1 The Jekyll and Hyde of Finance

You might recall Robert Louis Stevenson's story, *The Strange Case of Dr. Jekyll and Mr. Hyde* (1886). It's the tale of a London detective who investigates a series of strange occurrences between his old friend Dr. Henry Jekyll and a murderous criminal named Edward Hyde. It is revealed at the end that Jekyll and Hyde are the same person, with Jekyll transforming into Hyde via a chemical concoction he takes to live out his darker urges.[1]

Strangely enough, economic history shows that our financial system has a Jekyll and Hyde quality to it: finance is an essential and highly productive part of our economic system; but the financial system can also be a source of stagnation, instability, inequality, and crisis. In fact, we do not need to look far to see the valuable roles that our financial system can play in our daily lives: we rely on it to get mortgages to buy a home, or for a loan to buy a car; many of us need to borrow to finance our college education; we use banks to hold our savings, and to provide checking accounts, ATM cards, or cash to pay for stuff we want and need. In an emergency, we might need a short-term loan just to get by. For those of us who have the wherewithal to save, we rely on financial advisors and brokers to help us invest our funds in financial markets where stocks, bonds, and other financial assets are bought and sold. We use financial institutions to store or invest our savings to pay for education for ourselves, our kids, and to finance our retirement. Companies large and small need financing to build new factories, innovate with new equipment, or sometimes just to make it from the beginning of the month to the end. And governments—municipal, state, and federal—need to pay for big ticket investments that last a long time: schools, public housing, water infrastructure, roads, bridges, buildings, and to make the transition from fossil fuels to green energy.

This positive face of finance is crucial to the well-being of a modern capitalist economy like ours. But all too often, the destructive face of banking and financial markets takes over. The most dramatic example in recent years occurred when the world's bankers brought the global financial and economic system to its knees in 2007–2009. The economic and social costs of this Great Financial Crisis are mind-numbingly large. In a careful, but conservative estimate of the costs to the United States, economists from the Federal Reserve Bank of Dallas found that "the 2007–2009 financial crisis was associated with a huge loss of economic output and financial wealth, psychological and skill atrophy from extended unemployment, an increase in government intervention and other significant costs . . . We conservatively estimate that 40 to 90 percent of one year's output ($6 trillion to $14 trillion, the equivalent of $50,000 to $120,000 for every U.S. household) was forgone due to the 2007–2009 recession." Better Markets, a Washington think tank, came up with a similar estimate.[2]

To make matters worse, these costs were not shared equally among people and communities. Take, for example, the huge loss of wealth that families experienced because of the collapse of the housing bubble and stock market during the financial meltdown. According to a Pew Research Center analysis, because of the Great Financial Crisis the wealth gaps between White, Black, and Hispanic people rose to record levels. More specifically, with the bursting of the housing market bubble in 2006 and the recession that followed from late 2007 to 2009, inflation-adjusted median wealth fell by 66 percent among Hispanic households, 53 percent among Black households, and just 16 percent among White households. Following these declines, the typical Black household had just $5,677 net wealth (assets–debts) in 2009; the typical Hispanic household had $6,325 in net wealth, compared with the typical White household which had $113,149 in net wealth. The housing collapse associated with the financial crisis also affected different regions differently; and where the collapse was strongest, the recovery was weakest.[3]

Moreover, in less dramatic fashion, on a day-to-day basis, many people, especially those in marginalized communities, have little or no access to cost-effective financial services at all. And most others must pay high fees for the services they can purchase.

Why does the financial system have this two-faced nature? By doing a quick tour of some giants of economic thought we can see how economists have grappled with the Jekyll and Hyde of finance. We start with Josef Schumpeter, famous for coining the term "creative destruction"—now commonly called "disruption"—and for praising the key role of the entrepreneur and innovation in forging economic progress. Schumpeter argued in his *Theory of Economic Development* that banks are key institutions that provide entrepreneurs with the financial resources they need to create new businesses, new technologies, and new innovations. He would have applauded today's venture capitalists who serve that function for America's high-tech start-ups.

Alexander Gerschenkron, a Harvard economic historian, also cited the key importance of finance in the process of economic growth and development. In his famous 1962 article "Economic Backwardness in Historical Perspective," Gerschenkron argued that countries that developed after the lead countries of the United Kingdom and the United States, so-called late developers, needed to use financial institutions, such as investment banks and government banks, to amass the wealth required to invest in advanced industrial production. For Gerschenkron, the process of economic development can be greatly aided by financial institutions and markets that gather finance and allocate it for productive purposes. Gerschenkron used this framework to explain how France and Germany utilized their government and private investment banks to catch up with British industry in the late nineteenth and early twentieth centuries. MIT economist Alice Amsden brought Gerschenkron's story up to date in 2001 by showing the key role played by government development banks in combination with government-led industrial policy in the success stories of the "late, late developers," such as South Korea, Taiwan, and China in the late twentieth century.[4]

Thus, to these economists, financial institutions and markets play a key role in supporting economic growth and transformation.

Other economists have better grasped the dual nature of capitalist financial institutions and markets. Karl Marx saw the positive role that finance could play in capitalism by promoting capital investment in factories and equipment, the "accumulation process," as he called it. But he was also keenly aware of the Mr. Hyde of finance: Marx saw firsthand how the speculators and financiers in nineteenth-century London created financial bubbles of dizzying heights which would eventually burst and bring the system to its knees.

John Maynard Keynes, the British economist who transformed the field of macroeconomics in the 1920s and 1930s, was deeply ambivalent about finance. Like Gerschenkron, he noted the important role finance played in providing funds for modern industry. But at the same time, Keynes was an acute analyst of finance's role in helping to bring about the Great Depression, including its role in the stock market crash of 1929. Keynes was especially concerned about the negative role that financial "speculation" could have on the stability and effectiveness of the financial system. Generally, speculation is used to mean investing in the hope of reaping a short-term profit in an uncertain situation. Keynes meant something a bit more specific: financial investment in stocks, bonds, real estate, or other financial assets, taken not on the basis of calculations of the profitability of the underlying business or activity—what Keynes called "enterprise"—but rather based on the expectation that other investors were going to bet on those particular financial assets. Keynes likened this process to a "beauty contest" based on photographs in British newspapers, where the winner was the contestant who chose the photograph chosen by the largest number of other contestants. To win, contestants would try to guess what the other contestants were going to guess. Any "objective" assessment of beauty—such as it was—became secondary or even irrelevant.

In other words, in deciding whether to buy Widget Inc.'s stock, investor Joe wouldn't care whether the company was profitable or had a good business plan, but only whether Tom, Dick, and Harry were going to invest in it too. For, if they did, they would drive up Widget's stock price, allowing Joe to sell the stock and earn a hefty short-term capital gain. In this environment, Widget Inc. would attract financing not because it had a good investment idea or a great product line, but because everybody thought everyone else believed it did. Hence, they would send financial resources, not necessarily to where they were the most productive, but where people thought they could get the biggest short-term bang for the buck.

Such speculation, according to Keynes, could lead to fads, fashions, and even to financial bubbles and crashes. Keynes understood that such financial speculation was common in capitalism, but he thought it could become a big problem if it got out of hand.

Keynes wrote the following in his transformative 1936 book *The General Theory*:

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.[5]

US economist Hyman Minsky, a follower of Keynes, had plenty to say about financial markets gone bad. Minsky, largely ignored for most of his career by the mainstream of the economics profession, had been arguing for years that capitalist financial markets inherently cause bouts of instability and crisis. In his "theory of financial instability," Minsky argued that financial booms and busts result from bouts of investor optimism as the economy grows, only to be followed by waves of pessimism as the economy slows and possibly crashes. When the Great Financial Crisis of 2007–2009 hit, John Cassidy of the *New Yorker* brought Minsky out of obscurity when he told readers that they were living through a "Minsky Moment" of great financial instability. Minsky argued that in such moments, the government would come in to bail out the financial system—just as it did during the financial crisis—thereby causing the whole cycle of financial instability and government bailout to start over again. Still, as critical as Minsky was of the instability-inducing dynamics of modern financial markets, he believed that finance, with all its destructive aspects, is still a necessary aspect of a thriving capitalist economy. Minsky well understood the two faces of capitalist financial markets.

James Tobin highlighted another potential problem with capitalist financial markets. Tobin, a Nobel laureate who taught at Yale from the 1950s until the 1980s, was a pioneering analyst of financial institutions and markets and spent much of his career identifying their positive effects. In his later years, however, Tobin became skeptical about the efficiency and social value of late twentieth-century financial institutions and markets. His concern was not specifically about the occasional financial panics and crashes that afflicted capitalism, but rather, the costly inefficiency and day-to-day misallocation of our nation's resources when the financial system became bloated. In particular, Tobin expressed concern that with the accelerating growth of the financial markets and institutions in the 1970s and 1980s "we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private reward disproportionate to their social productivity."[6] Note this was written in 1984 when the financial sector was much smaller than it became in the twenty-first century.

Tobin's warning about financial "activities that generate high private rewards," such as speculation, versus those that promote "social productivity" and provide benefits for many, is crucial for understanding the shortcomings of our modern financial system and what we can do to correct them.

All of these concerns about the negative face of finance have appeared in the foreground of economists' writings. But there is an underground discussion as well that professional economists may feel uncomfortable with that is often at the forefront of the public's consciousness. I am referring here to the fact that financial activities are well known to be subject to corruption and manipulation. Economists have been wary of giving too much attention to these unsavory concerns, which they often see as aberrations of well-meaning, if sometimes selfish, mistaken, and even greedy financiers.

But Nobel Prize winners George Akerlof and Paul Romer broke this silence among mainstream economists when they wrote a widely read article in 1993, "Looting: The Economic Underworld of Bankruptcy for Profit," identifying conditions that lead bankers to strip their clients and banks of their assets, especially if they think they can get away with it. Their article nudged economists to analyze the range of corrupt and manipulative practices that financiers have used to separate people from the wealth. For example, the US government's Securities and Exchange Commission (SEC) lists almost a dozen of such practices, including Ponzi schemes, which the SEC defines as "an investment fraud that pays existing investors with funds collected from new investors." Ponzi scheme organizers often promise to invest your money and generate high returns with little or no risk. But in many Ponzi schemes, the fraudsters do not invest the money. Instead, they use it to pay those who invested earlier and may keep some for themselves. With little or no legitimate earnings, Ponzi schemes require a constant flow of new money to survive. When it becomes hard to recruit new investors, or when large numbers of existing investors cash out, these schemes tend to collapse. Ponzi schemes are named after Charles Ponzi, who duped investors in the 1920s with a postage stamp speculation scheme.[7]

WHICH FACE OF FINANCE WILL SHINE AT ANY GIVEN TIME?

The work of economic historian Charles Kindleberger offers us some clues into whether we will confront Mr. Jekyll or Mr. Hyde at any particular time. In his aptly titled book, *Manias, Panics and Crashes,* he described in meticulous detail how, on a global level over five centuries, financial crises have been what he called "a hardy perennial." Kindleberger showed that over a five-hundred–year period, a major set of financial crises occurred roughly every seven years. Figure 1 from Carmen Reinhart and Kenneth Rogoff illustrates these periodic crises for a more recent span of history.

The figure shows the percentage of the countries in the world that experienced banking crises each year, over more than one hundred years, from 1900–2008. It clearly illustrates the crisis periods: 1907, World War I, the Great Depression of the 1930s, the developing country crises of the 1980s and 1990s, and, of course, the great financial meltdown of 2007–2009.[8]

Two points stand out here. First, as Charles Kindleberger said, financial crises are, indeed, a hardy perennial of capitalism. The ups and downs of financial and banking crises over the sweep of the last hundred years are breathtaking. But the second point is more intriguing: If you look at the period between World War II and 1980, we see a long period of financial tranquility. This was a period of virtually no banking crises anywhere in the world. This was also a period of rapid economic growth, both in the United States and in other places, including Europe and Japan.

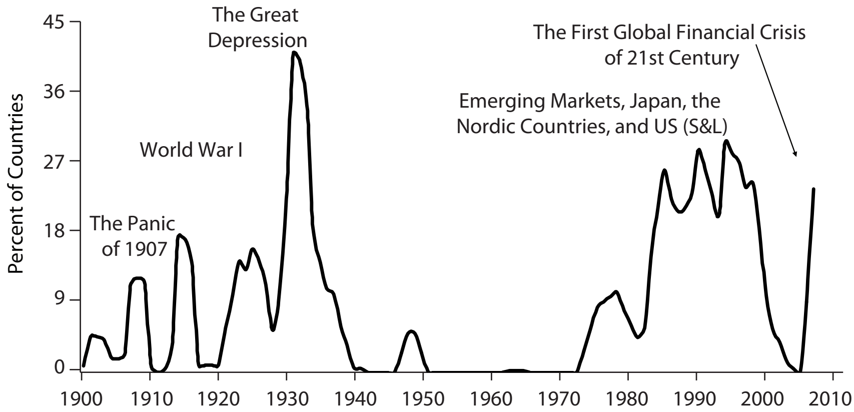

Figure 1. Proportion of countries with banking crises, 1900–2008, weighted by their share of world income. Source: Reinhart and Rogoff (2008).

Why did we have this period of relative financial calm and rapid economic growth? A central factor was the strong financial regulations that were implemented during Franklin Delano Roosevelt's (FDR's) New Deal in the 1930s, along with similar regulations in other parts of the world. These financial regulations greatly restricted the Dr. Hyde impulses of bankers, while incentivizing more socially productive financial activity. To use Keynes's terms, these regulations encouraged investment in "enterprise" and limited "speculation."

A second, though less well-known factor was also at play. Public banks and financial institutions, with a strong orientation toward serving social needs rather than toward maximizing private profit, played an important role in the US economy and abroad. For example, the New Deal financial reforms promoted "mission oriented" financial institutions to promote housing, small business, and state and local financing. A postal banking system was in place until the early 1950s. A public system of rural farm credit and domestic educational and housing support was also created, albeit, as I discuss below, in a highly racially discriminatory manner. In Europe, public financial institutions were dominant in many countries: banks were nationalized in France, and a system of regional public financial banks were set up in Germany, for example.[9]

These publicly oriented financial institutions and services helped to allocate credit to socially productive areas—housing, education, small businesses, and infrastructure. They complemented the purely profit-driven capitalist financial institutions, providing important stabilizing and socially productive financial services. In short, these publicly oriented types of financial entities helped to counter-balance the Hyde face of private, for-profit finance.

To be sure, strong financial regulations and an important role for public financial institutions are only part of the explanation for the financially stable and relatively prosperous period following the Second World War. Other important aspects included a period of relative world peace, social protections, an effective welfare state in the United States and Europe, strong labor unions, and limitations on instability inducing flows of international capital, among other factors.[10] Still, strong financial regulations and a significant presence of publicly oriented financial institutions who eschew the maximization of private profits were key.

The puzzle, however, is this: If we know the main requirements for a socially productive financial system, then why don't we have one? The answer is that financial reform and reconstruction is blocked by powerful, private financial institutions, their CEOs and top management, and their major investors and owners who make much larger salaries, bonuses, and profits when these banks and other financial institutions are lightly regulated and when they don't have to compete with publicly oriented financial institutions. These bankers wage a massive political fight against financial regulation and the promotion of publicly oriented financial institutions.

Since the 1980s, these bankers have been spectacularly successful in their political battles against regulation and reform. Not only have they succeeded in largely dismantling the tight financial regulations implemented by FDR's administration during the New Deal, they have also been able to ward off many new regulations in the aftermath of the Great Financial Crisis of 2007–2009. The bankers were able to win many of these battles despite public anger at the multitrillion dollar bailouts the bankers received from the taxpayers when the Great Financial Crisis hit. And to add insult to injury, just ten years later, when the COVID-19 pandemic was announced in March of 2020 and a global financial panic