# Inequality and financialisation:
A dangerous mix

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# Contents

# Foreword

The New Economics Foundation (NEF) report – *Inequality and financialisation: a dangerous mix* – is a timely contribution to an important economic policy issue. Britain has participated in a debt-led growth model that is reaching its limits. The origins of this growth model lie in the 1970s and the 1980s, when the financial sector was deregulated, setting in motion a self-reinforcing process of credit creation, asset price inflation, and debt-fuelled consumption. Built on rising house prices, which, as many indicators suggest, are 30–50% overvalued in the UK, this model is unsustainable.

Why should growth be based on rising debt? Households wouldn't need to take on debt if they received their fair share of rising prosperity. Wage growth has consistently lagged behind productivity growth over the last quarter century, and the share of wages in national income has fallen. British workers are driven to debt to maintain their living standards.

Financialisation and rising inequality affect each other in a number of ways. In the USA, loans to the very poor, so-called subprime mortgages, were sold as securities and bought by hedge funds – financial institutions that typically serve the super-rich. Rising shareholder value orientation forces firms to pay out higher dividends and inflate share prices through companies buying back their own shares. This is financed by reducing investment and cutting wages. Private equity investors load debt onto the balance sheets of firms, which then have little choice but to sell off assets and squeeze the wages of their workers.

These interconnected phenomena are recent and their effects are complex. It is the contribution of this NEF report to initiate a timely debate by highlighting these important developments to a broader public. That is to be congratulated. Britain will need to rethink the role of finance and wages if it wants to build a reliable and equitable growth model. And it will have to do so fast. The present mix of financialisation and rising inequality is a dangerous one.

**Professor Engelbert Stockhammer,**
**Kingston University**

# Summary

Rising economic inequality was a major cause of the financial crisis. This is the conclusion of an emerging body of research into the links between inequality and the growth in scale and influence of the financial sector. To reduce the risk of future crises, we must both roll back financialisation and implement policies to reduce inequality.

Over the past four decades, the financial sector has been extensively deregulated. It has expanded enormously as a result. Financial markets, products, and firms now play a much larger role in many areas from pensions and social insurance to homes and public infrastructure. Privatisation and the doctrine of maximising value for shareholders have increased the amount of economic activity focused on extracting the largest possible short-term profit. These trends are referred to collectively as 'financialisation'.

## A dangerous mix: financialisation and rising inequality

It is becoming clear that financialisation is linked with rising inequality, although the precise causal relationships are complex. Led by a dismantling of the controls over financial flows, the finance sector has been the main component of a decisive shift in the share of gross domestic product (GDP) towards capital and away from labour. Within the shrinking wage share, huge increases in income for top earners, particularly in the finance sector, have left even less for the other 99%. Meanwhile, barely constrained expansion of credit and the consequent relentless rise in asset prices have concentrated wealth in fewer hands. The process is self-reinforcing because increasing wealth accrues both higher income returns and greater political power.

In the UK, the share of profits absorbed by financial corporations has leapt from around 1% in the 1960s to 15% after the financial crisis. Unfortunately this does not spring from the creation of new wealth by a dynamic financial sector so much as from its ability to exploit failed markets to extract excess profits from the rest of the economy.[1,2] At the same time, after years of persistent decline, the recent small upturn in real wages masks a story of two parallel economies: real earnings for the top 10% rose 3.9% but earnings for the bottom 90% fell by 2.4%.[3]

## Inequality is an economic problem

Increasing inequality is more than a moral and political issue – it is a problem for the economy because it increases the risk of financial crises in four different ways:

1. Increasing inequality depresses demand since lower income groups have a higher propensity to consume.
2. Facing stagnating wages, people rely increasingly on debt to maintain their lifestyles and asset-price bubbles, especially in residential housing, drive up household debt.
3. Financial liberalisation allows money to flood into persistent debtor countries such as the USA and the UK, providing the funds for debt-led consumption and allowing large international imbalances to remain uncorrected.
4. Snowballing wealth at the top increases risky financial speculation.

These four drivers of financial instability have not gone away. In fact, our analysis of seven key trends suggests that the UK economy is particularly vulnerable. For example, the UK housing market bubble has not deflated compared with other economies, and households are once again piling on unsecured personal debt at a rate of £1 billion a month. Analysis of the 2014 Budget focused on the Office for Budget Responsibility's forecast of sharply rising household debt as the only source of economic recovery.[4] But a resumption of debt-led growth contains the seeds of its own demise, suggesting that rather than an economic renaissance, the UK is experiencing a relapse to its previous failed economic model.

## Where to from here?

This complex web of interlinked and structural problems has no quick and easy solution; further research is needed to unpick the causal relationships. However, the direction of travel for economic policy is very clear and has two components.

First, as unleashing the financial sector and abandoning the management of global finance has failed to deliver the promised economic rewards to all but a privileged elite, we need to roll back financialisation. We need smaller and better regulated banks and financial markets, and greatly reduced speculation and cross-border flows of footloose financial capital.

Second, far from being relaxed about widening inequality and dismissing it as a necessary part of dynamic capitalist economies, we should be concerned. The argument that increasing income and wealth inequality holds back growth and helped cause the financial crisis is compelling. We can start to rebalance the distribution of economic rewards by addressing low pay, investing in skills and targeted job creation, and making the tax system more progressive. Above all, we need political commitment to tackling the structural market distortions and imbalances of power that allow excessive inequality to arise in the first place.

# Introduction

We are living through a period of economic history defined by two powerful forces – the dominance of finance and the rise of economic inequality. This report serves as an introduction to how these forces are intertwined, the problems this has caused, and what we can do to solve them.

One of the most striking characteristics of the financial crash of 2008 and the Great Depression of 1929 is that both eras running up to the crises – the early 2000s and the 1920s – witnessed high levels of income and wealth inequality that developed as financial activities boomed.[5] A number of experts see this as no coincidence. They cite increasingly extreme economic inequality as a root cause of financial and economic meltdown.

In contrast, the mainstream story locates the seeds of the crash within the finance sector itself, from poor management, lax regulation, and perverse incentives. This version of events skates over deeper influential forces in society and the economy that have a powerful bearing on what happened. This matters, because we must get to the heart of the causes of the crisis if governments are going to take the right action for preventing another.

This report is intended to help bring public and policy attention to the connections between inequality and financial instability. Essential debates are taking place within academia and major international institutions to clarify our understanding and develop responses. This important work would benefit from a broader debate within society. Financial and economic stability matters to everyone, and at the same time 80% of people think that reducing economic inequality is a priority.[6] The inter-dependence between economic fairness and financial stability only strengthens the case for tackling inequality and holding policymakers to account for it.

This report is structured in four main parts:

1. **How did we get here?** We begin with an account of how economic inequality and the power of the finance sector evolved together in the latter half of the twentieth century. This helps to situate the events that occurred from 2007 in a clear historical context.

2. **Inequality as a cause of financial crises.** Part 2 sets out the emerging evidence for inequality as a root cause of the 2008 global financial crash. We draw on the latest work of academics and researchers.

3. **Will it happen again?** In Part 3, we look at whether and how the patterns of inequality and financial activity have changed over the past seven years to see whether we are at risk of another crisis.

4. **What can we do?** The final section, Part 4, puts forward policies that the UK and other governments should put in place to tackle the underlying drivers of instability and inequality in a mutually reinforcing way.

# Part 1: How the finance system and inequality became so connected

Forty years ago, a decisive transition occurred in the global political economy. A new era of neo-liberalism began which prescribed deregulation, free markets, privatisation, a reduced welfare state, and primacy for individual consumer choice. It resulted in two principal systemic outcomes: finance was freed to become the motor of the economy and the pursuit of greater equality was abandoned; instead the notion that the unrestrained pursuit of wealth would trickle-down from rich to poor was embraced. Financialisation and inequality became intimately connected.

After 1945, the global economy experienced a period of stability under the Bretton-Woods system of economic governance. Core concepts and policy objectives at this time included full employment, balanced trade flows, and a central role for state institutions in ensuring economic stability. The subsequent three decades have been described as a golden period for Western economies.[7] They were characterised by relatively high growth, high rates of employment, and gradually falling inequality. In the UK, inequality fell over time as low to middle income households gained slightly more from prosperity than richer households.

By the mid-1970s, this regime of economic management was starting to unravel as globalisation and oil-price shocks impacted on national economies. Neo-liberalism gathered influence as an overarching policy response, especially in the USA and the UK. A powerful alignment of corporate, financial and political interests sought to roll back the 'conscious direction' of the economy by state and economic institutions in order to enhance individual liberty and release what were believed to be more spontaneous, unconscious, and entrepreneurial market-based incentives and objectives.[8] This economic doctrine claimed that the pursuit of greater equality through state intervention was a drag on economic dynamism. It rested on the conviction that its policies would deliver rising wealth for all through higher economic growth.

At its heart, this shift involved liberalising and deregulating major aspects of the economy, notably finance and the labour market.

Financial deregulation comprised the phasing out of controls on cross-border international capital flows; deregulation of the type of activities permissible for banks; the lifting of interest rate ceilings and credit controls; and freedom to develop new types of financial institutions, such as hedge funds and equity funds – forming what has come to be known as the shadow banking sector (Box 2).[9,10]

The financial deregulation and liberalisation of the 1970s and the 1980s allowed finance to claim a dominant role. 'Financialisation' (Box 1) changed economic activity and outcomes in a number of ways. Among those most pertinent to the relationship between finance and inequality are:

- Focus on profit maximisation and priority for shareholder returns as a principle of corporate governance especially in the USA and the UK. This shifted the orientation of firms away from retaining corporate earnings and reinvesting them in the business and returns to workers, towards a model of downsizing the workforce where possible and distributing corporate earnings to shareholders.[11]

- Extraordinary rewards for financial relative to non-financial activities, as seen in the run-away pay and bonuses of City bankers.

- Systematic encouragement of individuals, households, and corporations to increase indebtedness, which returns income and profit to financiers and owners of assets.

Alongside the muscling up of finance, protections for workers were gradually being weakened (e.g. abandonment of the Fair Wage Resolution and abolition of wage councils in the UK in the 1980s and the 1990s) and trade unions and collective bargaining structures began to be seriously undermined. These changes were to have major consequences for how wages were set for ordinary workers going forward from the early 1980s.

In this section we describe the four principal routes by which financialisation and economic inequality have become mutually reinforcing:

1. Falling wages in favour of profits

2. Greater inequality in pay between top earners and the rest

3. Greatly increased concentrations of wealth

4. Wealth-generating properties of wealth itself

### How wages have given way to profits

One of the key trends associated with the processes of financialisation and increasing flexibility of labour is the declining share of wages to total income measured by GDP. This has been in favour of a growing profit share with profits received by private business owners, shareholders, and financial investors. This is a trend that has continued across Western economies since the 1970s. The UK is among those countries that has seen a marked decline in the wage share – by some 5.3% between 1970 and 2007.[12]

## Box 1. What is financialisation?

Financialisation is a term used to describe the penetration of profit-led motives into increasing areas of society, and the financial mechanisms by which this shift in power happens. The most widely accepted definition is 'the increasing role of financial motives, financial actors and financial institutions in the operation of domestic and international economies'.[13] More specifically, it can be explained via three broad shifts in the composition of economic activity that has seen power move increasingly from public to private interests.

### 1. Financialisation of households

The level of debt that people are driven to take on in order to sustain themselves has ballooned in recent decades. Structural changes have allowed for this indebtedness to soar, with households increasingly supporting themselves with interest-bearing debts to financial institutions – whether to pay for housing, education, health, risk management, or consumption more generally. The financial risk and burden of providing for old age has been shifted away from companies and the state towards the individual, leading to the growth of personal pensions. The counterpart to this knitting of finance into more and more aspects of society is the growth of lucrative industries offering financial services and products in these areas.

### 2. Financialisation of industry

This refers to the general shift away from corporate profit seeking through commercial activities, such as producing goods or providing services, towards seeking returns through financial trading.
The growing focus of publically listed companies on increasing shareholder value results in the management of corporations being shaped by financial motives and the stock market.

### 3. Finance sector growth

In recent decades, the global financial sector has ballooned in proportion to all other industries. In this context, financialisation refers to the increased scale and therefore power of the finance sector over national and international economies. The growth of this industry is characterised by the explosion in financial trading fuelled by the creation of new financial instruments available to trade, as well as increased economic transactions between countries. This increase in the scale and mobility of financial activities requires state support to cover the inflated risks posed to rest of the economy.

The precise reasons why the wage share has fallen are a matter of ongoing debate. Principal channels discussed in the literature are technological change, globalisation, declining labour market institutions such as trade unions and collective bargaining, and financialisation itself.[14,15] While all of these are likely to play some role, their relative contribution has been difficult to establish. There is increasing evidence, however, that the most popular explanation among mainstream economists – technological change combined with globalisation cannot suffice – instead there has been increasing attention more recently to the decline of labour market institutions and the role of financial activities as major drivers of changes in the wage share.

One study which looked at the distribution of the growing profit share among different parts of the economy (financial corporations including banks and investment funds, non-financial corporations, government, and finally households and non-profit organisations) revealed the financial sector as the prime beneficiary.[16] The share of profits absorbed by financial corporations, having been very low at around 1% through the 1950s and the 1960s, grew substantially from the early 1980s to the present day, reaching 15% after the financial crisis. From analysing the trends, the authors concluded that *'the whole of the upward trend in the profit share over the last 30 years is attributable to the increased profitability of the financial sector.'*[17]

## Growing inequality in the distribution of wages

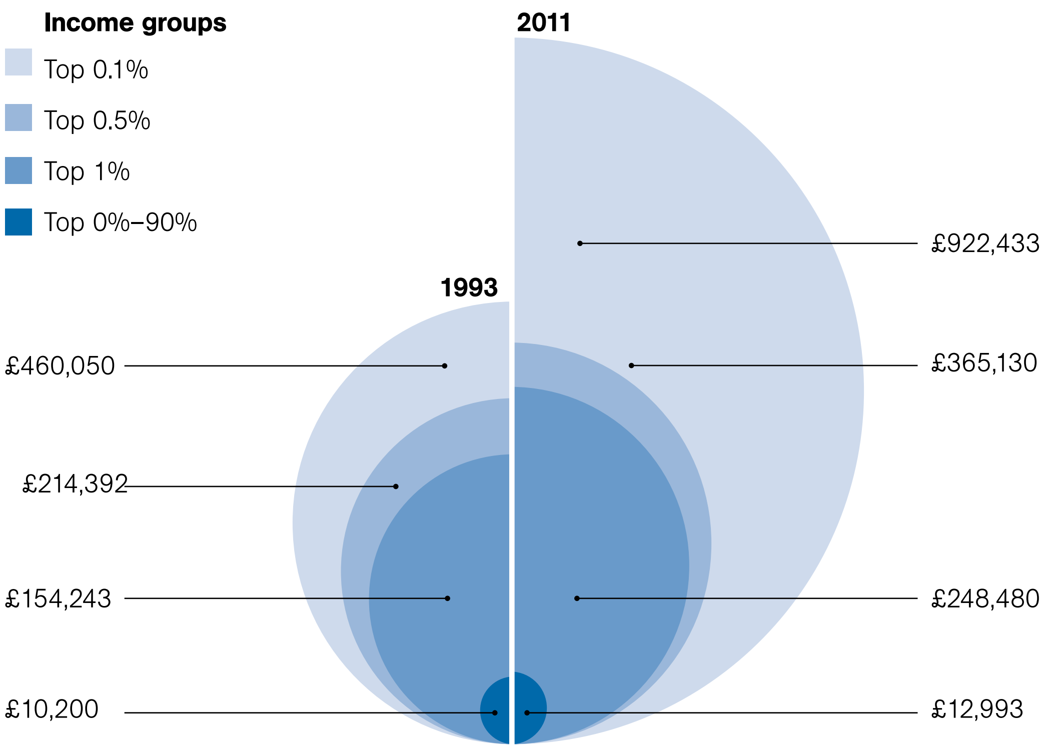
The UK has also seen a particularly sharp divide in the way the declining wage share has impacted more and less well paid workers. Most of the fall in the wage share has been borne by those earning average wages and below, while earnings for those at the very top have raced away. It has been estimated that three-quarters of the increased concentration of pay at the top is attributable to phenomenal pay for a few top bankers, financiers, and chief executives, mainly in the form of bonuses.[18] Remuneration in the financial sector has increased far faster than that of other sectors to the extent that in 2005, US executives working in finance were earning 250% more than executives elsewhere.[19] This means that ordinary workers have effectively been hit twice, having access to a shrinking slice of a progressively smaller wage pie. Previous studies have found that it is the increasing inequality in the distribution of wages – or the growing pay gap – that is the primary explanation for squeezed mid to low earnings share.[20]

The link to finance in this interpersonal distribution is not just because wages and bonuses in the financial sector itself are so extreme. The prioritisation of profit maximisation and shareholder returns in non-financial corporations has led to chief executives being rewarded in their remuneration packages for such financial activities as using profits to buy back their firm's shares. William Lazonick describes this process in the following quote. He refers to the USA, but buybacks have also occurred in the UK:

> *The most obvious manifestation of financialisation is the phenomenon of stock buyback, with which major US corporations seek to manipulate the market prices of their own shares… The prime motivation for stock buybacks is the stock-based pay of the corporate executives who make these allocation decisions.*[21]

Figure 1 shows how wages for different income groups have changed since 1990 in the UK. It demonstrates how ordinary workers making up 90% of the total have enjoyed a modest increase compared with the topmost fraction of earners who have doubled their incomes over the period, and from a much greater starting point.

Figure 1: Average incomes for selected groups in the UK




**Source:** BBC The Wealth Gap Analysis, updated for latest data from the World Top Incomes Database.

## The accumulation and concentration of wealth

The aspect of economic inequality that has gained attention recently is wealth inequality, which tends to be even more extreme than income inequality.[22] In his 2013 bestseller, *Capital in the Twenty-first Century,* French economist Thomas Piketty drew attention to how the concentration of wealth – including property, pensions, and financial assets – among the richest 1% and 10% in the UK (and elsewhere) has been rising in recent decades.

A central explanation for this concentration of wealth is the deregulation of finance, which removed the restrictions on the type, range, and scale of finance sector activities, and unleashed the global search for high

### Box 2. What is shadow banking?

Shadow banking refers to a tangle of unregulated and off-balance sheet activities undertaken by financial institutions. These activities emulate the conventional banking system, allowing (for example) loans to be made and assets to be traded, but without the usual rules and regulations that apply to banking. Shadow bank institutions are often based in tax havens.

Before the crash, the US shadow banking system grew to around 2.5 times the size of its conventional banking system. While the UK's shadow banking system is smaller than its conventional banks, it is still worth around 400% of GDP. Globally, around $70,000 billion of financial assets are tied up in shadow banks. That's equivalent to half of bank assets worldwide.[23]

Shadow banking is a problem because it is beyond public control and hugely complex. It grows as a result of financial institutions like banks and hedge funds trying to avoid regulations and generate high returns as quickly as possible. Up to the 2008 crisis, it was being used by conventional banks to help supply mortgages to customers, and then to manage those mortgages. These connections to the conventional financial system meant that during the crisis, when the shadow banking system collapsed it pulled down the rest of the financial system with it.[24]

financial returns for institutions and for those with savings (and borrowed funds) to invest. The forces at work included the contribution of privatisation to the rise of the stock market; profit-making from an explosion in now deregulated credit, especially for property and financial speculation on the one hand, and for household consumption and mortgages on the other; shadow banking activity (Box 2); and the growing hedge funds sector pursuing highly leveraged investment strategies.

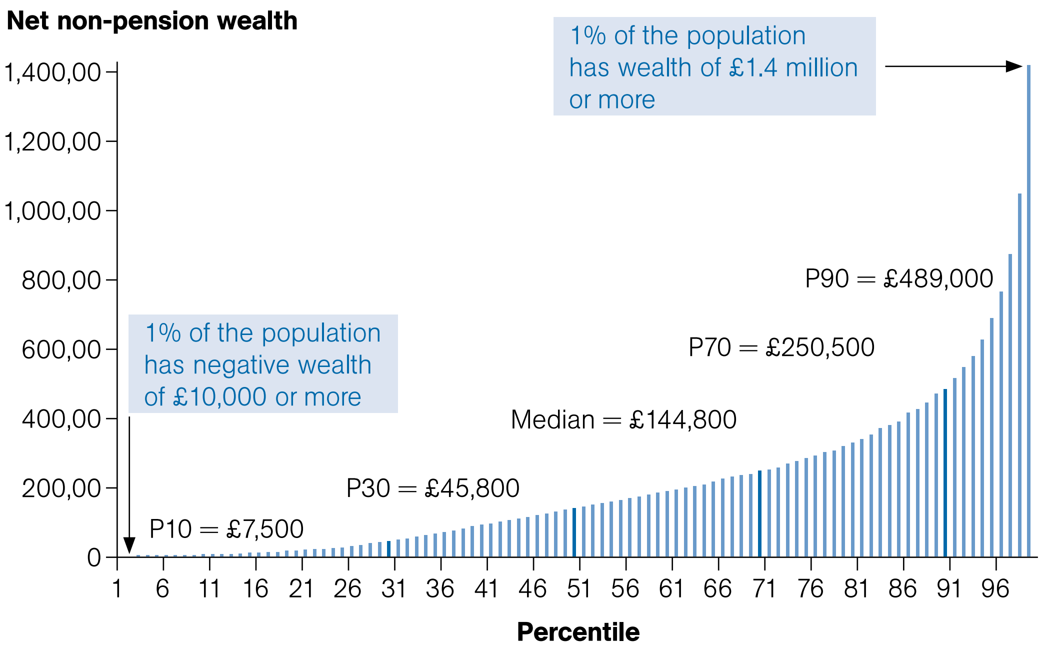
In addition to the deregulation of finance, we cannot forget that dramatic reductions in tax rates have played an important part in wealth accumulation. Top marginal tax rates in most Organisation for Economic Co-operation and Development (OECD) countries, including in Europe, have declined considerably in recent decades.[25,26] Research has found that this not only increases the post-tax shares of top incomes in many countries but that lowering top tax rates actually increases the pre-tax share of top incomes.[27] Several countries have also abolished or reduced net wealth and inheritance taxes.[28]

At the heart of the story about financialisation and wealth inequality in the UK (as well as other economies such as the USA and Australia) lies the residential property market. There is a strong association between more liberal financial flows, and especially credit creation, and asset price inflation. As Piketty has demonstrated, returns to capital exceed economic growth so it makes more sense to invest in capital accumulation through asset purchases (such as houses), than to invest in productive activity in firms which produces lower, slower returns.

In the UK, financial deregulation eased the availability of credit and coincided with a decisive political and cultural shift to home ownership. The story of the property market is discussed in more detail in Part 2 of this report. We note here, however, that the wealth winners in this story have not been new generations of homeowners, those who are generally saddled with ever larger mortgages, but rather people who own properties outright (with no mortgage), who own properties and rent them out, or who got in early and enjoyed ensuing windfall gains from the property boom.

Figure 2 illustrates how concentrated non-pension wealth (i.e., that comprised of financial, physical, and property wealth) is in Britain. The bottom half of the population have negligible property wealth, either because they are renting, or because their mortgage accounts for such a large share of the value of their property. The concentration of wealth in the top 1% of the population is stark.

Figure 2: Wealth distribution in Britain




**Source:** Hill, J. (2013) Focus: *The distribution of wealth: What we think, and how it is.* Discover Society. Data from ONS.

## Wealth begets wealth

Much as housing bubbles enter a self-reinforcing upward spiral of prices, two key forces ensure that once wealth starts to concentrate, the process does not reach a natural level but continues to drive further concentration of wealth.

First, substantial incomes are derived from the mere ownership of wealth, whether it is dividend income from shares, rental income from property, or interest income from extending credit. The concentration of the ownership of wealth therefore leads to the concept of 'money flowing uphill' from poorer to richer individuals.

To illustrate this phenomenon, an analysis of bank interest flows by income decile in the UK showed that 90% of households were net contributors to banks. Only the 10% of households with the highest incomes were net beneficiaries of interest paid by the rest.[29]

Financialisation has increased the range of financial instruments that the wealthy can use to capture higher shares of the proceeds of economic activity. From the rise of private equity, hedge funds, and tax avoidance vehicles to the explosion in financial derivatives and high-frequency trading, high net worth individuals (HNWIs) and ultra-high net worth individuals (UHNWIs) have access to a host of highly profitable financial speculation strategies that are unavailable even to the financially secure middle classes.

Second, one of the most disturbing impacts of economic inequality is its ability to affect democracy. Research has shown that high levels of economic inequality are associated with lower voter turnout among poorer individuals.[30] Conversely, there is growing evidence that the rich are able to use their wealth and income to lobby governments to fortify and extend policies that protect their privileges.[31] A recent study found that the UK was second only to Switzerland in the operation of the revolving door of personnel between government and the financial industry.[32]

The relationship to finance can be seen not only in the way that incomes and wealth have been concentrated so strongly with those in financial industries, but also through a process known as regulatory capture. This refers to the way in which regulators have come to be increasingly controlled by those they are meant to be regulating.[33] The UK is particularly vulnerable in this regard, playing host in London to one of the two main global financial centres equal with New York, but doing so within an economy a sixth of the size. Regulatory capture has been implicated in the lack of action on tax havens and ongoing financial deregulation which benefit a few but place risks on economic stability and funding for public services.[34]

### Summary

In this section we have examined the systemic interconnections between the finance system and unfolding trends in economic inequality. Led by a dismantling of the controls over financial flows, the finance sector has been the main component of a decisive shift in the share of GDP towards capital and away from labour. This process is compounded by the appropriation of huge wage increases by top earners, leaving a much reduced share of the pot for 99% of earners. The deregulation of credit and consequent relentless rise in asset prices has concentrated wealth in fewer hands, and the self-reinforcing nature of this accumulation through income returns to wealth and the political power accruing to wealth have made the process seemingly unstoppable.

But does rising inequality reach a point that imperils economic stability, and if so what would happen? We examine this question in Part 2, where we look more closely at the interconnected forces of financialisation and economic inequality as explanatory factors in the financial crisis of 2008.

# Part 2: Inequality as a cause of financial crises

Financial crises do not arise from the financial system alone. Although reforms have concentrated on fixing finance, there are fundamental economic forces that drive instability and, eventually, financial system collapse. Economic inequality is such a fundamental force. If we ignore it, financial stability will remain out of reach.

Diagnoses of the financial crisis have focused predominantly on finance itself – poor management, excessive risk-taking, and an inadequate regulatory framework. It therefore comes as little surprise that policymakers have responded with a package of structural, market, and regulatory reforms to the financial system in general, and to banks in particular. The aim has been to return to some notionally more stable version of 'business as usual' before the crash, with the Bank of England announcing in November 2014 that the investigation into the causes of the crisis is now complete and the measures needed to 'fix the fault lines' have been agreed.[35]

The mainstream explanation of the crisis fails to recognise the deeper underlying economic trends, such as the build-up of unpayable debt burdens that can impact decisively on financial stability. Recent academic research is building up an alternative set of explanations, challenging the assumption that inequality is an issue only for household finances and consumption trends. Instead, it recognises four routes by which growing inequality can drive the economic instability that led to the emergence of the crisis:

1 Income inequality and weak demand

2 Rising household debt and asset bubbles

3 Debt-led growth and international imbalances

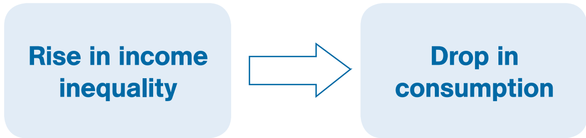
4 Wealth inequality and financial speculation

### Channel 1: Income inequality and weak demand in the economy

*Increasing inequality leads to a stagnation of demand since lower income groups have a higher propensity to consume.*

As we described in Part 1, the UK and other countries have experienced a significant fall in the share of prosperity going to wages along with a rising

Figure 3: MPC (Marginal propensity to consume) effect of rising income inequality.




share going to profits. A number of academic studies have concluded that for most OECD economies, GDP levels depend more on wages than on profits.[36] This means that as total wages are suppressed in favour of profits, the motor of the economy slows down.

This effect has been hugely compounded by the changes in the distribution of this shrinking wage pot that we analysed in Part 1. Recall that wages at the top of the earnings distribution, and especially the top 1%, have seen an explosive rise leaving mid- to low-income earners heavily squeezed. The changing distribution reduces overall demand for goods and services because those with less income have a 'higher propensity to consume'. They spend a higher proportion of their income than wealthier groups, who tend to save more. For someone on a low income, spending on basic needs like food and energy bills takes up a larger chunk of income, and total spending leaves little or none left over to save. Therefore, when inequality increases, and the poor lose out in favour of the rich, the overall consumption rate of a country decreases more than it would if everyone felt the squeeze evenly.

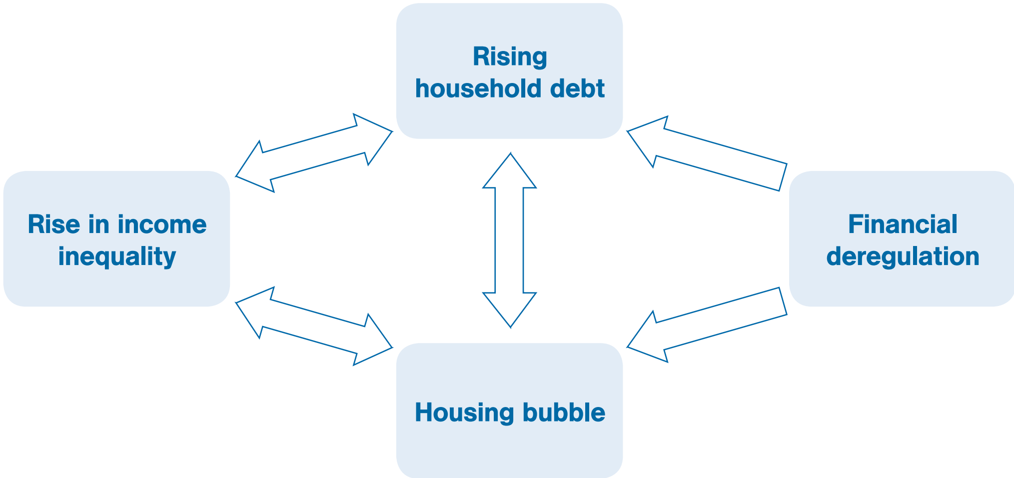
### Channel 2: Rising household debt and asset bubbles

*Rising inequality means that people rely increasingly on debt to maintain their lifestyle.*

Despite the falling overall wage share and the redistribution of incomes away from lower- to high- income households, rising household consumption was still the main source of growth in the UK, the USA, and southern European countries prior to the 2008 crash.[37] Unable to be paid for with wages, this increase in consumption was reliant on increasing levels of household debt and depletion of savings. At the individual household level, it meant large numbers of low-income households with little or no financial assets incurring unsecured personal debt, such as credit cards and store cards, often incurring high interest charges. Households with financial assets, in particular residential houses, could access lower cost secured mortgage debt. The decade before the financial crisis saw unprecedented levels of housing equity withdrawal as homeowners used rising house prices to increase their borrowing to fund consumption. In total, household debt rose in the UK between the period of 2000 and 2008 from 75% of GDP to 107%.[38]

There were two complementary drivers of rising household debt. First, growth in the demand for finance as households struggled to keep up with the combined effects of rising costs of living, house price inflation,

Figure 4: Linkages between household debt and the housing bubble.




and wage stagnation. Second, a sharp increase in cheap credit was made available through financial deregulation, fierce competition in mortgage markets, and the recycling of the additional income of high-earning households as loans.[39]

In the face of stagnating median wages, credit provided the means for ordinary people to maintain their standard of living. In addition, the cultural shift to greater consumerism encouraged spending and a huge growth in personal debt through the often aggressive marketing of consumer credit.

Since deregulation began in the 1970s, and accelerated in the 1980s and the 1990s, banks in wealthy economies such as the UK and the USA, increasingly began to create credit for non-productive activities, such as personal loans for consumption, mortgages, and speculation on financial markets. Speculative credit creation led to an asset price boom, where the cost of housing in particular was pushed to unrealistic levels. Underpinned by the new social norm and incentives to home ownership, demand for houses rose while the stock of housing was relatively static. The inevitable rise in house prices created its own demand, as investors sought property acquisition as an investment and store of wealth based on expectations that prices would continue to rise.

As larger and larger mortgages were needed to buy homes, the proportion of household income required to service mortgages rose. Banks facilitated ever increasing indebtedness by requiring lower deposits, feeding even higher loan-to-income ratios, introducing new financial products like home equity loans, and finally self-certified mortgages, which required little to no documentary evidence of the income of mortgage applicants.

These factors combined to create rapid increases in house prices in the run-up to the crash. The housing boom was welcomed by the finance industry, which stood to make large profits from mortgage lending. Further to this, the boom was encouraged by governments wedded to a privatisation agenda, the winding down of social housing, and the electoral bounce caused by the feel-good factor for homeowners of rising house prices.

**Box 3. The collapse of subprime lending.**

With more credit available to fund families wanting to get a foot on the property ladder, the average mortgage-to-income ratio rose sharply. Sub-prime lending and self-certified mortgages (where no proof of income is required) rose sharply in the UK in the lead-up to the crisis, with Northern Rock eventually offering to lend 25% more than the value of the property on which the mortgage was secured.

The most dramatic effects were seen, perhaps, in the US subprime mortgage market where people with poor credit histories were given mortgages with low initial payment terms but tied to exceptionally high interest rates. These loans were packaged and repackaged into financial securities that spread through the global financial system. At a time when many people struggled to find work that brought in a decent wage, mortgage-laden households found themselves unable to keep up when high interest payments kicked in. Between 1983 and 2007, the debt-to-income ratio of those at the bottom of the income scale in the USA more than doubled.[40] A series of mortgage defaults caused the collapse of the subprime market in the USA, rendered worthless the financial derivatives based on them, and sparked the beginning of the crisis.

## Channel 3: Debt-led growth and international imbalances

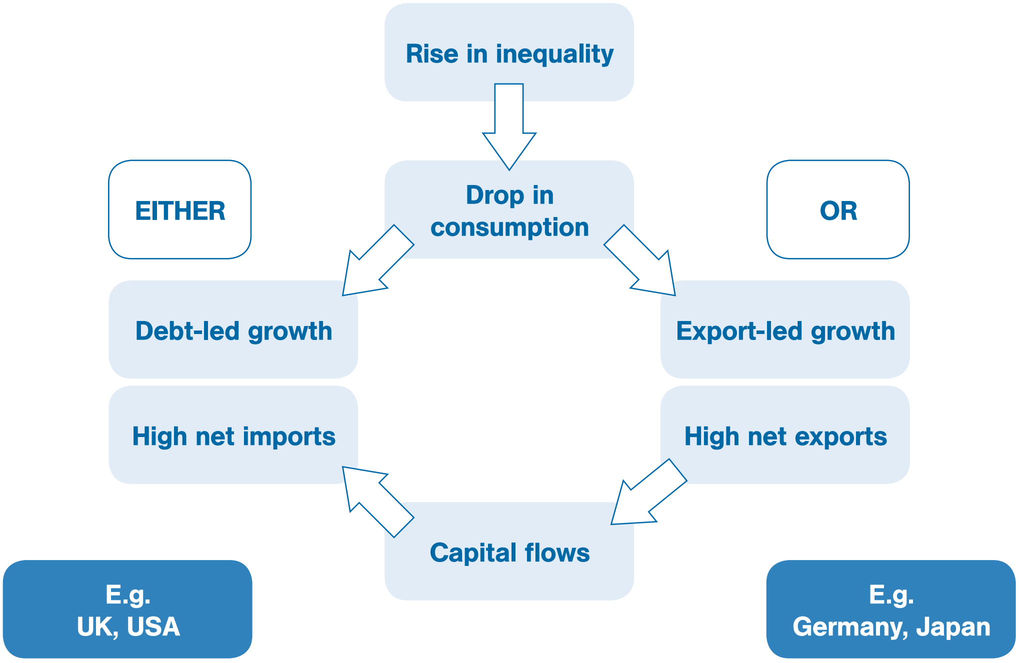
*Financial liberalisation allowed money to flood into countries like the USA and the UK, providing the funds for debt-led consumption.*

International financial deregulation in the 1980s unleashed a surge in international capital flows, as investors and investment funds sought the best global opportunities for financial profit overseas. This released countries from balance of trade constraints as imports no longer had to be paid for by exports but could be funded, seemingly indefinitely, by inflows of financial capital.

Certain countries, such as Germany, with an economy based heavily on the production and export of goods, ran a trade surplus of almost 8% of GDP before the crash, and countries such as the USA and the UK ran at a deficit of around 5%.[41,42] Large trade surpluses are balanced by those countries *lending* money to the rest of the world, while trade deficits are balanced by those countries *borrowing* from the rest of the world. Essentially countries could overcome domestic demand deficiencies (as explained in Channel 1) by following either an export-led or a debt-led growth route. Financial liberalisation allowed flows into deficit countries to continue to fuel the consumption boom with more debt (as discussed in Channel 2).

Such imbalances cannot persist forever. Funds earned from selling goods and services abroad are fundamentally different from funds borrowed from overseas or raised by selling assets to foreign owners. Production and

Figure 5: Interaction of rising inequality and international financial imbalances.




exports are flows that can be maintained year on year. Debt is a stock which demands ever higher interest payments as it rises, which then adds to the debt burden. Funding current account deficits through selling assets is also a strategy with a limited life span. The more domestic assets are held by foreign owners, the greater the payments of rent, dividends, and interest that have to be made overseas worsening the current account deficit yet further.

Such deficits can persist for relatively long periods in countries with a reserve currency that is always in demand, such as the USA, and in countries with a substantial stock of international financial assets, such as the UK. Furthermore, those countries with independent floating exchange rates have a mechanism for eventually responding to persistent deficits. However, countries without their own currency and which persistently fund current account deficits through foreign borrowing have no such mechanisms. As long as economic growth is strong, such international debts, whether public or private sector, can be serviced comfortably even as they accumulate. However, as soon as growth stalls or turns to recession, as it did as a consequence of the financial crisis, such external debts become much more difficult to repay, leading to increased risk of defaults.

This was how the secondary phase of financial instability unfolded within the Eurozone. The periphery countries, which had experienced the fastest credit booms before the crisis, were the worst hit by the banking crisis. The huge costs in terms of lost tax receipts and increased welfare costs of recession created rapidly increasing government deficits, increased risk of sovereign debt default, and also exposed banks elsewhere to much greater losses on private sector loans to the periphery countries. The substantial inter-country debt that builds up from chronic international imbalances provides a contagion route for financial instability.

### Channel 4: Wealth inequality and speculative financial activity

*Snowballing wealth at the top end increased the risky financial activities and entrenched economic inequality.*

With epicentres in Wall Street and the City of London, the explosion in financial market trading, particularly involving shadow banking instruments like derivatives, happened simultaneously with the rise of the super-rich and declining real wages. Recent academic work has begun to shed light on the mechanisms by which wealth inequality drives financial speculation, and what this means for financial stability. One explanation for this interrelation is that increasing wealth concentration at the top leads to an increased propensity to speculate. Just as rising inequality decreases consumption (by disproportionately affecting low-income families), it increases speculation, as those at the top end of the income distribution scale tend to hold riskier financial assets than other groups.[43] In short, if the rich get richer, there is an increased volume of wealth engaging in risky investment because the super-rich can afford to take more risks with their money.

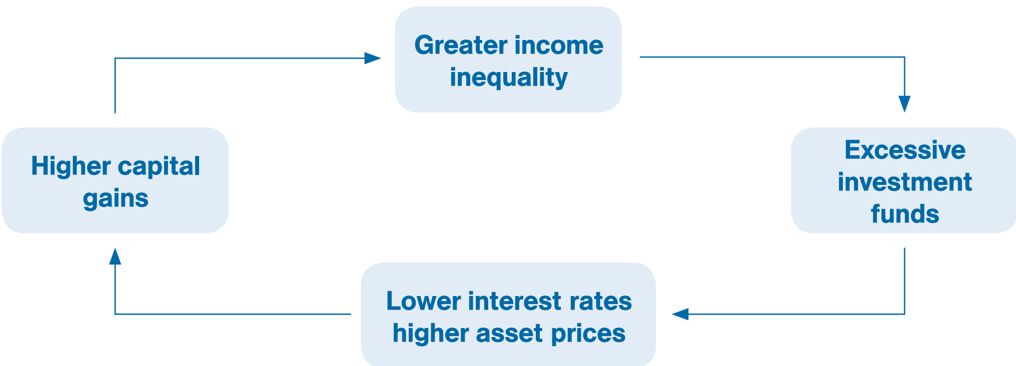
In the USA, the accumulation of wealth in the hands of a very small group of people doubled in the ten years preceding the crash from $19 trillion to $41 trillion.[44] This excess of wealth was a driving force behind the creation and build-up of risky products. At that point in time HNWIs owned more than half of the risky investment assets on the market – products such as collatorised debt obligations (CDOs) and derivatives whose value depend on future, and therefore unknown, fluctuations in assets prices.[45,46] The increase in the demand coming from these wealthy individuals stimulated a 'search for yield' – in other words, it created a push for higher returns on investments, relative to the growing volume of wealth. New speculative financial products, with high minimum investment requirements, were supplied to meet this growing demand of the super-rich.[47]

As the International Monetary Fund (IMF) recently outlined, when government bond yields are low and investors are looking for higher-yields on their investments, it is the shadow banking system that steps in to supply assets.[48] For example the upsurge in wealth before the crisis led to assets being increasingly placed under the management of hedge funds working outside of the mainstream banking system, which formed a crucial link in the subprime mortgage market. They were the major buyers of toxic CDOs that bundled together subprime mortgages. The US market for CDOs remained fairly small until around 2002, but grew 12-fold in size over the subsequent 5 years.[49] The market's now notorious collapse in 2007 is recognised as the trigger for the global financial system crash.

The argument that these toxic assets were created in response to external pressures coming from those at the top end of the wealth spectrum places inequality once more at the centre of the factors that contributed to the crash. Stagnant incomes stimulated the supply of risky loans, packaged into high-yielding financial instruments. It was the concentration of wealth that created the demand for them.

As well as being a consequence of increasing inequality, financial speculation helps to further entrench economic polarisation. Despite the flood of risky financial products on the market in the mid-2000s, this increased supply did not directly drive their price down. The assets on the market had a peculiar ability to create their own demand: as finance became more popular, asset prices and aggregate demand rose.[50,51] With high yields and rising financial asset prices on offer, investors and companies faced powerful financial incentives to shun more long-term investments in productive areas of the economy, such as manufacturing. As Minsky observed, investors' confidence is self-reinforcing until eventually we reach the 'Ponzi' stage of financial markets, with speculators betting solely on continuous rises in asset prices.[52] However, the bubble will eventually burst when the 'Minsky moment' is reached and the realisation dawns that financial assets are wildly overvalued.

Figure 6: Cycle of increased financial speculation and increased wealth inequality.




**Source:** Credit Suisse *Global Wealth Report*.

This boom and bust cycle reinforces economic polarisation because the gains from asset price booms go to the owners of those assets, who tend to be the already wealthy. When the bubble bursts, the wealthy take a hit on the paper value of their net worth but are also able buy distressed assets at steep discounts.

## Summary

Financialisation has transformed the global economy against a backdrop of increasing inequality. The analysis presented in Parts 1 and 2 of this report demonstrates how these two phenomena are instrumental – as both cause and effect – for financial instability. In Part 3 we look at what a failure in understanding and acting on this evidence means for our future risks.

# Part 3: Will it happen again?

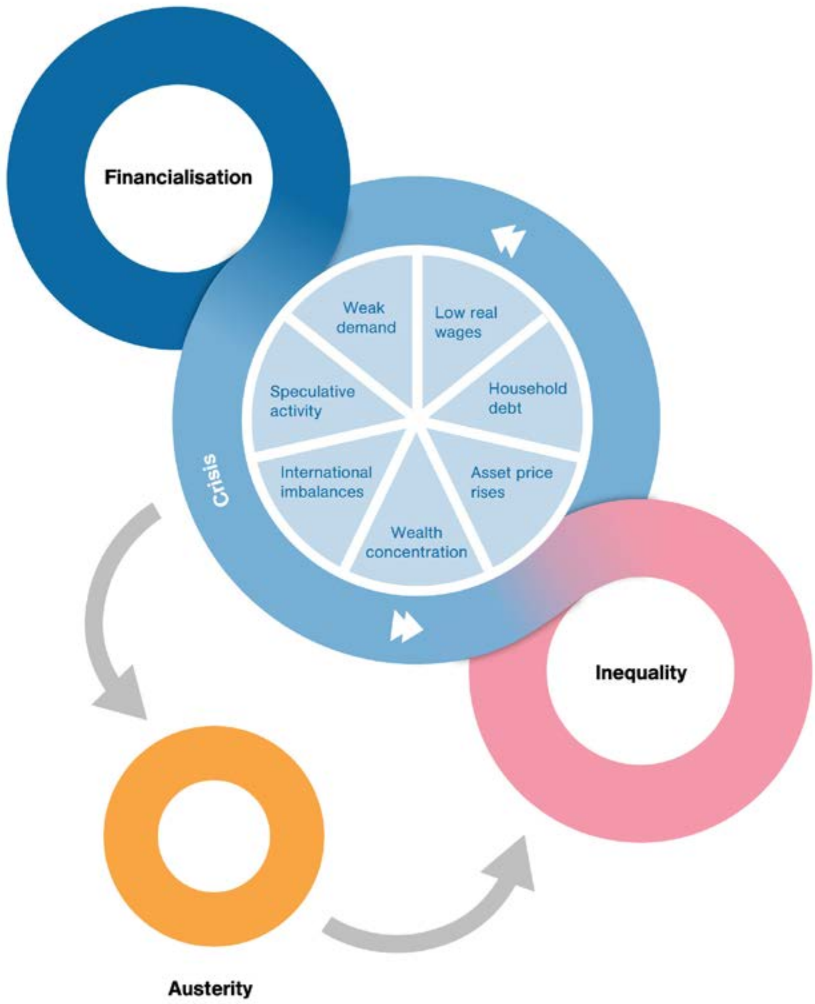
We are still in the grip of the 2008 financial crisis. Banking failures have transformed into soaring public debt, the Eurozone sovereign debt crisis, austerity, and permanently lost economic output. In this context, another banking crash could be even more harmful and much harder to escape from. We examine global and UK developments and find reasons for concern.

The last financial crisis was followed by severe austerity policies that have depressed demand and further entrenched the widening inequality gap. Immediately after the crash, a period of 'balance sheet recession' ensued, with indebted households focused on paying off their debts instead of spending. The Eurozone has, on the whole, become low-interest rate, slow-growth economies with high unemployment and stagnant median wages. Even in the UK and the USA, where unemployment has been lower and growth has been stronger, real wages have undergone a severe fall and growth has depended on the resumption of borrowing to fund consumption. There is no expectation that the output lost during the Great Recession will be regained.

In Part 2 we described four channels by which inequality and financialisation drive unstable economies. These channels can be broken down into seven interconnected indictors of economic instability, as shown in Figure 7. These are:

1. Weak demand,
2. International imbalances,
3. Low real wages,
4. Wealth concentration,
5. Speculative activity,
6. Household debt,
7. Asset price rises.

Figure 7: Interconnections between inequality and financialisation using seven key indicators of economic instability.




To gain some insight into the risk of future financial and economic crises, we first consider global developments in weak demand, stagnating wages, increasing wealth concentration, and speculative financial activities, as well as the evolving arrangement of international imbalances. We then shine a spotlight on the UK, where rising debt and a housing price bubble are an increasing cause for concern.

## Global developments

### 1 Weak demand: a continued slump in spending

> *Secular stagnation in advanced economies remains a concern. Robust demand momentum has not yet emerged despite continued low interest rates and easing of brakes to the recovery.*[53]
>
> **(IMF, 2014)**

The IMF's latest *World Economic Outlook* reveals a slowing of growth across the world's wealthiest economies, with none returning to the growth trends experienced before the crisis.[54] Many in the mainstream have begun to speculate that this stagnation could, in fact, be a permanent development, meaning that wealthy economies are fundamentally unable to create enough demand to sustain an upward growth trend. This was the warning of US Treasury Secretary Larry Summers who, in his speech for the IMF last year, claimed that 'secular stagnation' (a normality of negligible growth) could be here to stay.

In many wealthy countries, subdued consumption and low output growth continue despite the exceptionally low interest rates that are becoming commonplace. The IMF views the economic stagnation of the Eurozone as one of the biggest risks to the global economy, but has also flagged a slowdown of growth in major less developed countries such as Brazil and Russia.[55] In the UK, the Bank of England has held rates at 0.5% since 2009 in an unsuccessful bid to stimulate a recovery. Despite the UK economy's return to growth in 2012, wage growth has been negligible and interest rates have remained at a record low.

There has been speculation that if this deficiency in demand tells us anything, it's that economies seem to need credit growth faster than GDP growth to achieve a growing economy. Pre-crisis demand was unsustainable because of its reliance on huge accumulations of private debt based on asset bubbles. Without the same happening again, debt-led economies are unable to generate adequate levels of demand.[56] The OECD recently released evidence to show that economic inequality slows growth – but as was discussed in Parts 1 and 2, debt-led growth as an attempt to reverse this trend of low consumption, serves to further entrench inequality and the downward spiral continues.[57]

## 2 International imbalances: debt-led growth

> *Contrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing, breaking new highs.*[58]
>
> **(Geneva Report on the World Economy, 2014)**

Since 2008, the ratio of global debt to GDP has risen by 38% to 212%.[59] Although debt accumulation has slowed, debt levels in high-income countries remain persistently high, particularly in Japan and the UK. Meanwhile, total debt is racing ahead in the lower- and middle-income world, to a large extent led by China. With China's external debt (that which is owed to creditors elsewhere in the world) having risen 50% in the last year, some have suggested that the activities of emerging economies today are echoing the behaviour of higher-income countries in the 2000s.[60,61] In terms of international imbalances on trade accounts, there is little sign of any rebalancing of exports and imports. According to the Office for National Statistics (ONS), the UK current account deficit was at a near record high at the end of 2013, reflecting both a substantial trade deficit and a sharp decline in the value of UK income earned on overseas investments.[62]

With debt burdens now rising across a broad range of countries, it is reasonable to ask to whom this debt is owed. One possible explanation is that we are moving from a situation of creditor and debtor nations to one where household, government, financial, and corporate sector debt is increasingly concentrated in the hands of a global super-rich and mobile elite.

### 3 Low real wages

*Income inequality increased by more in the first three years of the crisis to the end of 2010 than it had in the previous twelve years, before factoring in the effect of taxes and transfers on income, according to new OECD report and data.*[63]

**(OECD, 2013)**

For many countries, real wages and incomes are lower today than they were before the crash. The slowdown in real wages may have been especially marked in the Eurozone but has been a feature in the USA, the UK, and Japan, too.[64] Overall, the OECD highlights that in 2010, across a range of countries, half of all workers saw their real wages fall, mainly as a result of pay falling rather than prices rising.[65]

In the seven years after the crash, the UK suffered the most sustained decline in real wages since records began. Real wages only started to rise again this year, and only by a mere 0.1%[66] This gloomy picture masks an even more disturbing return to rising inequality. Latest annual data, up to the end of 2013, shows that real earnings for the top 10% of earners increased by 3.9%, while earnings for the bottom 90% fell by 2.4%.[67] Falls in real wages are even more dramatic for the poorest households, who face much higher effective price inflation.[68]

As it is the income reductions of those at the poorest end of the scale that have the most negative impact on consumption and spending at an aggregate level, this widening inequality is not good news for economic growth.

In the USA, income inequality has seen an especially sharp return. Despite economic recovery in 2009, the distribution of the benefits has been extraordinarily uneven. It is estimated that 95% of the economic gains since the crash have accrued to 1% of top earners. Worse than this, fully 60% of the benefits have been reaped by the top 0.1%, the richest of the rich, who have made up all the losses they experienced following the 2008 crash, and more.[69]

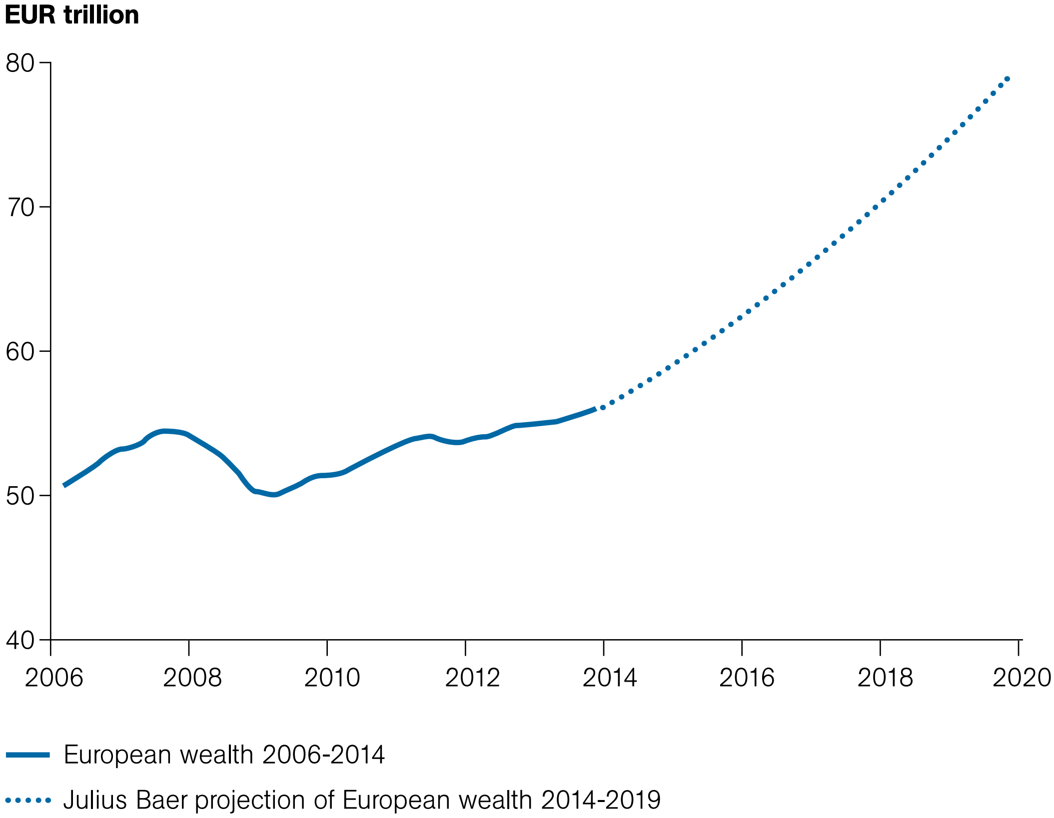
### 4 Wealth concentration: the rise of the super-rich

*In 2013, European wealth exceeded its pre-crisis peak to reach a record of €56tn.*[70]

**(Wealth Report Europe, 2014)**

During what has been an economically precarious time for the majority of people living in countries affected by the crash, the personal wealth of a

Figure 8: Private wealth in Europe.

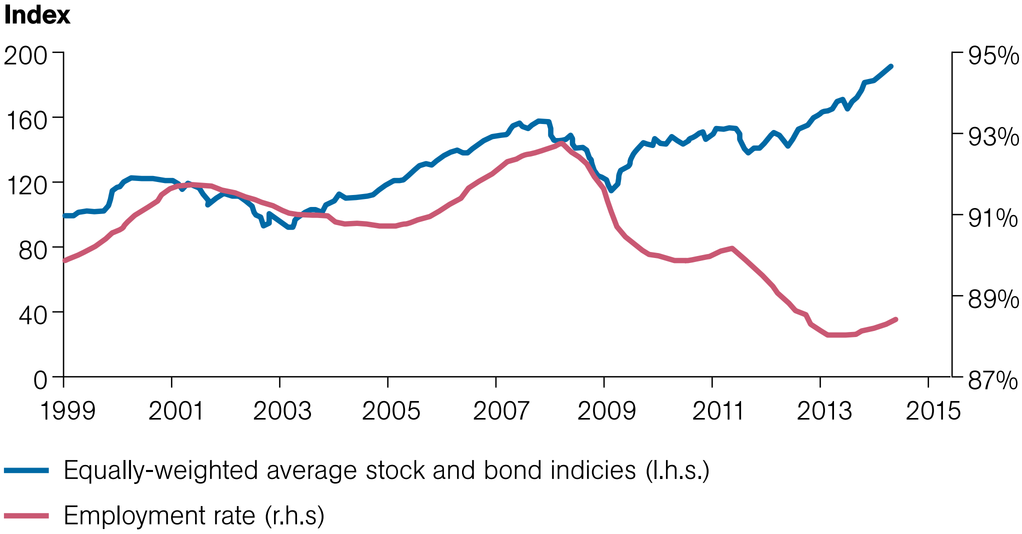



**Source:** Source: Julius Baer (2014), *Wealth Report Europe.* Data from Eurostat, ECB, IMF, national statistical agencies, OECD and Julius Baer.

small group at the top has surged ahead. Driven in large part by booming housing markets in pockets of the world, total global wealth grew by 8.3% last year to reach $263 trillion.[71] What may come as a surprise to those who have faced a sustained decline in living standards since 2008 is that the growth of global wealth since then has occurred at a record pace, with Europe maintaining its position as one of the wealthiest regions in the world.[72] Furthermore it shows no signs of slowing; Figure 8 shows a predicted 40% rise in private European wealth over the next five years.

As was outlined in Part 1 of this report, an overall increase in wealth does not mean that everyone becomevs wealthier. In fact, since the 2008 financial crash the contrary is true. Recent analysis suggests a structural break in inequality trends occurred around the time of the financial crisis, since which wealth inequality has noticeably increased in most countries.[73] It is the UK that is leading the inequality race amongst its economic peers, as the only G7 country in which wealth inequality has increased steadily since 2000 – seemingly unaffected by the financial crisis or subsequent recession.[74]

**Figure 9: Financial asset prices rise in Europe as employment falls.**




**Source:** Julius Baer (2014), *Wealth Report Europe.* Data from Bloomberg Finance L.P. and Julius Baer.

Due to the fact that since the crisis, values of financial assets in many emerging and already wealthy economies have soared whilst wages have either stagnated or declined, the gap between the wealthiest and everyone else has significantly increased. Figure 9 shows how, in Europe, owners of financial capital have seen a steady increase in the value of their assets since the crash, despite the vast increase in unemployment.[75]

A new economic categorisation of the super-rich has been created to account for this soaring wealth concentration at the top. UHNWIs are people worth the equivalent of $30 million or more. Despite its relative small population, the UK is ranked fourth in world for the total number of UHNWIs living on its shores, with the second largest growth worldwide in million-dollar-wealth households between 2013 and 2014.[76] As was discussed in Part 2, the continued search for high returns on investments by this increasingly wealthy group grows the market for risky financial activities.

## 5 Speculative activity: growth of shadow banking

> *In advanced economies, shadow banking seems to be shifting to less-well-monitored activities.*[77]
>
> **(IMF, 2014)**

The Governor of the Bank of England, Mark Carney, announced earlier in 2014 that to make the system more resilient, 'formerly risky areas of shadow banking, such as securitisation, are being transformed into sustainable market-based sources of finance.'[78] According to this account, it would seem that speculative financial activities have been reduced in the UK since the crisis.

This is not the full story. While certain speculative activities might be in decline, others are stepping in to fill the void. The IMF reported in October

2014 that shadow banking has in fact seen 'a recent pick up' in the UK, wider Europe, and in the USA, due to a shift to new, less-well-monitored or understood activities.[79]

Alongside this recent upsurge in shadow banking activity in wealthy economies, the story in emerging economies, such as China, Brazil, South Africa, Mexico, and Turkey is evocative of the 2000s in the UK and the USA.[80] The IMF estimated that across these emerging economies, shadow banking assets as a proportion of GDP expanded from 6% to 35% between 2002 and 2012 and banking sector assets more than doubled over the same period.[81]

The prime reasons provided for this recent growth are now familiar:

1 The overall growth of financial sectors in emerging markets stimulates the demand for shadow banking activities.

2 A renewed search for yield has occurred as international investors seek the highest possible returns on their investments.[82]

As was discussed in Part 2, speculative activity is both fuelled by wealth concentration at the top, and plays a part in further entrenching economic inequality. With an increasingly diverse range of risky activities taking place in a growing number of countries, the threats to economic stability posed by these largely unregulated industries are as present today as they were before the 2008 crash.

## A spotlight on the UK

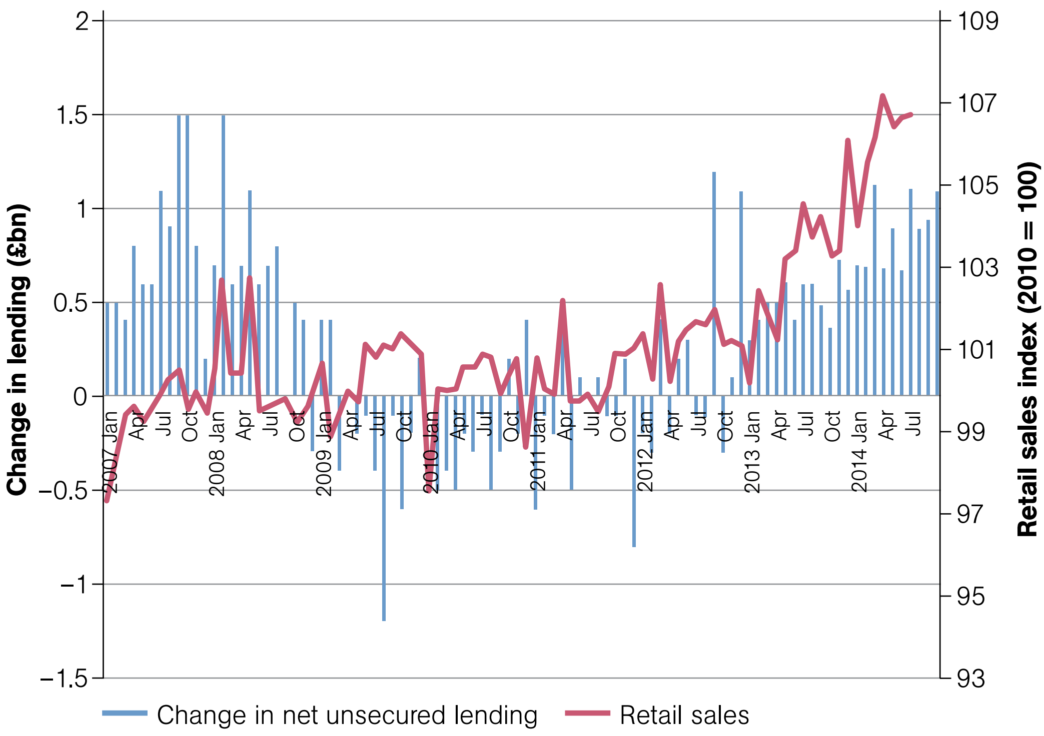
On top of the global indicators outlined, there are two trends posing a particular danger to the UK economy.

### 6 Household debt

> *UK households start from a vulnerable position, with debt at 140% of disposable income and the share of riskier mortgage lending rising markedly over the past year. Housing debt can represent a major risk because mortgages are both the largest asset of UK banks and the largest liability of UK households.*[83]
>
> **(Bank of England, 2014.)**

After a period of retrenchment, UK household debt levels are once more on the rise. As debtors attempt to reduce their liabilities, recessions that follow periods of rapid credit growth tend to be deeper and longer lasting.[84] The resulting drop in spending by UK households after the crash led the whole economy to decelerate. With the return to growth in 2013, this pattern has started to reverse. Households have begun borrowing again and unsecured lending is now increasing at a rate of close to £1 billion a month (Figure 10).[85] This is because with real incomes falling for most, it is debt that is helping sustain the UK's economic recovery.

Figure 10: Unsecured lending and retail sales 2007–2014.



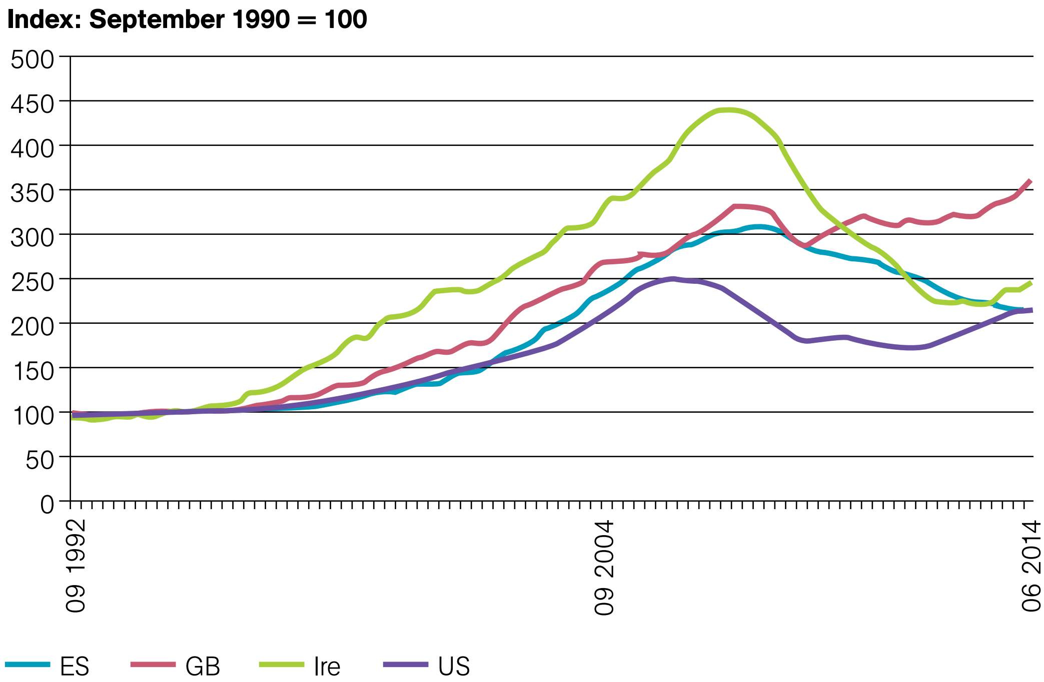

**Source:** NEF. Data from ONS (2014) *Trends in Lending*

On top of the recent sharp increase in unsecured lending (credit cards, payday loans), as Figure 10 indicates, secured lending is also on the rise. Although the record levels of mortgage equity withdrawal leading up to the financial crash have not returned, specific interventions to subsidise new entrants to the housing markets (such as the Coalition government's Funding for Lending and Help to Buy schemes) drive housing-related consumption while failing to address loan-to-income ratios. Most recently, the Chancellor of the Exchequer altered the Stamp Duty regime, which is widely expected to translate into house price inflation.[86]

This summer, both the Bank of England and the IMF warned that inflated property prices and related household indebtedness in the UK pose a real threat to financial stability.[87,88] A steady increase in the size of new mortgages compared with borrower incomes suggests that households are gradually becoming more vulnerable to income and interest rate shocks. As more and more people are driven onto the property ladder despite stagnating wages, an unsustainable mix of increasing interest payments and lower incomes throws the stability of the market into question.

While rising private debt has so far had only superficial impact on economic growth in the UK, its effects in compounding inequality are real. The financialisation of households through debt – as a compensation for wage stagnation – further burdens those at the poorest end of the income scale, while profits flow up to wealth owners.

Figure 11: Residential property prices in selected countries (Spain, Britain, Ireland, the USA) 1992–2014.




**Source:** NEF. Data from Bank for International Settlements (BIS), long series on nominal residential property prices.

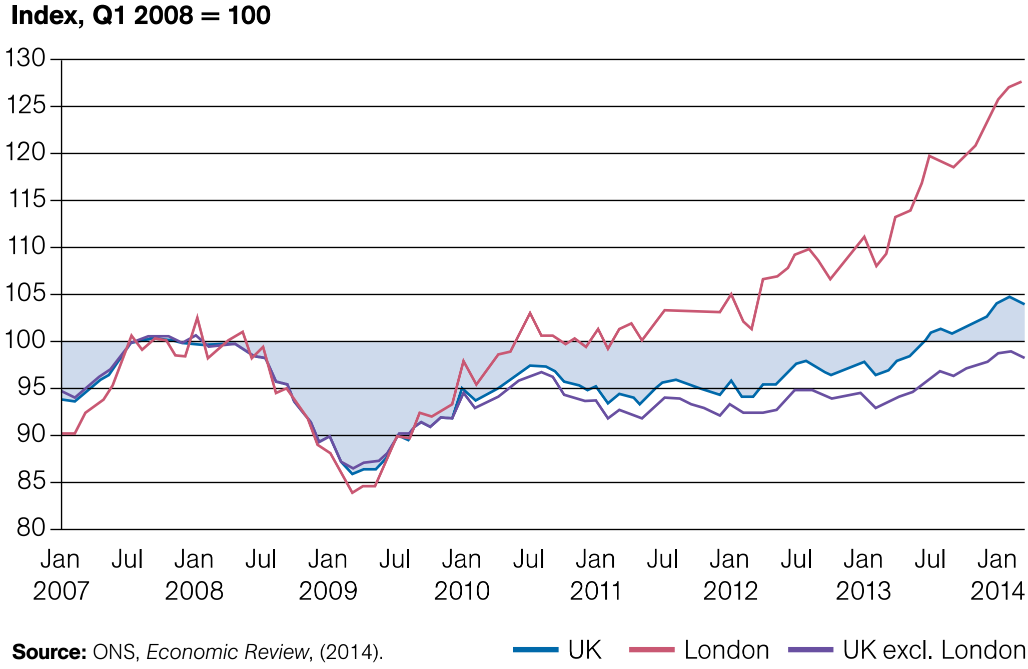
## 7 Asset price rises

> *The UK stands out as having the largest fluctuations in real house prices among G7 economies.*[89]
>
> **(IMF, 2014)**

While wage growth and consumer price inflation have both been relatively restrained in recent periods, the rate of house price inflation has received considerable attention. Because the value of property has a strong effect on consumption through the wealth effect and rising consumer confidence, and is also popular among key electoral constituents, much government activity since the crash has been focused on reflating property prices. The government's Help to Buy scheme is playing a role in driving people onto the housing ladder, despite the UK having the one of the lowest rates of investment in new housing stock as a share of GDP across the OECD economies.[90] This general lack of housing supply, combined with subsidised mortgage credit, results in fast rising prices.

While the financial crash caused an immediate decline in property prices, the bubble did not fully burst. House prices quickly resumed a rapid upward trajectory, with two major mortgage lenders recently calculating that prices were this year rising at the fastest rate since the crisis.[91] Figure 11 compares the trajectory of house prices in Britain compared with those in Spain, Ireland, and the USA. In all these countries, prices rose rapidly from 1996 to the mid-2000s. It is noticeable that in Spain, Ireland, and the USA, they deflated markedly after the crisis but in Britain after only a relatively small decline they resumed their upward trend.

Figure 12: House prices for the UK, including and excluding London.




**Source:** ONS, *Economic Review*, (2014).

In the UK, the shape of the housing market since the crisis has seen London and the South East soar ahead of other regions. So much so that the total value of housing stock in London and southern regions has risen by £435 billion over the past five years, with a net loss of £206 billion across everywhere else.[92]

Even in areas where property prices are rising, it is not the mortgage-laden households that are the prime beneficiaries. Unaffordable housing has led to the rise of 'generation rent', and sharpened the appetite of institutional investors for the lucrative private rented sector. Analysts are forecasting that private renting is on its way to becoming a new major asset class in the UK with private landlords, including increasing numbers of institutional investors, now owning 19% of all residential property – up from 12% ten years ago.[93]

## Summary

Signs of growth in some economies such as the UK and the USA, despite continued stagnation in the Eurozone, together with the apparent strengthening of bank balance sheets might be taken as evidence of a return to normal after the financial crisis. However, if 'normal' means an inherently unstable economic system that depends on accumulating debt and widening inequality, a return to normal is precisely what we need to avoid.

The recent trends examined here suggest that attempts to return to growth without addressing either financialisation or economic inequality might simply be sowing the seeds of the next global crisis. But if we must not return to pre-crash economic structures, what does a new 'normal' need to look like? We discuss this in Part 4.

# Part 4: What can we do?

As we have seen, analysis of the 2008 crisis has focused on the proximate causes – poor regulation and management of finance, perverse incentives, and lax monetary policy. As a result, reforms to financial system regulation and structure and changes to banking culture have inevitably dominated debates among policymakers.

> *"The crisis left a grim legacy and the answers are likely to be unorthodox"* [94]
>
> **Martin Wolf, *Financial Times*, 2014**

Evidence is building that inequality, together with financialisation, plays a vital role in creating the conditions for both chronic and acute financial and economic instability. This evidence suggests that policymakers must take much bolder action to tackle systemic factors. Our analysis in Part 3 of the risks of another crisis suggests they need to do this with urgency.

It is not difficult to see why there is resistance to taking more systemic action. The political establishment is still driven by a mainstream economics agenda based on the efficiency of markets, cost-cutting competitiveness, and a narrow view of value creation. This fails, for example, to see the fundamental role of decent wages and work to healthy economies.[95] As described in Part 1, economic inequality has a dangerous feedback loop back into policy-making (and a revolving door of personnel between finance and government) which undermines democracy and helps fortify policies that protect privilege.

An alternative agenda is possible. This agenda places finance in a service role in the economy and tackles economic inequality at its root. It is one that would better guard against another crisis and ensure better outcomes for people now and over time, recognising the limits of planetary resources. The policy platform we propose coalesces around three core themes:

1. Return to a managed international financial system, and socially useful banking.

2. Good jobs for all.
3. Fair and progressive taxation.

The three are closely connected and strongly reinforcing. Important feedback links across so that for example, achieving good jobs draws on the means for investment made possible by a more diverse and democratic banking system. Equally, good jobs with decent wages provide a broad and stable tax base.

In this section, we put some more flesh on the bones of these ideas with a focus particularly on UK policymakers. However, the agenda we propose is relevant across nations. In an interconnected world, we need joined-up action to tackle inequality and financial dominance for global economic health. In this respect, our three themes remain relevant even if the exact policy prescriptions under each would have to be adapted for different country contexts.

As we have seen in Part 3, global developments point to fundamental imbalances persisting or even strengthening since the crisis. But the UK poses particular risks. Rebalancing of the UK economy has not taken place and the only things that are growing are consumption, household debt, and property prices (but not investment, government expenditure, or net exports). As noted previously, both the Bank of England and the IMF are warning that inflated property prices and related household indebtedness in the UK pose a real threat to financial stability.[96,97] This means that the UK should be leading the way to address systemic drivers of instability.

## Key reforms to manage finance in the public interest

More radical reforms to the finance sector are required on three broad fronts: international and domestic regulation, restructuring of banking institutions, and monetary policy.

### *Regulation*

This has been the main focus of reforms since the crisis, with some curbing of financial speculation and attempts to improve financial stability. We need to go much further, however, and implement the Financial Transactions Tax in full to discourage short-term speculative trading; capital controls to prevent destabilising financial flows across borders and the hiding of wealth in tax havens; credit guidance to favour lending to real economy investment rather than to asset bubbles and speculation; and social obligations on banks to recognise that basic payment services and credit services are utility functions to which all citizens deserve access.

In particular, it is time to challenge the principle of the free movement of capital. This has achieved the status of credo – a doctrine that cannot be questioned among members of the international ruling elite. Yet not all capital flows are equal. Foreign direct investment in the formation of new fixed capital (whether tangible or intangible assets, in the case of new digital industries) has clear economic rationale. In contrast, the free flow of hot money across borders and currency zones fuels speculative financial markets and is a great source of profits for the financial sector. Its true contribution to wealth creation is greatly exaggerated and the analysis of this report suggests it is instead an accomplice in the causal factors of financial crises.

*Banking institutions*

We need greater diversity in ownership, mission, services, and geographical location of banks in the UK. We currently have one of the least diverse banking industries, and a striking lack of a significant stakeholder banking sector.[98] There are a number of ways to change this: transform the Royal Bank of Scotland (RBS) into a network of local stakeholder banks based on the successful German savings banks; provide active assistance, including patient capital, for the creation of new co-operative and social banks, to support Community Development Finance Institutions (CDFIs) and to scale up credit unions into a commercially viable sector able to compete with banks. We also need to extend the scope and scale of public banks – for example, the Green Investment Bank should provide cheaper finance for retrofitting houses to tackle fuel poverty.

*Monetary reform*

The area of fastest growing interest is unconventional monetary policy and reform to the money system, for which there is a wealth of theory, evidence, and practice to draw on. In highly financialised economies, the bulk of the money supply is created by the private banking system.[99] This has proved to be an unstable system, because in practice devolving money creation to individual banks does not lead to a socially useful overall quantity and allocation of credit overall. Some degree of central co-ordination is required.

Furthermore, where the money supply is almost entirely supplied as bank credit, it is impossible to expand the money supply without increasing debt. With interest rates unable to fall any lower, and Quantitative Easing programmes proving ineffective at stimulating real economy investment or demand,[100] an increasing number of commentators are advocating the creation of interest-free money as a necessary tool to combat deflationary pressures.[101] Sometimes referred to as ‘sovereign money’ because it is issued by the state rather than private banks, this can play a part in reducing aggregate debt levels in the economy. IMF research into one particular variation of this monetary reform concluded that it would completely eradicate the US national debt.[102]

Other forms of interest-free media of exchange, such as mutual credit currencies, can free businesses from reliance on expensive working capital bank credit. Such schemes already operate all over the world, with a thriving US industry and a Swiss system, known as the WIR, with 60,000 business members which has been operating since 1934.

## Achieving good jobs for all

NEF and Friedrich Ebert Stiftung (FES) have worked with experts from across Europe to devise a coherent platform for tackling economic inequality at root. Key to this platform are measures to tackle the labour market drivers of inequality which are so powerful.

### *Investment for good job creation*

A full employment agenda was at the heart of the post-war economic governance structure which brought stability and much improved economic democracy. We need to return to the ambition of a full emplyment guarantee to ensure enough good work for all. This would be facilitated by a state-owned investment bank with regional distribution structures and a mandate for supporting good jobs. Investment could support businesses either to create entirely new jobs, or to redesign existing jobs into good ones. We can look to examples overseas for how jobs that are low-paid and low-status in a UK context are respected and valued in other countries. This includes cleaning in Norway, retail in Germany, and food processing in Denmark.[103]

A job guarantee is helpful because it separates the question about whether there is enough work in the economy from the issue of whether there is work that would be valuable even if there are not current paid jobs to produce it. We can refer back to the strong history of thought around public provision of work opportunities. Keynes proposed 'on-the-spot' employment, while Hyman Minsky proposed a concept of 'employer of last resort'.[104] President Roosevelt's New Deal jobs programmes are good examples of targeted job creation approaches, which were socially productive. This is, of course, not to underestimate the need to design opportunities carefully so that there is a sustainable offer to those who take them and an efficient means of integration with the benefits system.

### *Decent wages*

There is clear evidence that the erosion of labour market institutions, especially trade unions, has contributed substantially to the problems of low-pay, in-work poverty, and income inequality.[105] At the level of the macro-economy, evidence reveals that most economies are 'wage-led', meaning that a decrease in the wage-share results in lower growth.[106] This is a direct challenge to the orthodox narrative that keeping labour costs down is essential for growth and competitiveness. Without an increase in wages to sustain reliable, debt-free consumption, investment and stable growth will not improve.

Boosting ordinary incomes can help households maintain their standard of living without resorting to debt. This would go to the heart of adressing a key dynamic explored in this paper. Government can take direct action in two key ways. In the first place we need a legal right to a collective voice for negotiation and decision-making at work. This could be enshrined in statute and promoted through best practice ensuring the legitimacy of an employee perspective on wages and other matters as a countervailing force to the interests of employers. A balance of employer and employee voice also offers a way to help transform poor-quality jobs into good ones by reforming management structures and creating common cause and fair reward structures between top and bottom earners. In the second place, a stronger wage floor would move the minimum wage progressively towards a living wage as a key means of tackling low wages and inequality at root.

*Skills and progression pathways*

Non-graduates especially are increasingly funnelled into low-paid jobs with few career progression opportunities.[107] But more broadly, there is a lack of skill utilisation and progression opportunities in terms of pay and career for too many British workers. Our current skills bias is strongly in favour of the technical and scientific. It risks ignoring or side-lining other important skills that we know we will need in the future world of work, such as care for the elderly.

We need an agenda that values different types of skills as being essential for society, thereby broadening the basis of quality on which to build a more sustainable economy. A pooled industrial or sectoral approach to training and career progression offers a mutualised way of achieving benefits to workers, businesses, and the economy. There are already examples of cooperative approaches, such as the training academy for construction skills in the East Midlands, and the Sector Skills Councils for finance and legal services.[108,109] The challenge is to take these initiatives into other important sectors, particularly more services since the service sector accounts for 85% of employment in the UK.[110]

## Ensure fair and progressive taxation

While we cannot rely on redistribution after the fact to resolve inequality at root, redistribution still has a crucial part to play in achieving economic justice. We need a tax system which is progressive, fair, and unavoidable and which supports productive activity and a fair distribution of power.

In the UK, once indirect as well as direct taxes are taken into account, taxation is regressive. It is increasingly recognised that the design of the tax system is vulnerable to capture by wealthy elites who not only have opportunities to build influential networks but also, having more resources at their disposal, can create strong lobbying power.[111] This capture has tended to strengthen the pressure for tax cuts as seen in the decline in top marginal tax rates in most OECD countries in recent decades.[112]

Recent polling suggests that 96% of the public would like to see a more progressive tax system.[113] It has been suggested that a top tax rate could be as high as 83% without impacting on productive activity.[114] Tax rates up to 80% are not unthinkable; they were the rates applied in the USA and the UK until the 1970s. Research has shown that lower top tax rates result in higher pre-tax as well as post-tax shares of income accruing to the highest earning proportion of the population.[115] This suggests that increasing top tax could reduce incentives for the very highly paid to seek ever greater pay rises.

We have described in this report how wealth inequality exceeds income inequality. Reform to taxation needs to embed wealth taxes if we are to seriously tackle the blight of economic inequality. Massive concentrations of wealth occur in property holdings as we have shown. It makes good sense therefore to design a system of land value tax as a principal means of redistributing wealth gains and the unearned benefits of holding land.

### Summary

We propose a definitive break from our business-as-usual economic management model which has failed to ensure stability or inclusive prosperity. Our policy agenda is to achieve transformation of three fundamental systems in the common interest – finance, jobs, and taxation. The policies we propose are not exhaustive and complementary measures would be needed to tackle other aspects of economic inequality (e.g. universal childcare) but they do offer a coherent platform for beginning a decisive unwinding of financialisation and economic inequality.

# Conclusion

## The 2008 global financial crisis may be over for the wealthy but the overhang in terms of depressed wages and growing indebtedness for ordinary workers goes on and gets worse.

Providing the back-story for the austerity measures that continue to drain economies, the tremors of the crash are still felt by many. Most nations have mustered only negligible growth – none of which is felt by workers.

The mainstream political consensus suggests that inequality is a price worth paying for economic growth. But new research from the OECD shows definitively that the inequality/growth trade-off is a false one. Its latest analysis adds to a growing body of research showing that inequality actually prevents economies from growing. The evidence for the UK is damning – suggesting that rising inequality has knocked 9% off cumulative growth between 1990 and 2010.[116]

This new research further backs up the argument that the UK's debt-led route out of the post-2008 recession threatens to lead straight back into another crisis. Pointing to a fundamental structural flaw in the economy, the message is increasingly clear: if the proceeds of growth are not shared, the economic pie stops growing. Wealth has not trickled down; instead, more has flooded up to the top 1%, and even more to the top 0.1%. Debt has been used to plug the wage-consumption gap for the rest, and the signals are showing quite plainly that this is unsustainable.

The increasing polarisation of rich and poor, of owners and workers, and of wealth and income, has permitted an alarming concentration of power at the top. These developments are intertwined with the financialisation of the economy over the past 30 years, and while academic research will continue to join the dots between financial instability and economic inequality, action does not need to wait for the detail. When even those who benefit most from the current system stand to lose from its inherent economic and social instability, the case to combat inequality becomes undeniable.

# Annex: Expert participants in December 2014 roundtable discussion

The following participants took part in our roundtable discussion 'Financialisation and economic inequality: A dangerous mix' to discuss framing and traction for the future of this work area. Participants were not asked to endorse this report, responsibility for which rests entirely with the authors.

| | |
|---|---|
| Silke Breimaier | Friedrich Ebert Stiftung |
| Mike Clancy | Prospect |
| Viv Davies | New Economics Foundation |
| Danny Dorling | University of Oxford |
| Giorgos Galanis | New Economics Foundation |
| John Grahl | Middlesex University Business School |
| Tony Greenham | New Economics Foundation (Roundtable Chair) |
| Steve Hart | Class |
| Helen Kersley | New Economics Foundation |
| Ben Kind | UNISON |
| Alice Martin | New Economics Foundation |
| James Meadway | New Economics Foundation |
| David Metz | UCL |
| Marloes Nicholls | Move Your Money & Meteos |
| Ozlem Onaran | University of Greenwich |
| Ann Pettifor | PRIME Economics |
| Andreas Prothman | German Embassy, London |
| Knut Roder | Sheffield Hallam University |
| Alfie Stirling | IPPR |
| Engelbert Stockhammer | Kingston University |
| Ulrich Storck | Friedrich Ebert Stiftung |
| Leila Talani | King's College London |
| Gregory Thwaites | Bank of England |
| Zoe Williams | The Guardian |
| Yuan Yang | Rethinking Economics |

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**Written by:** Alice Martin, Helen Kersley and Tony Greenham

**Thanks to:** Engelbert Stockhammer, Ulrich Storck, Silke Breimaier, Cam Ly, Giorgos Galanis, Annie Quick, James Meadway and all those who took part in the roundtable.

**Designed by:** the Argument by Design – www.tabd.co.uk

**Cover image:** yangimaging via flickr' – https://www.flickr.com/photos/yangimaging/5774510678/

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ISBN 978-1-908506-73-3