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DECOMMODIFICATION OF FINANCIAL REGULATION AND PUBLIC ACTION

Faruk ÜLGEN
Deputy Director of the Center of Research in Economics of Grenoble (CREG)
Director of International Relations & Conventions & Head of Distance Learning Programs
Department of Economics – University Grenoble Alpes
1221 rue des Résidences BP 47 38040 Grenoble Cedex 09-France
faruk.ulgen@univ-grenoble-alpes.fr

Abstract
This article seeks to analyze the institutional roots of the last decades' financial crises and in particular those of the 2007-2008 systemic failure. These instabilities seem to be mainly due to the liberalization of financial markets since the system-wide liberalization triggered the process of financialization of many sectors of the economy and gave the priority to the financial efficiency criteria within the decision process of market players. Mainly relying on speculative arbitrage, the economic engine is wheeled thanks to the attractiveness of financial innovations that have nurtured rent-seeking operations without supporting the financing of productive activities. I maintain that such an evolution is the great transformation of the New Millennium Capitalism that mainly rests on the institutional transformation of the regulatory structure that is the commodification of financial regulation. The latter has replaced public regulatory mechanisms by private self-regulation systems that rely on market price-directed contractual schemas. Such an institutional transformation has fueled the system-wide process of financialization and led market-based capitalist economies to a highly speculative and macro-economically perverse regime of accumulation. Despite recurrent downturns, speculative return-related wealth keeps increasing and widening the income inequality gap. For instance, even in the aftermath of the 2007-2008 financial turmoil and subsequent market failures, U.S. billionaire wealth almost doubled between 2010 and 2020, increasing 80.6 percent in 2020 dollars, while the median wealth of U.S. households only increased 15.1 percent between 2010 and 2016. From an institutionalist perspective, this article maintains that contrary to the usual doctrinal assertions, market-related liberal regulation prevents finance from contributing to economic development and restrains public action from supervising markets without generating social dilemmas. Without an appropriate organization and supervision, financial markets do not lead to a social optimum since they suffer several inconsistencies like the discrepancy between micro-rationality and macro-coherence, cognitive bias, and the publicness of financial stability. The viability of market economies depends on the sustainability of financial operations that requires specific public action aimed at systemic stability. In order to prevent the catastrophic consequences of financialization, financial regulation must be decommodified and financial stability must be handled as a common good.
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1. Introduction

This article addresses the inconsistencies between the commodification of financial regulation and the stability of the financial system. The regulatory commodification replaced extra-market public regulation by market-relying self-regulation and led capitalist economies to a macro-economically perverse speculative regime of accumulation. The 2007-2008 crisis (GFC) can be regarded as an institutional systemic failure of the process of liberalization of the 1980s-1990s. To date, despite the society-wide consequences of the GFC and the brutality of the 2020-21 Covid crisis, speculation-related wealth keeps increasing and widening the income inequality gap[1] without any growth perspectives and improving living conditions[2]. This situation worryingly contributes to economic insecurity (Minsky and Whalen 1996-1997).

In order to reverse this threefold perverse evolution (recurrent instabilities, economic inefficiency/persistent sluggishness, and growing inequalities)[3] and make the economy move to a sustainable path, institutional reforms must be implemented to frame a relevant public action plan on financial systems. An urgent change may come from the decommodification of financial regulation that should treat financial stability as a common good issue. To contribute to such a project an institutionalist analysis is suggested through three sections. The first section discusses major weaknesses that liberalized finance suffers (cognitive bias, discrepancy between micro-rationality and macro-coherence, the publicness of financial stability). The second section suggests an institutionalist interpretation of unstable financial dynamics. The third section discusses some policy avenues through extra-market financial macro-regulation aimed at systemic stability.

[1] Collins et al. (2020) document that the U.S. billionaire wealth almost doubled over 2010-20, increasing 80.6 percent in 2020 dollars, while the median wealth of U.S. households only increased 15.1 percent over 2010-16. In a NBER study, Wolff (2017) notes: "Median wealth in 2016 was still 34 percent down from its peak in 2007. The inequality of net worth, as measured by the Gini coefficient, after almost two decades of little movement, was up sharply from 2007 to 2010. It then increased moderately from 2010 to 2013 and again from 2013 to 2016, though the wealth share of the top one percent shot up by 2.9 percentage points. Middle class debt, with the exception of student loans, contracted sharply from 2007 to 2013 but then rose slightly from 2013 to 2016."

[2] The latest *World Economic Outlook* of October 2020 by IMF sounds the alarm on global developments and forecasts global economic growth of around -4.4% for 2020 with an increase in extreme poverty for millions of people around the world, due to a "long and difficult recovery" of the global economy which, moreover, is currently experiencing the shock of the Covid in an unexpected way. Nickel et al. (2020) document that despite notable improvements in the euro area labor market since 2013, wage growth was subdued and substantially overpredicted during the last decade.

[3] Such an evolution is fully opposed to the expected "European Prosperity Triangle" that seeks to bring together equity, economic growth and macro-stability (Pichelmann 2013).

2. Inconsistencies of financial liberalization

Financialization is the primacy of financial criteria over economic and policy decisions leading to a greater importance of the financial sector within economies (Palley 2007, Sawyer 2014). Financialization is the result of financial liberalization, regarded as a condition for economic development. Financial liberalization is rooted in efficient market hypotheses that rule the economics since several decades[4]. However, from the 1980s onwards, liberalization transformed economies into speculative-rent-generators without really contributing to large-scale development. It also fuelled the conditions that generated the GFC with persistent unemployment. Financial liberalization suffers some inconsistencies, namely cognitive bias, discrepancy between micro-rationality and macro-coherence, and the publicness of stability.

Cognitive bias and market behavior

Cognitive bias or cognitive dissonance is the tendency to consider issues only within a certain paradigm without challenging its basic premises. The policymakers and scholars also suffer such a behavior in spite of large crises that should call into question doctrinal beliefs (Kessler 2010). Tversky and Kahneman (1974) show that cognitive biases stem from the reliance on judgmental heuristics (rules-of-thumb) and that people do not learn relevant relationships between different variables in their decision process although data for such learning may be abundant and available. Akerlof and Dickens (1982) assume that people also have preferences over their beliefs about the state of the world, that they can manipulate their own beliefs by selecting information likely to confirm their desired beliefs and that the preferred beliefs are persistent over time. When economic actors convince themselves that their strategies are safe (profitable), they potentially make judgment errors due to the discrepancy between their beliefs and the true state of the world. But at micro level, the information about the state of the world is limited to what people can know and understand at their personal level. The final overall result can only be observed as a final result of previous market strategies. Olsen (2008, 1) also argues that people do not change their existing beliefs when confronted with inconsistent evidence and become overconfident about the relevance of their choices. In order to give relevance to such a self-confirmation process, people pay greater attention to facts that

[4] Referring to the ad hoc assumptions of competitive-market equilibrium and ignoring the monetary characteristics of a capitalist economy, the economics profession usually asserts that markets must be framed according to the rule of invisible hand and that public action must be reduced to its lowest expression as defender of private property.

substantiate their position. They are then in a "confabulation" (*honestly lying*) state and become irreceptive to any objective analysis of the situation.

Thaler (2018) notes that the crucial change brought forward by the Prospect, Nudges and the like approaches is that, unlike the efficient market models[5], errors can be assumed to be predictable. In this case, one can affirm that actors behavior leads to non-optimal results at the collective level[6]. Barberis and Thaler (2003) then point to the crucial differences between consistent beliefs assumption that leads to efficient market models and structural uncertainty[7] that leads to institutionalist analyses of a non-ergodic world.

Inconsistency between micro-rationality and macro-stability

The discrepancy between the supposed efficiency of micro-rational behavior and the expected macro-coherence lies in a sort of fallacy of composition: free markets cannot result in social harmony without any public organization and supervision. Micro-rationality and macro-stability are two distinct issues that do not have direct relationship with each other but through collective/public action. Micro-rationality relies on private information and beliefs about a given micro-environment and about a hypothetic external world. Macro-stability is related to the non-ergodic (non-collectively-planned) dynamics of the whole system. Minsky (1991) argues that markets evolve through individual heroic expectations about the future state of the world without having effective information on its dynamics (the future is not yet known). This uncertain environment underlines the fragile posture of micro-rationality as the working of markets rests on the subjective transformation of uncertainty into mere risk calculations thanks to mass psychology that let market players enter into fragile financial positions (Keynes 1936). From this perspective, individual rational behavior transforms, through the

[5] which are mainly based on the assumption of rational expectations that treat errors as white noise and therefore unpredictable (thus allowing us to assume that market mechanisms operate at the optimum).

[6] Here, the predictability of errors does not mean that we can avoid the error because we recognize it, but that we know that there will be an error that will affect the results in the opposite direction to those we would hope to achieve. And this, without allowing us to change our behavior to avoid such errors in the future!

[7] Barberis and Thaler (2003, 1053) note: "It is important to note that most models of asset pricing use the Rational Expectations Equilibrium framework (REE), which assumes not only individual rationality but also *consistent beliefs* [Sargent (1993)]. Consistent beliefs means that agents' beliefs are correct: the subjective distribution they use to forecast future realizations of unknown variables is indeed the distribution that those realizations are drawn from. This requires not only that agents process new information correctly, but that they have *enough* information about the structure of the economy to be able to figure out the correct distribution for the variables of interest. Behavioral finance departs from REE by relaxing the assumption of individual rationality. An alternative departure is to retain individual rationality but to relax the consistent beliefs assumption: while investors apply Bayes' law correctly, they lack the information required to know the actual distribution variables are drawn from. This line of research is sometimes referred to as the literature on bounded rationality, or on structural uncertainty."

private decision process, the Knightian authentic uncertainty into risk though this does not reduce the potential systemic instability at a macroeconomic level.

Publicness of financial stability

The publicness of financial stability lies in the monetary characteristics of a capitalist economy and may lead us to understand what's wrong with the way our economy works (Ülgen 2020). The monetary&financial system reveals to be a public infrastructure since economic relations are all resting on monetary&financial operations whose continuity is a sine qua non condition for the viability of society. Money is a society-wide institution, a set of rules/mechanisms/laws (the payments system) that organizes the issuance, use and repayment of private debts intended for financing of entrepreneurial expectations. This allows private units to undertake decentralized activities without any central plan or collective-decision process. Money and related funding processes/products are supplied by banks and remarketed by financial institutions. In this schema, money is ambivalent[8], a private&public organization, and transversal[9], determining and affecting every economic decision and existence (Ülgen 2014b). Consequently, the stability of financial operations is a prerequisite for continuous and sustainable economic relations. However, financial stability, which is a system-wide (systemic) issue, cannot be ensured through market mechanisms since it must be regarded as a public good to be provided by public action, partly in light of aforementioned inconsistencies of free market mechanisms. This issue is related to a more general "Collective-action/Tragedy-of-Commons" issue.

Collective action can be defined as actions of a group seeking a common goal following commonwealth and is related to social dilemmas that occur whenever interdependent-individual choices result in sub-optimal situation without collective organization. Ostrom

[8]Money is *ambivalent*, it is resting on private market decisions that rely on public rules and society-wide mechanisms. Therefore, money has a twofold nature. It lies both in private decisions and in public/extra market general rules. Money creation is related to private economic decisions of banks and entrepreneurs and allows economic agents to undertake profit expectations-based decentralised plans. At the same time, it relies on general (non-individual, non-private) rules (payment system rules). The payments system is a decentralized private-action system. But at the same time, it is a pure public mechanism since as the society-wide general means of payment and settlement money must rest on extra-market anchors. It is created through private individual decisions but it must stand as a common institution over the whole private economic sphere.

[9]Money is transversal since everything, everywhere and everyone is directly/indirectly involved in monetary (debt) relations *without necessarily taking directly part in the monetary and financial operations* through which the economy does usually evolve. Monetary (and related financial) operations takes everything into their oscillations since all economic transactions rely on monetary relations. Monetary and financial problems do structurally matter to all other sectors through the changes of strategies of the credit-money providers (banks) and of financial intermediaries. Hence, changes on money and financial markets affect the whole economy irrespective of decision units which are or not involved in debt relations.

(1998, 1) focuses on public good dilemma such that "all those who would benefit from the provision of a public good (…) find it costly to contribute and would prefer others to pay for the good instead". The result of such a decentralized rational action process is an irrational social outcome: the good everyone would need is not provided or underprovided in the absence of a collective coordination mechanism.

Developing this analysis through the usual criteria of identification of public goods such as non-rivalry and non-excludability, along with the societal criticalness of financial stability as a decisive aspect of the issue, Ülgen (2018, 2020) offers a comprehensive analysis of financial stability as a public good. Systemic financial stability cannot be provided at the level of private individuals' decisions and actions, may these actions be safe or risky from a microeconomic perspective. That leads to regard financial regulation as a problem of collective organization.

3. An institutionalist approach to a financialized economy

In order to suggest a relevant alternative model of systemic stability, it seems to be suitable to embrace an institutionalist perspective in the sense that the institutional framework (laws, rules, codes of conduct, etc.), elaborated by a collective and systemic will for a collective purpose, *in the name and for the common good*, is supposed to determine[10] the environment in which private actions would be consistent with societal expectations. This means that the institutional frame is intended to mould[11], to condition[12], and also to ordain individuals' behavior. In this line, Ülgen (2014a) maintains that major institutionalist works of Clark, Commons, Hamilton, Mitchell and Veblen (to quote but a few) in the early 20th century offer the basic elements for a relevant analysis of the functioning of a monetary capitalist economy and of endogenous instabilities. These roots anticipate, although scantly, the profound developments Minsky (1986) would offer some decades later through his endogenous financial instability analysis. Indeed, the evolution of capitalism is related to the evolution of the institutional environment that allows actors to adopt some specific strategies. For instance, when financial regulation, previously related to public control and supervision rules, is commodified and left to market practices, financial markets move toward two major changes. First, they are incited to develop innovations and enter into speculative activities through

[10] to fix in scope and extent.
[11] to influence and direct.
[12] to alter the reaction of actors to incentives, -i.e. particular stimulus or situation.

optimistic and short-sighted positions[13]. Second, they assess and manage their engagements through internal/subjective models and credit-rating agencies. Therefore, during expansionary periods, while cumulated disequilibria grow, the desire to make further profits generate cognitive bias. Actors reject prudential behavior and keep developing "likely" profitable positions.

This new regulatory environment opens a widespread breach between the quantitative/speculative micro-efficiency of the new finance and the qualitative/long-term efficiency of the monetary/financial system, required for societal viability. To cope with such destabilizing evolution and its destructive consequences, the redesign of the regulatory framework is a *sine qua non* condition that requires more voluntarist policies aiming at giving financial markets a positive role in economic evolution. Self-regulation in force on financial markets is proving to be inapt to ensure the functioning of finance in a sustainable way. It prevents finance from contributing to economic development and public action from supervising private strategies without generating social dilemmas.

In the aftermath of the GFC, most debates are related to the opposition between market liberalism and public interventionism and to what extent markets should be framed and regulated by the visible hand of public action. Polanyi (1944) argues that market-liberalism and self-regulation related institutional framework is the disembeddedness of economic mechanisms out of society. Financial liberalization is a process of a specific institutional change where the rules-of-thumb remove extra-market constraints and supervision in favor of liberal regulation. Polanyi asserts that generalized liberalization calls for public intervention to ensure systemic stability. To deal with the "stark utopia" (Polanyi 1944, 3) of market fundamentalism and its catastrophes, capitalist finance should be reframed according to the financial needs of socially sustainable activities. Therefore, researches on a possible reorganization of markets and regulatory structures should be developed with regard to the weaknesses of liberal models in order to "re-embed" the monetary&financial system in economic development. The decommodification of financial regulation seems to be a necessary step to put finance within its positive role of economic development financing. From this perspective, financial stability, as a critical public good, must be produced, distributed, managed and supervised by public authorities in order direct private actors' behavior toward globally compatible economic actions to achieve common good.

[13] for instance, by financing holding companies' LBO operations without questioning their financial and economic soundness at the long-run.

4. For an alternative financial regulation

The liberal regulation rests on market incentives and lies in punitive measures. But it is unable to save the victims as the crime is already committed. However, the primary goal of any regulation is to protect the integrity of the economy by ensuring the integrity of the financial system. This requires preventing individuals from endangering the entire economy through their possible failures. The regulatory alternative must then be a preventive/prudential framework.

It is possible to point to some policy implications for systemic stability through the opposition between micro-prudential and macro-prudential regulation. Whatever the public supervision implemented over individuals, micro-prudential incentives fail to prevent short-sighted individual behavior because of the limited scope/extent of private expectations. In financialized era, this sort of *macular degeneration* is permitted by the new speculation-oriented financial innovations and relations that lead to Ponzi schemes (Minsky 1986). A specific institutional feature of capitalist finance might be designed following Minsky's analysis of endogenous instability of capitalist finance that focuses on the role public power should play in the stabilization process. Indeed, Minsky maintains that the central issue that policy-makers have to deal with is the organization and management of endogenously unstable capitalism. Minsky (1982) asserts that an institutional evolution is necessary in order to shape financial systems in a consistent way. Such an evolution does require a "big government" to sustain capital accumulation and employment in period of stress and a central bank to intervene as a lender-of-last-resort during financial turmoil to ensure the integrity of the banking system.

In a similar way, Boar et al. (2017, 84) document that: "The main aim of macroprudential tools is to reduce systemic risks and the frequency of deep financial crises. Effective policy interventions should thus be reflected in a more stable economy. (…) For particularly open *and* financial developed countries, the net effect of macroprudential interventions on economic activity is especially beneficial."

In the wake of the GFC, numerous works studied the characteristics of relevant macroprudential policies to prevent and mitigate both the excessive risk taking and the possible effects of increasing risks at the systemic level (Galati and Moessner 2013, ESRB 2018, Bengtsson 2020). The de Larosière Report (2009) focuses on several weaknesses of financial systems and point to what should have not been done (what could be done in a reformed world). The report underlines fundamental failures in the assessment of risk, by financial firms and regulators. The originate-to-distribute models generate perverse incentives and contribute to increasing risks.

Remuneration and incentive schemes within financial institutions contribute to excessive risk-taking by rewarding short-term risky trades rather than the long-term profitability of investments. Market-based regulation results in conflicts of interests in credit rating agencies and worsen the regulatory weaknesses. This evolution cannot be contained if regulators focuse on micro-prudential supervision of individual institutions and not sufficiently on the macro-systemic risks of a contagion of correlated horizontal shocks. The core issue is obviously related to the institutional coherence of markets and the scope (possibility and capacity) of public agencies to shape and supervise markets in a way that would lead to a more stable configuration.

Placing the emphasis on the institutional framework following Coase, North, Olson, and Veblen, Haldane (2013) seeks to answer this question: What institutional features are likely to be most important in safeguarding financial stability -regarded as a public good-. He then argues that financial stability should be placed in the hands of an arms-length (public) institution. IMF (2013) also states that strong institutional and governance frameworks are essential for the effective conduct of macroprudential policy and that the central bank needs to play an important role. A few rules, aimed at ensuring systemic stability are the rules that should give markets good incentives but also prevent markets from involving society in societal risks. The two sides of the same issue come then into the picture: establishing restrictions to put the speculation out of reach of the credit system and providing incentives for long-term productive commitments. From this perspective, financial markets should be organized as a public good provision process. As capitalism develops through more financialized forms, new institutions and working rules may emerge in order to govern economic relations among public and private actors. Viability of society relies on the institutional transformation process seeking to ensure a sustainable provision of public utilities (financing the economy) and public goods (financial stability). Minsky (1986, 116) wisely states that markets cannot self-adjust and need public institutions to contain instabilities. "[I]t is necessary to inquire if policies can be adopted or institutions created that are able to constrain or offset the processes that would lead to incoherence. If the pricing mechanism of a decentralized capitalist economy can lead to coherent results *only if* proper policy or institutions rule, then intervention is necessary even though the market mechanism can be relied upon to take care of details."

5. Conclusion

The research conducted in this article suggests that financial instabilities mainly come from the lack of effective public action apt to organize a relevant regulatory system to keep frame

finance as a critical public utility. The article maintains that in a liberalized economy that relies on a flawed/irrelevant self-regulation, institutions fuel the system-wide process of financialization and lead markets to a highly-speculative regime of accumulation. In the wake of recurrent systemic crises, it is time to remove the assumption of micro-rationality-based economic efficiency and market-relying self-regulation in favor of alternative financial organization and regulation of markets in order to improve economic development in a sustainable way. Through an institutionalist analysis, this leads to regard financial stability as a public good that could not be entrusted to the vicissitudes of markets. The decommodification of financial regulation/supervision and the design and implementation of macro-prudential policies, consistent with the dynamics (weaknesses as well as potential strengths) of a monetary capitalist economy, must be regarded as the necessary first and urgent steps of economic policy reform.

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