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BEYOND AUSTERITY:
TOWARDS A GLOBAL NEW DEAL

Chapter V

**INEQUALITY AND FINANCIAL INSTABILITY:
STRUCTURAL LIMITS TO INCLUSIVE GROWTH**



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INEQUALITY AND FINANCIAL INSTABILITY: STRUCTURAL LIMITS TO INCLUSIVE GROWTH



A. Introduction

The illusion that unregulated financial markets could combine limitless prosperity with durable stability disappeared with the 2008–2009 global financial crisis. In addition, it is now recognized that a prolonged period of rising inequality preceded the financial crisis, and the rise was particularly marked in countries at the epicentre of that crisis. Some observers see a clear and direct association between huge inequalities in income distribution and financial crises (Milanovic, 2010), while others consider the search for a “one-note narrative” too simplistic (Galbraith, 2014).

What is certain is that little has been done since the crisis to tackle the problems of skewed wealth and income distribution. Indeed, efforts to revive the “Great Moderation” of the two decades prior to the crisis, marked by low inflation, fast growth and confidence in self-equilibrating market forces, appear to be based on a view of the crisis as an unfortunate accident stemming from the complexity of modern financial systems. On that view, growing inequality is deemed a temporary deviation from the historical norm, likely to be corrected as recovery takes hold.

This chapter challenges that view: it discusses, from a macroeconomic perspective, how increased financial instability, culminating in a financial crisis, may be related to growing inequality. The next section begins by examining the concept of “financialization” and how this contributes to both inequality and instability, followed by some stylized facts about the rise of financialization in developed and developing countries. Section C presents an empirical approach for uncovering linkages between rising income inequality and financial crises. It first examines the economic, financial, policy and international channels through which rising inequality intensifies the build-up of financial vulnerabilities. It goes on to show how financial and economic adjustment mechanisms, changes in external conditions and policy reactions in the aftermath of financial crises affect the distribution of income and wealth. The final section draws conclusions, and proposes how growth and financial stability may be pursued along with significant improvements in income distribution.

B. The finance-inequality nexus

There is a large body of empirical evidence which shows that a rising proportion of income in most countries is being captured by the financial sector. Indeed, in many cases, this sector is also exerting a growing influence on the wider economy and on policy.¹ Many such policy regimes that are driven by finance, and which have also supported fiscal austerity and allowed a continuing decline of labour income shares, are coming under growing scrutiny (Boyer, 2009; Stiglitz, 2012).

Studies critical of finance-driven regimes adopt a wide spectrum of approaches. One strand stresses that

unregulated market forces that tend to foster growing market concentration, will generate excess savings and productive capacity, whereby the search for profits will shift from productive investment to financial investment, leading eventually to economic stagnation. This can occur because of insufficient demand for the goods that investment produces, or because less successful industries, along with smaller enterprises that are outcompeted by the larger conglomerates, adopt high-risk investment strategies in an effort to service high levels of debt.² Another strand acknowledges that unregulated markets are prone to financial speculation and boom-bust cycles that constrain growth and

stability, and suggests that improved incentives and information flows, along with appropriate regulations, could correct the problem.³ While there are significant differences between these two lines of thinking, it is possible to adopt a schematic approach drawing from both, which recognizes the interrelations between inequality and financial instability.

1. Revisiting the links between financialization, inequality and instability

A common entry point in the search for linkages between financialization, inequality and instability can be provided by an analysis of the three main aggregate components of global demand. The first two – private consumption and investment derived from wages and profits or credit – contribute directly to spending flows. Conversely, income not spent can leak into various forms of acquisition of financial assets (net financial savings). The third component – government expenditure out of tax revenues or deficit-financing – plays a critical macroeconomic role in sustaining aggregate demand, particularly in situations of sluggish private expenditure. (This implies that fiscal austerity in a weak economic environment can exacerbate deflationary tendencies.) Total net world exports are zero by definition (hence not a component of global demand), but from the perspective of individual countries, net exports can be a source of demand, provided that equivalent net imports and financial inflows occur elsewhere in the global system.

Households, whose income depends on a mixture of wages and revenues generated from assets, are a major source of consumption. However, the propensity to save is higher for rentiers and high-income groups than it is for working families. Thus, greater inequality or declining labour income shares tend to reduce consumption, but it can stabilize, or even rise, to the extent that consumer credit compensates for falling wages. By contrast, investment is essentially driven by profit expectations, which are influenced by economic and financial processes and by assumptions made by entrepreneurs and speculators, including about wages, sales and asset prices. These varying expectations can have very different implications for the nature and sustainability of private debt, as well as for investment and economic growth.

Therefore, income distribution influences the composition of aggregate demand. Low levels of consumption

relative to income (thus higher savings) may be consistent with high levels of investment, *if* all such savings are utilized. One of Keynes's main observations was that in modern economies there is a tendency for consumption to fall because of a general pattern of uneven distribution of income and wealth, while the greater productivity of newly installed capacity, together with "animal spirits", higher savings from increased profits and easier monetary policy, can stimulate the urge to invest. However, when there is uncertainty about future revenue streams from investment and a growing predominance of speculative activity, there is the danger of investment becoming part of a casino economy (Keynes, 1936: 159). In the medium to long term, in order to ensure a steady pace of private investment and stable economic growth under full employment, it is necessary that real wages increase at the same rate as real labour productivity (Kalecki, 1965; Pasinetti, 1974). Failing to ensure this distributional prerequisite will lead to savings-investment paths that are unstable and below full employment.

Hyperglobalization, which has been associated with generally declining wage shares, has also exposed countries to new sources of external vulnerability, including sequences of global imbalances, price shocks and boom-bust cycles of capital flows. As anticipated by Minsky (1963, 1975 and 1986), the dependence of profits on physical investment has been greatly reduced in many countries, while financial innovation has expanded at a more rapid pace than countervailing regulations.⁴ Over time, speculative finance takes hold, feeding into a "normal" evolution of an economy based on the development of instruments and markets that enable ever higher levels of financial activity. While rising profits under these conditions can lead to a more widely shared sense of prosperity, the resulting apparent tranquility accelerates the pace of financial innovation and encourages even more reckless investment decisions, leaving the system increasingly vulnerable to shocks: stability thus feeds instability.

Financialization – a process by which financial institutions and markets increase in size and influence – has been a growing trend under hyperglobalization, and is widely documented (Epstein, 2005; Duménil and Lévy, 2004; Brown et al., 2015; *TDR 2015*). Its features include, inter alia, the rise of shareholder corporate governance, a proclivity to undertake short-term financial operations, unprecedented political power of large financial institutions and weak

regulation of financial markets (Stockhammer, 2004; Epstein, 2005; Vasudevan, 2016). Turner (2016b: 89) notes that financial players have generated huge amounts of money, managing assets and trading on their own account, and he stresses that, “in addition to the financial system doing more units of activity vis-à-vis the real economy, it does phenomenally more units of activity with *itself*”.⁵ The huge profits reaped by financiers in the years preceding the global financial crisis, and the losses that had to be absorbed by the rest of the economy in its aftermath, have led some observers to characterize this process not as financial innovation, but rather as “fraud” and “counterfeit” (Galbraith, 2014).

At the international level, Polanyi Levitt (2013: 86) refers to a “Great Financialization” taking place, involving an explosion of unfettered “movements of cross-border capital and trading in foreign currencies ... greatly exceeding the requirements of trading in goods and services”. She adds, “Finance-driven globalization, associated with excessive promotion of financial profits and speculation, has greatly increased the interconnections within the financial sector, with consequences for vulnerability and instability that were all too evident during the great financial crisis (GFC), and are becoming apparent once again”. It has diverted resources needed for long-term investment, while increasing developing countries’ vulnerability to external shocks (UNCTAD, 2011; *TDR 2015*; Akyüz 2011 and 2013), including shocks resulting from the disruption from trade (Cornford, 2012). The reverse causation also holds: globalization of trade and investment increases the scale and complexity of cross-border connections between financial institutions, thereby increasing the potential for cross-border financial contagion.

The financial liberalization processes that took place in various Latin American countries during the 1970s and 1980s, and especially the policy interventions in the aftermath of financial crises, characterized by nationalization of the huge losses incurred by private investors, are testimony to the role of governments in supporting capital accumulation and financial instability (Diaz-Alejandro, 1985; *TDR 2015*, chap. II). Indeed, States have been serving the interests of financial markets, both in opening up and absorbing losses, through the East Asian financial crisis in 1997–1998 and subsequently, exposing at the same time the heightened threat of contagion in an increasingly interconnected world economy (Baker, 2003; Sheng, 2009). Moreover, the global financial crisis of

2008–2009 exposed the gap between too-big-to-fail financial institutions, whose income derived from a mixture of service fees and asset management, and the majority of (wage-earning) households. This gap was, in part, engineered by pervasive “regulatory capture”, which enabled these institutions to shape policy decisions in their favour (Claessens and Perotti, 2007; Johnson and Kwak, 2011). The aftermath of the global crisis continues to show just how powerful financial institutions have become, not only requiring unprecedentedly large interventions by central banks, but also, de facto, acquiring an effective veto over various government policies (Polanyi Levitt, 2013).⁶ The adjustments imposed on other sectors of the economy, and the negative spillovers of such actions to other countries, have been huge.⁷

It follows that the dynamics of profit accumulation under financialization are associated with worsening income and wealth distribution, as well as recurrent financial crises. Also, when crises occur and governments and central banks react, policy space is likely to become even more constrained, with the risk of exacerbating income inequalities even further. The nature of each crisis undoubtedly varies depending on initial institutional conditions, the factor(s) triggering the crisis and the policy responses (Kregel, 1998 and 2014; Taylor, 1993). But a few common traits can be discerned. Foreign inflows dry up and capital flight occurs. Exchange rate depreciations sometimes follow, with an impact on domestic inflation as well as on the cost of external debt. In addition, investment is adversely affected (regardless of whether the interest rate is raised in an attempt to attract or retain capital, or if it falls as a result of monetary policy) because investors deleverage and do not expect consumption to rise in the medium term. Financial bailouts that rescue investors, both domestic and international, are not generally concerned with alleviating the strain on public finances caused by a crisis, or with providing relief to households who pay a heavy price through employment and income losses. This is compounded by a scaling down of social protection and services, and privatization of public transport and utilities. Negative multiplier effects cause further deterioration in the labour market in the form of even lower levels of employment, depressed wages and greater tendencies to informalization. At the same time, policies attempting to reignite investment and financial activity, especially through measures such as direct transfers, tax rebates and asset repurchases, tend to help those at the top of the income ladder.

The following stylized economic cycle emerges under hyperglobalization:

- Profit-makers with increasingly complex financial commitments tend to limit the growth of labour costs, and the resultant downward pressure on wages limits effective demand, thereby leading to excess capacity.
- The need to generate new sources of profits prompts financial innovations, which in turn provide expanding opportunities for profit accumulation in speculative activities.
- The pace of such financial innovations exceeds that of regulation.
- However, governments seeking rapid growth tend to support and incentivize profit-taking opportunities, thereby exacerbating inequality and reducing their capacity to avert future crises.
- These dynamics induce efforts to expand to other markets, often facilitated by the power and influence of the industrial and financial conglomerates of the major economies, given their larger size and more advanced techniques.
- Global integration offers new channels for capital accumulation through rents from financial operations, including in equity, bonds and foreign exchange markets, pushing up asset prices and allowing households to sustain credit-driven expenditure.
- The result is a pattern of “Ponzi finance” at the international level, causing massive vulnerabilities in the global financial system.
- When crises occur, the macro-financial dislocations, one-sided reliance on monetary policy, and consequent protracted weakness of aggregate demand and employment tend to worsen income distribution and exacerbate tendencies towards instability.
- Finally, under crisis situations, the burden is almost always borne by the public sector and transmitted to the domestic economy, as international investors exercise pressure to be served first.

2. Financialization in practice

This subsection considers various dimensions of the financialization process by examining three variables that can be measured using standard statistical methodologies. First, the size of the financial sector

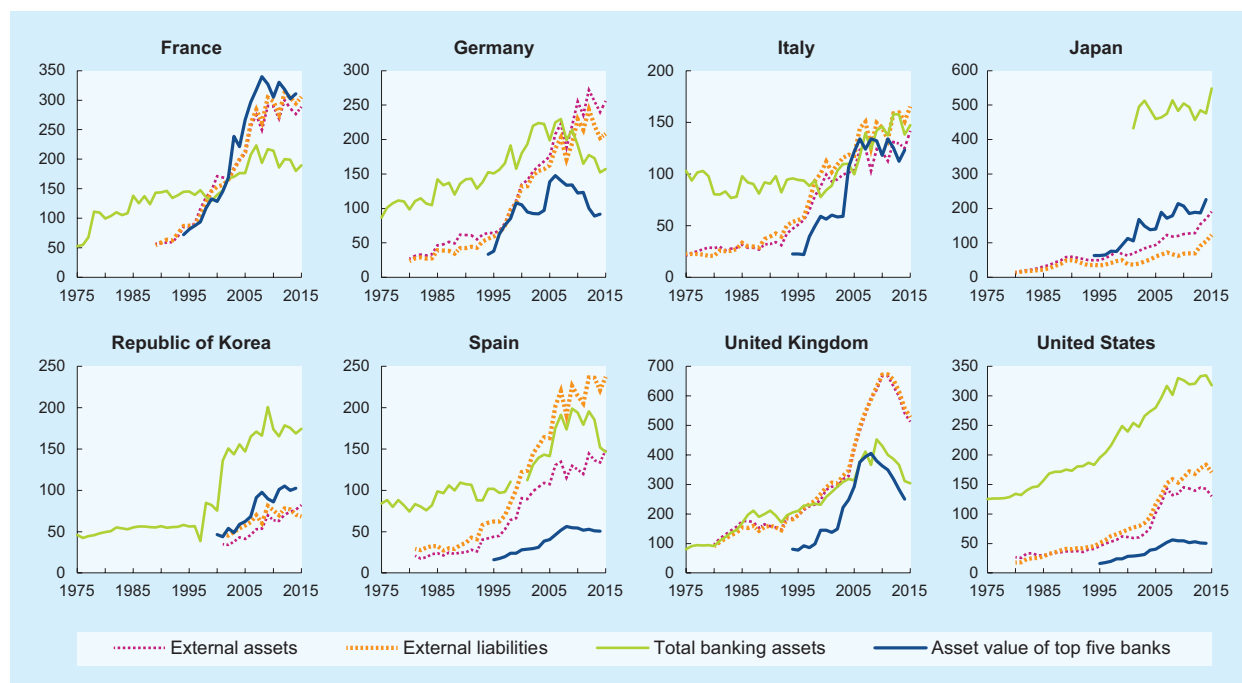
is proxied by the value of the assets of financial institutions – including “depository corporations” and “other financial corporations” – relative to GDP, as compiled by the International Monetary Fund (IMF) for its *International Financial Statistics* (IFS) database.^{8,9}

Second, the magnitude of external financial operations is estimated by calculating the values of cross-border assets and liabilities captured in the International Investment Position (IIP) tables of the IMF’s *Balance of Payment Statistics* (BoPS) database.¹⁰ These measures are also calculated relative to GDP. Taken together, they highlight the degree of internationalization of financial activities. By using stocks, rather than flows, these variables identify the size of inherited positions at each point in time. While the rise of external assets and liabilities, together, suggest greater exposure of a country to events beyond its control, the risk of financial vulnerability arising from high levels of liabilities tends to be higher for countries that do not issue currency traded in the major foreign exchange markets. Third, financial concentration and power are approximated using a variable that measures the assets of the top five banks relative to GDP, so as to combine the notions of bank concentration and their systemic importance. This can indicate how critical such banks are for the functioning of an economy. The consolidated balance sheets of financial institutions are used here (as opposed to unconsolidated balance sheets, which can vary considerably, especially for international banks), because even if a bank fails as a result of its cross-border financial operations, the most traumatic impact of its failure is felt by the economy of its headquarters.¹¹ This indicator can also implicitly suggest how much political power is wielded by the largest banks headquartered in a country.

The “financialization” variables described above are shown in figures 5.1 and 5.2 for selected OECD countries and developing economies. A general observation for all countries is the dramatic acceleration of all indicators of financialization since the 1990s. As noted in previous *TDRs*, OECD countries show a considerably greater degree of financialization on the three measures than developing countries.¹² While the financial crisis of 2008–2009 triggered some deceleration or even weakening of financialization in some OECD countries, no such tendency is evident in developing countries.

The degree of global integration of the financial sector of selected OECD countries economies, measured

FIGURE 5.1 Degree of financialization in selected OECD countries, 1975–2015
(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on IMF, *IFS* database for total banking assets; IMF, *BoPS* database for external assets and liabilities; Bankscope and WorldScope for assets of the top banks; *UNCTADstat* for GDP figures.

Note: Various categories of banking institutions and reported assets are provided in the IMF, *IFS* database. The series of banking assets shown are the most comprehensive, providing the longest series available. Thus, they may differ from country to country. The total assets of the top five banks are calculated by ranking banks, excluding central banks and development banks, from the two mentioned sources using the common methodology of consolidated balance sheets (i.e. encompassing all domestic and international activities of banks headquartered in each country).

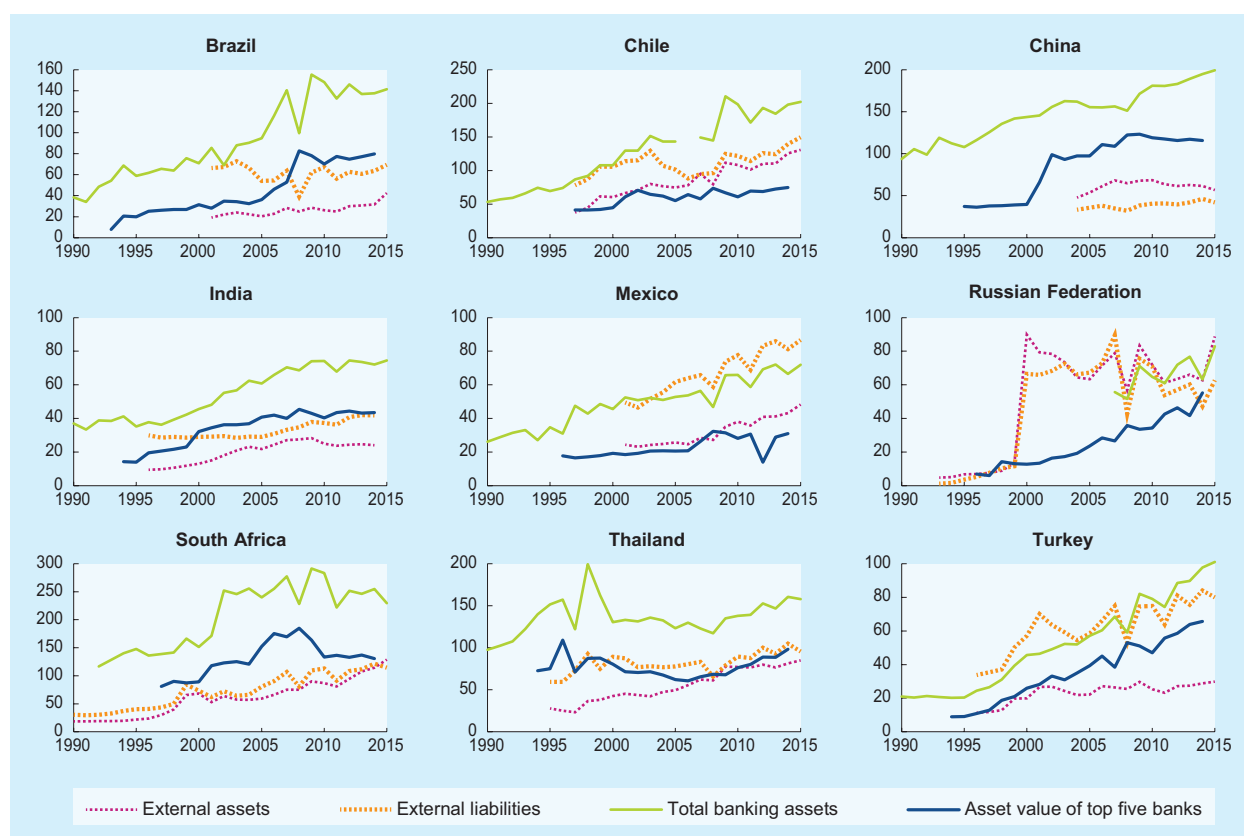
by their external assets and liabilities, is striking. For example, the combined external assets and liabilities represented about 13 times the GDP of the United Kingdom just before the global crisis; and they accounted for between three and six times the GDP of the other developed countries by the time of the crisis, while in Japan they rose to that level after the crisis. The dramatic growth of external liabilities relative to assets in Spain (and to a lesser extent in Italy) point to the growing vulnerability of those economies over the past decade.

Large bank conglomerates are the main vehicles for integration into global financial markets and for expansion into foreign portfolio markets. Other than Spain and the United States, the value of the assets of the top five banks (consolidated) was greater than GDP in the selected OECD countries.¹³ In France and the United Kingdom, the asset values of the top banks were between three-and-a-half and four times their GDP at the time of the 2008–2009 global crisis, while in Germany, Italy and Japan they were between one-and-a-half and two times their GDP. Most asset

values (except loans in domestic currency) are typically handled by trading desks in these large banks, and are valued at market prices that can fluctuate rapidly (especially foreign exchange positions, equities and bonds, and practically all financial derivatives). Indeed, most of the falls observed in the immediate post-crisis period reflect the sharp valuation effects triggered by the crisis.

The total assets of these countries' banks relative to GDP have more than doubled since the 1990s, reaching more than 200 per cent of GDP prior to the global crisis, with only Italian banks' assets below that mark, while those of Japan and the United Kingdom were more than 400 per cent of GDP. Even if banks' asset values have been considerably lower than those of total external assets and liabilities, it illustrates the asymmetric expansion of financial operations compared with other economic activities. And it is reasonable to infer that institutions conducting these financial operations exert a significant influence on macroeconomic performance as well as political decision-making in many countries.

FIGURE 5.2 Degree of financialization in selected developing and transition economies, 1990–2015
(Per cent of GDP)



Source: See figure 5.1.

Note: See figure 5.1.

Compared with the OECD countries, the picture for the selected developing and transition economies (figure 5.2) differs only in degree. Although the available data series for some of the latter countries are shorter, all of them have experienced rapid financialization since the mid-1990s. Their international investment positions, as measured by total assets and liabilities combined, have been large, ranging from about 100 per cent of GDP for Brazil, China and Turkey, to 250 per cent of GDP for Chile and South Africa. The only exception among the selected countries is India, at around 65 per cent of GDP, but even this represents a doubling over two decades. Particularly for the countries for which the foreign liability position has risen dramatically, this indicates a considerable rise in external vulnerability, made worse by the fact that most of their external debts are not denominated in domestic currencies.¹⁴

Except for India and Mexico, the values of the assets of the top five banking institutions headquartered in the selected developing countries are at present within

the range of 65 per cent (Turkey) and 130 per cent of GDP (South Africa);¹⁵ and in the Russian Federation the assets increased from under 20 per cent in the mid-1990s to nearly 60 per cent of GDP in 2015. In all the countries there has been an increasing trend.

Evidence from the countries presented underlines the growing importance of financial activity vis-à-vis the real economy. It highlights the asymmetric expansion of international positions involving markets that are beyond the control of domestic public authorities, as well as greater banking concentration and the large size of their balance sheets relative to domestic income.

3. Weak financial regulation as a major enabling factor

One major reason for the processes noted above is that, even after the 2008–2009 crisis, financial regulation has remained focused primarily on prudential

regulations rather than structural controls. The Basel I (1988) and Basel II (2004) prudential norms for banks were designed to equalize conditions for cross-border competition. They sought to level the international playing field among banks by harmonizing rules on capital requirements, risk management and transparency of individual banks, while ignoring systemic challenges related to bank size and their interrelations within an expanding and mutating financial sector. These shortcomings partly led to the creation of the Financial Stability Board (FSB) soon after the global financial crisis in April 2009, which was tasked with making recommendations to address the challenges arising from systemically important financial institutions.

Similarly, Basel III (2011) emphasized capital requirements at the expense of other regulatory measures, and made only limited progress in addressing systemic risks. Whether or not the new capital requirements are high enough (Admati and Hellwig, 2013), there is widespread agreement that the continued reliance on bank self-regulation, which is at the core of the Basel Accords, is not appropriate. More precisely, by maintaining the premise that banks are best placed to assess their own risk-taking, and that they should therefore themselves attribute risk-weights to the assets they use for fulfilling imposed capital requirements, the Basel Committee on Banking Supervision (BCBS) has ignored a key lesson that should have been learned from the global financial crisis. Only after observing the continued gaming of risk-weighted assets for the purpose of reducing regulatory capital requirements, have international standard setters seriously grappled with the problem of designing more stringent rules for the measurement of credit risk, and this in the teeth of fierce opposition from banks and regulators.

In any case, higher capital requirements only imperfectly address systemic risk arising from the rapid contagion and emergence of intensified liquidity risk. As observed amidst cascading fire sales during the global and other financial crises, the procyclicality and uniformity of existing accounting rules structurally reinforce herd behaviour, which adds to systemic risk.

There is widespread belief that the application of fair-value accounting by financial and non-financial institutions can aggravate financial instability and the procyclical behaviour of banks.¹⁶ In the absence of market prices, fair value is estimated by valuation

models. According to the Financial Stability Forum (FSF, 2009: 26), fair-value accounting has

[E]ncouraged market practices that contributed to excessive risk-taking or risk-shedding activity in response to observed changes in asset prices... When the markets for many credit risk exposures became illiquid over 2007-08, credit spreads widened substantially as liquidity premia grew... Wider spreads drove down mark-to-market valuations on a range of assets... The extensive use of fair value accounting meant that, across the financial system, these declines translated into lower earnings or accumulated unrealized losses... Mark-to-market losses eroded banks' core capital, causing balance sheet leverage to rise. Banks sold assets in an attempt to offset this rise in balance sheet leverage and to address liquidity issues, but such sales only pushed credit spreads wider, causing more mark-to-market losses.

Such observations led the FSF and the BCBS to recommend modifications to this form of accounting practice. However, these modifications have not been included in the International Financial Reporting Standards – IFRS 9 – which are the accounting rules for the valuation of financial instruments adopted by the International Accounting Standards Board in 2014. As a result, accounting and regulatory rules in this area can diverge. This could further reduce the transparency of reporting by banks, and complicate the work of regulators and accountants, especially in developing countries.

The recommendations of the FSF and BCBS amount to decentralized delegation of standard-setting to local regulators. But the perception that even the revised regulatory rules for controlling credit risk are inadequate, has led to more detailed alternative proposals. For example, Persaud (2015) has proposed “mark-to-funding” accounting, which would value assets not based on real-time market fluctuations, but on principles that would take into account the maturity of the sources of funding for financing liabilities. This would contribute to reducing liquidity risks which remain significant even under the Liquidity Coverage Ratio and Net Stable Funding Ratio measures introduced under Basel III. Such risks are likely to keep growing as herd behaviour among human and computerized operators intensifies as a consequence of increasingly homogeneous information sources, algorithms and regulations.

Notwithstanding the Basel and FSB recommendations, a growing number of large and complex banks

have become too large to supervise, not just for external regulators, but even internally. The necessity for restructuring the financial sector has been persuasively demonstrated after rigorous examination of the overall costs of correcting miscalculations of risks by a large and deregulated financial system (Felkerson, 2012). To avoid further costs to taxpayers, most regulators tend to converge on proposing measures for simplifying the structure of banks by separating and redistributing their various activities, including ring-fencing their retail operations. Simplifying the structure of banks' operations could also entail breaking down synthetic financial products into more transparent instruments tradable on financial markets, while subjecting more opaque and less liquid instruments traded over the counter to higher capital requirements. Regulatory approaches should allow regulators to manage the capital account in ways that are consistent with specific country needs (Reddy, 2013; *TDR 2015*). A Tobin tax has also been suggested as a measure for mitigating risks by absorbing a substantial share of the profits of short-term trading into a global fund (Shirreff, 2016).

Various experts and some regulatory insiders have also suggested breaking up big universal banks, not only because the stress experienced by such large institutions has potentially systemic implications, but also because financial concentration wields political power and breeds a culture of entitlement that lauds rent extraction and extravagant remuneration (Galbraith, 2014; Johnson and Kwak, 2011; Shirreff, 2016).

Finally, the proliferation of financial crises and the implied costs to the public have led to calls for reinstating the essential role of the public sector in ensuring the proper functioning of the financial system. A more permanent participation by governments in financial institutions, especially depository banks, could improve information flows between banks and regulators, contribute to subordinating profit motives to social objectives, and leverage financial intermediation with the aim of mobilizing technical and scientific talents for a less financialized, more equitable and sustained development process (Chandrasekhar, 2010).

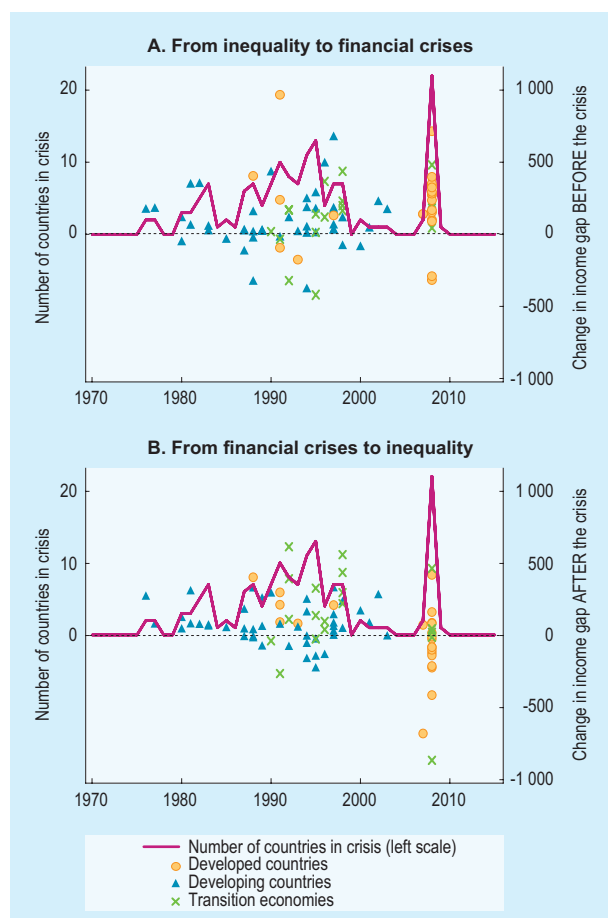
C. Probing deeper into the inequality-instability nexus

It is common to trace episodes of financial crises and rising inequality within relatively separate paradigms.¹⁷ The analysis proposed below departs from this approach in order to highlight the feedback mechanisms between worsening inequality, financial instability and non-inclusive growth.

To start with, it should be noted that financialization can worsen inequality in a variety of ways, regardless of whether a financial crisis eventually occurs. For instance, the financialization of a range of goods and services, which is often linked to privatization or inadequate delivery of public utilities and basic social services, has been an important means of extracting profits from households. Medical insurance and debts incurred because of medical expenditures, including hospitalization, provide one such example. A striking recent tendency in many countries is the explosion of student loans (discussed in chapter I), which reflects the financialization of tertiary education (Eaton et al., 2016; Messer-Davidow, 2017). This process has been described as “the takeover of social policy by financialization” (Lavinias, 2017). The expansion of digital (non-cash) modes of transaction that

involve fees for transactions imposed by banks and financial technology (fintech) companies, such as e-wallet providers, represents an extreme version of financialization which affects money as the means of exchange (Ghosh et al., 2017). All of these add to inequality because they involve payments from the general population to banks and to other financial agents that make profits from these processes. While recognizing this, the discussion that follows focuses on the relationship between financial crises and inequality.

An empirical examination of inequality and financial crises can be approached in different ways. This chapter considers systemic banking crises as defined by Laeven and Valencia (2008 and 2012).¹⁸ Such crises are closely linked to risky behaviour by private sector financial institutions and corporations as well as households. And, as noted above, they can trigger responses such as capital flight or forced socialization of private debts, and thus exacerbate external or public sector imbalances. Banking crises frequently occur with, or predate, currency crises or sovereign debt crises, and, in extreme cases, both.

FIGURE 5.3 Inequality before and after financial crises, 1970–2015

Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; and the *GCIP* database.

Note: Change in monthly income gap is estimated in 2005 purchasing power parity (PPP) dollars by measuring the absolute change between $t-2$ and $t-6$ (panel A) and $t+6$ and $t+2$ (panel B) – t being the year of the crisis – of the 3-year moving-average income gap between the top 10 per cent and the bottom 40 per cent.

With respect to inequality, the empirical analysis that follows focuses on personal income inequality, estimated in net terms,¹⁹ based on survey data²⁰ collected in the *Global Consumption and Income Project* database (GCIP, version March 2016) (see Lahoti et al., 2014). A global analysis of within-country inequality is a complex undertaking due to the diversity of economic and social class structures across developing and developed countries. A feasible way to deal with this diversity is to look at a set of population cohorts, such as the top 10 per cent, middle 50 per cent and bottom 40 per cent income segments. A universally valid observation is that the top income segment is also the “asset-wealthiest” (Davies et al., 2011; Piketty, 2014). However, wealth data are more scarce than income data, making an empirical investigation

combining both across many countries impossible. The middle segment can be “asset-rich” to a limited extent, while the bottom segment is unequivocally “asset-poor” or “asset-deprived” across both developed and developing countries. Palma (2011) has argued that inequality is best understood by looking at the tails of the distribution, which is confirmed by cross-country research that has found relative stability in the share of the middle 50 per cent over the past few decades (Cobham et al., 2015). Accordingly, this chapter uses the Palma ratio, which captures changes in the income shares of the top 10 per cent of the population relative to the bottom 40 per cent, as well as income gaps between these two groups as indicators of inequality.²¹

Figure 5.3 shows a systematic pattern of rising inequality across a sample of 91 crisis episodes,²² both before (5.3A) and after (5.3B) the crises. On the left-hand vertical axis in both panels, the line shows the number of financial crises each year since 1970. On the right-hand vertical axis, the position of the various symbols indicates whether the income gap between the top 10 per cent and bottom 40 per cent increased or decreased (above or below the zero line) in the run-up to financial crises (5.3A) and in their aftermath (5.3B). In the run-up to financial crises, the income gap rose in 81 per cent of the cases, and in their aftermath, it rose in 66 per cent of the cases.²³

Developing countries in the 1980s and 1990s, transition economies in the 1990s and, most recently, developed countries, all experienced rapidly widening income gaps in the run-up to financial crises, irrespective of their initial level of inequality. However, patterns have differed across country groups in the wake of financial turmoil. Among developing economies, countries with higher levels of inequality were more likely to record declining income gaps, while among developed economies, this was more likely to occur in the most egalitarian countries. Among transition economies, most of which still featured low levels of inequality in the 1990s, financial crises erupted in the singular context of the political and economic dislocations resulting from the break-up of the former Eastern bloc.²⁴

Admittedly, financial crises can have multiple causes and consequences, and rising inequality may not always be one of them, especially in smaller countries that are more vulnerable to changes in external conditions, as illustrated by a minority of cases in figure 5.3. However, beyond special cases, the stylized facts

captured in that figure underscore the plausibility of feedback mechanisms between inequality and instability before and after financial crises, as discussed in more detail below.

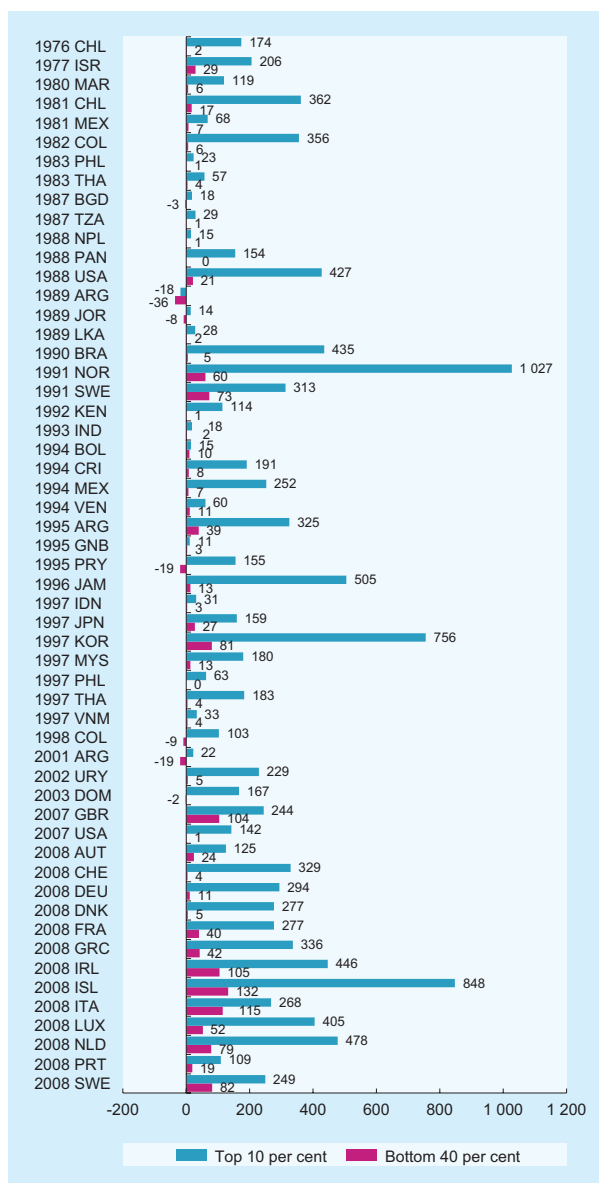
1. Disentangling inequality in the run-up to financial crises

Figure 5.4 decomposes widening income gaps in the run-up to financial crises (i.e. those mapped in the upper half of figure 5.3A). In 85 per cent of observed cases, both top and bottom incomes increased, though very asymmetrically. Income gaps were driven by the “great escape” of the top 10 per cent, outpacing modest increases in the average income of the bottom 40 per cent, which in a few cases masked declining incomes for the lowest decile.

A supply-side narrative linking inequality and financial instability (Kumhof et al., 2015; Coibion et al., 2016), suggests that a permanent increase in the share of top incomes in national income allows more savings to be channelled to the financial sector. The subsequent expansion of credit supply to poorer households means that debt and leverage increase, leading eventually to a financial crisis. This narrative posits a simplistic role for the financial sector as a passive intermediary of savings through credit supply. It ignores the creation of private liquidity through banking leverage and the broader process of financialization described above, thus overlooking the potential for instability that arises out of risky financial innovations in response to demand from asset-wealthy product classes (e.g. asset-backed securities or structured derivative products). As a corollary, this narrative further overstates the role of low-income households in causing the crisis (Lysandrou, 2011a and 2011b).²⁵

However, as alluded to in Laeven and Valencia’s description of systemic banking crises, it is the financial strategies of corporations and financial institutions that constitute the critical mechanism underlying financial instability. While destabilizing financial processes are always country- and crisis-specific, they are very often rooted in the quest for higher financial yields from asset-wealthy classes; this was the case in the 2008–2009 financial crisis in the United States (Goda and Lysandrou, 2014). In countries hit by the Asian financial crisis in 1997–1998, speculative practices by large domestic and foreign investors similarly played a key role. In

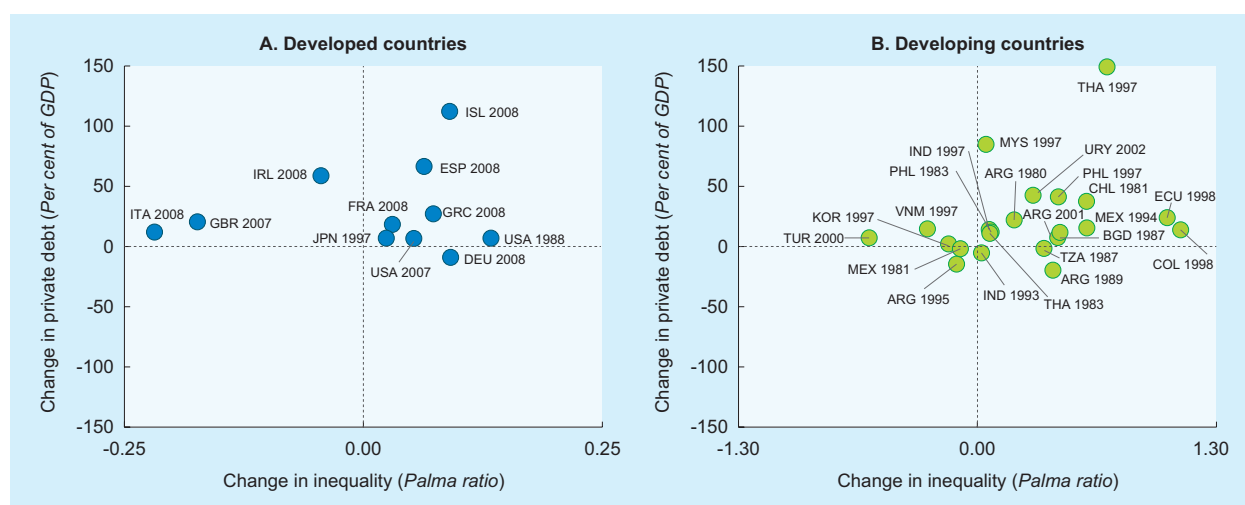
FIGURE 5.4 Decomposition of widening monthly income gaps in the run-up to financial crises, selected countries, 1970–2015 (2005 PPP dollars)



Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; and the *GCIP* database.

Note: Changes are measured as the difference between the 3-year centred moving average at t-2 and t-6, t being the year of the crisis. Crises are presented in chronological order with abbreviations for the selected countries based on the ISO Alpha-3 country codes, and the years refer to the year of crisis in the respective countries.

the Republic of Korea, for example, the volume of private debt barely increased in the run-up to the crisis (figure 5.5). Yet creeping financialization in this country enabled the rise of short-term operations of large industrial and financial conglomerates to finance long-term activities, thus putting the entire economy at risk (Lee, 2011). Cross-border speculative

FIGURE 5.5 Private debt and inequality in the run-up to financial crises, 1970–2015

Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; the *GCIP* database; and the United Nations *Global Policy Model (GPM)* database (<https://www.un.org/development/desa/dpad/publication/united-nations-global-policy-model/>).

Note: See note to figure 5.4.

operations that exacerbated currency and maturity mismatches also played a destabilizing role in other Asian countries (Chandrasekhar and Ghosh, 2013). But the spectacular rise of private debt in countries such as Thailand (Phongpaichit and Baker, 2007) and Malaysia (Jomo, 2007) may be traced back to external as well as domestic financial liberalization in a context of growing inequality. Meanwhile, Mexico suffered from excessive private debt build-up in the decade preceding its 1994 financial crisis (Gil-Diaz, 1998; Griffith-Jones, 2001), which then exploded as a balance-of-payments crisis (Kregel, 1998).

The main factor at work in all of these cases was the ability of the financial sector to engineer innovations aimed at exploiting weak regulations and loopholes to increase the profitability of financial operations on a global scale, irrespective of the robustness of domestic demand in the real sector or the viability of public sector finances. Furthermore, the political balance of power between different social classes and economic interests (e.g. trade unions, industrialists, bankers and exporters) is central to determining the direction of public policies, including for social protection, corporate taxation, financial, trade and other regulations. Political power also influences which incomes and sources of demand will be strengthened and the financial vulnerabilities that are exposed as a consequence. Outcomes are further influenced by incentives provided by the global trade and financial systems and a country's position, and strategies

within it, as well as by the general inclination for countries to pursue debt-led and export-led growth (Stockhammer, 2011; Goda et al., 2014). These accumulation regimes pose significant threats to equity and financial stability, and they also generate international coordination challenges which existing domestic political coalitions and international governance arrangements have failed to address.

As is widely acknowledged, financial cycles and crises are closely linked to private leverage (Borio, 2012; Schularick and Taylor, 2012). Moreover, changes in private debt as a share of GDP are positively correlated with increases in income inequality (figure 5.5 north-eastern quadrants).²⁶ A variety of cases help explain the postulated correlation in developed countries.

In Ireland, Italy and the United Kingdom, relative inequality may have declined, but the income gap rose and household indebtedness increased considerably, so that the resulting vulnerability became a major trigger of the financial crisis. Only Germany experienced a simultaneous rise in inequality (in relative and absolute terms) and a decline in private debt prior to the crash of many of its banks in 2008. This outcome may have resulted from its export-led growth regime, which sustained employment creation through the compression of unit labour costs relative to trading partners in the euro zone and elsewhere. Whether the limitations of this regime lie in unsustainable asymmetries of competitiveness and

inflation within a common currency area (Flassbeck and Lapavistas, 2013; Flassbeck, 2007), or in a continuing weakening of regional aggregate demand (Storm, 2016), the evidence is consistent with a co-movement of inequality and financial instability for the euro zone as a whole. These processes were induced by policy choices within the broader institutional architecture of the euro zone (Goodhart, 2007; Eatwell, 2012; Irvin and Izurieta, 2011).

Policy-induced inequalities and the macro-financial structures resulting from the compression of labour incomes were also at the root of the global imbalances that preceded the global financial crisis. In the context of growing financialization and openness (figures 5.1 and 5.2), inequality that depressed domestic demand led to an unsustainable combination of debt-led and export-driven growth strategies feeding one another in a polarizing and destabilizing process. At one end, surplus countries pursuing export-led growth compressed wage incomes to gain a competitive edge in international markets, thus increasing industrial profits and accumulation at the top. At the other end, the recycling of these profits abroad stimulated domestic asset inflation in deficit countries as well as financial rents accruing to asset-rich classes in surplus and deficit countries alike, which in turn fed into more financial engineering and instability (Akyüz, 2012; Cripps et al., 2011; Patnaik, 2010).

The impact of policy choices is also marked in developing countries, which showed a similar common pattern of private debt rising along with inequality (figure 5.5B), despite apparent differences across countries, regions and time periods. This resulted in diverse processes of financial destabilization. In the early 1980s, when the global drive for financial liberalization and openness was just beginning, financial excesses in the run-up to crises in Latin American countries such as Argentina, Chile, Colombia and Mexico were generally characterized by smaller increases in private debt levels compared to later crises in the same region in the 1990s and 2000s. In Asia, a number of countries also experienced financial instability in earlier decades, but the most significant private debt increases occurred in countries such as Malaysia, the Philippines and Thailand prior to the Asian financial crisis in 1997, which propagated contagious destabilization across the region and beyond (Delhaise and Beckerling, 1998).

By contrast, the tight control of the Chinese Government over its financial sector throughout the 1990s

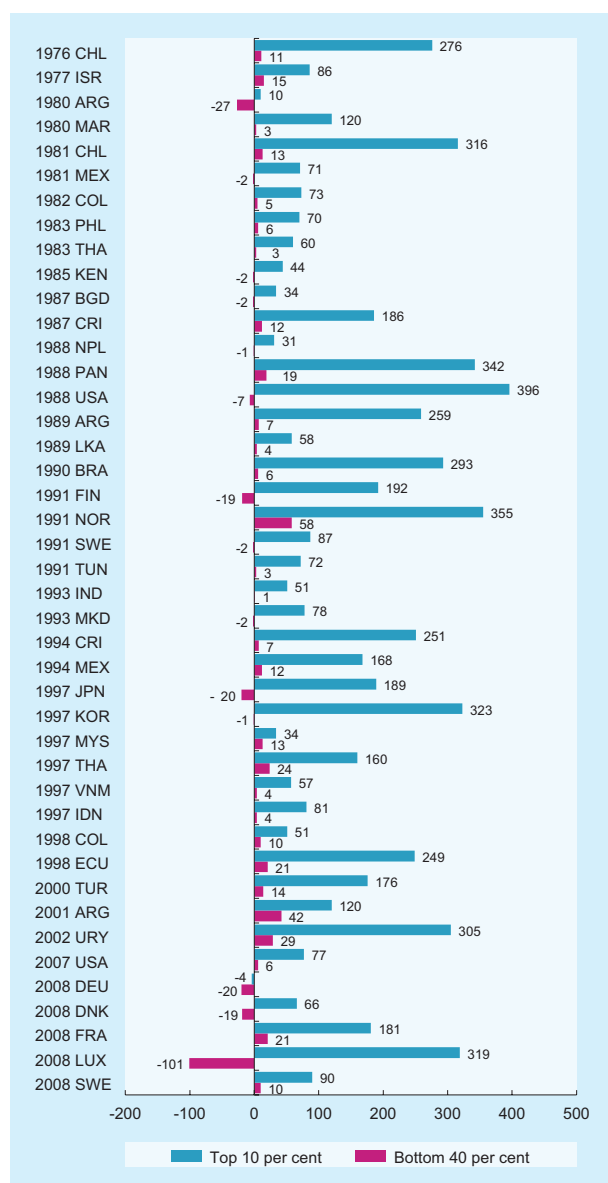
reduced the scope for rapid increases in private debt.²⁷ A decade later, with export-led growth in full throttle, record profits and current account surpluses were being registered. Unlike German surpluses, however, Chinese surpluses recycled abroad were mostly invested in safe United States Treasury bonds rather than in speculative financial products. This limited the financial spillover effects of the subprime crisis on the Chinese economy. However, subsequent attempts to foster growth have been associated with very dramatic increases in debt levels of all the major players in the economy, generating some of the risks associated with financialization despite a more controlled financial sector (figure 5.2). This is evident in the speculation in domestic housing and asset markets (Galbraith, 2012).

2. *Disentangling inequality in the aftermath of financial crises*

As noted above, income gaps between the top 10 per cent and the bottom 40 per cent widened in two out of every three observed financial crisis episodes. Decomposing such income gaps (i.e. those mapped in the upper half of figure 5.3B), reveals that they were driven by rising incomes for the top earners, though to a much lesser extent than in the run-up to a crisis (figure 5.6). More importantly, in many instances incomes for those at the bottom of the income ladder fell or stagnated. However, during post-crisis periods, characterized by rising unemployment and weak demand, such stagnation generally masked an income decline for the first and second income deciles that encompass the poorest segments of society. Furthermore, bottom incomes also declined in the overwhelming majority of crisis episodes that were also characterized by sharp falls in top incomes.

Even when income inequality does not worsen, the lowest income earners bear the brunt of painful market adjustments and economic policies adopted in response to financial crises. Financial instability and subsequent economic disruptions tend to have regressive distributional consequences that are compounded by the magnitude of the aggregate cost imposed on the economy. Figure 5.7 shows a “dynamic” GDP gap between its actual rate each year after a financial crisis and the trend growth prevailing before the crisis. Among more financialized developed economies all, without exception, endured lasting losses in GDP dynamism following financial

FIGURE 5.6 Decomposition of widening monthly income gaps in the aftermath of financial crises, 1970–2015
(2005 PPP dollars)



Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; and the *GCIP* database.

Note: Changes are measured as the difference between the 3-year centred moving-average at $t+6$ and $t+2$, t being the year of the crisis. Regarding countries and years listed, see note to figure 5.4.

crises; and none were able to return to their pre-crisis trend even a decade later. As most of these crisis episodes occurred during the global financial crisis, the sluggishness of economic recovery was exacerbated by simultaneous declines in GDP in the largest developed economies. Thus, negative feedback loops between major developed economies (e.g. France, Germany, the United Kingdom and the United States) and the rest of the world, created a deflationary bias.

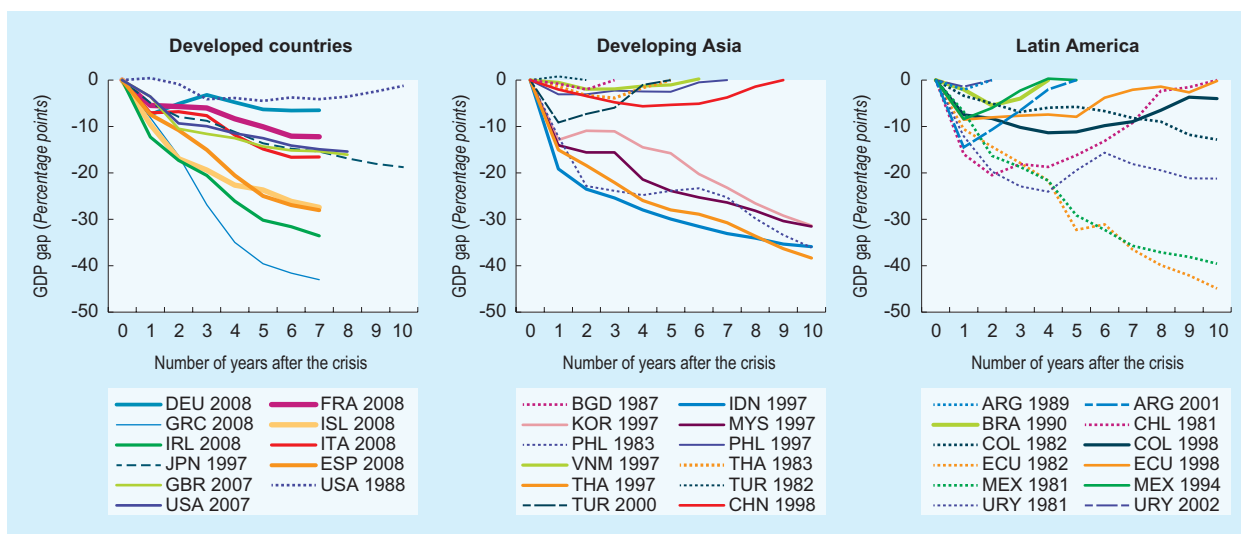
This made it even harder for economies individually to export their way out of recession, as only a few “winners” with favourable initial conditions could succeed. Most countries seeking export-led recovery aimed to improve competitiveness and attract foreign capital by means of labour market flexibilization and protracted austerity measures. In these countries, wage compression and fiscal restraint mostly led to income losses among those at the bottom of the ladder without corresponding net export gains, resulting in declining GDP and employment. For example, Greece, Ireland and Spain ended up permanently losing around 30 per cent or more of their trend GDP growth as inequality worsened noticeably.

Among the selected developing countries, about half recorded large cumulative losses following the financial crises that erupted over the course of the last 40 years (figure 5.7). In Asia, countries such as Indonesia, Malaysia, the Republic of Korea and Thailand experienced the sharpest GDP losses in the decade following the Asian financial crisis. China, the Philippines and Viet Nam fared better and recovered within less than a decade, largely owing to more successful export-led strategies, and, in the cases of China and Viet Nam, a more effective government response, particularly in maintaining and influencing investment (Abbot and Tarp, 2011). However, in most countries, deleterious changes in patterns of economic growth, including rising savings and declining private investment and public expenditure had negative effects on employment, poverty and inequality (Chandrasekhar, 2007; Patnaik, 2007).

In Latin America, market adjustments and economic policies induced by crisis episodes in the early 1980s in countries such as Chile, Colombia, Ecuador, Mexico and Uruguay unfolded in the challenging international context of high interest rates and sharp depreciations of national currencies. Governments responded by absorbing private sector liabilities denominated in foreign currency. The consequent severe deterioration of public finances led to steep falls in government spending (Diaz-Alejandro, 1985; Younger, 1993). All in all, the adjustments were costlier than for most subsequent crisis episodes in the region.

Of 37 crisis episodes examined using the United Nations *Global Policy Model* database, only two resulted in no apparent GDP loss: India in 1993 and Brazil in 1994. In both countries, drastic adjustments created conditions conducive to growth recovery,

FIGURE 5.7 GDP gap following financial crises in selected countries, 1970–2015



Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; and the United Nations *GPM* database.
Note: The pre-crisis trend is defined as the average growth rate of GDP over the 10 years preceding a crisis. Regarding countries and years listed, see note to figure 5.4.

but with increases in the Palma ratio in India, and worsening conditions for the middle-class in Brazil because of falling employment in the public sector and in small and medium-sized enterprises (SMEs).

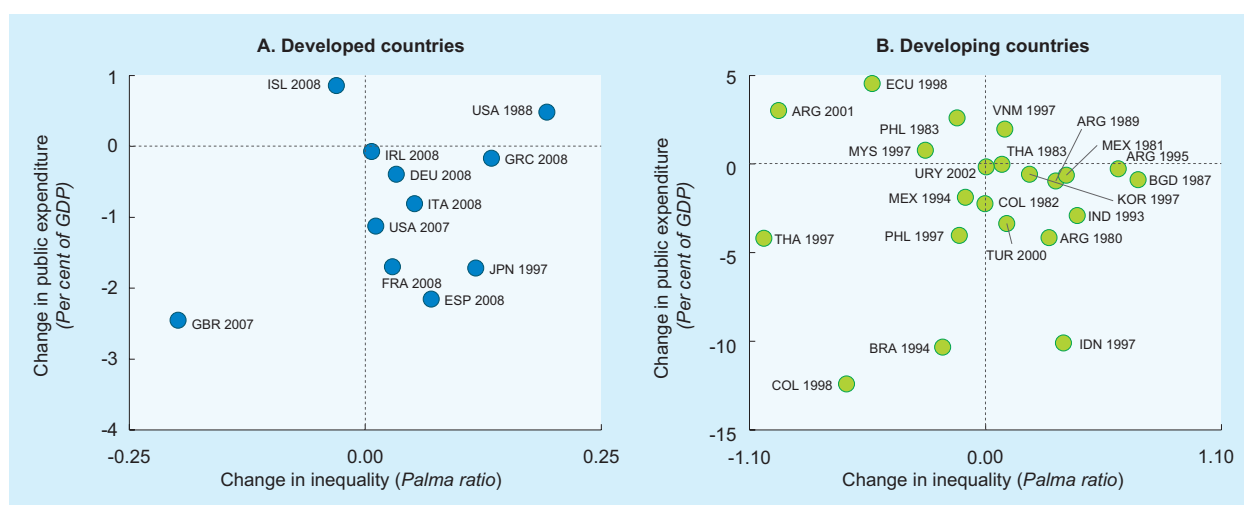
The aggregate costs of financial crises in terms of GDP result partly from inevitable dislocation and a rupture with unsustainable growth patterns which preceded the crises, but also from discretionary decisions that reflect the political balance of power across all relevant institutions, including central banks. Particularly in economies with relatively developed financial sectors and high levels of speculative activity, sharp asset deflation is a common outcome that policy makers need to address. In other economies with less sophisticated portfolio markets, large firms, and at times governments, have assumed unsustainable burdens of (mostly external) debt. Balance sheet failures present policymakers with a further dilemma: allowing insolvencies could exacerbate the negative effects on employment and stability.²⁸

In most past episodes of crisis, central banks actively sought to ensure the continued access to liquidity of privileged actors, including banks and other financial institutions, in addition to providing direct bailouts and recapitalization. Typically, private debts ended up being nationalized, leaving the richest segment of the population relatively untouched (*TDR 2015*). Policy reactions in the wake of the global financial crisis followed a similar pattern (Wray, 2012), with

unconventional monetary measures injecting trillions of dollars of public resources into supposedly efficient financial markets in an effort to reignite growth through an artificial reinflation of asset prices (Felkerson, 2012). These measures left the issue of excessive financial concentration and rents largely unaddressed, thereby allowing financialization to continue unchecked.

In general, apart from some measures adopted to avoid widespread financial collapse, few, if any, pressures were exerted on the favoured institutions (banks, enterprises and well-to-do households) to re-engage in the real economy by extending credit, generating employment and boosting demand. In addition, in many cases, public finances were overstretched, because of either direct bailout programmes and rising public debt-servicing or the negative shock to tax revenues. This forced widespread cuts in public spending, particularly in areas that tend to have greater multiplier effects, such as social welfare programmes and infrastructure development.

Few governments have been able to avoid the pressures for fiscal austerity or resist its proponents' assurances that large capital inflows into the economy would follow. However, those assurances run against growing evidence that the stagnation resulting from such fiscal stringency discourages more investment. Indeed, only a few countries resorted to expansionary fiscal policies to counter the recessionary effects

FIGURE 5.8 Public expenditure gap and inequality following financial crises, 1970–2015


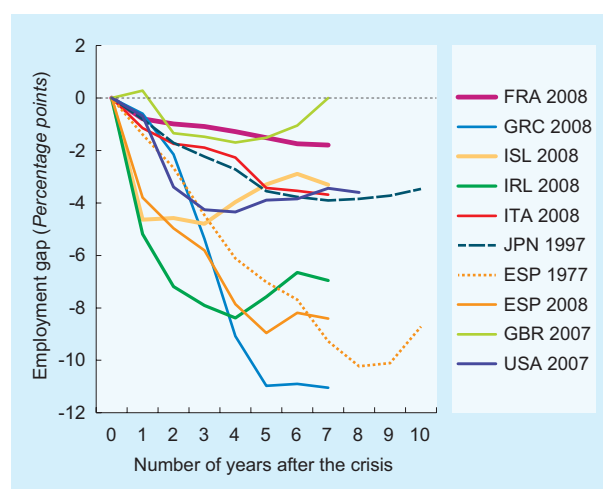
Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; the *GCIP* database; and the United Nations *GPM* database.

Note: The change in government expenditure (GE) is measured as the difference between the 10-year average of GE before crises and the 7-year average of GE after crises (data runs up to 2015, the 7-year horizon is chosen to include recent crisis episodes in developed countries). The change in the Palma ratio is measured as the difference between the 3-year centred moving-average at $t+6$ and $t+2$, t being the year of the crisis. Regarding countries and years shown, see note to figure 5.4.

of financial turmoil (figure 5.8). One example is Argentina, which introduced fiscal and redistributive policies in support of employment creation following its financial crisis of 2001.²⁹ Similarly, policymakers in Iceland restricted capital outflows, and ensured that the banks under government control helped to sustain the real economy, while the cuts in public expenditure required for accession to the European Union were postponed.

Following the global financial crisis, most developed countries (figure 5.8A) which, earlier, had opted for limited fiscal stimulus, reverted to severe austerity programmes to restore financial credibility. But cuts in social protection and public sector jobs only exacerbated deflationary effects, restricting employment generation and contributing to worsening inequality in most countries (south-eastern quadrant of the figure).³⁰ Despite claims to the contrary, the outcome has been further financialization, a continuing concentration and power of “too-big-to-fail” financial institutions, even more vulnerable households and financially stressed public sector balances weakened by sluggish revenue.

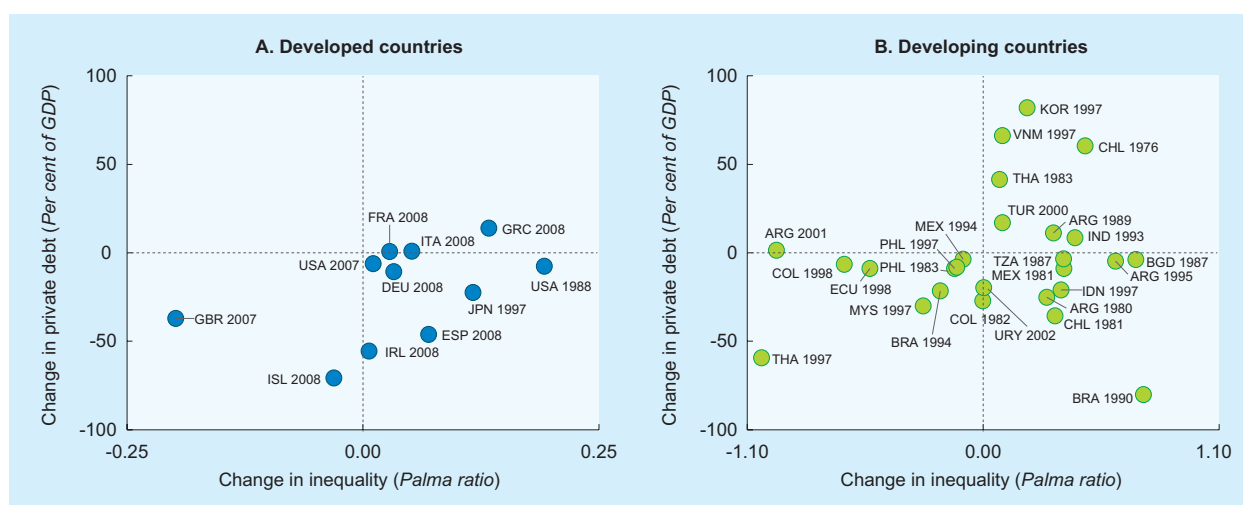
Employment declined in the hardest-hit euro-zone countries, such as Greece, Ireland and Spain, which were unable to devalue their currency or adopt an expansionary fiscal stance (figure 5.9). The United States in 1988 and Germany in 2008 were the only

FIGURE 5.9 Employment gaps following financial crises, developed countries, 1970–2015


Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; and the United Nations *GPM* database.

Note: The pre-crisis level is defined as the level at time t , t being the year of the crisis. Regarding countries and years listed, see note to figure 5.4.

countries that avoided severe declines in employment. In the United States, the continued entry of women into the labour force in a context of rising income inequality and easing credit conditions for consumers helped to sustain employment. In the case of Germany, programmes to retain most of the labour force, even if only in part-time employment,

FIGURE 5.10 Private debt and inequality following financial crises, 1970–2015

Source: UNCTAD secretariat calculations, based on Laeven and Valencia, 2012; the *GCIP* database; and the United Nations *GPM* database.

Note: Changes are measured as the difference between the 3-year centred moving-average at $t+6$ and $t+2$, t being the year of the crisis. Regarding countries and years shown, see note to figure 5.4.

combined with export-promotion measures, allowed a rapid recovery, albeit at the expense of economic activity and employment in other euro-zone countries (Flassbeck and Lapavistas, 2013). In both countries, however, inequality continued to rise.

Among developing countries (figure 5.8B), the pattern of changes in public expenditure and inequality varied much more. Even so, as in developed countries, most developing countries contained or reduced public expenditure and sold State assets following their respective crises. For the most part, financially constrained governments opted for cutting public expenditure, given the threat of capital flight and continuing currency depreciation pressures. Privatization did not necessarily improve budgetary positions, however, and in many countries the receipts were used to pay external creditors. The combined impact of fiscal austerity and privatization hurt the most vulnerable groups (Stiglitz, 2003; ILO, 2014), which explains the observed rising inequality in most cases (south-eastern quadrant). In Indonesia, which experienced the largest GDP loss in the wake of the 1997–1998 Asian financial crisis, monetary and fiscal tightening recommended by the IMF precipitated a devastating liquidity crisis and sharpened economic contraction. Forced to rescue large corporate and financial groups and nationalize their debt to prevent systemic collapse, the Government let public debt rise, from \$54 billion in 1997 to \$134 billion in 2001, including \$74 billion paid to international creditors.

In 2002, debt servicing was more than three times as large as the salaries of the entire civil service and military personnel, while the Government opted to increase taxes, fuel and electricity prices, thus hurting the poor disproportionately (Ramli and Nuryadin, 2007). In post-1997 Republic of Korea, the adjustments of large export firms and banks led to massive worker layoffs and a lasting deterioration in working conditions, in breach of the prevailing “developmental” social compact; this was soon followed by rising poverty and inequality (Kyung-Sup, 2007).

Excessively tight monetary policies imposed by the IMF on several crisis-hit countries through the conditionalities attached to its lending held back economic recovery and polarized income distribution even further. This was the case in the early 1980s in countries such as Chile, Mexico and the Philippines (*TDRs* 1986 and 1993).

The factors that trigger a financial crisis in the first place, as well as the policy responses to the crisis, determine when and to what extent private sector debt rises again. A general pattern can be discerned from figure 5.10. Most developed countries in the sample (figure 5.10A) experienced crises after a period of excessive or rising household debt. But their policy response mainly supported financial institutions and large corporations (and indirectly the asset-wealthy households owning them), with little regard for the needs of the middle class and the more vulnerable

elements of society who would have benefited from debt restructuring. The expectation that the recovery of banks and portfolio markets would reignite household spending based on credit expansion proved unfounded, as household deleveraging in many of these countries continued and private investors in productive sectors maintained a wait-and-see attitude.³¹ If the experience of Japan from the 1990s onwards is any indication, there are significant risks ahead for other developed countries with respect to the unresolved problems of income distribution and weak aggregate demand.

The picture for developing countries (figure 5.10B) reflects different combinations of private sector behaviour and policies. In some countries (e.g. Chile in 1976 and Argentina in 1989), where private

sector debt continued to increase after financial crises, policies supporting debt-driven expenditure contributed to triggering new financial crises a few years later (in 1981 and 1995, respectively). In other countries (figure 5.10B, north-eastern quadrant), currency devaluation led to a rise in the value of debts denominated in foreign currency, in many instances accompanied by policies aimed at gaining competitiveness to support export-led strategies. In a few other countries, rising private debt may simply have reflected the inability to meet debt repayment schedules, necessitating rescheduling. The majority of developing countries, lacking a successful export model, displayed a pattern of private sector deleveraging, in many cases accompanied by increasing inequality along a path of weakened economic growth (south-eastern quadrant).³²

D. Conclusion: Taming finance

The theoretical insights and empirical examination of financialization processes, financial crises and inequality reveal a complex and varied picture. However, a few clear lessons emerge.

First, the dynamics of hyperglobalization tend to enlarge the financial sector, stimulate financial innovations and cross-border operations.

Second, such expansion of finance, within each economy and across the global economy, adversely influences income distribution. Growth through such expansion tends to be polarizing in a cumulative manner, with versatile asset management and exuberant wealth creation at the top of the distribution scale, but oppressive debt burdens and restricted employment, income generation and social development at the bottom.

Third, financial innovations tend to develop at a faster pace than regulations, particularly where the latter depend on resource-constrained public agencies.³³ Further, since successful financial innovations depend heavily on making markets, which in turn requires volume,³⁴ they tend to be most lucrative when implemented by larger actors. This adds to concentration tendencies in the financial sector.

Fourth, the greater concentration into larger institutions and the weight of the largest operators, in turn,

threaten wider economic stability. The threat of collapse, together with its contagion across a broad swath of economic activities, provides finance with a unique influence over policymakers. The ability of finance to constrain policy space grows commensurately with its size relative to that of the real economy, as well as to the size of the top financial institutions relative to the rest.

Fifth, the influence of major financial institutions on government institutions is enhanced by their ability to expand beyond national borders. At the same time, attempts to regulate finance at the global level are limited by two factors. First, national regulators and standard setters need sufficient autonomy in order to take into account country-specific conditions. However, this entails the risk that the regulations considered will not be able to keep pace with financial innovators operating internationally. Second, global regulations are expected to conform to the conventional thinking of how finance works and what kinds of discipline should be imposed on it. Unfortunately, despite the wake-up call from the most recent financial crisis, the recognition that finance is inherently unstable is still not a globally accepted idea. As a result, international financial regulations continue to be subject to the flawed concepts of modern financial theory and behavioural finance which postulate that asset price arbitrage and utility maximization should guide adjustments in a world of free capital

movements. Indeed, the influence of this ideology reaches beyond the financial sector, for example in the design of new accounting standards for small enterprises or governments (e.g. International Public Sector Accounting Standards or IPSAS), as if it were natural, and even desirable, for the accounting practices of all economic organizations in a country to give priority to meeting the information needs of financial investors (Baud and Chiapello, 2017; Chiapello, 2016).

Sixth, the *prima facie* expectation that financial crises may serve to contain the power of finance and help to reverse the underlying tendency to inequality does not stand scrutiny. Although some instances of wealth losses and therefore falls in asset values relative to aggregate income can be observed, and despite concerns about unregulated finance among experts and the public, what eventually seems to prevail is the intent to return the financial system to its pre-crisis *modus operandi*. Thus, policy actions are tending to contribute to greater concentration, and to reinforcing the overarching role of finance. As a result, governments have become more constrained than in the preceding booms. The real economy is not being served by finance; quite the opposite. Employment and wages are being negatively affected, often in a permanent manner. The poor are bearing the greatest brunt of market adjustments and regressive economic policies; cumulative causation is taking effect, and recovery for those at the bottom of the income ladder is generally not as fast as for those at the top. The result is worsening inequality.

Seventh, empirical evidence suggests that when there is a rising trend in income inequality, financial crises become more frequent and widespread. This is because of the relative insufficiency of demand that results from incomes of those at the bottom of the ladder (and in much of the middle) lagging behind aggregate income growth. As a result, profit-makers tend to divert investment into financial innovation that seeks new forms of rent extraction. Regressive income distribution promoted by neoliberal policies therefore exercises a perverse incentive to undertake more financial risk, and risk-taking ventures tend to spread across the global economy. Thus, feedbacks from financial instability in one part of the world frequently transmit to other parts.

These conclusions broadly capture the current state of the global financial system. A continuation of

financialization processes, along with deepening inequality, increases the likelihood of financial crises recurring. For these trends to change in a more inclusive and sustainable direction, policy action is required on various fronts.

Some essential directions of the policies needed to effect change are sketched here, while more comprehensive policy recommendations are drawn in the last chapter of this *Report*.

- Policies need to influence primary income distribution in order to contain the rising share of profits in national income and its translation into unequal financial wealth. This can be done through proactive labour and employment policies, including the introduction of minimum wages tied to acceptable living standards, along with aggregate wage increases linked to average productivity growth.³⁵ Government action should contribute to employment, and should support social and infrastructure spending.
- Redistributive policies should include progressive taxes and transfers (Kohler, 2015). The net effect of both rising government tax revenue and social spending can have strong multiplier effects on aggregate demand, employment and technical progress.
- The economic and political power of finance needs to be contained. The financial system should be smaller and less leveraged, and it should focus more on meeting the credit needs of the real economy (Bair, 2014; Wolf, 2015). Institutions that are “too big to fail” and “too big to prosecute” pose a threat to stable and inclusive societies. Therefore policymakers need to consider breaking up the banks and imposing unlimited liability on partners in investment banks (Shirreff, 2016). More generally, smarter regulations are needed (Persaud, 2015).
- Publicly owned banks can help to subordinate profit motives to social motives and encourage credit for employment creation and investment. They can also help improve information flows that are needed to advance regulations that keep pace with innovations.
- Capital controls (*TDR 2015*; Reddy, 2013) need to be considered where required at the national level. But these should be combined with other reforms to influence the structure, size and governance of banks operating internationally. ■

Notes

- 1 See Duménil and Lévy, 2001; Crotty, 2003; Epstein, 2005; Krippner, 2005; and this *TDR*, chapter VI.
- 2 Examples of this approach include Crotty, 2003; Foster and McChesney, 2012; Lapavitsas, 2013; Patnaik, 2003; Smith, 2011.
- 3 Examples of this approach include, Galbraith, 2012 and 2014; Kindleberger, 2000; Plender, 2015; Turner, 2016a and 2016b; Smith, 2011; Stiglitz, 2012; Taylor, 2010.
- 4 Although Minsky considered regulation and institutional strength to be essential for controlling financial instability, he was a cautious observer of psychological motives and institutional constraints (see also Galbraith (Sr.), 1994; Shiller, 2005; Turner 2016a). According to Minsky (1986: 220), one of the factors for the excessively rapid pace of financial inventions is the fact that “successful innovators are rewarded by fortunes and flattered by imitators”. Investors innovate to circumvent regulations and expand their profit opportunities, assuming ever greater risks and expecting to be bailed out if they fail.
- 5 Some experts (Turner, 2016a; D’Arista, 2009) have observed that large financial profits are to a great extent the result of “alchemy” and of developments such as cross-subsidies between trading operations and retail banking, high leverage, public sector support and deposit warranties (see also Bair, 2014; Haldane, 2014; Kay, 2015; King, 2016).
- 6 Sheila Bair, Chair of the Federal Deposit Insurance Corporation of the United States from 2006 to 2011, when asked at a panel discussion on financial regulation whether banks were, in effect, driving the reform process, agreed that they indeed seemed to be doing so (Bair, 2014: 133). See also Johnson and Kwak, 2011; Plender, 2015; Shirreff, 2016; Smith, 2011; House of Commons Treasury Committee, 2010.
- 7 See UNCTAD (2012) for a succinct analysis of the global spillovers from the quantitative easing experiments undertaken by major central banks in the aftermath of the 2008–2009 crisis. These affected market conditions (correlation across asset classes) and portfolio behaviour (risk-on/risk-off, herd behaviour), and further limited the effectiveness of domestic policies.
- 8 Results for different countries are not necessarily comparable because data availability is not uniform (see, for example, IMF, 2008 and 2016).
- 9 Some authors have instead used the value added of financial enterprises, usually presented in the institutional accounts that are part of the standards of national accounting. However, those authors nevertheless note some limitations of this as a comprehensive indicator of financialization (for example, Turner, 2016b; Polanyi-Levitt, 2013). Haldane (2010) provides a comprehensive discussion about the limitations of using value added of financial corporations to measure the size of the financial sector. Others have emphasized the increasing “financialization of the non-financial corporate sector” (Milberg and Winkler, 2010), as well as the pervasive propagation of financialization to broader sectors of government, society and the environment (Brown et al., 2015).
- 10 Complementary, additional information is drawn from the locational banking statistics produced by the Bank for International Settlements.
- 11 According to Charles Goodhart (House of Commons Treasury Committee, 2010: Ev.2), what makes large financial institutions “too important to fail” is the fact that while they are “international in life they become national in death”.
- 12 Data availability for most developed countries is more complete than for developing countries, which makes comparisons difficult. For example, most developing countries do not provide all components for “other financial corporations”, and only a few of them provide all components for the “depository corporations” or report “claims on non-bank financial institutions”. On the other hand, for countries in the euro area, there are breaks in the series for “reserves in the central bank” and for “foreign assets” due to institutional changes that accompanied the creation of the euro. But none of these differences can account for the great disparity in levels between the two groups of economies.
- 13 Non-banking financial institutions and shadow banking institutions are not included in the ranking of the top five banks. However, in countries such as the United States, the largest financial institutions are not necessarily banks, as illustrated by the rise of BlackRock, a hedge fund that had \$5 trillion of total assets under management in 2017, exceeding those of the largest American banks (see, for example, Schatzker, 2017).
- 14 Most of the developing economies’ banks have had large exposure to liabilities incurred in foreign currency, at around 90 per cent of the total, on average, and this has not changed significantly in the past few years (see BIS, *Locational Banking Statistics* database).
- 15 Low figures in some developing countries, such as India, can be attributed to the continued existence of many informal financial operations (Ghosh et al., 2012).
- 16 Fair value in its basic form is defined as the amount for which an asset can be exchanged or a liability settled between knowledgeable, willing partners in an arm’s-length transaction. Fair value accounting applies to assets and liabilities other than those, such as simple debt instruments, held solely for the

- purpose of collecting contractual cash flows (which are measured at amortized cost).
- 17 See Kumhof et al. (2015) for a review of mainstream literature, and section C (introductory paragraph) and C.1 (above) for a discussion of authors who link both phenomena.
- 18 According to Laeven and Valencia (2008), “In a systemic banking crisis, a country’s corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time. As a result, non-performing loans increase sharply and most of the aggregate banking system capital is exhausted. This situation may be accompanied by depressed asset prices (such as equity and real estate prices) on the heels of run-ups before the crisis, sharp increases in real interest rates, and a slowdown or reversal in capital flows. In some cases, the crisis is triggered by depositor runs on banks, though in most cases it is a general realization that systemically important financial institutions are in distress.”
- 19 *Net (or disposable) income* is measured after direct taxes on income (from labour or capital) and direct transfers (such as social protection), which are generally intended to reduce *market (or gross) income* inequality. Policy measures, such as indirect subsidies (e.g. for green energy) or indirect taxes (e.g. regressive value-added taxes on consumption, a progressive Tobin tax on financial transactions) influence *post-fiscal income*, while in-kind transfers (e.g. public services for education or health) determine *final income* (Kohler, 2015).
- 20 Personal income inequality can be estimated using two different sources of information, though both have limitations. *Survey-based income inequality data* are available for a large number of countries, and provide estimates of net incomes (after tax and redistribution) or household consumption. They tend to underestimate inequality because top incomes are underrepresented in samples and top-coded in surveys; that is, instead of reporting the precise level of top incomes, surveys tend to assign them to a single top category of, for example, more than \$1 million (Alvaredo, 2010). Non-truncated *fiscal data* from the *World Wealth and Income Database* (<http://wid.world>) are available for a more limited number of developed and developing countries, but that database does not yet include any transition economy. It provides a more accurate picture of income distribution at the top (before tax), but has not been able to tackle the problem of underreporting of income to tax authorities and tax evasion, which has grown rapidly over the past few decades (Palan et al., 2009; Zucman, 2013; Alstadsaeter et al., 2017). Consequently, most available data tend to underestimate the real extent of income and wealth inequality.
- 21 Relative measures such as the Palma ratio or income gaps between top and bottom average incomes offer the advantage of highlighting changes among the income groups that historically fluctuate the most and exacerbate income disparities, whereas Gini indices are more synthetic and do not provide such information.
- 22 Among the 147 episodes identified by Laeven and Valencia (2012), 56 were not backed by sufficient original sources for income inequality estimates in the *GCIP* database (Lahoti et al., 2014). Despite attempts to improve the quality and comparability of income distribution data (e.g. Conceição and Galbraith, 2000; Solt, 2009; Lahoti et al., 2014), a fundamental limitation is that many developing countries started to conduct income surveys only in the 1980s, or even later. Consequently, changes in inequality cannot be investigated around all financial crises since the 1970s.
- 23 Inequality between income segments can be measured in absolute terms (income gap in monetary terms) or in relative terms (the ratios between income shares, such as the Palma ratio). The former option is used in figure 5.3. Using the latter leads to a slightly lower proportion of episodes of rising inequality in the run-up to financial crises (75 per cent instead of 85 per cent), because the income gap may increase even if the ratio of income shares decreases, depending on initial income levels. However, the share remains unchanged in the aftermath of financial crises (65 per cent).
- 24 Owing to the prevalence of singular political circumstances and unusually deep economic recession affecting all income segments in the transition economies during their transformation to market-driven models, along with data limitations (see footnote 20), financial crisis episodes in these economies are not considered in the rest of the empirical analysis.
- 25 Labelling the recent global financial crisis as a sub-prime crisis misleadingly shifts the blame for the crisis to the demands of asset-poor households in the United States for basic financial intermediation to match their expenditure patterns (such as house mortgages backed by stagnating or declining future income).
- 26 In charts produced using data from the United Nations *GPM* database, which is limited to 40 countries, the sample of crisis episodes is reduced further compared to charts based on data from Laeven and Valencia, 2012 and the *GCIP*, 2016.
- 27 Besides China, declining private debt is only observed in a few peculiar cases in the run-up to financial crises. Brazil in 1994 and Argentina in 1995 were just exiting a previous financial crisis (in 1990 and 1989, respectively), and Argentina in 1989 had just gone through several economic recessions, which explains why these countries experienced private deleveraging.

- 28 See Cornford (2016) for a critical review of approaches to assessing macroeconomic costs of financial crises, especially the most recent approaches proposed by the BIS.
- 29 In post-2001 Argentina, the Program for Unemployed Male and Female Heads of Households (Plan Jefes y Jefas de Hogar Desocupados) represents a clear example of a successful public intervention in an expansionary direction (Kostzer, 2008). By contrast, Ecuador post-1999, which is also an outlier in the north-west quadrant of figure 5.8, did not adopt a fiscally expansionary redistributive policy. There was a significant increase in public sector investment relative to the previous 10 years of financial instability and weak economic performance, but that increase was mostly driven by windfall gains in the oil-exporting sector. And while inequality measured by the Palma ratio decreased, the income gap actually increased (see figure 5.6).
- 30 Recalling footnotes 19 and 20, in the United Kingdom, the observed decline in net income inequality can be explained by a rise in the income tax threshold by 1,000 to 11,000 pounds sterling in early 2010, which reduced direct taxes on poorer households, as reflected in the measure of inequality used in figure 5.8. By contrast, austerity measures implemented subsequently, especially the reduction of in-kind transfers, are only imperfectly reflected in this measure. Importantly, wealth inequality remains above its pre-crisis level.
- 31 Greece may be considered a weak exception to this general pattern, partly because its crisis was not primarily triggered by private domestic debt, and partly because the slow pace of recovery of private sector incomes under a protracted recession has induced greater borrowing in order to maintain spending.
- 32 Argentina (2001) was an exception to this pattern, as the policies to support employment and household income helped to significantly reduce inequality without having to resort to increases in private sector debt (Galbraith, 2012). Other developing countries, such as Malaysia, the Philippines and Thailand also displayed declining inequality following the Asian financial crisis. However, this assessment is based on truncated survey data (see footnote 20) and is contradicted by whatever fiscal data are available, as in the case of Malaysia, where the top 1 per cent income share increased by about 1 percentage point after 1997.
- 33 Plender (2015) provides a detailed account of the thousands of pages of intricate regulations proposed by many of the large regulatory bodies.
- 34 See, for example, Duhon (2012), and Golin and Delhaise (2013), who describe how credit markets expand and banks' trading floors work.
- 35 As discussed in earlier *TDRs* (e.g. 2013 and 2016), the usual objection to protecting minimum wages and allowing growth of labour income at par with productivity is that profits tend to be squeezed, thus discouraging investment. However, if both social and infrastructure policies work in tandem with distribution policies, technical progress, rather than wage repression, becomes the main driver of profit gains (see also Galbraith, 2012).

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