The economic, legal and social aspect of the role of financial institutions before, during and after the financial crisis

Matjaz Nahtigal, Associate Professor, Faculty of Management, University of Primorska, Slovenia, email: matjaz.nahtigal@fm-kp.si

1. Introduction 2

2.1. The rise of financial institutions in the last three decades 2

2.2. Real economy, financial institutions and long-term development 8

3. Conclusions 15

References 18

Summary

The purpose of this article is to reflect upon the importance and the role of financial institutions before, during and after the financial crisis and to outline proposals for alternative approaches to the financial crisis. Without an understanding of the historic development, nature and scope, and important limitations of modern financial institutions, the regulatory reform of modern financial institutions cannot be successful.

The success of financial reforms and their restructuring can only be measured when modern financial institutions participate, support and develop the real economy and support a more balanced, inclusive and diverse social development process. This is what the really 'exciting' banking and finance organizations should stand for. At the moment, the Western societies are still moving away from the goal of socially useful role of financial institutions. The regulatory reforms, bail-outs and dominant ideas about the European banking union, for example, are impeding, rather than facilitating, hopes for real economic and social recovery on both sides of the Atlantic. Only after an in-depth understanding of the substantive intricacies of modern financial institutions, can we approach a meaningful and thoughtful regulatory reform.

Independent minded scholars from all over the world would make a historical mistake if they continue to ignore the wide variety of ways that the financial, economic and social reconstruction of modern societies in different parts of the world can be accomplished.

Electronic copy available at: http://ssrn.com/abstract=2194498

1. Introduction

The purpose of this article is to reflect upon the importance and role of financial institutions before, during and after the financial crisis and to outline proposals for alternative approaches to the financial crisis. Financial institutions are commonly mentioned in academic and public debates, but their role remains inadequately understood. Financial institutions and their activities grew immensely over the last few decades. They became highly sophisticated, so much so, that many of their detailed operations and transactions are only understood by highly specialized experts. This is part of the reason why they attract a lot of attention, not only for the purpose of bailing them out, but rather to better understand their role, importance and relevance to the real economy and to the societies at large.

It is worth remembering that in the in the period between 1950 and 1980, financial institutions were primarily 'uninteresting', 'boring' institutions' with the task of allocating financial resources from the savers to the productive activities of the society. In the period between 1980 and 2008, however, a fundamental shift in the world of finance occurred. Consequently, the world of finance and financial institutions has become one of the fastest growing sectors. The role, size and importance of finance have changed from the auxiliary role of supporting the development of other economic and social activities to a dominant role and position in modern (Western) societies. This fundamental shift has largely gone unnoticed.

At the explanatory level, the fundamental shift in the importance of finance can be explained as a necessary, natural development of mature capitalist societies. Only after the crisis, with its epicenter in the large financial institutions of the most advanced and developed countries worldwide, has it become clear that it will not be possible to return to the path of sustainable and equitable development without comprehensive structural changes in the role and activities of financial institutions.

The primary purposes of this article are threefold: (1) to analyze the underlying premises of the rise of financial institutions in the last three decades, (2) to illustrate how the financial system has become increasingly dysfunctional, and (3) to illustrate the possibilities of how to redirect and reorient financial institutions in the future to again become socially valuable and useful institutions.

2.1. The rise of financial institutions in the last three decades

Before analyzing the reasons for the rise of financial institutions in the last three decades, one observation should be made: although the best documented rise of financial institutions refers largely to the rise of financial institutions on Wall Street and London, this does not mean that a similar path of development did not take place in the European Union. On the contrary, the EU financial liberalization, establishment of the Eurozone and the idea that the EU needs large financial institutions in order to be able to compete with the US, led to the increased cross-border mergers. Subsequently, it also led to an increasingly weak supervision of banking activities.

Electronic copy available at: http://ssrn.com/abstract=2194498

Some of the comparative analyses shows that “the larger European banks have become too big to be supervised effectively and the problem may be worse in Europe than in the United States” (Goldstein and Véron, 2011, cited in Johnson, 2011a) Moreover, as argued by Simon Johnson, the former IMF’s chief economist, professor of economics at MIT, and one of the leading experts in international finance, there is no distinction between the practices of US (United States) and EU financial institutions: “It’s one big trans-Atlantic money market out there, and these banks lend money to each other all the time… Deutsche Bank and UBS and Goldman Sachs and Citi are all intertwined” (cited in New York Times by Nelson D Schwartz, February 23, 2009).

Many things have changed since the beginning of the crisis on both sides of the Atlantic, including expensive bail-outs, stress-tests, the adoption of new regulations in the US in the form of Dodd-Frank legislation, and various other monetary and fiscal activities. However, the fundamental discussion on the role, practices, activities and accountability of the financial institutions remains inadequately addressed. The fear remains, that without such a debate, taxpayer money spent to rescue the financial institutions on both sides of the Atlantic is more likely to fuel future financial crises than to secure the success of financial institutions performing socially useful activities.

The empirical findings on the rise of size, profits, and the volume of trade of financial institutions on both sides of the Atlantic in the last three decades are truly extraordinary. One interesting account was by one of the leading Financial Times commentators Martin Wolf, who was largely supportive of globalization with all of its tenets, but became increasingly aware of the downsides and risks involved in the process:

“The US itself looks almost like a giant hedge fund. The profits of financial companies jumped from below 5 percent of total corporate profits, after tax, in 1982, to 41 percent in 2007, even though their share of corporate value added only rose from 8 to 16 percent. Banking profit margins have been strong, until recently. Now, at long last, earnings per share and valuations have collapsed… A financial sector that generates vast rewards for insiders and repeated crises for hundreds of millions of innocent bystanders is, I would argue, politically unacceptable in the long run. Those who want market-led globalization to prosper will recognize that this is its Achilles heel. Effective action must be taken now, before a still bigger global crisis arrives” (Wolf, 2009).

A more carefully elaborated and documented analysis of the rise of the financial institutions was provided by Simon Johnson and James Kwak. They clearly illustrated how the financial sector vastly outpaced growth in households and non-financial companies:

“Between 1978 and 2007, the financial sector grew from 3.5 percent to 5.9 percent of the economy (measured by the contribution to GDP). Its share of corporate profits climbed even faster. From the 1930s until around 1980, the financial sector grew at roughly the same rate as

profits in the non-financial sector. But from 1980 until 2005, financial sector profits grew by 800 percent, adjusted for inflation, while non-financial sector profits grew by only 250 percent…; by the third quarter of 2009, financial sector profits were over six times their 1980 level, while non-financial sector profits were little more than double those of 1980" (Johnson and Kwak 2011b, loc 1185 and ff).

Johnson and Kwak continue to illustrate how the financial sector simply got bigger and bigger:

"…in 1978, all of the commercial banks together held $1.2 trillion of assets, equivalent to 53 percent of US GDP. By the end of 2007, the commercial banking sector had grown to $11.8 trillion in assets or 84 percent of US GDP… Asset backed securities, such as collateralized debt obligations (CDOs), which hardly existed in 1978, accounted for $4.5 trillion in assets in 2007, or 32 percent of GDP. All told, the debt held by the financial sector grew from $2.9 trillion, or 125 percent of GDP, in 1978 to over $36 trillion, or 259 percent of GDP, in 2007" (Johnson and Kwak 2011b,,loc. 1168, footnotes omitted).

The rise of the financial sector in the last three decades has had surprisingly little impact on the development of the real economy. Contrary to conventional wisdom, the rise of the financial sector, the comprehensive process of 'financialization,' characterized by the explosion of financial innovations, did not contribute to high levels of economic growth. On the contrary, despite the floods of cheap capital due to low interest rates and despite the rise of the financial sector, the growth rates in the 2000s were rather anemic. As explained by Simon Johnson:

"…the problem was that the cheap money was misallocated to the housing sector… that misallocation was due to the new mortgage products that made it so easy to borrow large amounts of money, the voracious appetite of Wall Street banks and investors for securities backed by those mortgages, and a decade of government policies that encouraged the flow of money into housing. And the more money that flowed into new subdivisions in the desert, the less flowed into new factories where Americans could go to work. Ultimately, the price of the housing bubble and the financial crisis is not just trillions of dollars on mortgages and mortgage-backed securities, but a decade of poor economic growth and declining real household incomes" (Johnson and Kwak 2011b, loc : 2822 – 2857).

The rise of financial institutions and the financial sector did not substantially contribute to the development of productive activities, such as an increase in labor productivity and a strengthening and improvement in the process of innovations in various industries. Instead, the banking sector has demonstrated "a capacity to generate huge crises because of the incentives to take on under-appreciated risks" (Wolf, 2009). On the other hand, it has only demonstrated a weak and tenuous capacity to support real economic growth in new, innovative ways in good economic times. Conversely, in the period of a crisis, the financial sector presents a drain on liquidity from the real economy and threatens to depress national economies and societies at

large. To emphasize this claim: in the EU the state aid between the period of 2008 and 2011 was €4.5 trillion euros, which is 37 percent of EU GDP. Despite this support for the banks, the real economy continues have difficulties to finance its development in many countries and regions of the EU and many EU governments have found themselves in dire fiscal position due to the banking bail-outs. Meanwhile, the unemployment in the eurozone and in the entire EU continues to be at the highest levels in its history.

Therefore, before discussing the need for both a macro- and micro- prudential approach in order to improve the regulatory and supervisory framework of the financial institutions, a theoretical and strategic debate about the actual role, meaning and importance of financial institutions should be discussed. For the time being, there is precious little of such a strategic debate. It appears that policy-makers, bankers, academics, and professional commentators take the massive bail-outs of the financial sector, with the help of taxpayer money, for granted as the only possible and necessary way out from the present financial, economic and social crisis. The fear is that such a knee-jerk approach does not lead toward the improvement of quality of financial governance and toward enhancing possibilities for more balanced, more inclusive and diverse social and economic development. Instead, it may lead toward more instability and even bigger crises in the future, as warned by Martin Wolf:

"What is emerging is a slightly better capitalized sector, but one even more concentrated and benefiting from explicit state guarantees. This is not progress: it has to mean still more and bigger crises in the years ahead" (Martin Wolf, Financial Times, September 2009, cited in Johnson and Kwak 2011b,loc 3752 – 58%).

Why is such a strategic debate not taking place? Perhaps society is so overwhelmed by the immense complexity of the financial activities in the ability to create complex financial instruments, they forget to inquire about the actual purpose and broad social use of such instruments. We are assuming that the 'masters of the universe' are able to manage our finances in the best possible manner, because they are operating with the help of sophisticated mathematic models. However, when we look closer to the various financial practices, such as the form of leverages and the supposedly superior mathematical models, we realize that there is no such thing as a perfect, smooth, watertight system of finance, financial institutions and their activities. One such example is the collapse of the Long-Term Capital Management (LTCM) hedge fund, with two Nobel laureats, Myron Scholes and Robert Merton as members of the board of directors. In 1997 they won the Nobel Prize in economics for a new method to determine the value of derivatives. A year later LTCM hedge fund has incurred a multi-billion loss after the Russian financial crisis, which prompted intervention of the Federal Reserve.

There is no normative framework that can guarantee a perfect, flawless and optimal financial intermediation. There are, however, financial frameworks that can help support overall economic and social growth in more sustainable and inclusive ways than others. There are also financial frameworks which are more prone to excessive risks and more capable of generating

financial volatilities and crises to the detriment of the economy and society at large. This insight, that there is no neutral regulatory financial framework and that different regulatory financial frameworks can lead to substantially different outcomes of the allocations of resources, should precede the vague and superficial debate about the need to reregulate the financial market and tighten independent supervision. The kind of links between financial institutions and real economy that can be established varies from one regulatory framework to another. The key challenge is to establish a regulatory financial framework in which financial institutions and their activities begin again by serving and supporting the long-term development of productive activities, such as the enhancement of productivity and the expansion of output.

The key problem is that the rise of the financial industry, and of financial innovations, was not accompanied with the rise of productivity and the expansion of output. In good economic times, the rise of financial institutions presents little support and no threat to the real economy. In periods of financial crises, however, a bloated financial sector that is primarily turned to the conundrum of mutual trading, presents a drain on the real economy and society at large. Masters of the universe that tend to concentrate financial, economic and political power via revolving doors between financial and political circles, lobbying for benevolent legislation and loose regulatory supervision via media and mainstream academics who often appear as their consultants, contribute little to the broader public good in beneficial economic times. In good economic times, top bankers, employees and shareholders benefit immensely and pay themselves bonuses that are disproportionate to actual developments in the market. In periods of financial crises, however, they turn to governments and their implicit guarantees. Consequently, Simon Johnson and James Kwak have concluded that:

"Never before has so much taxpayer money been dedicated to save an industry from the consequences of its own mistakes. In the ultimate irony, it went to an industry that had insisted for decades that it had no use for the government and would be better off regulating itself – and it was overseen by a group of policymakers who agreed that government should play little role in the financial sector" (Johnson and Kwak 2011b, loc. 3172-88).

The trouble is not only that the financial institutions turned to the government and taxpayers to bail them out, but the devastating social and economic consequences of the financial collapse due to the excessive risks, and many other dysfunctional activities, they pursued before the crisis. The crisis, and its subsequent measures, have negative consequences on the real economy, including homeowners, taxpayers, and the newly unemployed. It also has negative consequences on the undermined fiscal position of the government:

"…the collateral damage to the real economy was enormous. The collapse of the housing bubble tipped the economy into recession in December 2007, leading to the loss of 1.1 million jobs in the first eight months of 2008. The fall of Lehman Brothers in September 2008 and the ensuing panic triggered a severe economic contraction, leading to the loss of another 5.8 million jobs over the next twelve months as the economy shrank by 4 percent. The unemployment rate

doubled from 4.9 percent at the beginning of the recession to 10.2 percent by October 2009… As the economy declined sharply, the sudden collapse in tax revenues left government finances in disarray. State and local governments resorted to severe cutbacks in services. The federal government dedicated USD 800 billion in new spending and tax cuts to stimulate the economy. However, stimulus spending and lower tax revenues pushed the 2009 federal deficit up to USD 1.6 trillion, or 11 percent of GDP, more than doubling the previous postwar record. The long-term effect of the financial crisis and recession is even greater" (Johnson and Kwak 2011b, loc. 3510-28).

The apparent huge asymmetry in information in the economic and political power of big financial institutions has become detrimental to practically everyone outside of the financial circles. Large financial institutions rose above any supervision and started serving themselves and their shareholders. Disproportionate returns on equity for banks, fee structures beneficial to the managers, and bonus payouts, are just some of the indices of unsustainable and harmful asymmetry on the markets and society. Simon Johnson has, for example, accused Josef Ackermann, former chief of Deutsche Bank, as one "of the most dangerous bankers in the world", because even during the crisis, he was still pushing Deutsche Bank for a 25 percent annual return on equity, before taxes. Johnson has explained that such a goal encourages its bankers and traders to take more risks and employ lots of leverage, which can fuel profits on the way up, but amplify losses on the way down (Johnson, cited in Jack Ewing and Liz Alderman in New York Times, June 11, 2011).

The only way to cool off the financial capitalism casino is to create a more balanced, more diverse and more inclusive environment, not only for the financial institutions, but also for the economy and society at large (the need to cooling the international and national financial casino was first emphasized by Susan Strange 1986, 175 – 181). We need to re-connect financial institutions with long term productive activities of the real economy and society at large. Subprime lending was not about helping poor people solve their housing problems; instead, it was about creating new financial instruments for trading and betting between various financial institutions. The same applies to the European banks and their massive flows of cheap capital to the European periphery before the crisis. The financial flows were not directed to the productive investments of the peripheral countries in order to make them more competitive, instead, they were channeled to the property bubbles in the countries, such as Ireland and Spain. In other peripheral countries, such as Greece, financial flows went to private and public consumption. After the crisis, massive outflows of capital from the periphery left economic and social devastation of epic proportions in several countries, including Greece and Spain.

Several decades of prevailing doctrines that state that financial institutions perform most efficiently if they are left to themselves, alongside several decades of deregulation and financial liberalization, led to the highly asymmetric situation, without any proper mechanism of checks and balances. The efficiency hypothesis, where the market prices are always right, was at the heart of financial liberalization, deregulation and the explosion of financialization. It became

almost impossible to discern between socially useful financial activities and those activities aimed at new profit-making opportunities to enrich financial institutions, top managers, and shareholders.

Accordingly, financial institutions on both sides of the Atlantic were able to concentrate on increasing profits. At the same time, they attracted most of their talent from society and became highly geographically concentrated in a few leading financial centers, including Wall Street, London, and Frankfurt. It will require the determination, creativity courage and vision of the next generation of leaders, to be able to redirect and reconnect financial institutions with the rest of the economy and society. In saying this, there is much to learn from past inspiring leaders, such as Theodore Roosevelt, who confronted the biggest trust of his time, Franklin Roosevelt, who restructured the entire US economy, Brandeis, who was very well aware of the fact that financial institutions are dealing with other people's money, and William Douglas with his awareness about the need to democratize financial sector and to keep it in check via regulatory and supervisory means. If nothing is accomplished in terms of financial reform, the economy and society at large may remain a hostage to the financial institutions and the financial and political oligarchy, who are capable of extracting extra rents for a very long time.

2.2. Real economy, financial institutions and long-term development

Among the critics of the present financial environment, created in the last decades, is a significantly important and radical idea: breaking up several of the biggest financial institutions. The argument of Simon Johnson and several other important scholars is that the best way to tame large financial institutions and prevent future financial disasters at the expense of society is to break-up the largest financial institutions. The simplest explanation of the argument is that in making financial institutions smaller, a potential collapse of certain financial institutions would not bring international finance into turmoil. When large financial institutions operate in a highly leveraged form, with a great deal of debt and very little equity, huge and unfair costs may be imposed on the rest of the economy. While the implicit subsidies provided to too-big-to-fail companies allow executives and investors to increase compensation by hundreds of millions of dollars, the costs imposed on the rest of us are in the trillions of dollars. This led Johnson to the conclusion that this is a monstrously unfair and inefficient system. Many sensible public figures are increasingly pointing this out (Johnson, New York Times, May 10, 2012).

There are also other similar proposals for providing safer banking. One idea is legislating higher capital requirements. The purpose of this is to make sure banks and other large financial institutions depend more on equity and less on debt and to a binding 'leverage ratio' – a requirement according to which the banks should have at least ten percent in equity relative to their total assets (Johnson, ibidem).

Johnson admits that even smaller financial institutions, in comparison with today's megabanks, would not be sufficient to ensure financial stability. They would ensure, however, more efficient supervision and reduce systemic risks in cases of financial turmoil.

The authors arguing in support of the limitation on the size and leverage of financial institutions also discuss, with lesser attention, the issue of the quality of these hypothetically restructured financial institutions. The open issue would remain as to whether these smaller financial institutions would be capable of providing stronger and better long term support for the development of the real economy. Suppose that the first part of the issue can be described as a quantitative issue – the size, the cap on debt, on leverage and so on. As such, the second part of the issue can be described as qualitative. The qualitative issue can be described as the issue of the quality of financial support for innovations, for the enhancement of productivity and for the expansion of output.

The distinction should be made between all kinds of financial activities aiming at securing long term support for the development of a real economy and those financial activities aiming at creating benefits for the executives and investors. Needless to say, this distinction is, in reality, almost impossible to draw, but it nevertheless remains crucial. Dirk Bezemer, a finance professor from the Groningen University, is one of the few experts who pointed out this crucial, although rarely mentioned and analyzed, distinction. He has made a distinction between credit that supports economic growth and credit that fuels bubbles and subsequently hinders growth.

Bezemer's path breaking analysis starts with the recognition that current macroeconomic models do not distinguish between the credit flows that help and those that hinder the economy (Bezemer, 2012a 3). He is convinced that the neglect of credit and debt in economic theory left us unprepared for dealing with the financial crisis. Moreover, he has pointed out the paradox that the dominant macroeconomic models of 'general equilibrium' do not have "money, financial flows, credit or debt. The models that are widely used in policy institutes, academia and central banks, have no banks. These models assume the liabilities of all borrowers always exactly match the assets of all lenders.

The assumption is that, on the basis of accounting equality, the financial sector's assets are the real sector's liabilities. According to Bezemer, however, this accounting equality, on which macroeconomic models are based, is highly misleading and does not explain the true nature of modern finance. Namely:

"…most of that debt growth has NOT been due to lending to the real sector – to non-financial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the non-bank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments. These credit flows, and the activities they fuelled - share buybacks, leveraged buyouts, securitization - create no wage or profits for the many, but capital gains for the few, and a huge net debt burden on the economy.

Property and asset prices may be falling, but the debts that jacked them up are not. The threat to growth today is not a shrinking of the financial sector, but it enormous size. The accumulated claims by the non-bank financial sector cause a daily drain of purchasing power on the economy

in debt services. This is money that could be effective demand for goods and services and stimulate economic growth. Nowadays, finance is stifling, not stimulating growth" (Bezemer, April 2012b).

These findings have far reaching consequences for the debate on the role and importance of financial institutions in the modern economy and society. They go beyond the discussion of the size and scope of large financial institutions. On the basis of these insights, Bezemer has illustrated the process of the gradual de-linking of finances and the real economy over the last three decades. The financial institutions have turned away from supporting the real economy and from growing and developing in tandem with the real economy and society. These valuable insights by Dirk Bezemer, who has reminded us that James Tobin, when discussing the efficiency of the financial system, warned us that "…we are throwing more and more resources, including cream of our youth, into activities that generate high private rewards disproportionate to their social productivity" (reference cited from Bezemer, 2012a,2).

The theoretical reason for the confusion in explaining the role and importance of large financial institutions in modern societies comes from accounting equality, according to which the financial sector's assets are the real sector's liabilities. There is, however, a trade-off between "the financing of production (out of retained earnings and fresh lending) on the one hand and credit flows returning into the financial sector on the other" (Bezemer 2009a, 13). As noted by Bezemer, this trade-off is absent from the mainstream models, but is crucial to understanding the crisis.

On the basis of the flow-of-funds, credit has shifted away from the real economy to the financial assets market. This shift has created its own dynamics, according to which the credits into financial assets and financial instruments increased returns. This encouraged the next cycle of credit flows, debt growth and asset price rises. The unsustainable dynamic in the period of irrational exuberance was perhaps not viewed as deeply problematic, because the real economy developed and grew at the same time. In good economic times, the shift of credits from the real economy to the financial assets did not present a concern, due to the accounting identity assumption. This assumption created an illusion of common growth and prosperity. The longer the illusion lasted, the more destructive the social and economic consequences turned out to be.

If the above analysis is correct and the mainstream economic and legal experts and policy-makers failed to address the phenomenon, then the financial institutions turned away from supporting the real economy into extracting benefits from it. The crucial issue is how to re-connect the financial institutions and the real economy such that the financial institutions start supporting the real economy again. It is a challenge, not only in how to rebalance the power and influence the large financial institutions, but also in how to channel credit flows back into the real economy. This redirection would not necessarily make banking and finance 'boring' again, but it would make sure that the financial institutions grow and develop in a sustainable manner together with the real economy and the society at large. As a result, this redirection would

probably decrease returns and bonuses to the large financial institutions and their executives. It would, however, spread economic, financial and other opportunities to the larger segment of businesses, new entrepreneurs, to start up firms and to many other segments of society. The qualitative dimension of the financial reform should be added to the quantitative dimension of the financial reform.

For the time being, governments on both sides of the Atlantic pay little attention to such an alternative approach to the reform of the financial institutions. They continue to bail out the entire financial sector, regardless of the cost for the public finance, and ultimately, for the taxpayers. Their perspective seems to be that after bailing out the financial institutions, things would return back to prosperity, as we were witnessing in the years before the financial crisis. The problem with this approach is that the period of the so-called prosperity was based on many unsustainable and illusory premises. It was based on the supply of cheap money, on the toxic flows of excessive liquidity to increasingly inflated prices of financial assets, and on the so called credit democracy for the citizens. Not one of the premises was sustainable and not one can be restored.

The attempt to restore the status-quo ante situation by merely making more regulations on large financial institutions would only mean that financial institutions are still not sources of support and that they may continue to present a "sustained drain of liquidity from the real sector to the FIRE (finance, insurance and real estate) sector" (Bezemer 2009a, 13). This problem with credit flows, which was little understood and rarely mentioned before the crisis, continues to be unresolved. The consequences of not recognizing what Dirk Bezemer has recognized – that the credits flowing to the financial assets are distinct from the credits flowing to the real economy - go beyond the issue of the optimal size and scope of the financial institutions. Bezemer has offered another important argument to support this view:

"In the 1980-2007 era of cheap credit and deregulation, banks had every incentive to move from real-economy projects, yielding a profit, towards lending against rising asset prices, yielding a capital gain. In the 1990s and 2000s, loan volumes rose to unprecedented levels, supporting global assets booms in property, derivatives and the carry trade. The share of lending by US banks to the US financial sector – instead of to the real economy – went from 60 percent of the outstanding loan stock in 1980 (up from 50 percent in the 1950s) to more than 80 percent in 2007" Bezemer, 2009b).

Unfortunately, we do not have similar data for the EU, but it would probably be a fair assessment that in the last few decades, the EU, before and after the creation of the Eurozone, took a very similar path of development. This means that financial liberalization, cross-border mergers and the creation of large European banks led to a similar path of unsustainable development with negative economic and social consequences. As a result, the EU faces similar challenges in restructuring the banking sector to the US.

The challenges of restructuring the banking sector and financial markets go substantially beyond regulatory measures and quantitative limitations on the size and leverage. The crucial debate remains how to recreate a socially beneficial financial sector. In this sense, Dirk Bezemer is right when he is reminding us that the financial sector continues to be bloated and dysfunctional. As long as modern societies cannot channel credits via financial institutions primarily in the enhancement of productivity, wages and the growth of the real economy, the efforts to bail out such a financial sector will present a drain, not a support, for the long term economic and social development of modern societies. Therefore, the key challenge for modern societies is to restructure and redirect financial institutions to again start performing socially useful functions.

Nothing less than the future of democracy is at stake. Concern about the future of democracy in relation to the role and importance of financial institutions was very well understood by the scholars, practitioners and politicians, such as Louis Brandeis, Douglas Williams and Franklin Roosevelt, decades ago. However, it is poorly understood by the present generation of leaders and mainstream scholars.

Another important aspect of the finance and financial institutions situation that was overlooked by most mainstream economists, lawyers, and policy-makers is that corporations, businesses and other parts of the real economy are increasingly self-financed. This observation was almost completely ignored before the crisis in good economic times and remains to be largely overlooked today. Only a handful of scholars pointed to this issue of self-financing. The scholars who pointed out this phenomenon, including Roberto Unger, Zhiyuan Cui, and Colin Mayer, observed that relatively little real investment in the expansion of production and productivity is financed directly through stock markets:

"Corporations in all major Western countries fund almost all their capital expenditures – investment in plant, machinery, and inventories – internally, through retained earnings, in other words, through profits and depreciation. Since 1952, retained earnings have covered ninety-five percent of capital expenditures. Since the early 1980s, through mergers and acquisitions, buybacks, and dividend distributions, more stock has been retrieved from stock markets than has been issued. As a result, new equity as a net source of finance is negative!" (Cui in Unger 1998, 283).

Why is it possible that such an important and revolutionary insight has been ignored for such a long time? Part of the theoretical and practical reasons lie in the nature of modern financial activities as explained previously. Another part of the reason lies with the neoclassical and Keynesian literature, according to which the accounting identity between savings and investment exists by definition. Whatever is saved is going to automatically be invested. This implies that saving cannot be wasted and money cannot be squandered in the financial casino.

The reality of modern complex financial institutions illustrates a different picture. Huge volumes of financial transactions and trading between financial institutions do not necessarily and automatically guarantee that the financial flows will be channeled to enhance productivity and output. Empirical analyses illustrates that corporations have to rely on their own savings to finance their development. This observation, put forward by economic and legal scholars Bezemer, Unger, and Cui, has been suppressed by the neoclassical and Keynesian literature. The growing gap between the financial institutions and the real economy was less problematic in good economic times – when the underlying fragility and unsustainability of the financial arrangement was not taken seriously. It remains unaddressed today. Without addressing it, it is difficult to determine how it would be possible to overcome the ongoing crisis, except in the form of a temporary 'kicking the can' manner.

In addition to the theoretical reasons, practical reasons for ignoring the problem of the inefficient allocation of scarce resources lies ahead. Financial markets and financial institutions grew immensely in the last decades. Confronting them directly would require courage and wisdom, as well as the theoretical knowledge and practical skills rarely seen of public figures, such as policy-makers and advisers. It remains more convenient to marginally improve the regulatory framework while bailing out many of the failing financial institutions with taxpayer money, rather than approach a comprehensive and strategic restructuring of the financial sector. Strategic restructuring would require a quantitative restructuring in terms of size and caps, as well as a qualitative restructuring of financial institutions in order to reconnect them with the real economy and the rest of the society.

These are the reasons why the approach toward banking bail-outs and toward the banking union in the European context is far from efficient from a broad social and economic perspective. The entire approach needs to re-directed. The regulatory efforts should follow, not precede, such a reorientation. The best start in a new direction, such as this, is to focus on what worked best in the past. These were networks of small local banks which provided long term support for the development of small and medium sized local businesses. Local banks have traditionally been a backbone of local and regional development in many advanced economies, including the US decentralized banking sector and the German system of *Landesbanks*. They have a much better insight into the needs, possibilities and potential of local businesses and have a much bigger stake in the success of local and regional development. They represent one alternative possibility of how to secure a deepening of finance in place of the futile process of financial hypertrophy (Lothian and Unger 2011, 30).

Other forms of financial institutions with much larger stakes in supporting the long-term competitiveness of the real economy, and with much greater interest in the more equal and inclusive access to credit, should evolve. The difference between financial hypertrophy and financial deepening was established by Roberto Unger and Tamary Lothian. He explains the contrast in the following way:

"By the hypertrophy of finance, we understand increase in the size of the financial sector, of its share in profit, talent, and influence, regardless of the service that it renders to the real economy. By financial deepening, we mean the intimacy of the relation between finance and the real economy: not only consumption but also and above all production and innovation" (Lothian and Unger 2011, 27).

Institutional innovations in the area of finance are something substantially different than the proliferation of financial instruments and financial innovations in the last decades. Financial innovations served the purpose of enhancing the volume of trade without the ultimate goal of supporting the development of the real economy. Wouldn't it be really exciting for banking to re-connect the financial institutions with the development of the real economy, so that the next generation of talented bankers would participate, support and help develop the real economy and society at large? It is true that the banking bonuses for the top executives and the returns on equity could (and should) be closer in line with the developments, returns and rewards in the real economy, but such a realignment would serve the real social needs and return prospects for the many excluded parts of the population.

We need to multiply and diversify financial institutions in order to reconnect the world of finance with the world of real economy. For example, the role of venture capital, which provides equity to start-up firms, the role of regional development funds, the role of pension funds (on the need to activate pension funds for the purposes of long-term economic development see Roberto Unger 1998, 148 – 150) and the role of other financial institutions can all contribute to the diversification of financial institutions. It also contributes to more innovative ways for how to provide long-term support for the real economy and its restructuring for start-up firms, industrial innovations and the productivity enhancement (the possibility to transform the US financial system toward more equitable and more efficient system, see Dymski, Epstein and Pollin 1993).

A reorientation of the financial institutions is not without risks. The key point is that decisions for when and how to provide finances for the real economy must be taken on the basis of a high level of expertise and an understanding of the real economy. It must also be independent on any political meddling at the local, regional and national level. Policy-makers should support the improved links between the financial sector and the real sector, but they cannot, and should not, interfere with the professional decisions of which investment opportunities deserve high quality financial support. The same principle applies, even in the case of public venture funds. However, these venture funds present a rare, but potentially promising, vehicle of the future socially inclusive economic development.

Financial deepening, as a qualitative and quantitative contrast to development, would lead to a more balanced, more diverse and subsequently more inclusive development of the financial sector, real economy and society at large. It would require strong leadership and a renewed opening of space for the economic, social and financial initiatives bottom-up approach, as well as better chances to pursue a comprehensive economic and social reconstruction. It

would present a task, as Tamara Lothian and Roberto suggest in their proposal, to return the financial institutions from the position of bad master again into a position of good servant to the economy and society (Lothian and Unger 2011, 28 – 33).

Such a restructuring of the financial institutions would certainly require broader social and economic visions of modern economies and societies and would require broader social alliances. It would not be a magic wand, but it would certainly present a more transparent, more balanced and more inclusive approach to the economic and social recovery. Needless to say, it would also meet with strong opposition in the form of present financial and political oligarchies which continue to stymie any coherent and comprehensive approach to the recovery beyond hopeless but allegedly necessary bail-outs and banking unions in the trans-Atlantic world.

3. Conclusions

Since the beginning of the crisis, many valuable proposals for how to tame financial institutions were put forward. Among the most well-known is the Volcker rule, which is the prohibition of internal hedge funds, internal private equity funds, and proprietary trading in commercial banking institutions. They include a return to "narrow banking", limitations of the size and leverage of financial institutions. Laurence Kotlikoff suggested a limited purpose banking, in which banks are not allowed to borrow short and lend long. In addition, all risky assets must be held in mutual funds (Johnson, loc. 6461). In practice, new legislation and regulation, such as Dodd-Frank, was adopted. In a long and protracting legislative procedure – including heavy lobbying and opposition from the Wall Street – a comprehensive new legislation was adopted by the US.

According to Simon Johnson, the Dodd-Frank Act presents an important step forward in supervising and regulating large financial institutions and a missed opportunity. It is a complex legislation which leaves a dizzying number of details to regulatory discretion. Thus, it will depend largely on the integrity, quality, independence and professionalism of the regulatory bodies. More specifically, the courts will have to supervise and regulate the financial institutions better than they have in the past.

Lawyers at Davis Polk counted 243 new rules and 67 new studies required by the Dodd-Frank Act. Despite the comprehensive legal framework, many important aspects are exempted from legislation, such as the new requirements for trading and clearing derivatives, which includes an exemption for "commercial end users" that use derivatives for hedging purposes. Johnson has pointed out that the size of that loophole turns out to be largely dependent on the wording of the rule defining exempt transactions (Johnson and Kwak 2011b, loc. 4396-4413).

It will be many years, before a judgment on the efficiency of such legislation could be made. It will also take many years before it will become clear as to whether the president's announcement, when signing the Dodd-Franck Act, of the American people never again being asked to foot the bill for Wall Street's mistakes and about the transparency and risk reduction of

such a bill (Johnson and Kwak 2011b, loc. 4324-44) will be possible to verify. It is already possible, however, to say that the Dodd-Frank Act does not present as substantial a reform of the financial institutions as the Glass-Stegall Act, in the New Deal era, despite the fact that the magnitude of the problems and issues related to the role of financial institutions is bigger today than at any other period of industrial, financial and social development.

Alternatively, more thoroughly thought out approaches toward financial sector restructuring are needed. According to the available reports and data, in the EU, the European commission has approved €4.5 trillion (37 percent of EU GDP) in state aid measures to financial institutions between 2008 and 2011 (EU Observer, June 2012). The real tragedy is, however, that despite this massive support in state aid (and therefore leaving out other measures of support, such as the ECB measures) many EU member states economics and their regions economies continue to be in recession with high unemployment and with very weak financial institutions. The situation is not significantly better in the US, despite a more integrated federal financial system. The challenges ahead for the policy-makers today are even bigger than at the eruption of the crisis. Kicking the can down the road has its limitations too.

As a starting point for a more substantive reform of financial institutions, we again turn to Dirk Bezemer, who argues convincingly that there is no neutral regulatory framework. Only after we understand the nature, character and scope of modern financial institutions and only after we envisage a significantly reoriented role of the financial sector in the modern economy and society, can we turn to the adoption of a substantially different regulatory framework. Such a framework would be more inclined to provide high quality financial support for the development of a real economy, for its active restructuring, for enhancement of productivity and for the benefit of more socially inclusive overall development. Namely:

"More specifically, the balance sheets of firms, households and governments, and the regulations in the economic system on what sorts of balance sheets are being allowed, co-determine what forms new credit flows can take, how much there can be of it to different sectors (e.g. to the FIRE sector versus the real economy), and consequently how the economy will evolve. These will not the only factors shaping the economy, but neither can they be fully abstracted from, as is current practice in much of economic research. In sum, there seem to be important contributions that accounting researchers can make to economics – rather than just the other way around, as is sometimes suggested" (Bezemer 2009a, 33).

There is no doubt that financial institutions and financial instruments will develop in the future. Robert Shiller is correct about that and also about the many socially useful innovations that were developed in the past. The trouble is, however, that financial institutions in the last three decades contributed less to the public good than they did before the crisis. Many mainstream academics, policy-makers, monetary authorities, financial institutions' representatives and corporate media defended the liberalized, deregulated financial institutions. The biggest challenge remains how to make the financial institutions serve broad social interests

and make sure that they are doing their best in delivering better products and services. Unlike Robert Shiller, who believes that improved regulations would be sufficient enough for financial institutions to serve broad social interests in the best possible manner Shiller loc. 432-52), many other scholars, described previously, argue convincingly that a mere regulatory reform will not be sufficient. Independent minded scholars from all over the world would make a historical mistake if they did not deeply understand the substantive nature of this disagreement. They should also not pay attention to the possible alternative ways to approach the financial, economic and social reconstruction of modern societies in different parts of the world.

References

Bezemer, D., 2012a. Finance and Growth: When Credit Helps and When it Hinders, conference paper, presented at the Berlin conference, organized by Institute for new Economic Thinking, available at: http://www.scribd.com/doc/93886065/Bezemer-Dirk-Berlin-Paper (visited on September 5, 2012).

Bezemer, D., 2012b. Finance and Economic Growth Delinked, Eurointelligence, April. Available at:http://www.eurointelligence.com/eurointelligence-news/archive/single-view/article/finance-and-economic-growth-delinked.html (visited on September 5, 2012).

Bezemer, D., 2009a. »No One Saw This Coming«: Understanding Financial Crisis Through Accounting Models. Munich Personal RePEc Archive, available at: http://www.eurointelligence.com/eurointelligence-news/archive/single-view/article/finance-and-economic-growth-delinked.html (visited on September 5, 2012).

Bezemer, D., 2009b. Lending must support the real economy, Financial Times, November 4.

Dymski, G., Epstein G., Pollin R. (eds), 1993. *Transforming the U.S. Financial System – Equity and Efficiency for the 21st Century*, M.E. Sharpe.

EU Observer, 2012. Brussels: 'Banks should pay for banks. June 6. Available at: http://euobserver.com/economic/116517. Visited on September 5, 2012.

Ewing J. and Alderman L., 2011. Deutsche Bank's Chief Casts Long Shadow in Europe, New York Times, June 11.

Goldstein, M. and Véron N., 2001. Too Big to Fail: The Transatlantic Debate, *Working Paper Series WP 11-2*, Peterson Institute for International Economics, Washington, January.

Johnson, S., 2012. Breaking Up Four Big Banks, *New York Times*, May 10.

Johnson, S., 2011a. Battle of the Bank Policy Heavyweights, Economics (New York Times blogs), June 10, 2011. Available at:

<http://economix.blogs.nytimes.com/2011/03/10/battle-of-the-bank-policy-heavyweights/> (visited on September 5, 2012).

Johnson, S., 2011b. 13 *Bankers: The Wall Street Takeover and the Next Financial Meltdown*. First Vintage Books Edition, January 2011, Kindle edition.

Lothian, T. and Unger R. (2011) Crisis, Slump, Superstition and Recovery – Thinking and acting beyond vulgar Keynesianism, joint piece, available at: http://www.law.harvard.edu/faculty/unger/english/pdfs/JOINT_PIECE.pdf (visited on September 5, 2012.

Schwartz, N.D., 2009. As it falters, Eastern Europe raises risks, *New York Times*, February 23.

Shiller R. (2012). *Finance and Good Society*, Princeton University Press, Kindle edition.

Strange, S. (1986). *Casino Capitalism*, Basil Blackwell, cited edition published in 1997.

Unger, R., 1998. *Democracy Realized*, Verso.

Wolf, M., 2009. Why is it so hard to keep financial sector caged?, *Financial Times*, February 5.