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Transforming Financialization and Inequality in a Post-Covid World

By John M. Balder

Introduction- During the past decade, income and wealth inequality reached peak levels not witnessed since the eve of the Great Depression in 1928. Much of the blame for this two-tier society is placed at the feet of technological change and globalization. However, two important contributors are often ignored: first, the financialization of the U.S. economy, which has heightened the role of speculative trading and capital gains, which primarily benefit the top 10% of U.S. households, and second, the suppression of wages. It is troubling that in a country as wealthy as the United States, even before the pandemic, nearly 40% of all U.S. households could not handle a one-time expense of $400 without either selling something or borrowing. The Biden administration has been doing an admirable job at elevating awareness of these issues; however, reversing them will require long-term structural changes that will require broad participation of civil society to enhance productive activity and the creation of value.

Given the enormity of current challenges, policies that were adopted during the Great Depression provide a helpful historical reference point. One important feature of the New Deal was the focus on job creation, productivity growth, and wages.

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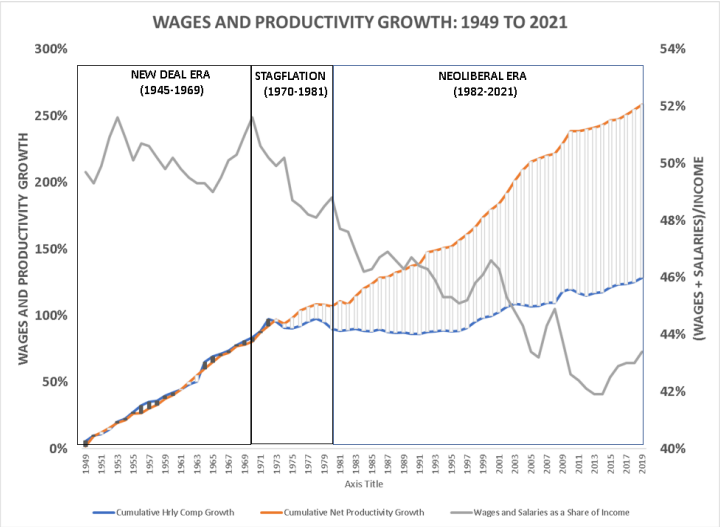
Transforming Financialization and Inequality in a Post-Covid World

John M. Balder

I. Introduction

During the past decade, income and wealth inequality reached peak levels not witnessed since the eve of the Great Depression in 1928. Much of the blame for this two-tier society is placed at the feet of technological change and globalization. However, two important contributors are often ignored: first, the financialization of the U.S. economy, which has heightened the role of speculative trading and capital gains, which primarily benefit the top 10% of U.S. households, and second, the suppression of wages. It is troubling that in a country as wealthy as the United States, even before the pandemic, nearly 40% of all U.S. households could not handle a one-time expense of $400 without either selling something or borrowing. The Biden administration has been doing an admirable job at elevating awareness of these issues; however, reversing them will require long-term structural changes that will require broad participation of civil society to enhance productive activity and the creation of value.

Given the enormity of current challenges, policies that were adopted during the Great Depression provide a helpful historical reference point. One important feature of the New Deal was the focus on job creation, productivity growth, and wages. The macroeconomic policies put in place after the Second World War linked wage increases with productivity growth (see chart below). This ensured that workers were fairly compensated for their contributions. However, beginning in the 1970s, productivity growth (orange line) diverged sharply from increases in hourly compensation (blue line). Wages and salaries, as a share of income have plummeted over the past forty years (grey line).



Source: Economic Policy Institute, FRED, Author

Figure 1

What prompted this shift? The postwar compromise worked well so long as growth remained robust. However, as real growth slowed, inflation rose and corporate profits fell, supporters of neoliberalism (Friedrich Hayek and Milton Friedman) argued that a shift in ideology and policy was needed. The new ideology or political program (neoliberalism) meant that "markets are in particular to be preferred over states and politics, which are at best inefficient and at worst threats to freedom."[1] Throughout the crisis-driven 1970s, Friederich Hayek, Milton Friedman and other

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[1] Crouch (2010), p. vii. Other names used to describe this ideology include market fundamentalism, market liberalism, market triumphalism, or the Washington Consensus. The argument is advanced that unfettered markets are best capable of "satisfying human aspirations."

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right-wing economists pushed for adoption of "free market" or neoliberal solutions. Throughout the 1970s, capital became increasingly concerned that the labor market had become too "rigid," wages were too high and government regulations impeded corporate profits.

The election results in the UK (1979) and the US (1980) effectively buried the postwar compromise. Government has been transformed over the past forty years from a countervailing force to markets that balanced the needs of labor and capital (under the postwar framework, aka, managed capitalism) into a full-fledged facilitator of financial markets and capital. At his first inaugural address, Reagan memorably stated: "Government is not the solution to our problems; government is the problem." This claim and the policies that have followed have reallocated income and wealth from the bottom to the top, while eroding faith in the ability of government to deliver collective solutions. Another result has been the emergence of populist solutions on both the left and right.

II. Background: The Postwar Compromise

As discussed above, the postwar compromise included an agreement between capital and labor ("Treaty of Detroit") that ensured that wages would rise along with increases in productivity growth. Business had reluctantly agreed to this framework, given that there were serious concerns about the viability of the capitalist system, given the Great Depression that had preceded World War II. In support of this initiative, the government utilized macroeconomic policies in support of full employment and supported organized labor in its negotiations with capital. From 1945 to 1970, real wages and productivity rose rapidly supporting growth in aggregate demand.

There were several other aspects to the success of the postwar compromise that included constraints that were imposed during the Great Depression on banks and other financial institutions. In particular, the Banking Act of 1933 (Glass-Steagall Act of 1933) included provisions that mitigated the types of speculative behavior that had contributed to the collapse of the banking system in 1933. Banks and other financial organizations were compartmentalized; interest rates were regulated by the Federal Reserve (Regulation Q); and commercial banking was separated from investment banking, helping to ensure that *banks did not utilize insured deposits to engage in destabilizing speculation.* The Banking Act also provided banks with deposit insurance that ended panicked "runs" on bank deposits. In short, banks operated under the 3-6-3 rule (borrow at 3%, lend at 6%, and be on the golf course by 3:00 pm). Finally, banks were subject to extensive regulation and supervision. This system generated a quarter century of financial stability as banks operated as servants to productive capital. Success for a bank was closely aligned with its clients meeting their goals.

The Bretton Woods Monetary Accords were the final component to the postwar compromise. The U.S. dollar became the reserve currency, linked to gold at a price of $35 per ounce. The exchange rates of other currencies were in turn linked to the U.S. dollar. This fixed exchange rate system, in combination with capital controls, accomplished several objectives. First, it restricted global flows of speculative capital that undermined exchange rates during the 1920s and 1930s; second it provided flexibility to nations to formulate macroeconomic policies that worked in their interest; and third, it provided fixed exchange rates that could be adjusted under specific conditions. This agreement helped facilitate the recovery of Western Europe and Japan from World War II.

In terms of macroeconomic performance, annual economic data from the postwar period (1948-1973) is compared with the post-1980 period in the chart below. Real GDP growth was 1.5% higher under the postwar compromise and the average rate of unemployment was 1.4% lower. Unit labor costs rose by more in the postwar period (relative to its average rate of increase since 1980), despite low inflation, given the link between productivity growth and wage increases. And output per hour was 0.90% higher than it has been since 1980. Income inequality declined sharply under the postwar compromise and financial markets were remarkably stable.

Table 1

MACROECONOMIC DATA: VARIOUS PERIODS				
	Real GDP Growth	Unemployment	Unit Labor Costs	Output Per Hour
1948-1973	4.1%	4.8%	2.5%	2.80%
1974-1979	3.0%	6.8%	7.7%	1.40%
1980-2020	2.5%	6.2%	2.2%	1.90%
2010-2020	1.8%	6.4%	1.6%	1.20%

Source: FRED,Author

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By the late-1960s, the postwar compromise experienced turbulence as a series of events unfolded. First, Western European, and Japanese industries were by then fully recovered from World War II. The U.S. trade balance narrowed significantly in response to rising competition and the U.S. was funding a balance of payments deficit that generated a glut of U.S. dollars. From 1967 to 1971, foreign central banks absorbed the US dollars as their economies imported inflation from the U.S. The Johnson administration's decision to finance the war in Vietnam and the Great Society also fueled rising inflation.

Another source of stress was attributable to the strength of organized labor. The economist Michal Kalecki had argued in 1943 that the loss of the "sack" to business owners, or what Marx had called the "reserve army of labor," would result in heightened class consciousness of workers, reducing workplace discipline and elevating demands by owners of capital for greater control over the workplace. Kalecki argued that ultimately discipline mattered more to capital than profits. In 1968 and 1969, wildcat strikes erupted that added tension to an already unsettled situation, providing one more source of pressure on prices.

In August 1971, President Nixon severed the link between the U.S. dollar and gold; several years later, capital controls were lifted by the U.S. and subsequently by other developed nations. These steps increased the mobility of capital strengthening its hand in negotiations with labor over wages, benefits, etc. Capital was now mobile; labor was not. Also in August 1971, a memorandum was prepared for the Chamber of Commerce by Lewis Powell, at the time a corporate attorney (and later a Supreme Court justice), that helped launch a counterattack by capital: The memorandum stated

> "Business must learn the lesson that political power is necessary, that such power must be assiduously cultivated, and that when necessary it must be used aggressively and with determination – without embarrassment and without the reluctance which has been characteristic of American business." [2]

Jacob Hacker (2011) states that the resultant "organizational counterattack" by business was both "swift and sweeping." He notes that corporations assembled a major lobbying presence in Washington D.C.: (1) corporations with public affairs offices increased from 11 in 1968 to 400 a decade later; (2) firms with lobbyists increased from 175 in 1975 to 2,500 in 1982; and (3) political action committees (PACs) representing business increased from 300 in 1976 to 1,200 by mid-1980. The results of these efforts became clear as business scored several major victories against consumer interests and labor unions during the Carter administration.

These initiatives dovetailed well with the neoliberal program that had been incubating in the wings for several decades.[3] This program originated in 1947 when Friedrich Hayek arranged a meeting of a group that would be known as the Mont Pelerin Society (MPS). The meeting consisted of forty men (all men) who supported free markets, individual liberty, and private property. They also opposed the New Deal and what they called "collectivist" or "statist" policies. Hayek was convinced that these policies would lead to totalitarianism.[4] Members of the MPS supported private property and the free movement of capital. Unlike libertarians, they viewed enforcement of those rights as the primary mission of a strong state, which would be allied with capital. They did not object to corporate monopolies, but they vehemently opposed organized labor.[5]

At the time the neoliberal program was introduced, Keynesian policies and the New Deal (managed capitalism) were meeting with success as the world recovered from WWII. In addition, unfettered markets were viewed as having been responsible for the Great Depression, and memories of that disastrous experience remained fresh in policymaker's minds. However, Hayek and other members of the MPS understood that they were playing the "long-game." They created the foundation for a free-market approach and were prepared to wait for an opening. Wealthy individuals and various corporations supported the MPS and provided necessary funding to the organization and its affiliates over the next several decades as the MPS patiently waited its turn.

For this effort to succeed, Hayek believed that strategically the MPS had to attract interest among the intellectuals (who he called the "second-hand dealers in ideas"). Once the intellectuals had "bought in" to the cause, they would help spread the word. To help facilitate this outcome, members of the MPS created numerous think tanks, including the American Enterprise Institute (AEI), the Cato Institute and later the Heritage Foundation. Institutes were also setup in the UK, including the Adam Smith Institute and the Institute for Economic Affairs. James Buchanan would launch Public Choice Theory (which viewed governments as "at

[2] Powell (1971).

[3] For more detailed interpretations of neoliberalism, see Mirowski (2013) and Harvey (2005).

[4] Other members of MPS included Milton Friedman, James Buchanan, Ronald Coase, and George Stigler. Friedman, Coase, and Stigler were professors at the conservative University of Chicago, where Hayek would subsequently be employed.

[5] The initial test-case for neoliberal policies occurred in Chile following the coup against the democratically elected president, Salvador Allende. The imposition of policies resulted in massive oppression of the Chilean people. The thrust of the movement remains closely aligned with the objectives of the global financial sector.

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best incompetent and at worst corruptly self-seeking")[6] and Henry Manne would establish a program to "educate" judges about the virtues of free markets and neoliberalism.

The MPS became increasingly influential during the 1970s as tensions accelerated and stagflation (stagnant growth and rising inflation) took hold. By the end of the 1970s, neoclassical economic models had shifted in a similar direction, embracing the free market. Milton Friedman proposed direct control of the money supply (monetarism) to reduce inflationary pressures. Newly appointed Federal Reserve chair Paul Volcker hiked short-term interest rates to peak levels of 20%, prompting a severe double-dip recession accompanied by record-level (10%) unemployment. Rising unemployment further undermined the authority of organized labor, which further strengthened capital.

Even before Reagan was elected as president, the balance of power had shifted toward capital, as the Carter administration deregulated several industries (e.g., trucking, airlines, telecommunications, and finance). However, implementation of these policies would become far more aggressive and confrontational under Reagan. In a highly visible move, Reagan fired the striking air traffic controllers and disbanded their public sector union. He appointed people to the National Labor Relations Board who supported management in ongoing disputes with organized labor. He appointed people to government agencies whose views were antithetical to the missions of these agencies, as regulations were either eliminated or else ignored. Reagan engineered tax cuts for corporations and wealthy individuals in 1981. *Indicative of the dramatic rightward turn in economic policies as well as the loss of organized labors' influence, the real value of the minimum wage declined by 30% throughout the eight years he was president.*

III. Finance and Inequality

The rightward shift in policy produced a transformation in economic activity away from the mix of government and markets (managed capitalism) toward the "free market," *especially finance.* The free market had been actively marketed by Milton Friedman and others throughout the 1970s. Margaret Thatcher, an admirer of Friedrich Hayek, would boldly state that "There is no alternative," noting that "There is no such thing as society. There are men, women and families." The push was on to reverse the social safety net and leave individuals to their own wiles in determining their own future, an unfortunate concept of individual liberty. Reflecting years later on the transition, Milton Friedman stated:

> "Only a crisis – actual or perceived – produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around. That, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes the politically inevitable."

Two dimensions to this transition, that are largely ignored, were particularly noteworthy.

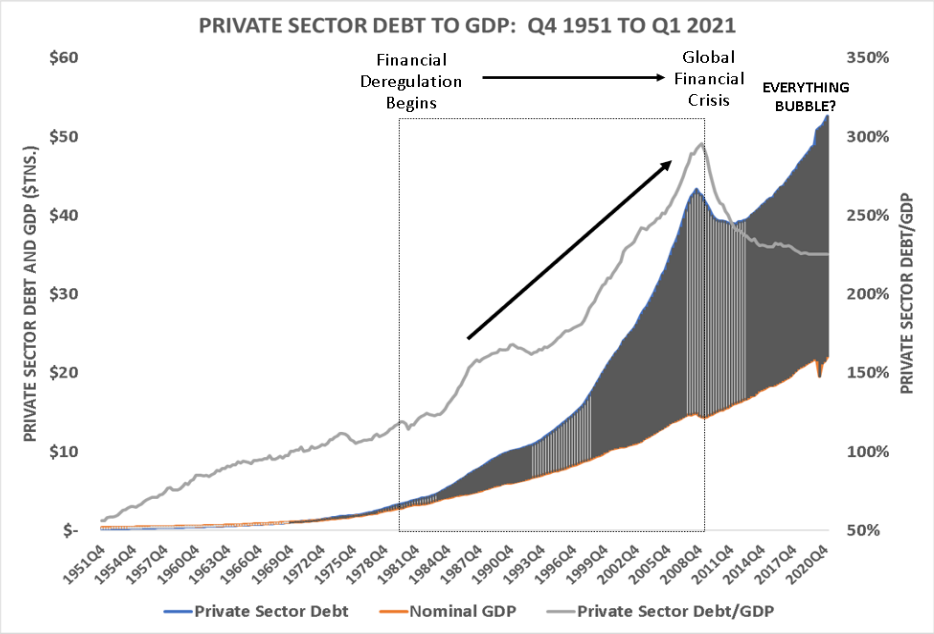
- *The first trend was the shift of income away from labor (and wages) and toward capital (profits).* Multiple factors have suppressed wages over the past forty years though the shift from government and organized labor as countervailing factors to owners of capital to the neoliberal program of deregulation, privatization, and globalization was a key driver of the income and wealth disparity.
- *The second trend was the shift toward financialized (finance-led) growth.* Operating under constraints from 1945 to the 1970s, finance had served as a servant to productive capital. The decision to remove Depression-era constraints, both voluntarily and in response to arbitrage and innovation by financial firms, brought about the turn to financialization, as investment in productive activity has increasingly given way to asset-based speculation.

As these transformations unfolded, an ideological infrastructure evolved. The concept of "efficient markets" and "shareholder value maximization" became affiliated with the notion that financial institutions and markets were capable of self-regulation. The deregulation accelerated throughout the 1980s and 1990s under both political parties. And as the Depression-era constraints were removed, credit growth accelerated relative to incomes in a series of debt-driven boom-bust cycles (see chart below).[7]

[6] Crouch (2010), p. 63

[7] The political party of the administration in power made little difference; in fact, the Clinton administration was by far the strongest advocate of unfettered finance. Steps taken during the 1990s set the stage for the global financial crisis in 2008.

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Source: Federal Reserve, FRED, Author

Figure 2

Financialization describes the over-arching importance of finance in dictating economic outcomes. In part, it reflects the symbiotic relationship between credit and asset prices (see diagram below). Once constraints are lifted, as credit growth accelerates, it fuels rising asset prices, which in turn spurs more credit creation, greater use of collateral, etc., in a positive feedback that ultimately results in a boom-bust cycle.

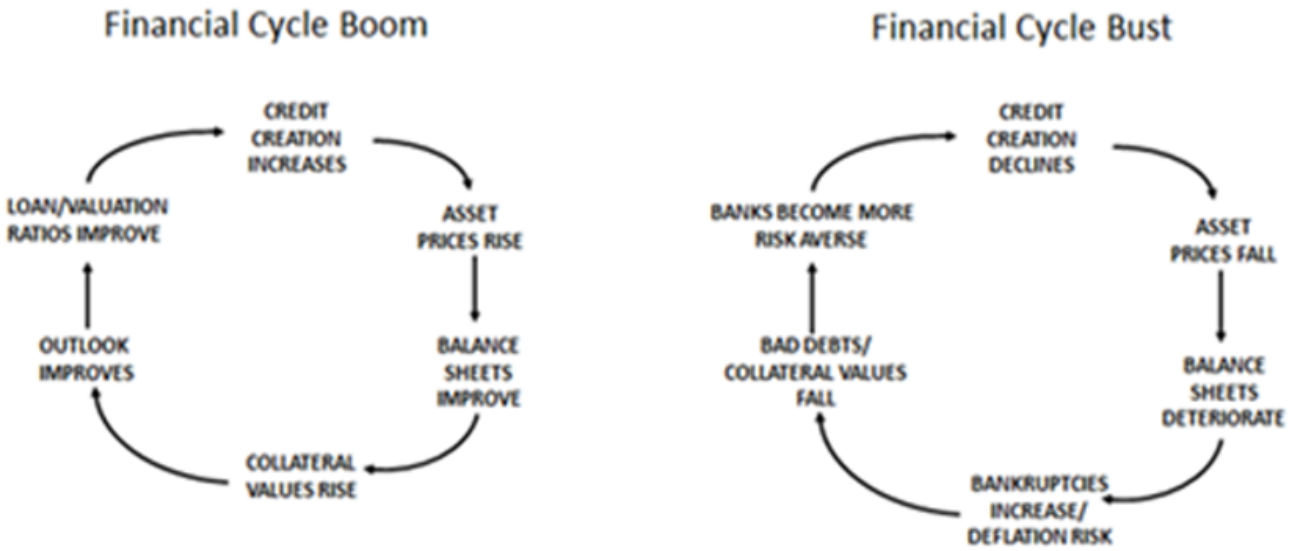


Diagram 1

The financialization of the US economy also impacted the finance, insurance, and real estate (or FIRE) sector, households, and non-financial corporations.

a) Finance, Insurance and Real Estate (FIRE) Sector

The explosive growth in credit elevated the profits of the Finance, Insurance and Real Estate (or FIRE) sector, which accounted for 40% of overall corporate profits from 2001 to 2004 and continues to account for a greater share of profits today than it did during the 1960s and 1970s. Major banks benefit from a low cost of funds, given access to deposit insurance, "too-big-to-fail," and access to the lender of last resort. Salaries and bonuses paid to employees in the financial markets were about equal to those paid in other sectors in 1980, but by 2007, compensation for finance was 70% higher than for other occupations requiring similar

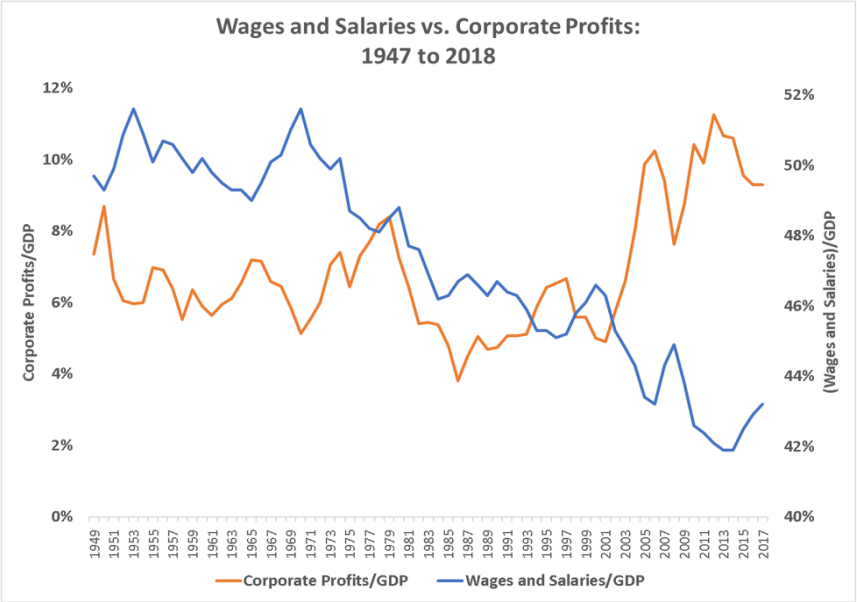
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levels of education. [8] This is largely attributable to the economic rent collected by financial institutions since 1980.

Revenues generated by major banks and other financial firms were not "clawed back" during the global financial crisis. For example, the insurance company AIG, issued credit default swaps (CDS) that provided insurance to major financial institutions who purchased the swaps. The premiums paid to AIG were utilized to pay bonuses and dividends to shareholders. These funds were not used to build reserves against potential losses, given the assurances of a senior official at AIG that the instruments being insured (CDOs, etc.) were AAA-rated, meaning reserves were not required. In any case, the U.S. Government ended up paying $180 billion to pay off holders of these swaps in full (with no haircut applied), as senior executives at AIG walked away with their compensation intact.

b) Household Sector

Suppression of wages compelled households to borrow to purchase homes, autos, education, health care, etc., resulting in rising levels of financial fragility. Stagnant wages have elevated corporate profits since the early 1980s (see chart below).



Source: Federal Reserve, FRED, Author

Figure 3

Home purchases were a significant driver of economic activity during the early 2000s. House prices doubled in value (in the 20 major U.S. cities) and mortgage debt likewise increased from $6.83 trillion to $12.76 trillion between 2000 and Q2 2006. House prices peaked in Q2 2006 and then proceeded to fall by 33.6% by Q1 2012. Throughout the house price boom from 2000 to 2007, mortgage rates declined as financial institutions extended loans to numerous customers, including subprime and Alt-A loans. Many of these loans were packaged into securities and sold to investors via Collateralized Loan Obligations (CDOs), etc.

To illustrate how this process worked, suppose a homeowner purchased a home in Q1 2000 for $100,000, borrowing $80,000. She held a 20% equity position (equal to $20,000) in the home. Over the next six years, the home doubles in value. Throughout this period, this homeowner has been refinancing the mortgage, given declining interest rates, and each time increases the amount she has borrowed, while retaining her 20% equity position. The mortgages peak in Q2 2006 at $160,000, meaning she now has a $40,000 equity position in the home. The additional $80,000 she has withdrawn in equity over the six-year period have been used to support her income. It has also contributed to growth in aggregate demand, though importantly it is a liability for the borrower, so it will need to be repaid.

Real estate prices peak in Q2 2006, and then began to decline, slowly at first, and then, into the crisis, rather abruptly. The value of her home declines by 33.6% from Q2 2006 to Q1 2012, meaning that the home is now priced at $132,800. She is now underwater by $27,200, given her outstanding mortgage of $160,000. Admittedly, this example simplifies reality, given that the homeowner would have paid down the mortgage, etc., but the reality holds. Many homeowners

[8] Phillipon and Reshef (2008).

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borrowed against the rising value of their homes, given little or no growth in their income, and this decision increased financial fragility.[9] And in the real world, the terms of the loans (no income, no assets no job or NINJA, etc.) were far more egregious than in the example directly above. As Paul Mason states:

> "If a declining share of income flows go to workers and yet a growing part of profits is generated out of their mortgages and credit cards, you are eventually going to hit a wall. At some point, the expansion of financial profit through providing loans to stressed consumers will break, and snap back. That is exactly what happened when the subprime bubble collapsed."

c) Non-Financial Corporate Sector

Financialization has also dramatically reshaped corporate governance at non-financial corporations (NFCs). The principle of shareholder value maximization was originally introduced by Milton Friedman in a 1970 article he published in the *New York Times Magazine*, in which he argued that maximizing shareholder value should be the only objective or corporations.[10] In November 1982, the SEC implemented Rule 10b-18 permitting corporations to buy back their own stock.

To illustrate how this might work, assume that Rachel Smith is the CEO at XYZ Corporation. She is being pressured by stock analysts at various investment banks to increase shareholder value. During the previous two years since accepting the post as CEO, Smith has cut employment by XYZ by 5,000 in a move to "improve efficiency." This has boosted the stock price from $40 to $50 per share. Smith now wants to engineer a buyback of XYZ shares. She proposes to the board that the company borrow $1 billion (which can be done at record low interest rates, given Fed largess) from ABC Bank to buy back 20 million shares of stock. The board grants its approval, and the CFO engineers the transaction. Stock analysts give the transaction a "thumbs-up" and issue a "buy" order on the stock. The share price rockets to $60 a share and annual compensation for Smith increases from $20 million to $25 million.

The above stock buyback contributed to the compensation provided to Smith and to shareholders of XYZ stock. However, the transaction has not resulted in the creation of value. In fact, the net effect, as documented by William Lazonick (2014, 2016), has been to hollow out corporations, which are incentivized to cut investments, employment, and R&D spending to meet short-term share price or earnings-per-share (EPS) targets. Financial engineering has become increasingly commonplace over the past forty years. These activities have made already wealthy U.S. households even more so but have not promoted job or value creation.

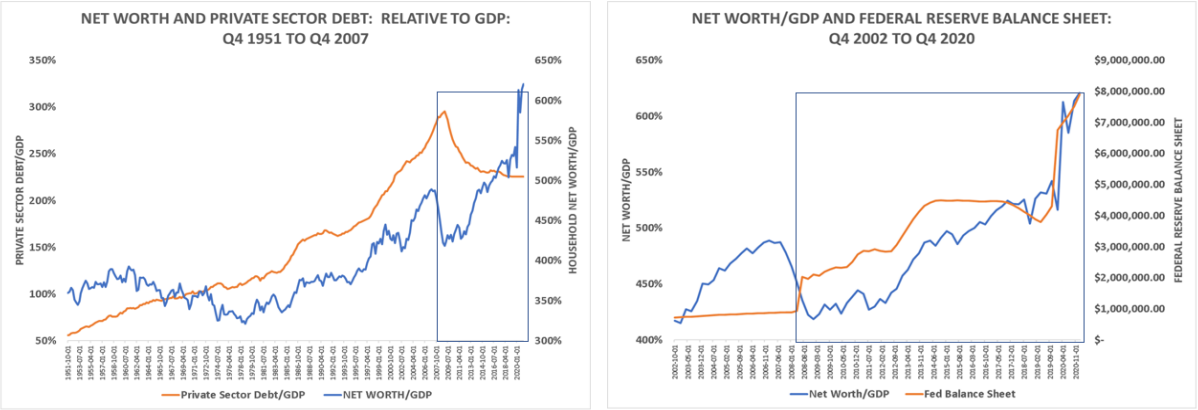
d) Debt Creation and Net Worth

The explosive growth in private sector debt from the early 1980s until 2007 (orange line in left hand chart below) resulted in significant increases in net worth to GDP (blue line in both charts), with two major downshifts, first during the tech bubble and once again in the global financial crisis. Since the onset of the global financial crisis, private debt growth has slowed relative to GDP, especially within the household sector. However, as the right-hand chart illustrates, the Federal Reserve balance sheet has increased significantly, given Quantitative Easing (QE). The Fed's balance sheet has increased from under $1 trillion in 2008 to $8 trillion and as it has increased, asset prices have ballooned as well.

[9]The economist, Hyman Minsky, suggested that purchasing a leveraged asset while depending on that asset to appreciate was what he called Ponzi finance. And this is how the U.S. economy financed itself throughout the early years of the 2000s.

[10] Friedman stated: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits….".

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Source: Federal Reserve, FRED, Author

Figure 4

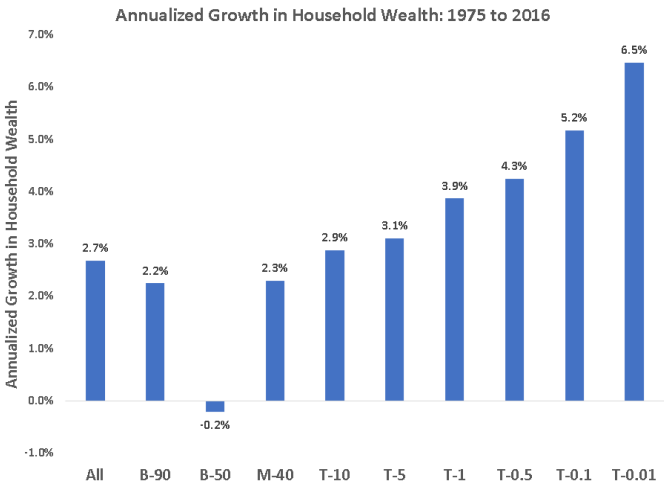
When the Fed conducts Quantitative Easing, it purchases securities from the financial markets, primarily government securities and mortgage-backed securities. In exchange, the Fed creates reserves within the banking system, that now (since 2008) pay interest to those institutions. Importantly, reserves cannot be lent to private borrowers; in any case, the objective in creating the reserves was not to spur borrowing, but instead to reduce interest rates. The reserves remain "stuck" in the banking system.

With that said, reduced interest rates generate capital gains to the sellers of those assets, who then can purchase other assets with the cash provided by the banking system. So, the net effect of these transactions is that *asset prices tend to rise.* This has been the pattern of growth in financialized economic systems for several decades.

e) Financialization and Inequality

Financialization has contributed to rising levels of income and wealth inequality, given enormous capital gains that have occurred over the past forty years. The top 10% of U.S. households now own 88% of all U.S. stock and 86% of all financial assets. On average, a household in the top 10% owns more than 66 times the amount of stock owned by a household in the bottom 90%. And the top 1% own 53% of all U.S. stocks, meaning they own 112 times the stock owned by the bottom 99%.

Average annual rates of growth in household wealth are illustrated in the chart below by households. B-90 refers to the bottom 90% of households by wealth, B-50 to bottom 50%, M-40 to middle 40%, T-10 to top 10%, etc. Remarkably, the rates of growth increase the further up the ladder one goes. The bottom 50% actually endured losses in net worth from 1975 to 2016.



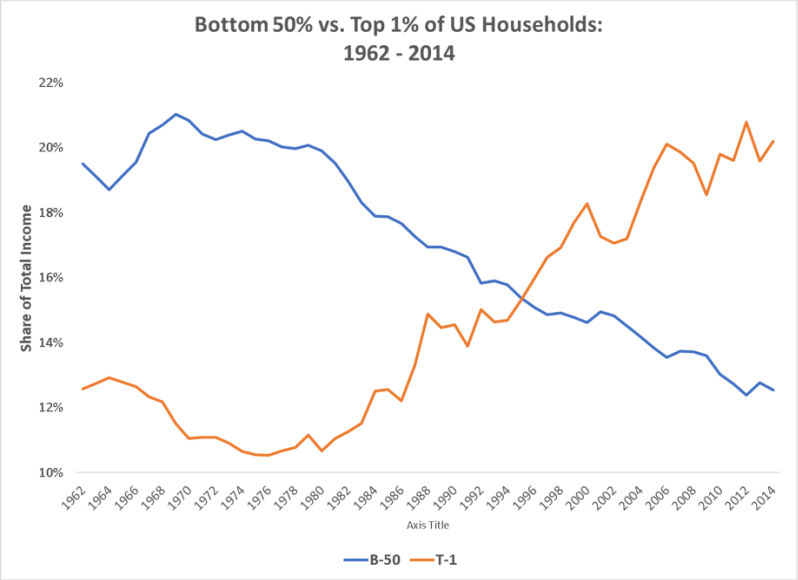
Source: Federal Reserve, FRED, Author

Figure 5

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The gains have been particularly robust at the top of the distribution, namely within the top 0.01% of US households. In a neoliberal economic system, economic power translates into political power (e.g., Citizen's United, et al). As the Supreme Court justice Louis Brandeis clearly stated in the early 20th century: "We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both."[11]

An examination of incomes over the past forty years likewise reveals increased concentration. The incomes of the bottom half of U.S. households (B-50) have fallen from close to 20% of total income in 1982 to slightly more than 12% in 2014. The share going to the top 1% of households (T-1) has increased from 11% to 20%. If the share going to the bottom 50% of households had remained stable at 20%, on average a household in that group would have earned more than $25,000 in 2014, as opposed to the $16,200 they actually earned. And median wage earners (M-20 or from 40% to 60%), according to Mishel and Bevins (2021), would have earned $20,696 more than the $48,852 they actually earned in 2017, which would have reduced their need to borrow.



Source: Piketty, Saez and Zucman (2018)

Figure 5

The redistribution of income from the bottom to the top has implications for growth in aggregate demand. The top 10% of U.S. households tend to save a significant portion of their income, while the bottom 80% spend virtually all of theirs. So when income is reallocated to the top, it creates new pools of savings. Tax cuts for the wealthy have had similar implications, meaning that there are massive pools of capital that have accumulated and are looking for a home. At least a portion of this "wealth" has found its home in the financial markets, which have fueled rising inequality. Importantly, this shift has not stimulated productive growth, job creation, R&D, etc.

IV. Financialization and the Fed

The Federal Reserve has fostered financialization in four ways:

(1) The Fed strongly *supported financial innovation and deregulation* under Alan Greenspan. Paul Volcker, who preceded Greenspan as Fed chair, had a healthy skepticism as to deregulation. Toward the end of his life, Volcker commented that the most beneficial financial innovation he could think of was the ATM machine. The decision by the Reagan administration to appoint Greenspan as chair was partially driven by his support for free markets and deregulation (as an acolyte of Ayn Rand). In any case, both political parties supported the shift to deregulation.

(2) The Fed utilized an *asymmetric monetary policy* under Greenspan that persists today. To some extent, monetary policy has been forced to respond to the impact of deregulation, given that the "herd" of financial market participants are far more of a threat to financial stability than they were prior to deregulation. The "Fed Put" results in the Fed cutting short-term interest rates whenever growth slows, or asset prices fall; this provides a movable floor to asset valuations. However, in the reverse

[11] The wealth of three people in the United States is now more than the amount held by the bottom 50% of U.S. households, a staggering statistic that underscores Brandeis's point.

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situation, the Fed has not been inclined to raise short-term interest rates. This creates moral hazard ("heads I win, tails someone else loses"), which has fueled upward movements in asset prices that dates back to the stock market crash in 1987.

(3) The Fed's participation in the *bailout of major banks and non-banks* (e.g., AIG). When asked by Scott Pelley of 60 Minutes how the Fed financed the bailout of AIG the day before, was it tax money, Bernanke stated "No. It's not tax money. The banks have accounts with the Fed, much the same way that you have an account in a commercial bank. So, to lend to a bank, we simply use the computer to mark up the size of the account they have with the Fed." This response provided powerful impetus for underwater homeowners and small businesses to ask why they were not recipients of Fed largess.

(4) Implementation of *Quantitative Easing* policies that purchased securities from financial market participants while providing banks with interest-earning reserves. These purchases boosted asset prices and further widened the divide between the top 10% (and even more so, the top 1%) and the rest of U.S. households.

Ideology overpowered reason during the 1980s and 1990s. Unfortunately, there was little understanding as to what differentiates banks and finance in general from other sectors of the economy. A commercial bank is granted the privilege of creating credit when it receives its bank charter. This privilege is unique to the banking system. When a bank creates credit, given double-entry bookkeeping, it also creates money. When a bank extends a loan of $10,000 to someone, it places a deposit in an equivalent amount in her account. *Money is a public good.* The belief that banks were capable of self-regulation implicitly assumed that banks would manage and monitor risk properly. This granted banks an enormous opportunity. Given that credit growth fuels asset price appreciation, as constraints were lifted, banks shifted away from support of productive activity toward asset-based speculation, as proprietary trading became an increasingly important source of profits. This repeated the experience in the years leading up to the Great Depression in a somewhat different format. The conservative economist and co-founder of the original Chicago School, Henry Simons, remarked that applying "free market" rules to finance is to commit a "category error." The Fed chair, Marriner Eccles similarly testified before Congress that given the economic cycle, "laissez-faire in banking and the attainment of business stability are incompatible." This is at least in part due to the presence of positive feedbacks; the concept of a "market clearing price" is foreign to financial markets, especially once constraints no longer exist.

Finance can serve as a responsible servant to the productive economy, or it can instead become an irresponsible master. This was understood by the authors of the Banking Act of 1933, which was designed to address the issues that resulted in the Great Depression. The application of free market principles to banking and finance inevitably ends in a financial crisis, though positive feedbacks between credit growth and asset price appreciation can provide the "illusion of a "new economy," as they did during the 1920s and again in the early 2000s. Keynes stated the situation well when he said "Financial markets can remain irrational for far longer than any of us can remain solvent"….though he should have added, especially given the Great Depression, "but not forever."[12] As the process ended in 2008, it became clear who the losers were, namely the bottom 90% of U.S. households (especially the bottom 50%), many of whom lost jobs and their homes, and the U.S. taxpayer.

The objective of this article is not to rehash the global financial crisis nor to bash the Federal Reserve. Mainstream economists as a profession (many of whom work at the Federal Reserve System) were lulled into a false sense of comfort by the emergence of a new set of economic (known as Dynamic Stochastic General Equilibrium or DSGE) models that posited stability.[13] Remarkably, these models did *NOT* incorporate money, finance, credit, or banks, based on the assumption that money is "neutral" and does not impact the real economy.[14] Little did they know….

Since the early 1980s, the Fed has protected its independence within the Federal Government based on concern about political pressure that might result in inflationary monetary policy. Inflation since the 1980s has morphed from goods and services prices and become lodged in asset prices. However, asset-price inflation generates capital gains (realized or unrealized), which results in pressure being applied by market participants, etc. to perpetuate this process, via the Fed Put, etc. In my view, the Fed's argument re independence has been eviscerated by recent developments. In fact, the Fed has never been more effective than when it was led by Marriner Eccles and worked closely with the U.S. Treasury Department during the Great Depression and World War II. As financialization unfolded, the Fed has become captive to the financial industry it is supposed to regulate (cognitive capture), as others have recognized.[15]

[12] John Kenneth Galbraith referred to this pause as the "bezzle," namely the period in which the winner enjoys the gains while the loser is not even aware of losses.

[13] For more discussion of these models, see Balder (2018, 2020) and Keen (2011 and 2017).

[14] I have discussed the misunderstandings of money by mainstream economics in numerous articles including Balder (2018 and 2020). MacLeay, et al (2014a and 2014b), Keen (2011 and 2017) and Werner (2016, 2014 and 2005) provide insights in support of this argument.

[15] See Canova (2014, 2010).

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If and when the Fed acts to end Quantitative Easing, asset prices will fall sharply, as they did in December 2018. Asset prices have been inflated over the past decade by QE and stock buybacks, despite weak growth and modest support from the underlying fundamentals. The private sector debt overhang is still massive, especially given how it is distributed within the household sector today; it continues to cast an immense shadow over future growth in aggregate demand. Record low yields on junk bonds should send a cautionary note. Under the current set up, the Fed today appears to have little choice but to continue doing what it has been doing, acting as a "market maker of last resort," despite the fact that its actions only serve to further exacerbate the concentration of income and wealthy.

There have been numerous innovations, including ongoing discussions about whether central banks should create digital currencies (CBDCs) that could be deployed directly to citizens. Morgan Ricks (2016) and colleagues have proposed FedAccounts, which could be utilized by the un- and underbanked. There is little question that the financial sector will be transformed by these developments over the next decade or so. The main question is whether another financial crisis will be required to move the needle on these types of initiatives. The growing concern about inequality is assisting ongoing efforts to rethink how finance operates, though it cannot happen quickly enough.

There is a need for a more robust discussion about the Federal Reserve's conduct of monetary policy and whether and how it has contributed to financialization and rising inequality. Members of the Federal Reserve System have voiced legitimate concerns about rising inequality in speeches and the Fed regularly convenes conferences and publishes written articles, including its annual Economic Well-Being of U.S. Households about this important topic. To the best of my knowledge, no research departments within the Federal Reserve System has studied the implications of Fed policies on the distribution of income and wealth (race, gender, etc.). A no-holds review by people working outside the central bank should be made a priority for the Federal Reserve System. And it should also incorporate the economic models that are utilized both inside and outside the Federal Reserve System. It appears clear, based on comments from insiders and outsiders, that the neoclassical economics profession is not equipped to address these issues.[16]

a) Marriner Eccles: Outstanding Fed Leadership

By today's standards, Marriner Eccles was an unusual choice to chair the Federal Reserve. He grew up in Utah as the son of a Mormon banker who believed in "rugged individualism" and hard work. Marriner never went to graduate school or college; in fact, he never graduated from high school. He would later claim that this left him with "less to unlearn." He arrived in Washington D.C. as a banker in February 1933 as one of two hundred witnesses who were to appear before the Senate Finance Committee, which was investigating the cause of the Great Depression.

Eccles was the only witness among the two hundred who opposed a balanced budget, His remarkable statement at that hearing is well worth reading in full (Eccles 1933), as it provides remarkable insights. Eccles strongly recommended that the government *go on a "war footing"* and stimulate aggregate demand, much as it had done during World War I. He stated:

> "If a man owed himself he could not be bankrupt, and neither can a nation. We have got all of the wealth and resources we ever had, and we do not have the sense, the financial and political leadership, to know how to use them."

Eccles noted that the problem was not a lack of resources or wealth, but the fact that workers did not have sufficient income to purchase production. He acknowledged that the expansion of credit had closed the gap during the 1920s but recognized that "eventually you reach the point of saturation – because you cannot keep forever the process of consumption on the basis of credit." As growth in credit slowed, debtors stopped repaying debt, unemployment rose, banks failed, and the economy spiraled downward into the Great Depression.

The parallels between Eccles' analysis of the Great Depression and the global financial crisis that occurred 75 years later are striking. He focused on how wealth creation during the 1920s tilted toward the wealthy and corporations, which stymied growth in aggregate demand. Eccles criticized the sharp reduction in corporate and inheritance taxes that had been pushed through during the 1920s. These had "primarily benefited the rich and led to excessive wealth accumulation." In combination with lax monetary policies engineered by the Federal Reserve in 1927-1928, the result was an excessive expansion of credit that spurred the Great Depression that followed.

President Roosevelt would appoint Eccles to chair the Federal Reserve System during the 1930s and 1940s. Eccles navigated monetary policy through the Great Depression and the Second World War. Most remarkably, given his childhood, Eccles had an extraordinary ability to reach beyond his own experiences. As he observed the hardship endured by the customers of his bank during the early 1930s, he concluded that self-help and hard work were not sufficient to address the Great Depression. The

[16] For varying perspectives, see Mirowski (2013), Smith (2011), Romer (2016) and Galbraith (2009)

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testimony he delivered in February 1933 would help shape the New Deal.

Importantly for the economy today, Eccles astutely recognized that the inequitable distribution of income in 1933 made it incumbent on the U.S. government to spend because leveraged households and businesses were unable and/or unwilling to do so. This lesson was understood when the pandemic arrived in March 2020.

b) Fixing What Ails

Solutions to current challenges definitely exist; beyond ideological blinders, the primary question is whether the political will exists. Reversing financialization, encouraging creation of public banks, ensuring jobs for everyone who can work (or a universal basic income) and restructuring of the Federal Reserve System would be at the top of my list. However, the more important question that will be discussed here is how to create an opening for potential transformation, especially in the current hostile political climate. In my view, that is a far more difficult challenge than developing workable solutions.

A deeply troubling trend known as "agnotology" has become apparent in recent years. Robert Proctor has defined agnotology as "the study of willful acts to spread confusion and deceit, usually to sell a product or win favor." Mirowski (2013) states that, "The aim of agnotology is not so much to convince the undecided, but to fog the minds of anyone lacking the patience to delve into the arguments in detail (which is pretty much everyone)." There is no question that the use of agnotology has exploded in recent years with the growth of social media (Facebook, etc.).

Neoliberal think tanks have participated in this effort and have been effective in muddying the waters. One such think tank has argued that the global financial crisis was caused by Fannie Mae, Freddie Mac, and the Community Reinvestment Act (CRA). And many otherwise knowledgeable people believed these false claims, perhaps given a disparaging view of government. In addition, neoliberal think tanks also have argued that climate change is not a problem. The main objective to these statements and the research that "supports" them, is to delay action by creating confusion in the "marketplace of ideas." These think tanks have successfully managed to scuttle serious efforts to develop workable solutions to real-world problems.

Rather than assemble a wish-list of changes that will not be adopted, perhaps the more important question is to examine *how and where change is likely to begin.* There is no easy answer to this question. Hayek and the MPS met with success in reshaping thought, arguing that free markets are preferable to states and politics. Friedman became the chief marketer for the notion that "market good, government bad," regularly utilizing the invisible hand of Adam Smith in defense of the neoliberal program. His argument took hold as the postwar compromise deteriorated.

Karl Polanyi (1944) stated that part of the appeal of the "free market" ("laissez-faire") of the 1920s was the promise that it made to excise government in favor of the invisible hand. In the words of Ronald Reagan, "government is the problem." Polanyi correctly stated that this promise was "utopian," meaning impossible to achieve. Democracy, open discussion of ideas, development of policies, etc., is a messy business. If long-term solutions are to evolve in response to current-day challenges, it is not entirely clear where they will emerge.

Fortunately, several books have recently been released from outside the economics and financial markets profession that discuss these issues. Robert Putnam (2020) examines the origins of the New Deal in the Progressive Movement that materialized from the 1890s until 1920, before going on hiatus for a decade. It returned with the election of FDR in 1933, as many of his advisors had themselves participated in the Progressive movement. Importantly, Putnam notes that the Progressive movement "did not have a national blueprint in mind at the start." Perhaps most relevant to today, the movement was *"intensely pragmatic," and "not premised upon ideological beliefs."*

Many of the proposals that emerged evolved out of local communities before they became national programs. Putnam calls on people to build a "grassroots, issues-based movement," noting (in the words of E.J. Dionne, that "Democracy is a long game." If long-term solutiions are to evolve in response to current challenges, they will likely originate in civil society, from non-governmental organizations, churches, professional associations, etc. It appears clear, despite the Biden administration, that there is only so much government can do to launch these initiatives.

As regards the topic of this article -- the contribution of neoliberal ideology and finance to rising inequality -- perhaps the first step is to understand the drivers of inequality, how financial markets and institutions have impacted the division of wealth, the role of ideology in shaping outcomes, and the reasons why finance is so biased toward those who already own enormous amounts of wealth. We need to understand the impact of financialization on U.S. households and then to scrutinize and understand why economic power morphs into political power.

It is important not to fall into the trap of developing purely "economistic" solutions, as I have often in my writing, given that humanity is about much more than the accumulation of wealth. Michael Sandel (2020) states that the grievances today are not only economic, *but also moral and cultural.* Especially among those voters who feel excluded, Sandel argues the issue is not "simply wages and jobs, but also social

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esteem." There is a need to restore the "dignity of work." He argues that our meritocratic society "…has a dark side. The more we view ourselves as self-made and self-sufficient, the less likely we are to care for the fate of those less fortunate than ourselves. If my success is my own doing, their failure must be their fault." This divisiveness has undermined "human flourishing" and is "corrosive of the common good."

As relates to the dignity of work, Sandel states that

> "…it is a mistake to assume that the market value of this or that job is the measure of its contribution to the common good. But over the last several decades, the idea that the money we make reflects the value of our social contribution has become deeply embedded. It echoes throughout the public culture."

I have often pondered that thought in terms of why it is that the average employee at Goldman Sachs makes X times the income that is earned by the average teacher. Sandel quotes a statement from Martin Luther King:

> "One day our society will come to respect the sanitation workers if it is to survive, for the person who picks up the garbage is in the final analysis as significant as the physician, for if he doesn't do his job, diseases are rampant. All labor has dignity."

It is important to put a human face on current challenges and not to fall into the trap of economistic solutions. Pragmatism and non-ideological solutions are needed that emerge from civil society and make sense to people. Utopian approaches that once may have appealed, whether socialism, communism, neoliberalism, capitalism, etc. no longer (if they ever did) provide useful guidance. A meritocracy may seem a fair arrangement to many; it rewards people for their contributions, except that as I read Sandel, it becomes quite apparent that it is, indeed, "corrosive of the common good." We are where we are for a reason, but that does not mean we need to continue on our current path. In fact, as one writer stated, "Neoliberalism, like Communism, is the God that failed" It is worth pondering, as Marriner Eccles did in a speech, "what is an economy for?" Fortunately, no economy is immutable; as social systems, they evolve. For better or worse, all of us must take the lead in this process.

V. Conclusion

An optimist will argue that challenges generate opportunities. Perhaps the pandemic will open this process to further scrutiny. In the throes of the Great Depression, Franklin Delano Roosevelt was elected president. As Thomas Frank states:

> "…the talented people surrounding Franklin Roosevelt stood very definitely outside the era's main academic currents. Harry Hopkins, Roosevelt's closest confidant, was a social worker from Iowa. Robert Jackson, the U.S. Attorney General whom Roosevelt appointed to the Supreme Court, was a lawyer who had no law degree. Jesse Jones, who ran Roosevelt's bailout program, was a businessman from Texas with no qualms about putting the nation's most prominent financial institutions into receivership. Marriner Eccles, the visionary who Roosevelt appointed to run the Federal Reserve, was a small-town banker from Utah with no advanced degree….."

Clement Attlee became prime minister of the UK in 1945. Seven of his Cabinet ministers had spent time working in the coal mines. The lack of credentials for these leaders did not dissuade them from delivering bold actions. Both leaders and their advisors laid the foundations for an economic framework that created decades of robust postwar performance accompanied by declining inequality and a stable financial system. Needless to say, there were numerous challenges, including virulent racism, gender discrimination, imperial adventurism, etc., but the course correction initiated then perhaps provides the best hope for today.

We clearly live in a world of second-best solutions. As the adage goes, "If I were you, I would not start from here." Agreed, but we must operate in the real world. *The destruction of our faith in the ability of government to deliver based on the nightmarish neoliberal dream of privatization, globalization, and deregulation has created the polarization that persists today.* Extreme individualism has undermined our faith in collective action that can offer prosperity and allow humanity to flourish. As Eccles noted in the throes of the Great Depression, "we have got all of the wealth and resources we ever had, and we do not have the sense, the financial and political leadership to know how to use them." A similar challenge awaits humanity today. *The economy has operated best during the past century when it combines government and markets. It is clear that the neoliberal policies have "failed the marketplace test."*

In a "back to the future moment", it is time to recognize that the preferable framework is one that creates a real-world, interactive bridge between the private sector and government (which served from 1945 until the 1970s as both a bridge and as a countervailing check on capital). The collaboration that somehow evolved during the Great Depression and World War II offer historical evidence of what governments and markets can achieve when they work together to solve problems. Given the challenges ahead, we could do far worse than a "back to the future" moment. Better that we get there sooner than later!

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