



A **red pepper** pamphlet by Jack Copley

**An Angry Person's Guide to Finance:
Making sense of the complex and frustrating financial world**

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In memory of Bryn Gough

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What's the purpose of this pamphlet?

People living in the UK have a lot to be angry about. A lack of say in political affairs, lack of control over their work, the relentless pace of their job, boredom and monotony during the working day, job insecurity and wages that don't pay enough. In recent years, finance has become another great source of anger, as the crisis has added a further burden onto the shoulders of working people.

However, while many work-related grievances can be understood by people as what they really are - the results of organising society in a capitalist manner - the realm of finance is covered in a veil of mystery. This difference in understanding has serious implications for bringing about change. For example, if a company's decision to cut its workers' pay is understood as a reversible human choice to put profits before people, then it can be resisted by strikes or protests. But if the financial activity that resulted in the 2008 crisis cannot be understood, then popular anger will probably be expressed in undirected outbursts and frustrated confusion, rather than the kind of political action that could bring about real change.

There are two big problems facing anyone trying to wrap their heads around finance. The first is technical jargon. The language used by those working in the

financial sector, and those who comment on it, is often totally incomprehensible. The terms and phrases used seem almost 'scientific', leading people to believe that finance is a kind of natural phenomenon that only trained experts can make sense of. But underneath the complicated words are concepts that can be easily explained - most of the time.

The second problem is the incredible scale, complexity and interconnectedness of financial transactions. Unfortunately, this is less easy to explain. In fact, any attempt to sketch out exactly how the different aspects of finance interact with each other, and how these then interact with the 'productive economy', would take a lifetime.

The purpose of this pamphlet is to try to tackle the first problem, by explaining some of these concepts as simply as possible and showing why we should be concerned about them. By doing this, we aim only to shed light on the second problem, rather than solve it. We want to hint at the extent to which global finance resembles an impossibly tangled web - an enormous orchestra with no conductor - and how this relates to capitalism as a whole. By doing so, we seek to provoke a conversation about whether any of it is socially useful.

How will we go about this?

The financial system has undergone an incredible transformation in the past 30 to 40 years. This pamphlet will explain the key changes in finance and place them in the broader context of recent capitalist history, with its fierce struggles between workers and their bosses.

Reading it from beginning to end will offer this conceptual and historical understanding of modern finance. However, if you just want to dip into this pamphlet at different points to get your head around specific topics, it will serve that purpose too.

Part I will give a brief outline of the changes in business profitability since the Great Depression of the 1930s. Profitability is key to understanding the bigger picture – after all, the economic system that finance is a part of is geared solely towards making profit. This will serve as the historical background against which we can understand the changes specific to the financial sphere.

Part II will explain four long-term trends in finance: disintermediation, securitisation, the growth of financial derivatives and deregulation. Together, these processes have forged a new financial system, which has inflated to monumental proportions. The emergence of each of these trends is closely tied to changes in the profits of capitalists in general, discussed in Part I.

Part III will look at some of the financial issues that have received the most press coverage recently and make them a bit more understandable. Specifically, we'll clarify the meaning of shadow banking, leverage, credit rating agencies and the 2008 financial crisis. We'll also show how each of these headline-grabbing issues is related to the four trends discussed in Part II.

Profitability is key to understanding the bigger picture – after all, the economic system that finance is a part of is geared solely towards making profit

Part IV will go over some of the financial regulations that are being implemented since the 2008 crisis. We'll focus on Dodd Frank, EMIR/MiFID, Basel III and ringfencing. Based on what you've read in the rest of this pamphlet, you can make up your mind as to whether you think any of these regulations will be successful – or even if finance can be regulated for long periods of time at all.

Part V will summarise the key points made in the pamphlet and suggest some important questions for the future.

Part I

The broad context

Changes in capitalist profitability

It may appear strange to begin a discussion of finance with capitalist profits in general. But we must not fall for the fantasy that finance is the real 'driver' of the economy, as some bankers insist. In fact, the fate of finance is closely tied to production.

In a lot of classical economic theories, the financial system is supposed to grease the gears of production. The stock market distributes investors' money to the most profitable parts of industry (people tend to buy stocks in the most successful companies), while banks connect lenders with borrowers, providing loans to companies so that they can further expand production.

But what happens when profits *throughout* industry are in trouble? One outcome is that lending and borrowing through the financial system increases. Companies that can't afford to pay back previous debts or compete with rivals because of low profits borrow more and more (as do unemployed/underpaid workers).

Furthermore, investors shift their money from unprofitable production to risky but potentially lucrative speculation. So, when industry is unable to make high profits, money often flows towards the financial system - like insects buzzing around the brightest light.



A brief history of profits

The Great Depression (1930s) and WWII left the world transformed. The economic crisis caused countless businesses to collapse and the war physically destroyed huge swathes of industry in Europe -leading to a great decline in the cost of materials and machinery. The Depression had impoverished working people, lowering wages, and the war effort had turned them into a strictly organised production army. So, the means to produce

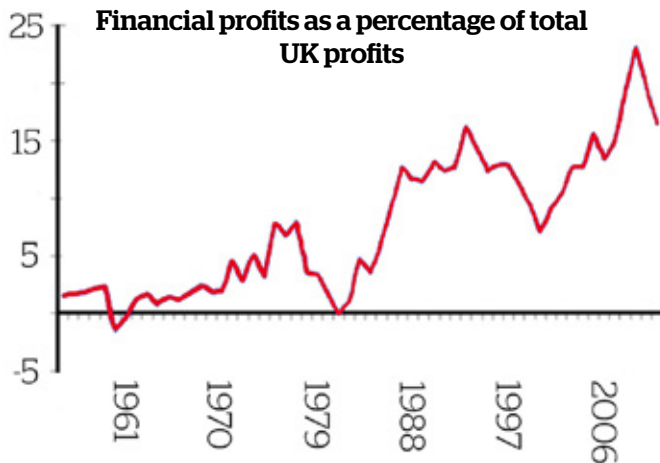
things became very cheap. This set the stage for an enormous boom in capitalist profits.

Profitability remained very high through the late 1940s to the early 1960s. Capitalists were incentivised to invest more and produce more. Assembly lines whirred as commodities flew out of factories at an incredible rate, while society had to adapt to consume all these goods.

However, from the mid 1960s, profitability began to tumble. The profits that capitalists could expect on a new investment became smaller, which made them think twice about investing. By the 1970s, the world economy was in full-scale crisis, and profitability continued to fall. (The exact reason why this happened is hotly debated, so we won't delve into it here, although we try to point out some important factors later.)

The point is that, by the 1970s, the post-war boom was over. Businesses tried to save themselves by beating back the advances that workers had made. In Britain, strikes brought whole sections of industry to a standstill as tensions between working people and their employers reached breaking point.

This conflict and recession actually helped to restore capitalist profits, due to the defeat of working-class



in finance that are affecting us today. Capitalism is driven by profit. It's why capitalists get out of bed in the morning and it's what they think about as they tuck themselves in at night - if they want to stay afloat, that is. Unsurprisingly, crises of profitability create a mad struggle to restore it. Hence, we must be aware of the 1970s profit drought in order to understand the spectacular growth of the financial industry that followed it, as it was here that capitalism seemed to have rediscovered the key to high profits.

power and a cheapening of production materials/equipment. By the 1980s, profitability began to rise, before faltering at the end of the decade. It rose again in the 1990s, with the internet-based boom. By 1997, profitability had peaked - but it never reached the heights of the post-war era. The period from then until now has seen weak profits. This meagre restoration of capitalist profitability from the 1970s onwards is commonly called 'neoliberalism'.

While this information might not seem relevant to banking, it is essential to set the scene for the changes

Part II

Important long-term trends in finance

Disintermediation

To understand disintermediation, we first have to understand intermediation. Imagine two people: Mae and Liam. Mae is a retiree with a lot of savings that she wants to invest. Liam is young entrepreneur looking for a loan to start up a new business. Neither have the right information or knowledge to find each other and work out a deal, so they each go to a bank. The bank takes Mae's deposit and lends money to Liam. It does what Mae and Liam cannot do by themselves because it has expertise and access to market information. Furthermore, if Liam is unable to repay his loan then the bank takes a loss, not Mae. This is financial intermediation, with the bank as intermediary. In the most basic sense, disintermediation is the removal of the bank from this picture, so that Mae and Liam meet in the market and come to some agreement by themselves.

In reality, Mae and Liam are likely to be Mae & Co Pension Fund and Liam Software Ltd - institutional lenders and borrowers who deal with huge amounts of money. During the 1970s, institutions like these began to use banks less and less, and this trend continued through to the 2000s. Instead, they started to lend and borrow through capital markets, which allowed them to do business without an intermediary. They did so largely to avoid the expense of using banks. It costs a lot

of money for banks to assess the creditworthiness of borrowers, keep an eye on the loans they have issued and take the hit if a borrower cannot repay. This is effectively paid for by those taking out a loan from a bank, through higher borrowing costs (interest rates).

A crisis of capitalist profits spurred disintermediation. This shifted power from traditional finance to a new realm of securitised finance

The profitability crisis of the 1970s led companies to seek to cut costs and get the cheapest credit possible. One way they did this was to stop borrowing from banks. As a result, disintermediation took hold and this traditional form of banking became less important globally.

While financial disintermediation reduces costs by cutting out the middle person, it also lays the foundations for serious problems. One of the crucial roles of the intermediary is to provide information about risks to the borrower and lender. Without banks carrying out this role there is a dangerous lack of understanding of large-scale risks, as a complex web of loans are made

without a centralised authority monitoring them. Unnoticed risks can accumulate and cause mass panic when they are discovered. (It is because of this lack of information that credit rating agencies have become more important.)

The point to take away from this section is that a crisis of capitalist profits helped to spur disintermediation. This shifted power from traditional finance (bank deposits and loans) to a new, misty realm of securitised finance (capital markets etc), which we will explain next.

Securitisation

Securitisation is the process by which an asset that cannot be immediately converted into cash is transformed into a tradeable asset - a 'security'.

Imagine a woman, Niamh, goes to a bank and takes out a mortgage to buy a house. Before securitisation, the bank would purchase the house, Niamh would pay an initial deposit and then make regular repayments to the bank, with interest, until the mortgage is paid off. Through the process of securitisation, the bank still issues the mortgage to Niamh but then sells on the mortgage contract to someone else - Joe the investor. The bank earns money from the one-off fee it charges Joe, and Joe earns money from Niamh's regular mortgage repayments. The debt has been securitised - transformed into an income-generating asset that can be sold on.

The reality of the situation is larger and more complex. Instead of one mortgage being securitised, banks (and other 'loan originators') group many mortgages together into a single 'mortgage-backed security'. This generates a lot of income, due to all the different people making regular repayments on their mortgages. Instead of selling this whole mortgage-backed security to a single investor, the bank can split it up into different slices (called 'tranches') and sell these small slices of the larger

mortgage pool to different investors. Different slices are given different grades by credit rating agencies, from AAA, meaning the safest, to BB, meaning the riskiest. An investor who buys an AAA-rated slice will be paid before the other investors.

Mortgages are not the only type of debt that is securitised in this way. More or less any kind of debt, from credit cards to student loans, is repackaged, chopped up and sold to different investors. A large pool of different kinds of securitised debt that borrowers can purchase slices of is called a 'collateralised debt obligation'. Banks are not the only institutions that can do this. Corporations can securitise their own assets (like loans they have issued) and sell them on to investors - allowing them to raise cash cheaply without having to get a bank loan.

Let's go back to our previous example of Mae & Co Pension Fund. Before disintermediation, Mae and Co would have deposited the workers' pensions that they were holding into a bank account. These pensions would earn interest over time. The bank could then loan this money out to Niamh for her mortgage, or to someone else for a credit card, and so on. If Niamh never repays her mortgage the bank takes the loss and the workers' pensions are still safe. After disintermediation,

Mae and Co decides to use the workers' pensions to buy a chunk of securitised debt on the capital market (a market for trading financial securities) - maybe a slice of a mortgage-backed security. Now the workers' pensions earn the money that Niamh repays on her mortgage debt, rather than earning interest paid by a bank. However, if Niamh cannot repay her mortgage there is no bank to take the hit and the workers lose the pension money they had entrusted to Mae and Co.

Lending and borrowing still happens. Mae and Co still invests its money and Niamh still gets her mortgage. The key difference is the riskiness and complexity of securitised finance, which took off in the US in the 1970s and in the UK in the mid 1980s. While banks are regulated and people's bank deposits insured by the government, securitised finance is largely unregulated and uninsured. Businesses might make more money by investing in securitised debt than depositing it in a bank, which makes it very attractive considering the unimpressive profits since the 1970s, but they also take a big gamble by accepting all of the risk.

Furthermore, securitisation intimately links the fates of people and businesses in different parts of the world. A Japanese car manufacturer may be investing in the debt of British credit card holders. A worker in Coventry may

be, without their knowledge, investing in the mortgages of people in California through their pension fund. This confusing interconnectedness, alongside the incredible scale of securitised lending, is partly why the failure of the US housing market in 2007/2008 had such a massive impact all over the world.

In 1970, 63% of US corporations' borrowing was done through traditional bank loans. By 2010, disintermediation and securitisation had reached such a stage that bank loans made up less than 30% of US corporate debt.

The attack on working people since the 1970s

After WWII, working class people in the UK and many other countries organised into trade unions and demanded better working conditions, better wages and more workplace control, as well as better public services from the government. Workers gained more control over their own work and gained a larger share of the value they created. In the 1970s, when profits began to dwindle, this working class power became a barrier to businesses' ability to compete - creating a crisis of capitalism.

Why is this simplified story relevant to contemporary finance? Well, clearly capitalism still exists - so how was it saved from crisis? It was partly saved by a ferocious attack on working people's organisations throughout the 1970-80s. This involved shifting manufacturing to poorer countries, sacking many workers, passing anti-union laws, restricting wage growth and cutting public services. As Margaret Thatcher's chief economic advisor later recalled: 'Raising unemployment was an extremely desirable way of reducing the strength of the working classes . . . [which] has allowed the capitalist to make high profits ever since.'

However, people still need money to buy goods in order to keep the economy afloat and people still need housing, healthcare etc so that they are physically

capable of working. How can jobs, wages and public services be attacked to save capitalism if capitalism needs workers to spend money and have access to services?

This is where finance comes in. By giving credit to workers, in the form of loans or credit cards, workers can still consume without increasing wages. By giving mortgages to people with a bad credit history, they can still have a roof over their heads without the government building council housing. So credit acted as one part of a temporary solution to this crisis of capitalism.

However, because of disintermediation and securitisation, working people's debt did not just sit in bank accounts, but was spread around the world, contributing to a global financial bubble. Falling interest rates since the early 1980s have made credit very cheap. As we discussed, multinational corporations ended up raising money for their operations by buying and selling people's credit card, mortgage and other debt - essentially, making money from the fact that working class people cannot rely on their wages and public services to make ends meet, and therefore have to burden themselves with endless debt.

Financial derivatives

In its most simple form, a financial derivative is a kind of insurance policy. There are three main types: swaps, futures and options.

Three kinds of derivatives

First, let's explain swaps. Imagine Liam's company invests in the capital markets. He buys a slice of mortgage debt and then sits back and watches his money grow as people slowly pay back their mortgages. Now, while this might work out great for him, if enough people cannot repay their mortgages he will lose his money. Furthermore, because these securitised capital markets are largely unregulated, he cannot expect the government to bail him out (although in practice it did).

To address this danger, Liam gets in contact with Joe the investor and together they work out a deal. Liam will pay Joe a certain amount of money every month, and in return, if Liam's investment goes sour because people default on their mortgages, Joe will pay Liam the amount of money that he originally invested.

For Liam, this is an insurance policy: even if his investment goes wrong he will not lose his money. For Joe, this is a bet: he is betting that Liam's investment won't go wrong and he will earn money from Liam's

regular payments. This is a swap derivative - specifically, a 'credit default swap'. There are also swaps on interest rates, currencies, stocks and more.

Futures are simpler. Assume, for instance, that Liam needs to change some euros into dollars next month, but he is scared that the price of dollars will increase before then. He meets Joe again, who agrees to sell Liam these dollars next month at a fixed price, so long as Liam pays him a fee. If the price of dollars increases above the fixed price it will have been worth it for Liam, because Joe has to pay the difference. If the price of dollars declines then Joe's bet has paid off, because Liam has paid him more for those dollars than they are actually worth. This is a way for Liam to reduce future risk. That's why it is called a future derivative.

An option is very similar to a future. Instead of agreeing with Joe to definitely buy those dollars at a fixed price next month, Liam instead agrees to have the option to buy them, if he is happy with how their value has changed. This is another way to insure against risk.

Swaps, futures and options are all financial derivatives, because they derive their value from the underlying asset. The asset can be all kinds of different things: company stocks, securitised debt, currencies, interest

rates etc. If its value has the potential to increase or decrease, there will probably be derivatives on it!

The dangers of derivatives

Derivatives might seem like a rational way for businesses to avoid unnecessary risk, especially in the modern context of less information and regulation. How can capitalists be expected to produce things without feeling confident that their investments won't be lost? However, a couple of factors make derivatives incredibly dangerous.

Firstly, to take out a derivative on an asset, you don't need to actually own that asset - as crazy as that sounds. For example, imagine person A loans you money. You would expect person A to take out a swap derivative on that debt, in case you don't pay it back. However, in reality, persons B, C and D can all take out swaps on your debt, even though you don't owe them any money! They are just betting that you won't pay it back, in which case they will get paid by whoever sold them the derivative. But they have no stakes in the matter. It's like taking out an insurance policy on a house that you don't own - now you want it to burn down. This allows the derivatives market to grow to incredible sizes.

Now, say I notice that these people are betting against you repaying your debt. I might get suspicious that they know something I don't, so I will be a lot less likely to lend you anything. This will make it far harder for you to pay back your original debt to person A. Basically, the more investors speculate with derivatives that a debtor will default, the more likely they are to default. It's a self-fulfilling prophecy.

Derivatives allow capitalists to win or lose huge amounts of money on relatively small investments

This is exactly what has been happening to Greece. Investors taking out 'credit default swaps' have been betting that Greece won't be able to repay its debts. As a result, the population of Greece faces an unending attack on their jobs, living standards and the very fabric of their society.

Secondly, derivatives allow capitalists to win or lose huge amounts of money on relatively small investments. In other words, they increase investors' leverage. Let's go back to our example of Liam and his euros-into-dollars problem. Say Liam spends €10 to buy \$20. He goes to the Post Office and changes this money. If

the value of the dollar rises by 10%, then he can go back to the Post Office and change these \$20 into €11 - he has gained an extra €1. If the dollar's value falls by 10%, he will lose €1.

Now, imagine Liam instead buys a €10 derivative that will give him the option to buy \$2,000 in the future, at a fixed exchange rate of €1 to \$2. If the dollar appreciates by 10%, then Liam can exchange his €1,000 for \$2,000 as agreed beforehand. He can then bring this \$2,000 to the Post Office and get €1,100 in return. Minus the cost of the option derivative, he makes a profit of €90. If the dollar's value drops there is no point in using the option derivative - he has lost all of his €10. By investing the same amount of money (€10) in a derivative on an asset, instead of just buying the asset, investors can make much larger profits - but expose themselves to far more risk.

These two features of financial derivatives effectively detach them from the real economy, meaning that their growth isn't limited by the amount of actual stuff that society produces. The financial derivatives market did not even exist before 1973 but was valued at ten times the size of world GDP in 2007. Furthermore, the majority of derivatives trades are not officially recorded (these are called 'over the counter' or 'OTC' derivatives),

meaning that it's incredibly difficult for regulators or governments to get a clear idea of this maze of trading. For this reason, businessman Warren Buffet called derivatives 'financial weapons of mass destruction'. Considering that London is the epicentre of derivatives trading, we should be very concerned about this.

In the context of relatively unimpressive profitability on productive investments since the 1970s, financial derivatives have been a very attractive way for capitalists to make quick and potentially huge profits. This has been especially true since interest rates dropped to historic lows in the early 2000s, making credit very cheap and encouraging speculation.

Doubtless, the heightened risk of the global economy since the end of Bretton Woods has prompted many capitalists to use derivatives for insurance, but this can't explain the huge size of the derivatives market. Of all the interest rate derivatives trades in 2007 - the most popular kind of derivative - 91% were between financial companies. This suggests that they had little to do with ensuring that production continued to run smoothly, and more to do with speculation.

Deregulation: a timeline

Governments impose regulations on their financial sectors because they are aware of the damage that rampant speculation can do to an economy. After the Great Depression, many governments enacted quite strict banking regulations, while from the 1970s onwards, they gradually scrapped them. Today, financial regulation is next to non-existent.

This deregulation was the result of the times – capitalists desperately searching for a profitable place for their money – so it shouldn't be seen as the root cause of the current financial turmoil. Nevertheless, learning the history of important deregulations can help us understand how the trends we have discussed were encouraged and perpetuated. We'll focus specifically on the US and UK.

1957 - The creation of the Eurodollar markets

Earlier we suggested that the seeds of the current financial problems were planted in the 1970s, but – as with most generalisations – this isn't the full story.

After the experience of the Depression, the leaders of the most powerful capitalist states created the 1944 Bretton Woods agreement. This attempted to prevent a return to the problems of the 1930s by establishing



(among other things) international regulations on the movement of money across national borders. These would stop panicked capitalists from withdrawing all of their investments from a country at the first sign of economic distress, and therefore making the problem worse.

At the end of 1956, the US – seeing Britain's invasion of Egypt as a challenge to its own imperial ambitions – helped to orchestrate a 'run on the pound'. This economic warfare meant the mass sale of pound sterling, causing a sharp decline in the pound's value. In response to this threat, the British government

increased interest rates on the pound (to make it more valuable) and put limits on lending pounds to foreign borrowers (to avoid damage to the balance of payments).

This did great damage to banks in the City of London, which needed to continue making international loans and deposits to stay competitive with other global financial centres. So, instead of dealing in pounds, these banks started to use dollars. Lending and borrowing in dollars wouldn't affect the British balance of payments, so the British government agreed that if these banks used dollars they wouldn't have to follow any Bretton Woods regulation - they remained in London physically, but in practice they were considered 'offshore'.

This capital market, named the Eurodollar market for obvious reasons, undermined the Bretton Woods agreement because of its unregulated nature. The market began to grow, with US banks moving into London to avoid the domestic regulations that damaged their profits. The market was enormous by the late 1960s and 1970s, as corporations sought cheap credit due to declining profit rates and as Arab oil exporters turned their massive oil revenues into Eurodollar loans (following the 1973 increase in oil prices).

The massive amount of unregulated lending and borrowing taking place in this market started to contribute to the kind of crises that Bretton Woods had been created to prevent. Therefore, in the 1970s and 1980s, deregulation of the official banking sector didn't seem as big a deal, because so much financial activity was already totally unregulated.

1971 - The beginning of the end of Bretton Woods

Controlling the movement of money wasn't the only aspect of the Bretton Woods agreement. Another was the 'fixed exchange rate system'. Under this, countries would establish a ratio between their currency and the US dollar (say £1 to \$2), and then this ratio could move up or down by 1%. The US dollar in turn had a fixed ratio to gold. This meant that ratios between different currencies were stable and rooted in gold - which made trading easier - but because of the 1% flexibility, countries didn't have to cut public spending to the same degree as before in order to maintain the value of their currency.

By the early 1970s, the US had an enormous amount of debt - partly because of dwindling profits, as US corporations became outcompeted by west European (not British) and Japanese firms, and partly

due to the Vietnam war. This meant that the dollar became overvalued - its ratio to gold was distorted. Instead of tackling this problem with harsh austerity that would have accelerated social struggle, in 1971 Nixon announced that the dollar would no longer be convertible into gold.

This ended the fixed exchange rate system. Money now had no official basis in gold reserves, which meant that the value of a currency simply depended on 'market confidence'. This removed a crucial barrier to the expansion of finance, as credit and debt were no longer officially linked to any physical substance.

1974 - Repeal of the US interest equalisation tax

This tax made it more expensive for US investors to purchase foreign securities, in order to stop the flow of dollars abroad. Its repeal helped to create global capital markets with little restrictions on the movement of money.

1975 - 'May Day' at the NYSE

This refers to the deregulation of the New York Stock Exchange on 1 May 1975. The costs of buying and selling securities were formerly set at a fixed price, but with

this deregulation they became exposed to competition. This caused a fall in the cost of borrowing and lending through capital markets, which led to enormous growth.

1979 - Britain abandons exchange controls

With this move the British government followed the lead of the US in 1974, abolishing any restrictions on investing abroad. This was the end of the Bretton Woods controls on the movement of money across borders.

1986 - The 'Big Bang'

The year 1986 marked a huge spree of deregulation in the City of London, subsequently named the 'Big Bang'. Deregulation got rid of the fixed prices for buying and selling securities (like the NYSE had done in 1975), which created a similar explosion of capital market activity. Furthermore, new technological innovation was introduced and foreign banks were allowed entry into the London Stock Exchange.

All of these changes sucked even more money into the City of London's wheeling and dealing, while US banks began to take over. In 1985, Britain's banking assets were worth £762 billion. By 2005, they were worth £5,526 billion.

1999 - US Gramm-Leach-Bliley Act

Named after three US congressmen, this got rid of the Glass Steagall Act of 1933. Glass Steagall was a piece of legislation passed after the Wall Street crash, which separated the activities of high street (commercial) banks and investment banks. This was supposed to stop ordinary banks from making risky investments and speculations with people's hard-earned savings. After 1999, commercial banks were allowed to engage in this kind of activity again.

The repeal of Glass Steagall didn't cause the financial crisis, as some wrongly claim. Disintermediation, securitisation and the financial derivative s market all existed before 1999 - as did the long-term problem of low profitability. But the Gramm-Leach-Bliley Act did probably make the crisis worse, by allowing ordinary high street banks to merge with investment banks, creating enormous conglomerates.

2000 - US Commodity Futures Modernisation Act

This legislation, despite its progressive sounding name, was a very destructive act of deregulation. It effectively made a broad swathe of financial derivatives exempt from government regulation or oversight.

The market for derivatives such as 'credit default swaps', which allow investors to bet on the likelihood of a person or institution not repaying their debt, was already enormous and complex before 2000. But this act pushed it even further into the shadows, encouraging its expansion. The total value of credit default swaps was \$144 billion in 1998, rising to \$62 trillion in 2008.

The role of interest rates

When Paul Volcker was appointed as head of the US Federal Reserve in 1979, the global economy was facing a severe crisis. Workers were demanding better wages and conditions despite businesses closing down, and inflation was rampant. Putting money in the bank or financial investment to earn interest became far more profitable than investing in production.

To battle this situation, in 1980, Volcker increased interest rates to historic levels (this affects global interest rates too). This made the cost of borrowing skyrocket, which plunged the economy into a deeper recession, as businesses went bust or restricted their operations. This harsh economic climate helped to break labour's back and fight inflation. It had devastating effects on working class people, as factories across Britain shut their doors - many never to reopen.

But it was great for finance, as even more money was redirected from production into interest-earning activities. However, because banks still had limits to the amount of interest they could pay on deposits (due to government regulations), businesses increasingly channeled their money into disintermediated finance, such as capital markets, where there were no interest rate limits. Hence this helped to spur the expansion of disintermediation and securitisation.

When interest rates fell in the the early 1980s, they fell fast. This discouraged saving and made investing and lending more profitable. However, while this helped bring about a recovery of production, finance remained grossly swollen. This is because profitability in productive industries remained unimpressive. The attack on working people and the general cheapening of production materials hadn't been enough. Making things still wasn't as profitable as speculating on the increasingly deregulated financial markets.

Therefore, low interest rates didn't lead to a rebalancing of production over finance. They made saving and earning interest less attractive, but made borrowing very cheap. This fuelled a huge expansion of credit - especially through the growing market for securitised debt - as companies borrowed to make up for relatively weak profits and workers borrowed to offset low wages.

This was greatly accelerated in the early 2000s, when the US Federal Reserve cut interest rates to all time lows to avoid a deep recession after the 'dot com bubble' burst in 2001.

So high interest rates initially sucked money into finance in the late 1970s and early 1980s. This helped to cement the new shape of the financial sector. When interest rates then dropped rapidly, it fed a huge, growing tumour of debt.

Part III

Recent headline grabbers

Shadow banking

In the news, we often hear references to ‘financial institutions’, rather than simply ‘banks’. The reason for this is that, through disintermediation, lending and borrowing has shifted away from traditional bank loans and deposits, and towards a diverse array of institutions that technically aren’t banks. These are often referred to as ‘non-bank financial institutions’, or ‘shadow banks’. We’ll explain some of them here.

Special purpose vehicles

When you read about the financial crisis, one term keeps popping up: ‘special purpose vehicles’ or ‘SPVs’. Also known as ‘structured investment vehicles’, SPVs are companies that are created by larger companies to serve a narrow and specific purpose. They don’t have their own buildings, offices or staff – they only exist on paper. So what are they for?

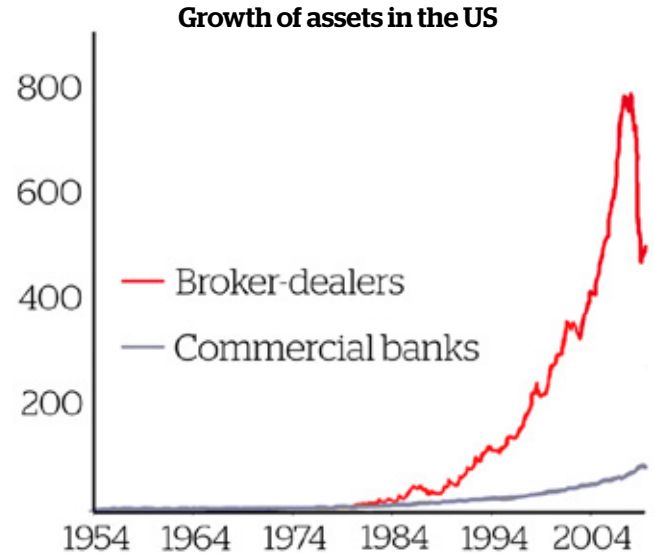
Let’s revisit our example of Liam Software Ltd. Liam’s company needs to borrow money to invest in new research and development. Instead of borrowing from a bank, which is costly, Liam decides to set up an SPV. Now, cast your mind back to our discussion of securitisation. Remember that, through securitisation, banks and other institutions can gather a load of debt (such as from mortgages or credit cards) into a big pool. This pool is

then sliced up and sold off to investors as 'securities' for a large fee. As homeowners or credit card holders pay back their debt, this money goes to the owners of these securities. The big pool of debt is called a 'collateralised debt obligation' (or a 'mortgage-backed security' if it's just mortgage debt). These collateralised debt obligations are created and managed by SPVs. Liam's SPV earns money by selling these securities to investors for a fee - and these fees add up to quite a lot of money that can now be used for research and development.

So, SPVs are institutions set up by companies to raise money, which earn profits largely through securitisation (as well as through buying and selling financial derivatives and other instruments). These institutions are technically separate from the original company, which means that they don't appear on the company's official books. Therefore, even if a company is severely in debt because its SPVs lost a mountain of money, it can appear to be doing fine on paper.

Investment funds

Hedge funds are companies that take investors' money and use their market expertise to channel it into profitable investments. The manager of the hedge fund will collect money from investors and pool it, before



using some to purchase securitised debt, financial derivatives and other kinds of financial instruments. After a certain amount of time - maybe a year - the manager will assess the profits the fund has made. This profit will be split between the hedge fund manager and the investors, usually about 25:75 (there are other specific payment arrangements, but these aren't too important).

Money market funds are very similar to hedge funds – the difference is what they invest in. While hedge funds can invest in a diverse portfolio of financial instruments, from stocks to derivatives, money market funds invest only in short-term securities. These securities are usually issued by governments or stable companies, meaning that money market funds are supposedly safer than hedge funds, although they aren't as profitable.

Private equity funds invest in the equity of a private company. This means that they essentially buy partial control of a company and earn money by restructuring the company and making it more profitable.

These investment funds behave like banks in many ways, taking money from investors and distributing it into profitable investments. But the profits on these investments are often much higher than the interest earned on bank deposits, so investors are drawn towards these funds. As a result, they deal with huge sums of money, while being subject to less regulation than official banks.

Broker-dealers

A broker-dealer is usually part of an investment bank. When an investor wants to buy securities on the capital

or stock market, they need to go through a broker. The broker gives them access to this market, carrying out whatever sale or purchase the investor wants through their computer systems and providing advice on good deals – for a fee of course. Brokerage is the service they provide for their customers, who could be individual investors, hedge funds or industrial companies. Dealing is what this company does for its own benefit. Dealers securitise debt, create financial derivatives and sell all of these instruments wholesale to other financial institutions, on what is known as the 'secondary market'.

Big investment banks such as Goldman Sachs in the US and HSBC in the UK all have broker-dealer subsidiaries. These broker-dealers have been conducting an increasingly massive amount of trade in recent years. The money that they deal in is not government-insured, like the deposits in a high street bank, but uninsured investments.

Banks aren't gone, but they're not alone

While bank loans and deposits have been overtaken by securitised lending, this doesn't mean that banks themselves have disappeared. Instead, they have just changed how they earn money. By 2007, about 54% of UK banks' income was from non-interest earning

activity. Banks have transformed their business models in order to survive - now trading directly for themselves in securities and derivatives, often through shadowy subsidiaries.

Together, SPVs, investment funds and broker-dealers make up a large part of this 'shadow banking' system. They lend and borrow huge sums of money, but not in the traditional manner of a bank. This type of finance is not as regulated as normal high street (or commercial) banking; it operates in the shadows. By 2011, shadow banking had reached \$67 trillion. So when we want to get an idea of the total scale of the financial sector, we can't just look at banks, because a whole other world of lending and borrowing exists below the surface.

Leverage

Leverage is a strategy that allows companies to earn potentially bigger profits through borrowing.

To understand how leverage works, and why people have been making such a fuss about it, we'll use a simple example. Imagine you have a friend who is coming back from a holiday abroad. You ask her to buy you some cigarettes in Duty Free, for £2 a pack, because you know you can sell them to your friends in Britain for £4 a pack. You decide to spend £10 to buy five packs, which you sell for £20, making £10 profit.

Now, suppose that instead you spend £10 of your own money and borrow £90 from your parents. With this £100 you buy 50 packs, which you sell to your mates for £200. You get your initial £10 back, give your parents back their £90 and pocket the remaining £100. By borrowing more money than you have in cash, you can greatly increase your profits. This is called leveraging. In our example you were leveraged 10:1, meaning that you borrowed £10 for every £1 of your own money.

While high leverage can result in magnified profits, it can also result in magnified losses. What would have happened if none of your British friends wanted to buy the cigarettes from you? You would not only have lost your initial £10, but you would also be in £90 of debt.

Big financial institutions' leverage ratios in 2008

Barclays	61:1
Deutsche Bank	53:1
USB	47:1
ING Group	49:1
BNP Paribas	36:1
Fortis	33:1
Lehman Brothers	31:1
Goldman Sachs	26:1

Leverage is very risky business. For banks, leverage means how much debt they have compared to how much capital they own. There are relatively strict rules for normal banks about how much debt they can get into, called 'capital requirements'. These rules aim to deal with panicked people withdrawing their savings from a bank during crises, because the bank will have enough money to deal with a rush of withdrawals.

However, as lending and borrowing has been increasingly conducted outside traditional banks, leverage among financial institutions has increased.

The markets for securitised debt and derivatives have provided a cheap way for financial institutions to borrow, and thus increase their leverage, without being scrutinised by regulators. Of course, these institutions often don't directly make these risky, debt-driven investments through securitisation and derivatives - they do this via shadow banks. This is how they evade capital requirements.

Credit rating agencies

Credit rating agencies are private companies that rate the reliability or creditworthiness of securities, and the issuers (sellers) of those securities.

Why are they so powerful?

In recent years, credit rating agencies have had lots of publicity. But they weren't always the headline-grabbers that they are now. Their contemporary importance can only be understood in the broader context of long-term financial trends.

As we explained previously, since the 1970s institutional investors and borrowers have been using banks less and less. Instead, they lend and borrow directly with one another in capital markets. This trend is called disintermediation. The things being lent and borrowed have increasingly been chunks of debt (like mortgages or credit card loans) that have been chopped up and sold from one institution to another. This is called securitisation. Furthermore, there has been a great ballooning of the opaque financial derivatives market, which allows capitalists to insure their investments and (more often) to earn profits through gambling. This has been accompanied by the gradual deregulation of finance.

These four processes have acted to remove any central authority from monitoring lending and borrowing at the same time as inflating the financial system to ludicrous dimensions, spinning a web of incredible complexity. The crucial question for businesses trying to conduct their affairs in this new, complicated environment is: how can we be sure if the institution to which we are lending can repay us? Without adequate information on creditworthiness, businesses simply cannot carry out their activities and the economy goes into crisis.

Credit rating agencies have filled this information vacuum. Two agencies dominate: Standard & Poor and Moody's, with Fitch a distant third. Together these three companies control about 95% of the credit rating market. These agencies rate the creditworthiness of companies, countries and even individuals that issue securities. They analyse data on an issuer's income, how much money they owe, their position relative to their competitors, and even qualitative information about the type of management, or, in the case of countries, the political atmosphere (whether the government is pro-trade unions etc). They chew up all this different information and spit out a super-simplified rating: from AAA down to D. Businesses can then use these ratings to decide who to lend to, borrow from, or generally do business with.

Because of this, credit rating agencies can appear to struggling countries as vultures, circling overhead and waiting for signs of weakness to downgrade their credit ratings. Such a downgrade can provoke a withdrawal of investment and all the unemployment, poverty and public service cuts that ensue. For this reason, countries often go to great pains to please these agencies.

The dangers

Credit rating agencies have been criticised for a number of things.

Firstly, they have been accused of making bad situations worse by downgrading companies or countries in the middle of a crisis. After the 1997 Asian financial crisis these agencies repeatedly downgraded Japan's credit status, making it harder and harder for Japan to borrow money, drawing accusations of fuelling the crisis. Something similar has happened to countries such as Ireland and Greece in the EU recently .

Secondly, they have been criticised for accepting payment from the very institutions that they then rate. Critics argue that they have an incentive to give overly generous ratings (called the 'issuer-pays model'). Before the 2008 financial crisis, the agencies consistently

gave AAA ratings to slices of securitised mortgage debt, which then turned out to be very, very risky.

These criticisms are legitimate and deserve to be debated, but they mainly raise questions of how credit rating agencies can be run better, rather than questioning why they have such great influence in the first place. For this reason, we cannot think about the rise of credit rating agencies without looking at the long-term trends of disintermediation, securitisation, financial derivatives' growth and deregulation, which have allowed these agencies to command such power.

The 2008 financial crisis

The crisis that broke out in 2008 is not simple to explain. It featured all of the 'big news' things in this part of the pamphlet; all the long-term trends discussed in Part II helped to make it as disastrous as it was; and the propeller lying below the surface that ultimately churned up this chaos was capitalism's unquenchable thirst for profits, which we talked about in Part I. We'll try to weave all of this together and paint a basic picture of how the crisis unfolded.

The bubble inflates

The 1990s was a relatively successful decade for capitalist profitability. New internet technology fuelled an economic boom and despite falling profitability in the late 1990s, this was prolonged until 2001 by a speculation bubble. The bursting of this bubble, along with the shock of the 9/11 attacks, pushed the global economy towards recession.

In order to avoid a deep slump, the US Federal Reserve lowered interest rates to nearly zero (which influenced global interest rates). This encouraged companies to borrow money because the interest on repayments was so low, allowing them to delay the effects of the recession. The cracks in the economy were essentially papered over with cheap credit.



One result of this 'cheap money' policy was a housing bubble in both the UK and US. House prices were increasing with no end in sight. Banks began to give 'subprime' mortgages to people who looked unlikely to be able to repay. Even if people couldn't repay their mortgages and the bank had to repossess their houses, the houses' value would have increased so much that the bank could still make a profit. As we know from Part II, these banks often didn't hold onto these mortgages, but instead securitised them and sold them to investors around the world.

These record-low interest rates also further inflated the markets for securitised debt and financial derivatives, which had been growing for decades. Banks and shadow banks took advantage of the cheap credit to speculate wildly with these financial instruments, increasing their leverage to hugely risky ratios.

The bubble bursts

As is inevitable with all bubbles, this one eventually burst. The frenzy of economic activity in the 2000s wasn't based on pushing workers to produce more things in less time, or for less money. Nor was it based on technological innovations. Instead, it was spurred by low interest rates and cheap money.

When the US Federal Reserve increased interest rates in 2007, disaster followed. Many families (especially those with subprime mortgages) were unable to cope, because the increase made their repayments unaffordably high. People across the US started to default on their mortgages, driving down house prices. This didn't just affect the banks that had written the mortgages, because they had securitised them and sold them on. These bad debts were spread across the globe, on the books of many financial institutions, industrial companies and even households.

As the US housing market started to fail, panic spread. Credit rating agencies began to downgrade securities that were mixed up with subprime mortgages, labelling them as poor investments. These bad mortgages weren't the sole reason for the crisis. They were the wick that lit the dynamite, which consisted of an enormous mass of securitised credit card debt, student loans, car loans, financial derivatives and so on.

At the peak of the UK government's bailout measures, £1.16 trillion was transferred from taxpayers' pockets to the banks

Once the mortgage debt failed, it sparked a chain reaction of failure throughout this web of debt and speculation. Investors that had bought derivatives on various securities (most likely for gambling) all scrambled to cash in at once, which was impossible, bringing this multi-trillion pound market down around their ears.

Due to the complexity and opacity of the disintermediated financial system, no one knew which institutions were healthy and which were mortally wounded by this turn of events. Investors became wary

of lending to each other. Businesses rely on credit to operate their day-to-day activities, so this 'credit crunch' was catastrophic.

The British bank Northern Rock found that no one wanted to buy the securitised mortgages of UK homeowners that it was selling on the capital markets. In early 2008, people rushed to withdraw their savings from the bank, until it was nationalised by the government.

Later that same year, the giant US investment bank Lehman Brothers collapsed, due to owning too much bad mortgage debt. Next to collapse was Bear Stearns investment bank, followed by Merrill Lynch. By the end of 2008, three out of the five Wall Street investment banks had disappeared and the remaining two were restructured.

This provoked full-scale panic. If even these enormous institutions could fall to pieces, then who was it safe to lend to? As the lubricant of credit dried up, the gears of industrial production began to grind to a halt. Two of the three biggest US car manufacturers went bankrupt, companies across the UK began sacking their workers and global trade dropped to its lowest point since 1982. The financial crisis was now an economic crisis.

The bailouts

To avoid a complete freeze in lending, which would have threatened the very existence of capitalism, some governments decided to hand massive quantities of taxpayers' money to certain big banks. The idea was that banks would then begin to lend this money to businesses and the economy could get back to normal.

In October 2008, the US government passed a bailout package of \$700 billion. This money was to be used to buy bad debt from troubled banks and to be given directly to banks as cash.

Later that month, the UK government bailed out the British financial system by giving £37 billion to Lloyds TSB, Royal Bank of Scotland and Halifax/Bank of Scotland. While some British banks, such as Barclays or HSBC, didn't ask to be bailed out directly, they nevertheless benefited indirectly from the bailout, as more money was now flowing through the system.

This wasn't the only support that UK taxpayers gave the financial system. The government nationalised Northern Rock and Bradford & Bingley at great cost; it repeatedly injected cash into struggling banks, through a number of different schemes; and the Bank of England



repeatedly printed more money to help boost lending, in the process known as 'quantitative easing'. Similar measures were taken by many other nations.

The effects of the crisis and bailouts on ordinary people have been colossal. The first 18 months of the crisis destroyed \$50 trillion of wealth, a whole year of global GDP, as businesses failed and production slowed. At the peak of the UK government's bailout measures, £1.16 trillion was transferred from taxpayers' pockets to the banks. To put this in perspective, jobseeker's allowance

- which the government insists is unaffordable without large-scale cuts - only costs the taxpayer £4.9 billion a year. We have no idea how much of this will eventually be repaid to us, but we will certainly have lost billions.

This loss is being translated into cuts in government spending at the same time that businesses - unsure of their ability to make profits - are attacking workers' wages and employment rights, while barely hiring new people. As of 2013, one in four Britons have jobs that provide 30 hours or less work per week, one in five earn wages that do not cover the basic costs of living and one in six children live in poverty.

The bursting of the debt bubble has revealed just how weak the underlying economy has become. The financial crisis has unmasked capitalism's long-term profitability crisis.

Part IV

New attempts at regulation

US Dodd Frank

The Dodd Frank Act was signed into law by President Obama in 2010. Written as a response to the financial crisis, three years later it is still a long way from being fully implemented.

Dodd Frank comprises four basic principles:

1. Stop financial institutions from becoming so large that their collapse threatens the global economy.
2. Stop predatory lending by banks.
3. Stop banks from trading with their own money rather than that of their customers (proprietary trading).
4. Make financial derivative trading more transparent.

The verdict

The task of coming up with actual laws to fulfill these principles was handed down to various agencies, all of which have had to fight lobbyists at every turn. The financial industry has five lobbyists pestering each member of Congress. The resulting regulations are so confusing and bastardised that they've been referred to as 'FrankNDodd' (like Frankenstein, get it?). Here's how Dodd Frank's four principles stand at the time of this guide's writing.

1) A new agency was set up to monitor the performance of huge financial institutions. Along with this, new procedures were put in place to help these institutions go bankrupt without plunging the whole system into crisis. Government bailouts of individual companies are prohibited.

A glance at the biggest US banks should help us decide whether this principle has been achieved. As of 2013, the top four banks have assets equal to half of the GDP of the US. They are even bigger than before. If any of these banks collapsed, the damage would be so great that the US government would be forced to bail them out.

2) The Consumer Financial Protection Bureau was created to stop the kind of predatory lending that led up to the 2008 crisis.

This might be the best part of Dodd Frank, as it seems to genuinely expand consumer protections. But it will by no means avert another financial disaster. While predatory mortgage lending was the spark that set off the crisis, the enormous balloon of securitised debt consisted largely of non-predatory loans.

3) The 'Volcker Rule', named after former Federal Reserve head Paul Volcker, is supposed to stop

proprietary trading. Proprietary trading is when a bank that is insured by the government decides to use its own money to make risky bets. When these bets go wrong, the stability of the financial system is threatened. The thrust of this regulation is to separate high street from investment banking, without having to reinstate the Glass Steagall Act that we discussed earlier.

As of 2013, the top four banks have assets equal to half of the GDP of the US. They are even bigger than before

As this part of Dodd Frank hasn't even been fully written yet, never mind enacted, it's impossible to assess its success or failure. Regardless, we can be sure that proprietary trading was not a cause of our currently bloated financial system, nor the 2008 crisis.

4) A number of steps have been taken to make the trading of financial derivatives more transparent. 'OTC' derivatives trades, which are traditionally privately negotiated contracts between just two parties, will be subject to more oversight.

This leaves the fundamental nature of derivatives

unchanged, simply attempting to bring some of them out of the shadows. Furthermore, it is unclear whether US financial institutions will be able to avoid even this oversight, by relocating their derivatives trading to another country. Five years since the crisis, the market for financial derivatives is bigger than ever. One financial analyst has estimated its size at \$1,200 trillion - or \$1.2 quadrillion. Yes, that is a real number.

You may have noticed that we haven't mentioned securitisation. That's because Dodd Frank does even less to tackle securitisation than derivatives. Whereas before Dodd Frank, financial institutions could securitise debt and then sell it all to investors, now they can only sell 95% of it. They must hold on to 5% of the risk themselves, to discourage them from selling bad debt. You might think that this is a pathetically weak rule that leaves 95% of the US securitisation market untouched - but you'd be wrong. It does even less than that. Financial lobbyists have gutted even this regulation, meaning that huge swathes of securitised debt will be exempt from Dodd Frank.

EMIR and MiFID II

EMIR

The European Market Infrastructure Regulation (EMIR) is a piece of regulation passed by the EU to make the financial derivatives market more transparent. This regulation began to be put into effect in March 2013.

The EMIR is Europe's equivalent of Dodd Frank's rules on derivative trading. It will:

1. Force 'OTC' derivative trades to pass through (or be 'cleared' by) an institution authorised by the EU, in order to reduce the murkiness of this market.
2. Ensure that each of these derivative trades is reported to companies that compile records of financial trading.
3. Comply with new risk management standards.

MiFID II

The Market in Financial Instruments Directive (MiFID) was originally passed by the EU in 2007 to make trading in things such as derivatives more competitive. However, since the crisis, a number of amendments have been passed to make these markets more safe - referred to as MiFID II.

This regulation basically extends and compliments the EMIR in attempting to bring more clarity to the trading of financial instruments, especially derivatives.

The verdict

Despite the obvious fact that the financial system is global, the regulations that are being created in different regions do not fit together like a jigsaw puzzle, forming one global set of rules. Instead, they are so complex and specific that it's incredibly difficult to determine how many loopholes exist.

After a massive lobbying campaign from the financial industry - especially the City of London - the EU's regulations on derivatives are even weaker than Dodd Frank's. The regulation of derivatives trading in Asia may be even lighter. It is likely that instead of strictly regulating financial derivatives and making them more transparent, these regulatory initiatives will simply push derivative markets to different parts of the world - like squeezing one part of a balloon.

Basel III

Basel III is the latest regulation from the Basel Committee on Banking Supervision - a group made up of representatives from different wealthy countries. The Basel Committee created two widely celebrated international banking regulations (Basel I and II) in the years that led up to the biggest financial crisis since 1929, so we know they mean business this time ...

Basel III basically tries to fix the problem of banks borrowing and lending massive amounts of money without having much money in their coffers. This was increasingly the case in the run up to the 2008 crisis. It does this by forcing banks to hold onto a certain amount of cash relative to the amount of risky loans they make. Furthermore, Basel III forces banks to adhere to a leverage ratio, which means that banks cannot borrow endless amounts of money while having little cash.

The verdict

There are two big problems with Basel III.

First, it doesn't go nearly far enough. According to the new rules, banks must hold capital worth 10.5% of the total risky loans they give; the requirement before the crisis was 8%. The new leverage ratio is similarly unimpressive: 33:1. This means that banks must now

UK ringfencing

have £1 for every £33 they lend. This is an incredibly loose restriction. Let's not forget that the financial institution whose collapse marked the official start of the 2008 crisis, Lehman Brothers, was leveraged 31:1. If Basel III had existed in 2008, Lehman Brothers would have been given the thumbs up by regulators!

The second problem is that even these meagre regulations don't apply to enough institutions. The shadow banking system, through which a huge proportion of securitisation and derivatives trading takes place, will not be seriously tackled by Basel III. These shadow banks, such as SPVs and investment funds, were some of the most highly leveraged of all financial institutions, yet they will pass under the radar of this latest regulation. This will likely cause more money to flow into shadow banking, as investors avoid the costly new regulations.

Basel III is designed for a traditional, textbook banking industry - not the disintermediated system that we have today.

It's important to remember that Britain, alongside the US, was at the heart of the 2008 crisis. Financial regulations in the City of London were, in some ways, more lax than anywhere else in the world - causing electronic money to gravitate towards our shores. Of the enormous (and enormously destructive) OTC derivatives market, nearly half of it was concentrated in the UK in 2009.

With this in mind, we might expect Britain's regulatory response to the crisis to be among the strongest in the world. Instead, the biggest regulation has been a strange set of rules called 'ringfencing'.

Ringfencing forces banks to separate their high street activities (taking deposits and lending) from their investment activities. In this sense, it is similar to the US Glass Steagall Act (1933-1999) and the recent US Volcker Rule. However, it's not as strong as either of these regulations. Ringfencing doesn't split banks up into retail and investment banks - it just requires them to separate the finances of their retail sections from their investment sections, while allowing them to remain part of the same overall company. If banks refuse to cooperate with this regulation the government has the right to forcefully split up the bank (called 'electrifying the ringfence').



Securitisation, through which a great part of lending and borrowing takes place, makes the distinction between high street and investment banking less important. Debt is repackaged and sold around the world, with high street banks, investment banks, SPVs, hedge funds, pension funds, industrial companies and a million other institutions all taking part. Ringfencing is the wrong answer to the wrong question.

The assumption underlying this regulation is that investment banking = risky, retail banking = safe. By drawing a line between the two, people's deposits will supposedly be safe even if a bank loses lots of money through gambling.

The verdict

Like too many new regulations, ringfencing seems more suited to a traditional banking system than the actually existing disintermediated one. For example, the first banking collapse of the recent crisis was Northern Rock, a high street bank with no investment wing.

Part V

Summary

What to make of it all

This pamphlet has painted a picture of how finance changed in the past 30-40 years, why this happened, and how this is related to changes in capitalism more generally. The bare bones of the story went like this:

Capitalists invest in order to make profits - otherwise they'll go out of business. Two keys to high profits are being able to get cheap material/ machinery and paying workers less in wages than the value of what they produce. Following the Great Depression and WWII, both of these criteria were fulfilled (as well as other factors), so there was an enormous economic boom with huge profits. However, this period of high profits had come to an end by the 1970s.

In a desperate struggle to regain profitability, capitalists did a number of things. First, they beat back the advances that working class people had made, by attacking trade unions and lowering pay. The recession of this period also cheapened equipment and materials. Then, both capitalists and workers began to borrow more money, the former to make up for weak profits and the latter to make up for weak wages. Companies began to use banks less and less - instead lending and borrowing through the cheaper process of securitisation.

Furthermore, capitalists started to gamble in the financial derivatives market, hoping to reap big profits. Financial regulations were peeled away to allow this expansion of credit and speculation.

This combination of factors, as well as the internet boom, helped to restore relatively meagre profits through the 1980s and 1990s. But by the end of the 1990s, capitalist profits began to falter again. To avoid a deep recession, interest rates were cut drastically to encourage more borrowing, adding further fuel to the already blazing fire of finance. This towering inferno of debt eventually collapsed in 2008.

As Part IV of this pamphlet makes clear, the new financial regulations created since the 2008 crisis are woefully inadequate. Many of them address the wrong issues, and those that take aim at important problems are far too weak to change anything fundamentally. This is incredibly frustrating and brings a few different explanations to mind: Our politicians are incompetent! If they're not incompetent then they're corrupt, acting as the puppets of the 'banksters'. Most politicians and business people are ideologues, brainwashed by free market ideas. The financial sector is so powerful that it can just veto regulations it doesn't like!

There are elements of truth to all of these. But the most important explanation for the lack of strong financial regulation has been largely missing from the public debate, especially on the left. That is: finance plays a massive role in modern capitalism, and to handcuff it with strict regulations would have huge consequences.

It would be contrary to historical experience to argue that there is a way to make capitalism run smoothly without churning up working people in its gears

Financial activity is not just about lining the pockets of bankers with extravagant bonuses. In fact, the whole notion that production is 'good' and finance is 'bad' is unhelpful. Is environmentally-harmful sweatshop production really 'better', in any meaningful sense, than a Wall Street firm placing bets on interest rate movements?

Instead, we must distinguish between what is 'socially useful' and 'useful for capitalism'. Sure, contemporary finance is not socially useful; neither is a great deal of production. But the currently bloated state of finance is useful for capitalism, in certain ways.

Finance has acted as a crutch both for companies that have found it increasingly difficult to make high profits through production and for working people who have had poor wages since the 1970s. Capitalism is cyclical, with long periods of boom followed by long periods of bust. We've been in the latter phase for more than 10 years - possibly even 40 years - but huge financial bubbles have partially hidden this fact. Surprisingly, former US Treasury Secretary Larry Summers has arrived at very similar conclusions: 'I don't see how growth [in the 2000s] would have been adequate if either tighter monetary policy or much stronger regulatory policy had cut off the housing boom.' Even 'unsustainable bubbles and loosening of credit standards during the middle of the past decade ... were sufficient to drive only moderate economic growth'.

Those of us who are disgusted by the human misery caused by the crisis, and are determined to spend our energy doing something about it, must first have a clear idea of the implications of our actions. A serious regime of strict financial regulations could get rid of the kinds of practices discussed in this pamphlet. But it would almost certainly plunge the global economy into a deep depression. Businesses that have long struggled to achieve high profits would fall like dominoes, and workers would face a huge drop in living standards



as credit dried up (in 2013, 75% of new cars bought in Britain were paid for with credit). Then, after sufficient capital had been destroyed and working people had been ground down far enough, the conditions could be ready for another economic boom.

Or, perhaps there could be another 'Keynesian' boom, with huge government spending to encourage capitalists to invest. As with every time this has been tried in capitalism's history, profits would eventually dry up and we would be faced with another return to poverty. Labour Prime Minister James Callaghan discovered this in 1976, as the government struggled to reverse the end of the post-war boom: 'We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists.'

This may seem like a grim picture to paint regarding the prospects of tackling modern finance. But it would be contrary to historical experience to argue that there is a jolly, undiscovered way to make capitalism run smoothly without churning up working people in its gears. The pursuit of profit at any expense is capitalism, and enormous financial bubbles are a direct result of that. In the short-term, we must try to tackle finance pragmatically with the tools that we have at our disposal. There is no shame in that. But to do away with

these excesses once and for all, we need to think hard about getting rid of capitalism altogether and running our society a different, democratic way.

We live in a radical time: the richest 85 people have more wealth than the poorest 3.5 billion. We need radical changes.

Appendix

The graph on page 7 is derived from economist Michael Roberts' analysis of the global profit rate. The Y axis is left blank because there is some dispute over the magnitude of the rate of profit at different periods, but there is a broad consensus on its general shape. This can be accessed here: http://thenextrecession.files.wordpress.com/2012/09/roberts_michael-a_world_rate_of_profit.pdf

The graph on page 8 is derived from this blog post by economist Michael Roberts: <http://thenextrecession.wordpress.com/2012/12/05/osbornes-mess/>.

The graph on page 23 is derived from data presented on page 2 of Tobias Adrian and Hyun Song Shin (2009) 'The Shadow Banking System: Implications for Financial Regulation'. Federal Reserve Bank of New York, No. 382.

The table on page 26 is derived from data presented on page 111 of Raffaele Scalcione (2011) *The Derivatives Revolution: A Trapped Innovation and a Blueprint for Regulatory Reform* (Alphen aan den Rijn: Kluwer Law International).



An Angry Person's Guide to Finance

Jack Copley, 2014

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The 2008 financial crisis affected billions of people, many of them severely. Yet this monumental event remains widely misunderstood. People trying to get their heads around modern finance, to understand how it has so negatively affected their lives, usually run into an impenetrable wall of jargon. Legitimate anger is too often reduced to uncomprehending exasperation.

This easy-to-read pamphlet cuts through the technical terms, explaining the most basic and central elements of today's financial system - and it does so in a way that will magnify feelings of outrage, rather than smother them. *An Angry Person's Guide to Finance* explains the workings of the financial sector, its historical development and its relationship to the actual production of goods and services.

This holistic perspective is urgently needed. It is only by understanding how finance is related to capitalism as a whole that we can grasp its true nature and - crucially - think about ways to change it.

Jack Copley has an MA in international political economy from the University of Warwick, where he is about to carry out doctoral research on 'The Roots of Financial Expansion in Weak Profitability' as part of the ESRC-funded 'Rethinking the Market' project.