avoiding the kind of netting-out calculations that can distort a bank's apparent stability and security.

Finally, we believe this 10 per cent equity ratio should be an intermediate target. A longer-term target, subject to extensive review and testing, should be to increase the tier 1 equity ratio of banks to closer to 15 per cent over the medium to long term, as a level at which banks can operate securely without requiring public subsidy or generating systemic risk (Admati and Hellwing 2013).

The impact of equity requirements on the banking sector

Critics argue that forcing banks to hold a higher share of equity would restrict lending and potentially limit economic growth, claiming that equity is always more expensive than debt. This argument is, however, as Roger Alcaly (2014) recently argued, 'highly exaggerated, unsubstantiated, and implausible', reflecting more the interests of the banking industry than the likely impact of higher equity requirements. It is worthwhile addressing some of the objections that are commonly laid at the feet of equity-related regulation.

First, equity regulation does not tell a bank how to operate nor how much it can or should lend. It simply requires that a larger proportion of any lending activity is funded with unborrowed money, with lower leverage rates based on a higher ratio of equity compared to debt as a proportion of total assets. Reducing the leverage of banks would not inhibit the capacity of good banks to lend. One example is Handelsbanken, which operates with a tier 1 equity ratio of 19.4 per cent (Handelsbanken 2012), far higher than many of its rivals, yet has both expanded its lending year-on-year throughout the global financial crisis and returned the highest return on equity last year, 14.8 per cent, of any European retail bank (Wilson 2013). Moreover, it is a self-reinforcing cycle. Carrying a higher equity base lowers the premium on equity capital and makes it cheaper for equity-rich banks to lend and borrow (Amati and Hellwig 2013). Therefore, as Diane Coyle has argued, viable banks would certainly be able to increase lending based on unborrowed funds through higher equity ratios (Coyle 2013). Only non-viable banks would be restricted by this kind of reform, which is not a bad outcome; it is in the wider public interest to limit the operation of businesses that operate with very little equity and expand through systemically risky levels of leverage.

Second, the confusion arises from a deliberate opaqueness of language. Equity is not the same as reserves; banks would not have to hold or 'set aside' the equity, letting it go fallow. It is simply that less of their operations could be funded through debt-based leverage. There is admittedly a trade-off between reserve requirements and lending, as under a reserve system banks would be required to keep a proportion of their deposits in the central bank. However, the massive trade-off between higher equity ratios – as opposed to reserves - or higher lending that is implied is not correct. Of course, some banks may indeed choose to shrink their lending. Again, if their lending model was previously based on inadequate capitalisation and an excessive level of debt-based leverage that is only sustainable via implicit public subsidy, then this may not necessarily be a bad outcome. Moreover, it would potentially open a space for other lenders to move into, including vehicles such as the British Investment Bank or so-called 'challenger banks'.

Given we know that much lending currently goes into the commercial or property market, a drop in overall lending need not lead to lower investment rates if credit monitoring and targeting ensures that more credit reaches the productive, non-financial economy.

Third, on a related point, equity financing need not be more expensive for banks or the wider economy. As David Miles, a member of the MPC, argues in his paper, 'Bank capital requirements: are they costly?', between 1880 and 1960, bank leverage was on average about half the level of recent decade. Yet during this period, despite a far greater use of equity funding, banks' reference rates of interest and the rates charged on bank loans were not significantly higher. Indeed, during that period Bank of England data shows that 'the spread over bank rate of much of bank lending was consistently below 2 per cent' yet the reference rates on the stock of bank lending to households and companies since 2000, despite far lower equity ratios and greater levels of leverage and debt-financing, has been barely above 2 per cent (Miles 2013). In other words, banks have historically been able to finance a far greater proportion of their activities with equity than today, including lending, without a corollary of far higher costs and restricted support to the real economy. Moreover, as Miles underscores, the lack of any obvious empirical link between leverage rates and the cost of bank loans is similarly absent from data from the US. Indeed, evidence suggests that a doubling of equity rates from present levels would lift the total cost of bank funds by as little as 10 points (Miles et al 2012). Given the wider benefits of a more secure, less subsidised banking system this would create, this is a very small implied cost.

Fourth, major financial corporations should not be privileged in how they operate. No other major non-financial corporation would be allowed, or able, to operate with an equity ratio less than 50 per cent. Given that, unlike other non-financial corporations, financial corporations have systemic effects on the stability of the wider economic system, it is arguable that they should in fact be required to be more secure. That is why 10 per cent tier 1 equity requirement is a realistic goal to start with but more ambitious targets should follow. To argue that banks could not operate within a 10 or 20 per cent equity requirement is to ignore the history of banking and take a view that banks can only operate as they do now: as highly leveraged, institutionally fragile institutions. Both theory and experience suggests otherwise.

Why, then, do we persist with inadequate Basel III ratios? Most likely it is that those defending the current low equity ratio requirements have both the most to gain and the greatest power to affect decision-making. Banks benefit significantly from their current ability to leverage so highly, with high gearing bringing greater profits, rising share prices, and the swelling of bonuses. Indeed, as Andrew Haldane has shown, around half the total profits of the world's 29 most significant banks between 2002 and 2007 was generated by the web of implicit and explicit subsidies the sector received, bolstered by a clearly inadequate equity ratio (Haldane 2012b).

Moreover, as the recent financial crisis demonstrated, when leverage turns bad it is wider society, not the banks themselves, that has to meet the cost. It has been estimated that equity levels closer to 15 per cent would have saved the major US banks from insolvency in 2007–08 (Calomiris and Meltzer 2014). Similarly, in the UK, if the average pay of the domestic banking sector (including remunerations) had been reduced by 10 per cent between 2000–07 then an extra £50 billion of capital would have been available to shore up the banks' balance sheets. Incidentally, this was nearly the exact amount the UK government injected into the UK banking system to avert a full-blown crash (Davies 2012). The present system, then, is 'intellectually bankrupt' (Wolf 2013b). Major and systemically vital financial institutions are still encouraged to 'borrow excessively and take on so much risk that the entire banking system is threatened' which 'is just like subsidising and encouraging companies to pollute when they have clean alternatives' (Admati and Hellwig 2013).

Ultimately, this means that financialisation will continue if the basic operating model of banks remains so dependent on excessive leverage supported by implicit (and occasionally explicit) public subsidy. Raising the equity ratio of banks is one way to redress this balance. Raising equity ratios would involve 'a fundamental conflict between what is good for bankers privately and what is good for the broader economy' (ibid) and this report recommends action firmly in favour of the latter.

Strengthen oversight of the financial markets

> *'There clearly are bits of the financial system, and particularly the bits that relate to fixed income securities, trading, derivatives, hedging, but possibly also aspects of the asset management industry and equity trading, which have grown beyond a socially reasonable size.'*
> Turner 2009

In Lord Turner's now famous remark, he identified the growth of aspects of the financial system that bear little positive relationship to the real economy. Financialisation in many ways is bound up in the growth of these socially useless aspects of finance. Of course, some of this growth reflects real value where these trades do what they are intended to do: help manage risk, provide improved access to liquidity and improve maturity transformation. Yet much of it is because intermediaries and value extractors are now entrenched in the financial system, with ever higher trading and liquidity offering great potential for rent-seeking simply through the churn of trading. Geoff Mulgan, for example, argues that 'capital has come to serve capital, not value; and financial systems have too often become predators' (ibid: 284). Technological change, with the rise of high-frequency trading and 'dark markets', enhances this process, with upwards of 60 per cent of global financial trades now conducted by computer algorithms in opaque structures only loosely related to financing the real economy (Lewis 2014).

Another challenge is that many of the transactions identified as having grown beyond a socially reasonable size no longer take place in registered, transparent exchanges. The over-the-counter (OTC) derivative market has for example grown to roughly 40 per cent of all trades in the US (McCrank 2014), while the volume of European shares traded privately rather than on a public exchange jumped 35 per cent from the third quarter of 2012 to the following year to a record high of $279 billion (Reuters 2013), with London at the epicentre of such trading. The lack of transparency is also conducive to malpractice such as the manipulation of the LIBOR rate, the mass laundering of the funds of criminal networks, the multibillion-pound mis-selling of securities (Lanchester 2013), or the explicit facilitating of tax evasion, which the Treasury estimates will be as high as £47 billion by 2014/15 (Murphy 2014).

Derivatives

Derivatives are:

> *'[E]ssentially forms of organised speculative gambling on price changes. The "derived" financial asset is a contract (or wager) between two parties that the price of a commodity or asset at time x will be £y. The contracts are also traded; that is they are bought and sold by third parties. Profits and losses are the result of the divergence, at the designated time, between the derivative contract price and the actual price of the commodity or asset from which it is "derived".'*
> Ingham 2009: ch 7

While financial derivatives have been in operation since at least the 19th century, the increasing growth of financial activity within the economy has seen their trading soar, so that the outstanding over-the-counter market for all derivatives was estimated to be worth $710 trillion at the end of 2013 (BIS 2014).

As a breakdown, in December 2013, the $710 trillion in outstanding derivatives is as follows (figures rounded from BIS 2014):

- $584 trillion in interest rate contracts
- $70 trillion in foreign exchange contracts
- $25 trillion in unallocated derivatives
- $21 trillion in credit default swaps
- $6 trillion in equity-linked contracts
- $2 trillion in commodity contracts

Financialisation has accelerated the turn to financial complexity and created an uncontrolled, often rigged financial system. As Geoffrey Ingham describes, 'even participants struggle to comprehend the astonishing proliferation of specialized markets by which money is mutated' (Ingham 2009). For a prospective investor to fully understand a 'CDO^2' financial derivative, for example, Andrew Haldane (2010) suggests they would need to have absorbed more than a billion pages of information. Responsibility is therefore abdicated within financial markets and by individuals on the grounds of the growing scale and deliberately opaque complexity of transactions, which in turn helps to support rent-seeking activity and potentially financial scandal (Chang 2013). Reducing opacity, and more widely, simplifying the complexity of financial markets would therefore limit the capacity for rent-seeking and help to financial activities in the real economy.

The enormous increase in socially useless financial products, both in number and amount traded, as well as the growth of capital circulation unconnected to investment in production, reflects the dominant intellectual current of the last 30 years, in particular the efficient-market hypothesis (Fama 1970), which argues that markets price assets and risk correctly. As a consequence, the theory states that there should be a perfect coincidence between the development of unregulated financial markets – and the new products it created – and wider social welfare. It was this animating view that led Alan Greenspan, then the chairman of the US Federal Reserve, to dismiss the idea of a housing bubble shortly before the housing market collapsed, or Joseph Cassano, a key executive at AIG, to claim six months before the firm's collapse that 'it is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of the [credit default swap] transactions' (quoted in Taibbi 2009).

However, financial markets are more complex than the efficient-market hypothesis presumes. Complexity and behavioural economics as well as revival of Minskyian, Keynesian and Marxian theory has painted a richer picture of how they operate (see for example Dolphin and Nash 2012b, Pettifor 2013, Harvey 2014). As Haunauer and Beinhocker argue, then, we should see financial markets as being:

> *'[M]ore like an ecosystem than a machine. In such a system, markets may be highly innovative and effective, but they can sometimes be far from efficient. And likewise, people may be clever, but they can sometimes be far from rational. So if markets are not always efficient and people are not always rational, then the twentieth century mantra that price equals value may not be right either.'*
>
> Hanauer and Beinhocker 2013

On this basis, we make two recommendations to reassert democratic oversight over the financial ecosystem.

Establish a Financial Product Board within the Bank of England's Prudential Regulation Authority

The statutory duty of the Prudential Regulation Authority (PRA) is primarily to promote the safety and soundness of financial firms and the wider financial system by making forward-looking judgments on risks posed by the actions of firms.[31] The Financial Product Board (FPB) would assess whether new financial products, such as within the derivatives market or structured financial assets, pose a risk of destabilising the financial system, as set by the current guidelines of the PRA, and trading of such products within the UK jurisdiction would be dependent on FPB approval. The burden of proof should be upon those creating new products to demonstrate their utility.

As noted already, much of the enormous growth in the trading of financial assets has not been linked to improving productivity; much of it, after all, is a zero-sum game. To counteract this, the new FPB should work closely with the PRA and the Financial Conduct Authority to execute the PRA's secondary duty: to facilitate effective competition within financial markets (introduced in the Financial Services (Banking Reform) Act).

In terms of the model of governance, a useful guide may be provided by the Medicines and Healthcare Products Regulatory Agency, which is responsible for ensuring the medical products market in the UK operates safely.[32] Similarly, the FPB proposed here should have the authority to ban the trading of a financial product – or order its appropriate modification – if it is deemed to pose an unjustifiable risk or promote uncompetitiveness within financial markets. The process of authorisation or otherwise of any new financial product should be conducted promptly and thoroughly.

At the same time, due consideration must be given in the design of the institution to ensure that systemically risky trade does not simply migrate offshore. One potential option would be for the UK to push for an equivalent body operating with international oversight that would apply to offshore and shadow financial institutions as well as mainstream financial centres and institutions. Given the UK's importance in the world's financial ecosystem, there is the potential for the UK to lead in pushing for a safer financial trading environment on a global level.

Establish a licensed, organised exchange for the UK over-the-counter derivatives market in the UK

This initiative would mean the creation of a consolidated regulatory position for the market, requiring OTC trades to occur in a registered exchange in a way the UK market currently lacks.[33] This should aim to adapt reforms established in the US under the Dodd-Frank Act 2010, which sought to improve the transparency and resilience of the derivative and hedge fund markets through a process of standardisation, central clearing and organised exchange trading. It would also go with the grain of the recently announced agreement of the European Commission and the Commodity Futures Trading Commission (the EU executive and the US derivatives regulators) to tighten oversight and more strongly regulate the transatlantic derivative trade (CFTC 2013). Indeed, the UK exchange should be established with a view to expanding to the European level.

Establishing an organised trading exchange trading for OTC derivatives, which should include within it equity, credit, commodity, interest rate and foreign exchange derivatives, could deliver a number of benefits, including 'a higher level of transparency, enhancing liquidity, ensuring efficiency and risk reduction

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31 For more information, see: http://www.bankofengland.co.uk/pra/pages/default.aspx

32 For more information, see: http://www.mhra.gov.uk/Howweregulate/

33 Others have recommended introducing a similar exchange mechanism – see for example Lallemand 2012.

and providing an easy access for market participants' (CESR 2010). Combined with other steps, such as prohibiting financial products that offer commodity index replication and nothing more (Lallemand 2012) and requiring appropriate levels of collateral to be posted for derivative trades in the OTC market, establishing an organised, licenced trading exchange would bring substantial benefits to the wider financial system and economy. Indeed, the only likely substantial losers would be short-term financial traders who currently extract significant amounts of rent through their intermediary position in the market rather than longer-term investors.

Establish an EU credit-ratings agency

Capitalism is acutely reliant on intermediaries who can assess value effectively. Credit-rating agencies, auditors and legal firms provide the signals to the wider marketplace in which value is assessed and trade occurs. As such, they 'are the facilitators of contemporary capitalism, and not ordinary participants' (Davies 2014). Moreover, not only are they integral to the functioning of the system, 'those tasked with *representing, measuring and judging* capitalist activity are also seeking to *profit from* capitalist activity, which brings certain consequences with it' (ibid).

Arguably one such consequence of this marriage of judgment-making and profit-making was the series of catastrophic misjudgments of the three dominant global credit-ratings agencies – Moody's, Standard & Poor's, and Fitch Ratings –that in turn helped to precipitate the financial crisis. For example, at the beginning of the month of their collapses, neither AIG nor Lehman Brothers had a rating with a big three agency worse than 'A'. Similarly, in 2006, Standard & Poor's gave Ireland and Spain a AAA rating and Iceland a AA+; in 2007, all three countries slipped into a state of financial crisis that would last for years (Silver 2012). As Will Hutton (2010) and Ha-Joon Chang (2013), among others, have highlighted, such failures have recurred post-crisis.

Given that an accurate ratings system is a collective public good, in that it helps a marketplace to operate effectively, and the record of failure of the current oligopoly, combined with the potential for vested interests to emerge, an alternative is urgently needed to provide an effective public option. **We recommend establishing a not-for-profit ratings agency within the European Union to assess the creditworthiness of major European financial institutions, both public and private, providing an alternative ratings agency to complement the three dominant private ratings agencies.**

We suggest an EU credit-ratings agency should be financed from a small portion of the estimated €30 billion a year the EU's financial transaction tax is expected to raise (EC 2011). As IPPR's report, *Don't bank on it*, has previously stated, we support the introduction of such a tax within the UK to throw 'grit in the wheel' of financial transactions (Dolphin 2013). Yet it would also have a revenue-raising capacity which should, in part, be hypothecated to support this new proposal.

The public credit-ratings agency would be a not-for-profit body established within the structure of the EU but possess an independent governance structure at a remove from political pressure. In assessing the credit worthiness of major corporations, it should pay greater attention to the drivers of long-term growth and the productivity potential of firms, such as the amount invested in R&D, rather than focusing on shorter-term signals, such as recent quarterly profit reports. In assessing the credit worthiness of countries, it would look at traditional metrics, such as a country's debt-to-GDP ratio, its growth or inflation rate and the size of its deficit.

It is important to note that this is a function that public agencies perform effectively already. For example, the periodic country reporting provided by the IMF provides an effective credit-rating of sovereign debt. Indeed, an ideal goal would be to have a global public credit-ratings agency, for example run by the UN. However, we believe any such reform should start at the EU level, given that the financing and institutional expertise is already available. In doing so, this would ensure that a public option is available to provide competitive pressure and a more democratic alternative within the current ratings system.

5.
INVEST THE GAINS OF FINANCIALISATION TO HELP FUND PUBLIC EXPENDITURE

Reversing financialisation will not be an easy or swift endeavour. Alongside institutional reform of the financial markets, other strategies will be required to ensure social welfare is maximised even as the economy slowly definancialises. As one such strategy, we recommend that **a British Future Fund should be established to help fund future public expenditure requirements by hypothecating revenue from specific financial transactions.** This sovereign wealth-style fund would help support future public expenditure by 'skimming' off the proceeds of large-scale private financial accumulation for public benefit.

The benefits of the British Future Fund

In terms of impact, a British Future Fund (BFF) would be a complementary strategy to other measures to reanchor finance in the real economy. A fund of £100 billion would take a number of years to build up, and at current rates of return would generate roughly £3 billion a year for public expenditure, although some of these profits would have to be reinvested in order to continue to sustain and grow the fund. History demonstrates that an initial capitalisation can grow quickly: the Norwegian Government Pension Fund, for example, was capitalised with $400 million in 1996 and now owns an estimated 1 per cent of global equity, or roughly $818 billion in January 2013.[34] Norway's fund is underpinned by that country's resource wealth, particularly oil, but nevertheless it does show that significant growth can come from effective stewardship and suggests that collective capital ownership strategies can play an important part in responding to financialisation. In particular, there are three arguments in favour of such an approach, even if it will take a number of years to make a substantial impact.

First, the BFF could help to address the fiscal dilemma confronting all modern democratic states committed to maintaining reasonable levels of public expenditure in the face of financialised economies. For these countries, like the UK, tax is primarily based on labour income, yet labour's share of national income is declining relative to capital, lowering the overall tax take (Reed and Himmelweit 2012). The capital share, on the other hand, is increasingly mobile, making it difficult to tax effectively. In any case, the cost of public goods funded by general taxation is rising quicker than labour productivity and income in general. As Gerry Holtham has acutely argued, if the UK is to escape this fiscal dilemma it must find new revenues to fund public expenditure. Rather than trying to tax financial capital, one potential solution is to establish new forms of collective ownership, via a claim on a portion of the amount of financial capital in circulation (Holtham 2014). Public accumulation of the proceeds of financialisation can then help to fund future spending in line with public priorities.

Second, the BFF is in step with the contemporary progressive agenda of 'shifting from redistributing income to redistributing assets' (White 2013). In part, this agenda is based on a revival of the Rawlsian notion of an egalitarian property-owning

34 For more information on the Norwegian fund, see: http://www.swfinstitute.org

democracy that seeks to restructure patterns of ownership within the economy, much more broadly dispersing claims on return to capital (see for example O'Neill and Williamson 2012). Rawls argued that financialised capitalism 'permits very large inequalities in the ownership of real property (productive assets and natural resources) so that the control of the economy and much of political life rests in few hands' (Rawls 1985: 137–138). One way around this is to entrench widespread claims on return to capital by extending new forms of collective ownership, of which a BFF would be one institutional example.

Finally, there is a deep current in British progressive thinking that claims on return to capital should be democratised. This has been a sentiment shared across the political spectrum in the past, crystallised intellectually by James Meade's classic 1964 book, *Efficiency, Equality and the Ownership of Property*. It found expression in policy in the 1950s, as Labour examined the idea of a 'Future Fund'-style body in its policy document *Towards Equality*, while the SDP actually adopted the creation of a 'Citizen's Fund' in 1986 as official policy (Jackson 2005). Similarly, today, interest in 'predistribution' suggests there is renewed potential for exploring institutions that widely disperse claims to capital prior to market exchange (Hacker et al 2013). These trains of political thought could both ground and benefit from being made real in a visible and potentially popular institution like the BFF.

Operation of the British Future Fund

The BFF would operate as a profit-making body, although strategically it would focus on investing in sustainable long-term value creation rather than short-term profit maximisation. Once a proportion of any profits made were reinvested to ensure the fund's sustainability, the remainder of the surplus would be used to fund social investment, as set out in the fiscal strategy of the government of the day. In terms of governance, however, the fund would be managed independently of ministerial direction, albeit with certain ethical investment guidelines in place. Similarly, while in time the fund would come to own a portfolio of assets within the financial sector, it would not seek to interfere in the day-to-day management of private firms. Essentially it would act as a silent 'rentier' in terms of taking a capital share in the proceeds of financialisation and reaping the dividends.

There would be several potential ways to capitalise the BFF, even during a period when budget surpluses or resource windfalls are unlikely. We recommend the following options should be considered.

- A scrip tax (a tax paid with shares not cash) on specific capital transactions, for example, as part of the banking sector levy. The levy is expected to raise £2.7 billion in 2014/15 and £2.9 billion each year over the following four years (Seely 2014). A scrip tax has the advantage that it would 'dilute existing shareholder holdings but result in no cash outflow or liquidity strain on the company' (Holtham 2014). Similarly, a small share levy could be applied during any merger and acquisition. Companies typically overpay for acquisitions by up to 20 or 30 per cent of the original asking price. Such a levy would not deter a merger or acquisition process, but it would ensure that a collective equity stake was taken.
- Similarly, a share of equity could be taken in the process of taxing remuneration packages. ONS figures show the total bonus pot within the financial sector in 2012/13 was £13.3 billion, a significant amount of which was awarded in share schemes (Anyaegbu 2013).
- More widely, during the sale or development of any public asset, the public's right to a stake in communal resources – such as the electromagnetic spectrum used in telecommunications –a proportion of the revenue raised, say 10 per cent, could be hypothecated to the BFF. Similarly, a proportion of potential revenue from stamp duty could be hypothecated.

- While it is unlikely that the UK will see a further round of quantitate easing (QE), any such scheme in the future should consider buying equities, not gilts. As Holtham (2014) shows, if 'a third [of recent QE] had been invested at home and the rest abroad', on behalf of the fund, it would be 'worth over a fifth of annual GDP'. The added benefit of this is that QE would more directly benefit the nation at large, whereas the gilt-based model has disproportionately benefited the 5 per cent of wealthiest households (BoE 2012).
- The North Sea oil windfall of the 1980s was spent on reducing tax rates for the wealthy or supporting increased unemployment benefits. If a similar opportunity arises, albeit that it is likely to be smaller, via the exploitation of new energy sources, preferably renewable, then a levy could be devised to ensure the fund has a share in revenue gained from the UK's natural resources.

Examples: what would these capitalisation options be worth?

- If the Pfizer bid of £69.4 billion offer for AstraZeneca had been accepted and a 2.5 per cent scrip tax had been applied to this acquisition, this would have deposited nearly £1.73 billion worth of shares into the BFF.
- Barclays bank recently increased its bonus pool to £2.4 billion pounds in bonuses for 2013, a 10 per cent increase from the previous year despite profit falling by a third (Slater and Vellacott 2014). A scrip tax of 2.5 per cent on the total bonus pool, in addition to normal revenue taxes, would have deposited £60 million worth of shares into the BFF without diluting the productive capital that the bank could invest with. Overall, the ONS suggests the total bonus pot for the finance and insurance sector in 2012/13 was £13.3 billion (Anyaegbu 2013) which, at a 2.5 per cent scrip rate, would raise £332.5 million worth of equity for the fund.
- The sale of the 4G spectrum recently raised £2.3 billion. Ofcom has estimated that the 5G spectrum is approximately seven times larger (Curtis 2013). Even if the 5G sale raised only five times as much as the 4G auction did, a 10 per cent levy – set at a higher rate to reflect the public good nature of the asset – would still deposit roughly £900 million into the BFF. Multiplied over time, supplemented by other forms of income such as scrip taxes on bank bonuses and reinforced by returns to investment and compound interest, this could quickly form the nucleus of an effective fund.

As outlined above, we would recommend that the BFF and any potential surpluses it accrues is used to support future investment in public goods. However, there is also room to explore other alternatives, for example in the form of a basic income, as is provided by the Alaska Permanent Fund, a state-based sovereign wealth fund-style body out of which every Alaskan resident receives an annual payment of nearly $1,000 annually (Cummine 2013). At the very least, a debate should be had over where the surplus of the BFF is invested. However, our key point and recommendation is that innovative new forms of public ownership of financial capital will ensure that public welfare is supported by the social accumulation of some of the proceeds of the UK's financialised economy. In doing so, finance can be reoriented to better serve the common interest.

6. CONCLUSION

> *'We had to struggle with the old enemies of peace – business and financial monopoly, speculation, reckless banking, class antagonism, sectionalism, war profiteering. They had begun to consider the Government of the United States as a mere appendage to their own affairs. We know now that Government by organized money is just as dangerous as Government by organized mob. Never before in all our history have these forces been so united against one candidate as they stand today. They are unanimous in their hate for me – and I welcome their hatred.'*
>
> Franklin Roosevelt, address announcing the Second New Deal, 31 October 1936[35]

In the midst of the Great Depression, in the long aftermath of the greatest financial crisis of capitalism, Franklin Roosevelt and the New Deal set about reconstituting the institutional design of finance in the United States. Most famously this occurred in the Glass-Steagall Act, which separated commercial and investment banking. Yet it also found expression in a host of experiments to reanchor finance in production, whether in the growth of a network of public banks, support for credit unions or radical action to tackle overleveraged banks and overindebted households (see Katznelson 2013). This was successful because Roosevelt was able to marshal a broad-based coalition of those who recognised that some sections of finance had come to stand in opposition to sustainable, widely shared prosperity and deep, vibrant democratic life. To reuse Roosevelt's words, reform ensured that finance became a useful appendage to society, not the reverse.

In our own time, despite a similar financial catastrophe, no such radical change has occurred. Instead, crisis has rapidly calcified into stasis, leaving the basic financial architecture that caused the crash still largely in place. This report has therefore argued a financial reformation is required, based principally on a reassertion of the democratic, public interest over the financial system, and in particular over those privileged institutions that create and allocate credit within the economy. Only by reforming the design of the system – rather than treating its symptoms – can financialisation be reversed and finance come to better serve society.

Beyond the specific proposals contained in this report, definancialiation presents a challenge to the language and approach of mainstream political parties: the dominant slogans of this parliament – 'One Nation' and 'We're all in it together' – both empty out the conflict of interest between different sectors and classes that is inherent in excessive financialisation. What is required instead is a confident assertion that finance is vital to the UK's future but it must be more productively anchored in the real economy in a way that deepens democratic life. Currently this is not the case. Democracy must therefore reassert itself; if, as Roosevelt has it, that earns the 'hatred' of a narrow band of the beneficiaries of financialisation, then that is to be welcomed.

35 http://docs.fdrlibrary.marist.edu/od2ndst.html

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