



PROMOTING
**GROWTH AND
SHARED PROSPERITY**
IN THE UK

SPEECH

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REFORMING FINANCE

FOR A NEW ERA ECONOMY



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ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

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BOLD IDEAS
for CHANGE

The following speech was delivered by Carlota Perez, visiting scholar at the University of Cambridge and a member of IPPR's New Era Economics panel, at a seminar event 'Reforming finance for a new era economy', hosted by IPPR on 27 October 2011. Ms Perez was joined at the top table by David Miles, member of the Monetary Policy Committee of the Bank of England, and the seminar was chaired by IPPR director Nick Pearce. The discussion was conducted under the Chatham House rule – this text is reproduced with the speaker's permission.

The most important thing to do when looking for a solution to a problem is to know the fundamental nature of the problem. In my view, the current focus of financial reform is off-target. For that reason, I decided that the most useful ideas to share with you, rather than specific policy proposals (where I am not an expert), are those that could serve as criteria for working with the experts towards reforming finance for what indeed will have to be a 'new era economy'.

This crisis is not a simple bubble crash, however major, nor is it just a financial problem. The parallels being made with the 1930s are indeed in order. In fact, the economy and society have been experiencing a technological revolution that is changing the patterns of production, consumption, trade and finance, and radically modifying the range of opportunities in a new global context. What the automobile and mass production unleashed in the 1920s, is what the internet created from the 1990s. The policy challenge we face is like going from the 1920s and '30s to the 1950s and '60s. And if we get it wrong we are liable to stay stuck in the 1930s for a long, long time.

We do not need to go back to 'business as usual', nor can we. That is over! This is more like reconstruction after the war or after the fire of London. We need to rethink and redesign the economy and how it will work, and that has consequences for the changes to be made in the regulation of and incentives for the financial world, which would have to fund the transition.

Once we understand this much wider direction of change we can come up with criteria for the choice of options among those being offered by the experts in finance (and we can probably encourage them to cast the net wider and come up with even more imaginative and original proposals). The last time around, Keynes provided a bold blueprint that was adequate for that transition. Today we need an equivalent transformation, tailored to the nature of the current shift.

Why do I hold such a radical view? Because there are powerful parallels in history that help us explain what is happening now and aid us in gleaning what the future may hold. To fully appreciate this, we need to change the focus from finance to the wider economy and from there even wider, to technology and institutions – all with a long-term historical lens. Only then can we come back to examine the role of finance in the new era (as the title of the seminar invites us to do).

The lessons of history

This is the fifth major technological shift since the industrial revolution. The analysis of how these great upheavals evolve and modify the structure of the economy reveals a recurring pattern: major crashes regularly occur midway along the diffusion path of each

technological revolution, with 'golden ages' following on their heels, after some significant institutional reconfigurations. And in fact, those great bubble collapses mark the pendular transition between two very different periods of 20 to 30 years each.

The first two or three decades of each technological revolution, before the crash, are a turbulent period of creative destruction, when the new technologies replace or renew the exhausted old ones. Finance is the driver of the economy in this period, helping unfettered free markets to choose the winning products and the leading companies of the emerging technological revolution. The state must then take a back seat while the basic transformation is being forced by competition and while the new infrastructure at the heart of each of these revolutions is being installed, through overinvestment, supported by capital gains in the stock market. Canal-mania and railway-mania were as apparently irrational as the dot.com bubble, but they all left pretty complete networks in their wake. This period (which I call 'installation') is a time for fast millionaires and frequent bubbles and, indeed, each has ended with a major bubble collapse that reveals a breakdown in the real economy, in what has seemed every time like endless prosperity. Along with discovering what had been going on in the casino, we then witness polarisation of income, high rates of unemployment, deteriorated regions, unpayable debts and other ailments in the economy and society that arouse anger against the 'culprits' and call for punishment and regulation.

The two or three decades after each crash have in fact been golden ages. That is when the full deployment of the potential of the new technologies takes place. It is a time for the whole economy to take advantage of the vast innovation and productivity increasing opportunities installed in the previous decades. It is also when the benefits of the new wealth creating potential spread more widely across society. Production, and not finance, now drives the economy, with the state becoming proactive again. Finance then innovates to support the intense wave of expansion, reaping its profits from it and not from speculation.

That is what can now be ahead. But it does not happen automatically. It will have to be the result of explicit policies geared to achieving such an outcome. Let's look for instance at the previous golden age, the post-WWII expansion. This resulted from the successful outcome of a positive-sum game set up between business and society through the welfare state. Reliable and growing incomes across the whole of society along with low-cost suburban housing (made possible by the automobile and electricity) guaranteed a steady stream of demand for the products of the mass-production revolution. Houses, cars, electrical appliances, frozen foods, disposable plastics and so on could be produced in ever-growing quantities, as more and more people had enough disposable income to reach 'the American Way of Life'.

Financial innovation, this time in mortgages and consumer credit, fuelled this golden age (together with unemployment insurance and pensions, which took the fear out of debt). Other activities, supported by financial growth and innovation included the expansion of private corporations, world trade, government spending (including the Cold War, which was another source of demand for innovation in the mass production revolution) as well as other investments across the world, in infrastructure, raw materials, energy etcetera. All that may sound boring next to the excitement of derivatives, super-fast trading, CDSs, CDOs and other synthetic instruments. But it was profitable enough to maintain a healthy and growing financial sector.

Of course, the fact that the current technological revolution is about handling information and its instant transmission across the world will hugely influence the options for the future

financial system. It will be global, it will be information intensive, it will be infinitely rapid and agile to take advantage of any arbitrage possibility, and it will be able to constantly innovate. But it does not have to be a casino. It will all depend on the regulatory framework and the resulting financial architecture.

The tasks for government

Saying that the reform of finance has to be done in the light of a vision for a new economy does not deny that there are problems to confront that are specifically financial. These major collapses both signal the need for structural change to take advantage of the new growth potential and reveal the toxic practices of the financial world in bubble times.

In fact, the task for governments after these major crashes is threefold. The first is intensive therapy to save the system; the second is the redesign of regulation and the third is enabling the structural shift in the real economy. It is the third that provides the adequate criteria for the second and sometimes even for the first. On this occasion, the transfer of the crisis from the banks to governments is providing a choice of intensive therapy options that may be more or less effective for relaunching growth. Without setting the economy on a solid recovery path, the financial system simply cannot be saved.

So how do I envisage this future prosperity? The fundamental premise for examining future options is to understand the nature of the techno-economic paradigm that emerges from the information and communications revolution. That is the source of the huge wealth creating potential that is waiting to be exploited, if market conditions are reshaped in its favour and if the dynamics and the direction of demand are clear for all concerned.

In my view the conditions are there for a sustainable global golden age, based on universal ICT, 'green' growth and full global development. ICT is the enabling infrastructure; green growth provides the direction of innovation for sustainable growth across the whole planet; and full global development – understood as the incorporation of more and more countries in production and trade and of more and more people in consumption across the globe – would provide the required dynamics of demand. For it to be a win-win game for all countries – advanced, emerging and developing – it requires strategies of complementary respecialisation. This means understanding globalisation as a process whereby global companies locate their various elements in different territories depending on their relative characteristics and the governments of those territories engage in a process of explicit differentiation to define the role they can – and want to – play on the global stage.

And now we can go back to finance in the UK and in general.

Regulating finance

There is a difference between the prosperity sustained by a financial bubble (which is typical of installation periods and is what we lived in the '90s and '00s) and the prosperity of solid production expansion across the whole spectrum, which is typical of deployment periods (and is what happened in the post-WWII golden age and also in the Belle Époque and the Victorian boom). During the initial installation period, finance gets excited at first about the extraordinary profits from technological innovation (at a time when the old technologies have become exhausted and the economy is stagnant). The excitement brings a growing flood of avid money to the market which ultimately ends up in a casino of financial innovation decoupled from the real economy. That prosperity is more like a 'gilded age' (as Mark Twain described it).

In contrast, during golden ages, finance supports both production and consumption across the board, and shares in the profits of a flourishing and rejuvenated real economy.

The whole problem of adequate regulation has to do, then, not with restraining finance but with steering it away from the toxic behaviours of recent times and opening sufficiently profitable avenues in the direction of the real economy. How to do this is not simple, of course. There is the inherent difficulty of the task, which requires a deep understanding of the 'reflexes' of the financial world. And this difficulty is compounded by the enormous power and resistance of the financial community, coupled with the lack of conviction and determination of government leaders.

Are we doomed, then? Is there any hope of stopping the casino? I fear coming to the conclusion that things must get much worse before they can get better and that the established discourse favouring unfettered free markets and against state intervention still needs much further battering.

The billionaires that have come out in favour of being taxed and the youth movements such as Occupy Wall Street may already be making a dent in the politicians and may still grow stronger. We don't know how long the process will take. But if what I'm saying is the correct assessment of the situation, there is no exit from recession by just introducing timid – even strong! – financial regulation and tackling fiscal deficits.

It would instead make sense to work on defining the criteria for radical policy design and to collaborate with financial experts in translating them into effective proposals. An obvious example of simple criteria would be to strongly favour long-term patient capital over short-term speculation. We could consider, for instance, a capital gains tax that is very high in the short-term and diminishes to zero after five years (as proposed by Lou Gerstner, the CEO that rejuvenated IBM) and a financial transactions tax that would be insignificant for medium and long-term investors but would penalise super-fast trading.

Other criteria could be to favour investment in the real economy over derivatives, futures and other betting types of financial activities; to encourage venture capital and enable funding of knowledge-intensive services; to find ways of enabling the early phases of green innovations (consider, for example, a price floor on hydrocarbons through a variable tariff when the price falls below a chosen level, as suggested by Tom Friedman); to define and promote a basic floor of enforceable global regulation and so on. And to do this through a bold revamping of the tax system and of whatever other means can be at a government's disposal.

Yet, regulating finance only at the national level makes no sense at all. Finance is now inevitably global, by the intangible nature of its services and products when operating in the internet age. That is the reason for needing a global regulatory floor and an agency with power to enforce it. But the role of the financial sector as a global industry operating in the national space can certainly be a dynamic and important part of a country's economy and a crucial element of its specialisation in the global arena. That is an obvious option for the UK.

The financial sector in the United Kingdom

Finance has recently been the object of well-deserved anger in the advanced world. And, since the enormous increase in the power and relative weight of the financial sector has accompanied the massive outsourcing of the fabricating industries, many voices have been heard calling for the reduction of the financial sector and the revival of manufacturing.

In my view this is not a fruitful idea. The financial sector is a major UK asset for acting in the knowledge economy on a global scale; what it needs is intelligent and effective regulation and reorientation, as discussed above. Whatever the UK will find as its successful areas of respecialisation to restore full employment, these do not have to be seen as an alternative to finance. If anything, conditions should be such that it is profitable for finance to fund the revival of the UK economy.

What I see as the problem both in the UK and in other advanced countries is that the financial sector has gotten used to profit rates that are way above those experienced by the production economy (with the exception of a few of the ICT industries, which were at the origin of this leap in profit levels). Worse still, as Galbraith pointed out in his *History of Financial Euphoria*, the financiers really think that it is their genius that got them all this excess wealth, rather than the special bubble conditions that made it easy. They do not see that their genius would not have taken them so far in the 1950s or '60s, or in a less-developed country. Due to this blind spot, any regulation that might bring those profit margins back to a reasonable – though still high – level is seen as taking away what they deserve, and threatens to get translated into higher charges to customers. This is one of the reasons why the bail-out of the banking system may be seen as overdone. On previous occasions, huge losses were proof of having made mistakes in valuations. Lehman Brothers may not have been enough to help instil these lessons.

If all this sounds like an uphill struggle, just put yourselves in the shoes of the governments and economists of the 1930s and try to envisage the likelihood of the policies that unleashed the post-war boom. It was no easier nor did it seem more feasible. But they did it!

Thank you.