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# FESSUD

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Financialisation and the Financial and Economic  
Crises: The Case of The U.K

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# Financialisation and the Financial and Economic Crises: The Case of The U.K

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**Abstract:** This paper investigates empirically financialisation and its effects in the UK economy. It presents an historical overview of the changes of the UK financial sector with the long-run development of the UK economy, mainly since the 1980s. Section 3 examines the effect of financialisation on income distribution, investment, household consumption and the country's current account. It is argued that income inequality has increased since the mid 1980s. Rentier income too has increased whilst retained earnings have fallen during the period between 1997 and mid 2000. The data suggests that dividend and interest payments by the non-financial sector have increased significantly during the period under consideration. On the other hand investment in capital stock has steadily declined. Financialisation is also evident when analysing the UK's household sector. Perhaps the most revealing evidence provided in this section was the level of debt of the UK's household sector. The high levels of debt were associated with a decline in the propensity to save. In its foreign sector the UK's current account has been in deficit for most the period between 1980-2013. Also the country's International Investor Position has been negative during the same period. With strong linkages to the global financial system, the UK economy entered into deep recession in 2008.

**Key words:** Financialisation, capital markets, UK economy, banking, finance.

**Journal of Economic Literature classification:** G20, G30, N10, P16

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## Acronyms

BIS	Bank for International Settlements
FSA	Financial Services Authority
FSB	Financial Stability Board
FSR	Financial Stability Report
IIP	International Investment Position
GNP	Gross National Product
LIBOR	London Inter-Bank Offered Rate
ONS	Office for National Statistics
OTC	Over the Counter
SME	Small and Medium-sized Enterprises
UK	United Kingdom
US	United States of America



## 1. Introduction

In the accompanying sister paper, the UK Country Report<sup>1</sup>, the paper discussed the development of the UK financial system and of financialization in the United Kingdom, including included rising leverage of households and corporates, deepening of inequality and changes in consumption and investment patterns. Detailed discussion of events and empirical data and support are provided in this paper and should be referred to by the reader.

In this paper, the themes of the UK Country paper – differentiating between “empirical” and “structural” financialization are built on, presenting a more conceptual approach focusing on structural financialization in order to examine the evolution of the UKs financial sector and its implications for long-run macroeconomic development and on the recent financial and economic crises. This includes returning to the evolution of the UK’s financial system but, building on the more empirical and historical approaches of the accompanying paper, examining the nature of the changes taking place including transmission mechanisms of disturbances from the financial system to the real economy.

It also places greater emphasis on the UK financial system’s place in the international financial system which is important both to provide the full context for the inter-relationship of the changes in the domestic financial system with those in the international system, including contagion effects, and because of the UKs financial system importance as a hub for international financial system compared to other European financial systems.

Finally, this paper is differentiated from its sister paper by the greater emphasis on policy analysis, including its role in dampening or accelerating financial and economic crisis. As will be discussed, the paper presents the view that policy in the UK from the early 1980s onwards was largely an accelerator of instability and crisis.

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<sup>1</sup> Shabani, Tyson, Toporowski, and McKinley (2014)



In the first section I, the paper presents a historical analysis considering the Bretton Woods system and how it broke down in the early 1970s and evolved into the liberalized financial systems and became integrated with the Euromarkets, encouraged by the reduction of credit regulation. By the end of the 1990s a “new order” had been established in the UK financial system that led to rapid innovation within, and expansion of, the financial system that lies at the core of financialization. The impact of this was to undermine financial regulation and monetary policy, leaving few policy tools to prevent or adequately manage rising systemic risks that emerged in the 2007 financial crisis.

In the second part of the paper the implications for long-run macroeconomic development are considered, including impacts on distribution, investment, consumption and current account. As will be discussed, these were intimately linked to “empirical” financialization – that is the growth of – the financial sector through increases in leverage, but also to “structural” financialization and the political economic environment that promoted and supported it.

In the third section the paper considers how these issues have altered transmission mechanisms within the financial system and between the financial system and the real economy. Within the financial system they have affected stability through increasing interdependence within the financial system in relation to liquidity and asset valuations, encouraging implicit “herd” behaviour. Changes in the transmission mechanisms have also impacted on financial institutions’ responses to exchange and interest rates, and in this way affected the effectiveness and independence of monetary policy. Finally, the relationship between the real economy, including savings and investment, has been altered, undermining the traditional role of the financial system in serving the real economy through effective and efficient intermediation.

Finally paper concludes by summarizing the main finding of the paper and concluding that the process of financialization was not a predetermined outcome,



even of simple liberalization of financial markets, but of the permissive policy environment under successive governments. Without such political endorsement structural financialization would not have manifested itself in the corporate and household sectors or in the increasing instability of banking and capital markets and the economy as a whole.

## **2 Long-run development in the UK's financial system and its links to the international monetary system and Neo-liberalism (1945 to 2013)**

### **Development of the UK Financial System in the 1980s**

The UK financial system entered the 1980s integrated into an international economy that was unable to accommodate new realities in a stable and coherent fashion. As a consequence, coherent change could not occur. To a considerable extent this pattern of development followed from the use by the USA and, to a negligible extent, the UK of their respective international currency positions to finance post-War rearmament with its resulting deterioration in both countries' current account balance. Nixon's devaluation of the US dollar exported inflationary pressures to the rest of the world. The build-up of eurodollar balances led to considerable exchange rate and interest rate volatility and a dislocation between the real exchange rate and real interest rates. There was no oversight of international banking, and there was no single system of pegging the exchange rate in the face of increasing volatility. Economic expansion was increasingly concentrated in a few countries and the growth of world exports was slower than at any time since World War II. Individual countries were forced to make uncoordinated unilateral adjustments. For the most part, the central problem addressed by economic policy was persistent inflation usually accompanied by relatively slow economic growth. Increasingly, the UK Government found that the traditional policy of credit controls was less effective, and began a tentative loosening of financial market controls. So-called stagflation led to the search for simple policy "solutions", particularly in the UK. This empowered the authorities to ignore the Keynesian vestiges that remained in the international financial system and to embrace monetarism and floating exchange rates.





The so-called Keynesian Revolution was therefore nearly over when the US President Nixon declared that “we are all Keynesian now”. The sources of, and interests supporting, the revolt against Keynesianism, that gathered strength in the 1960s and 1970s, have been exhaustively documented. They united around an ancient idea that society is nothing more than a simple sum of actions by individuals to which collective action has nothing to add. Rather, the state exists merely to institute and enforce rules which facilitate individuals to “truck, barter and exchange” each according to her own expectation of gain and loss. Hence, in principle, the role of the state is confined to providing a legal system and collective defence. In summary, in such a society the state existed to preside over systems of market exchange.

This idea of the minimal state found its most powerful political advocates in the forms of Ronald Reagan and Margaret Thatcher. Both traded extensively on the rhetoric that the state had failed as an agent of political economy. Not only could it not create wealth but also it was a deadweight on private enterprise and so crowded out the incomes and wealth created by private firms. The political economy of the 1980s aimed to remove the burden of the state from private companies through corporatisation, privatisation, a balanced budget and reduced taxes.

In practice, things were never so simple. First, in the UK, the state remains a very large provider of many goods and services and forms significant capital assets and employs millions of people for this purpose. To this day, UK Government makes many economic decisions which affect developments throughout the whole economy. Second, the failures of the financial system in the 1970s led to the resumption of controls over particular financial activities. These were of varying effectiveness and coverage and were largely abandoned by the mid-1980s. Third, many vested interests supported some existing types of state intervention and these were often politically influential. However, during the 1980s these vested interests



(especially workers' organisations) were deliberately and consistently undermined; a policy that continues. Fourth, many economic activities were not distributed through markets and in some instances proposals for application of markets were strenuously opposed. This is particularly true of services like education and health. By the 1980s, full employment as a goal of economic policy had been largely abandoned, and the scope of economic policy was reduced to securing low inflation.

The assertion that inflation is a "purely monetary phenomenon" is very old. It was restated in the 1960s by Friedman and Schwartz in their "Monetary History of the USA" where they pioneered the use of econometric techniques to unearth uniformities in the data which had previously been considered to be too unreliable to form the basis of monetary policy. A number of UK academics (Johnson et al, 1972: 121-200) applied Friedman and Schwartz's methods with varying success to UK monetary history. Hence, monetary analysis began a march away from detailed analysis of institutional dynamics the apogee of which was the Radcliffe Report. This meant that henceforth monetary analysis was less concerned with how monetary worked than with the overall results emanating from the monetary black box in response to certain policy inputs. By this means monetary analysis provided a reason, applied with growing intensity throughout the 1980s, to assert the importance of active monetary policy. Indeed, some even argued, on the basis of econometric models involving rational expectations and highly flexible markets, that it was possible to reduce inflation by reducing the rate of expansion of the money supply to below that of the rate of growth of nominal income without incurring rising unemployment. However, proponents failed to recognise that the UK financial system served not only the UK but also the rest of the world. Hence, UK financial markets were under the sway of forces emanating from the international financial system with only a tenuous foundation in the UK economy. This meant that monetary policy aimed at UK inflation was often subverted by international developments. It also meant that accurate targeting of monetary policy instruments became very difficult during times of stress in international markets.



The failure of successive attempts by the UK government to control money supply, let alone, inflation, did not undermine the confidence with which these assertions were propounded. Indeed, using a long line of research conducted at the IMF the failure was laid at the door of fixed exchange rates so increasingly freely floating exchange rates came to be regarded as a way of making monetary policy effective. When even that failed to enable systematic control of monetary variables, attention was diverted to the technical details of the transmission mechanisms between monetary policy instruments and desired outcomes like low inflation. Increasingly, these discussions took a longer menu of variables into account so that inflation looked less like a purely monetary phenomenon and much closer to the Keynesian idea that it was the outcome of all the variables in the economic system. Eventually, in the 1990s, the only monetary policy instrument used was interest rates and the low inflation came to be seen as a cause of faster economic growth.

More crucially, monetarism can only be effective if the economy to which it is applied is composed of systems of open markets which quickly reach equilibrium after suffering a shock. Again, politically the failures of monetarism could always be blamed on the sclerosis induced by trades unions. In fact, the efficacy of monetary policy is always hostage to whether or not financial markets are sufficiently deep and liquid to smoothly withstand the interventions dictated by monetarist policies. In theory, deep and liquid markets, whether subjected to unexpected shocks or pre-announced policy change, adjust quickly from the previous equilibrium to the next. Hence, policy change is incorporated into plans for spending and saving with minimum disruption and at minimum cost. This is why it was believed that monetarism could reduce inflation without causing unemployment and without interrupting capital accumulation. However, when such open markets are not present, market equilibria may never be attained or reached only after long delays. In those circumstances, the impacts of policy cannot be accurately foreseen and will, in the short-to-medium-term, be highly disruptive to the real economy. So much so



that it is by no means certain that monetarism will have the macro-economic results it predicts.

## **Policy and Liberalization in the 1980s: Laying the Foundations of Financialization**

A benign steady state equilibrium involved sustained, if not rapid, real per capita GDP growth, absence of balance of payments crises and relatively low inflation. The hobbled Bretton Woods System made this combination increasingly difficult to achieve in the late 1970s and early 1980s. Rather than seek multilateral policy means many countries independently sought to remedy faltering economic growth. Often this took traditional neo-Keynesian forms such as Government-sponsored infrastructure development and sustained deficit finance. There were also attempts in some countries to instigate active industrial policies in which the government sought to install new types of capital goods in order to promote new export industries. Often these initiatives were financed through international borrowing from Euromarkets. By 1980, these developments led in many countries to increases in the costs of government financing and an accumulation of foreign debt.

By 1980 such innovations in financing had undermined the traditional credit and macroeconomic controls. Bank accounts were a means of obtaining an overdraft and consumer credit (such as hire purchase) expanded. At the same time, imports were stimulated by increased demand. The resulting increase in the current account deficit was financed by means of overseas debt which added to debt service and which was subject to exchange rate risk. The dependence on overseas finance became so common that the IMF's definition of balance of payments equilibrium was changed into the foreign sector imbalance that can be financed for the foreseeable future.



Policy of this kind can only be sustained if export proceeds grow sufficiently quickly to meet debt service payments. However, by the early 1980s world trade was growing slowly and in many countries real interest rates were higher than real rates of GDP growth. As a consequence, debt to GDP ratios rose. Predictably, many Third World countries defaulted and some countries in the First World ran into difficulties.

### **Policy and Commercial Responses**

The response of the UK Government newly-elected in 1979 was to attempt to bolt for equilibrium. The new Conservative government took on a monetarist mantle with all its free market adornments. Government expenditure was reduced in real terms, some public assets were disposed to private hands and some existing public functions were corporatized. Private enterprise was allowed to compete for Government contracts and with existing state concerns. Support to firms under industrial policy was withdrawn. Trades unions were systematically disempowered. At the same time, targets for the growth in the money stock were established but not achieved.

Ostensibly the Government aimed to allow the economy to take the shape that is dictated by market dynamics. To this end regulation of interest rates and capital movements were progressively withdrawn. Exchange rates were substantially freed from Government manipulation, Sterling was made freely convertible, stock market commissions became negotiable (the Big Bang) and day-to-day regulation of financial company balance sheets ceased. Together, these changes opened the UK financial system to the world and the UK economy to the world's finances. As a result, the UK financial sector was freed to adjust to changes in the international financial system with little interference from regulators. Together, these measures meant that financial institutions were granted the freedom to make markets in any way they saw fit.

The strategies adopted by financial companies in the UK financial system were similar to those employed by many large companies. They involved entry into



overseas markets; the cultivation of mass markets for consumer products; and innovation of many new wholesale products such as derivatives.

Such developments involved the restructuring of banking and finance through mergers and acquisitions. It also involved banks in taking new risks, such as house mortgages, which were previously considered illiquid asset. As a consequence, investment banks, finance companies, building societies and clearing banks started to morph into each other. The traditional distinction between clearing banks and other retail financial providers became blurred. Later this trend extended to incorporating stock brokers, stock jobbers and discount houses into financial conglomerates.

The new conglomerates used extensively the new technique of computerised management systems which encapsulated the principles of the Effective Market Hypothesis. This idea suggested that any financial asset could be priced according to the best current estimate of the risk that the asset entailed, relative to the yield on a zero risk asset like Government stock. Risk is measured by the variance in the price of the financial asset in the past. Hence, the greater the variance in price, the greater the risk and the higher the interest rate that should be charged for taking it on relative to government stock yields. It was common to amend this calculation for average default rates on different types of lending so that computerised systems could make decisions on loans without the need for local information. By implication, no lending proposition embodied unacceptably high risk provided a sufficiently high price is charged for accepting it.

This, in turn, encouraged rationalisation and simplification of branch banking systems and led to retail banking becoming a sub-sector of retail trade. In many ways, therefore, the 1980s became the "My Bank" era in the UK. Branches became less a source of individual savings and more a means of selling financial products to customers.



At the same time, UK banks became important investment banks as UK firms made a series of direct investments in the USA and the EU. The business of corporate finance, which was once largely the preserve of stock brokers and investment banks, became dominated by the newly emerging financial conglomerates. Much of the business was directed at helping MNCs take advantage of tax concessions or tax loopholes. Much was conducted “off balance sheet” in semi-autonomous subsidiaries presided over by computerised management systems. The whole operation was financed by money market liabilities and frequently the resulting assets were on-sold to pension funds and other long-term investors.

The world thus created was entirely new. There was no history to act as a guide to the risks and uncertainties implicit in this new situation. The centralised, high-level balance sheet management systems themselves created new uncertainties. In particular, some deals were undertaken without understanding how vulnerable they were to interdependencies with other firms (including other banks), general economic conditions and the state of sentiment in the financial system many aspects of which were beyond their control. Thus, many banks grew rapidly in the 1980s but without a full appreciation of the risks undertaken with a consequence many were under-priced.

As the 1980s progressed, the UK financial system became ever more reliant on short-term money market liabilities for its liquidity. Increasingly, they were the result of savings or credit formed in many parts of the world not just the UK. At the same time, the investments their on-lending financed were highly cyclical although overseas investment cycles tended to be the inverse of domestic ones in developed countries. Increasingly, this risk factor led banks to lend to MNCs rather than to countries so that, over time, overseas investment became more direct investment and less in the form of loans or other debt.



## International Developments

Britain's position as an international financial intermediary has meant that its financial balances are peculiarly susceptible to developments in the international financial system.

For much of the 1980s the Bretton Woods System remained in place on the fringes of the international financial system. The succession of US fiscal deficits during the Reagan Presidency led to a significant rise in the stock of world currency. This assisted in preventing a collapse of international finance in the wake of the Third World defaults which took place from 1982 onwards. However, the Bretton Woods System played only a minor part in the re-scheduling and re-negotiation of international debt that was managed by the financial conglomerates most closely involved with the active assistance of the US Government. These negotiations led ultimately to the Brady Plan in 1989 which brought the IMF back towards the centre of the international financial system but in an amended and emasculated form.

Because of the freedoms accorded to the UK financial system, a disproportionately large share of international financial flows was secured by UK-based markets and companies. The issue, sanctioned by the US Government, of world currency on a massive scale by the US banking system to meet domestic US needs, would, by the prevailing monetarist reasoning, have led to a weakening in the real value of the US dollar. As a result, confidence in New York markets waned in the rest of the world. Hence, during the 1980s the structural foundations were laid for the London markets to rival those of New York at the centre of the international financial system during the boom of the long 1990s. Similar forces were at work to enhance the relative positions in the international financial system of the Frankfurt and Singapore markets.

To a considerable extent, this development was made possible by changes in the Bretton Woods System. As currencies were floated, the IMF ceased to manage international reserves and oversee balance of payments adjustment. Instead, it





increasingly took on the role of safeguarding private international banks by encouraging, through conditionality, nationalisation and forgiveness of Third World debt and privatising Third World state assets. The World Bank became increasingly reliant on the international financial system for its funds. A diminishingly small proportion of its total lending was to the poorest nations at concessionary rates for social rather than economic projects. Successive rounds of trade liberalisation led, by the early 1990s, towards the formation of World Trade Organisation (WTO) to replace the GATT and enforce market liberalisation (including liberalised international capital flows) on members. Hence, the Bretton Woods System adapted in the same general direction as the international financial system but at a slower pace. In doing so, its ability to control or even amend market developments was materially compromised.

Ultimately these developments were summarised in Williamson's 1989 statement of the Washington Consensus. This purported to represent the widely-accepted principle for economic policy that had been forged during the 1980s. (In fact, its date served really to show how far behind Chile, New Zealand and the UK the USA and the EU had become.) Nevertheless, it is a useful indication of the mind-set that existed at least in much of the Developed World at the start of the long 1990s.

### **The Deepening of Financialization in the 1990s: The Path to Instability and Crisis**

The displacement of the US financial system from its central role in international finance was nevertheless frustrated by the 'flight to safety' that was precipitated by international financial instability. Following the refinancing of the most seriously 'at risk' international debts, the international financial system grew rapidly in the long 1990s. During that time, many hitherto entirely domestic financial markets were drawn into its ambit. This occurred, for example, as rapidly developing countries, such as the so-called Asian Tigers of Japan, South Korea and Taiwan, began to reduce regulations and allow open markets in money and capital. It also occurred when the separation of mortgage-based lending from clearing banks was eliminated in the UK. As a consequence, a very wide range of financial products became



available for domestic customers. One result was that the dynamics of the international system began to influence domestic monetary affairs. Another was that previously unconnected markets now became open to contagion from others newly connected to them. A third was that it became possible for many new borrowers (principally corporate and financial) to access international sources of capital. At the same time, and by the same causes, the effectiveness of the instruments available to the Bretton Woods System to forestall or manage system instability was materially reduced.

A financial system of many markets undertakes spatial and maturity transformation. The prices which govern these transformations are respectively the real exchange rate and the real interest rate and are both determined by the dynamics of the financial system. They are in real terms because they express the barter terms of trade between given resources in one place or time compared to the same resources in another place or another time. These are the most important relative prices affecting an economy because they determine, in the long-run, its temporal and spatial dynamics and extent. Hence, prices set in the financial system intimately affect incentives, relative prices, accumulation and real incomes which, in turn, determine the structure and trajectory of the real economy. In practice, this transformation does not usually take place in the hands of one firm or even one market but normally involves many firms in many markets. Hence, these transformations involve many intermediaries in many different countries each of which performs a small part of the overall transformations required. At the same time, the new activity in the financial markets was creating new debt structures. During the long 1990s (so-called because its monetary stability continued to lull central banks and financial authorities into a false sense of security right up to the start of the financial crisis in 2007), the influence of the real economy on the UK financial system weakened as financial markets proliferated.

However, because the transformation process takes place over time and space it is inevitably invested with risk and uncertainty; expectation and disappointment. Any



one of these may lead to volatility in markets as returns exceed or fail to meet expectations. In addition, the presence of uncertainty, which implies the existence of the unforeseen and the unforeseeable, means that it is unlikely that these markets will ever reflect the true long-run costs of the activities undertaken on them and through them. As a consequence, it is not possible to model the financial market using variants of rational expectations or risk and reward. These characteristics are shared unequally by all markets connected to the system. Markets or firms with the most effective methods of hedging risk or managing uncertainty tend to be least affected. Participants in financial systems must be in a position to collect, process and make choices about relevant information so that they minimise the risks, if not the uncertainties, they undertake. Hence, the boundaries of a given market are determined by the ability of participants to undertake this information processing. Not only will this ability vary between firms but also all firms are hostage to the decisions of others. Hence, the ability of any market participant to manage risk depends, in part, on the information processing ability of the poorest information processor in the market. Moreover, no firm can know when the information it is processing ceases to be a reliable guide to choice making as a result of uncertainty. In these circumstances, choices based on risk calculations may be inappropriate and lead to system contagion. Hence, on occasion, when unknown levels of business uncertainty are accompanied by high levels of corporate gearing, achievement of market equilibrium (if it is feasible) may take so long that market volatility is undampened for extended periods.

### **Policy Developments**

Throughout the long 1990s markets developed in many dimensions. Multiple layers of markets meant that the number of participants in the UK financial system increased. As a consequence, the ability of the authorities to exercise meaningful prudential management of the financial system was compromised. It was no longer possible for the Bank of England to ensure system stability by regulating the balance sheets of a few key financial institutions. Instead, the Bank of England came to the



conclusion that its role should be predominantly a matter of operating monetary policy through interest rate manipulations so as to maintain inflation at low levels. Starting in the mid-1990s, based on econometric models of the UK economy, UK policies were conducted by setting Bank Rate (i.e. the rate at which the Bank of England is prepared to buy and repurchase financial securities, hence its common name the 'repo' rate) so as to ensure future inflation was kept within desired bounds. From 1998, this policy was conducted by the Bank of England independent of the Treasury.

Financial markets had come to be regarded as inherently stable and financial institutions as just another commercial undertaking so that nothing but light-touch monitoring and intervention was required to ensure system integrity. This represented a reversal of the old adage that money is far too important to be left to bankers. At the same time that the Bank of England was granted its independence, its role as prudential manager of the financial system was passed to the Financial Services Agency (FSA). However, the FSA adopted an approach of risk-based supervision which was conducted by exception on individual institutions taken in isolation. The UK authorities developed a trust in stable market equilibria that was reinforced by the unprecedented economic boom. Hence, there appeared to be little need to intervene in the commercial activities of financial companies. One consequence was that many companies took on new types of financial business without the aid of adequate information about the rewards, risk and uncertainties involved. Many of these firms sought to retail financial securities on a mass scale to customers not previously served by the financial system.

The new institutions went beyond the traditional UK list of clearing banks, discount houses, acceptance houses and bond dealers. It came to include building societies, finance houses, investment banks, stockbrokers, MNCs and the treasuries of investment funds, pension funds and large domestic non-financial companies. Thus, for example, in the retail financial market credit cards (although issued by only a



small number of international companies) came to be operated by a wide variety of organisations which actively marketed them.

The larger the number of institutions involved in a given system the less influence a particular institution has over the system as whole because of the countervailing strength of arbitrage in the medium term. However, by the same token, more institutions means less chance of discovery so a higher chance that a particular market participant will seek (singly or in combination) to manipulate markets for short-term advantage.

Moreover, systemic risk arises not from the net amounts owed by one institution to another. Normally, these net amounts are the difference between two extremely large gross flows in an out. However, if an institution were to fail to meet its obligations then the gross obligations it has with the rest of the system will not be met. In a typical money market this will be more than sufficient to undermine the liquidity of all other participants so that they too will be forced to default. As a result, all participants in a highly integrated money market like that of the UK are likely to fail if one does.

The computerised general ledger systems introduced in the 1980s were expanded and made accessible to retail customers. This enabled access to payment services unlimited by time and to wherever the telephone system extended. Starting with ATMs and EFTPOS, retail banking remote from branches extended its reach through the internet, electronic cards and now mobile telephones. The relatively low fixed costs involved in this type of financial service encourage new entry into retail financial services by non-financial companies. These developments extended the My Bank era to all walks of life.

The My Bank era was, for many, the era of a massive rise in personal wealth through house purchase. The 1990s saw mortgage lending rise rapidly which, in turn, drove up house prices. By adoption of innovative financial instruments (e.g. securitisation) and more liberal lending criteria as competition in retail markets intensified, the



market for house purchase was extended. This trend was accelerated as the public housing stock was disbursed among its tenants and the traditional building societies were de-mutualised to become retail banking chains.

For many business borrowers many new types of security were devised each with its own pattern of risks and rewards. These included a wide variety of instruments called derivatives which were compiled from complex combinations of swaps, forwards and options. In many cases, these were so difficult to price that frequently their promoters would supply buyers of them with computer programmes to provide estimates of their value. Inevitably, such securities tended to be illiquid because so few institutions were capable of finding prices for them. Moreover, many buyers of derivatives relied upon the good name of their promoters rather than an assessment of the value of the assets which underlay them. This practice was perhaps excusable when securities were traded among a few highly-capitalised and well-managed institutions. Indeed, in an earlier, simpler age the name of a clearing bank, discount house or acceptance house was sufficient to ensure good value of trade bill or bill of exchange. However, as derivatives came to be traded beyond such a charmed circle of financial institutions markets became more ignorant of the extent of risks involved. Or, more precisely, the menu of risks undertaken through market activity became significantly greater than the inventory of available information about those market risks that could be brought to bear upon the choices about market opportunities. As a consequence, in some cases, trades took place beyond the limits of information required to correctly price them. In other words, market participants entered a zone of ignorance.

These developments led directly to the securitisation of risk. In this process, security of varying quality can be bundled together as one asset issued by a well-respected institution. If that institution is of first quality, then the assets it issues are also of first quality. Hence, the over-arching security can be taken onto a buyer's balance sheet as if it were first class. However, when mortgages on real estate are packaged for on-sale in this way a number of processes occur which are not invariably prudent



and which cannot be readily verified by potential buyers. First, mortgages with a high risk of default are combined with those carrying lower risk so that the average risk of the whole package is acceptable. Second, many of the mortgages included in the package may themselves be part of a securitised mortgage package. Third, the ultimate buyer has no claim on the real estate security upon which the original mortgages were based. Fourth, many of the mortgages that were securitised were agreed by salespersons only interested in achieving sale targets and not trained in prudent lending. This meant that mortgages of more than 100% of real estate value were lent to people who could not afford to service them. Together, this meant that holders of securitised instruments based on house mortgages could not make an accurate valuation of the risks attached to them or to their underlying value. Hence, for many financial firms (e.g. Northern Rock) which bought these securities were (probably unwittingly) operating in the zone of ignorance in which market data are an imprecise guide to the extent of risk or the value of opportunities.

The boom of the long 1990s allowed the UK financial system to operate in its zone of ignorance for a considerable time. As a consequence, the real interest rate and the real exchange rate that was determined by it bore little or no relationship with the realities of the underlying economy. It was, therefore, a matter of chance whether or not Sterling was under- or over-valued at a particular time or whether real interest rates reflected the true price of time. As a result, these two key prices failed to provide accurate information to decision-takers about the long-term prospects that they faced. This is likely to have led to misallocation of resources and disturbed the process of capital accumulation. Income growth meant a ready supply of short-term liabilities to finance balance sheet growth. It was as if new savings flows were sufficient to pay the minimum of debt service required to prevent default. As such it was similar to a massive inadvertent Ponzi scheme. However, ultimately the growth in short-term credit and balance sheet growth slowed. A negative credit accelerator activated a negative credit multiplier and the 2007 Crash was upon us.



It is noteworthy that the question of an international reserve currency became of relatively marginal importance. Floating exchange rates and unrestricted convertibility meant that any national currency could potentially be used for international transactions and governments need to hold reserves of foreign currency extended only to their own transactions balances. It only became a policy issue in the UK during the late 1980s and early 1990s when the UK joined and left the ERM and again in 2002-03 when it was decided not to join the Euro. The rejection of the Euro was principally the result of counsels which feared that the UK economy was insufficiently productive in the long-run compared to that of Germany, and hence would need a currency under-valued in relation to the Euro.

The long 1990s saw further integration and growth of the UK financial system. Integration had several dimensions including:

- Blurring of previous distinctions between institutions;
- Multiple financial products offered by many institutions;
- Centralised ledger, loan management and marketing; and
- Foreign and domestic business conducted in closer concert.

As a consequence, the service received by customers became relatively standardised. Product discrimination was increasingly common and financial conglomerates competed on price to attract new business.

However, the public appearance of price competition was deceptive. First, much new loan business was syndicated between financial institutions. Thus, although an institution may win business in competition, its competitors are likely to also profit from the business by providing much of the finance involved. Hence, "losing" institutions know that they are likely to be able to lend profitably to the customer concerned whatever rate the quote for the business. Second, participants in the UK money market and foreign exchange market have been found to be using the internet to manipulate interbank interest rates and exchange rates.





These relatively minor manipulations, sustained over long periods, are a visible sign of a hidden reality. Financial institutions are heavily dependent on each other. Each must know what the other is doing and must be able to trust that proposed actions will not adversely affect its own business. It is inevitable, therefore, that frequent contacts, at all levels in the organisations, occur between institutions and between the markets that the institutions make.

It is also true that financial institutions set nominal interest rates and nominal exchange rates. Much of the inter-institutional communication concerns these prices. They are the way that each institution tells its fellows what it is doing and shows that it can be trusted without revealing details of its own business or that of its customers. In other words, the institution reveals itself as part of the financial flock so that it will not incur large imbalances with the rest of the system that could threaten system stability.

Concerted behaviour of this kind is an adequate response to systemic risk, credit risk, maturity risk and exchange risk. However, it does not address uncertainty or large-scale parametric change. Consequently, in the face of unmanageable uncertainty or large-scale change which threatens the financial system, concerted action ensures that all parts of the system fail together. It is possible that a particular institution could assure itself against this possibility by holding a sufficient reserve of assets which could be liquidated at minimum cost at very short notice in any conceivable state of financial markets. However, such a holding would impose a considerable opportunity cost on the organisation. Against that cost it is likely, therefore, that managers would weigh the risk of system failure and the likelihood that the government could be induced to ensure that all citizens meet the costs of forestalling the failure of the financial system. It is likely that they would conclude that holding such reserves would not be a profitable use of the organisation's resources.

## Regulatory Responses in the UK

Following the crisis that broke out in 2007, and preliminary inquiries by the G20 and the International Monetary Fund, the European Union and the Basle Committee of the Bank for International Settlements undertook a review of banking regulation. The Basle Committee recommended reform of the capital requirements for banks with increased capital and decreased leverage under Basle III. EU proposals included more comprehensive regulatory controls, to include for the first time non-banking institutions such as hedge funds.

In the UK various post-crisis initiatives sought to review financial sector regulation. In 2010, the Independent Commission for Banking recommended reforms whose stated goal was a 'stable and competitive' financial sector that would 'reconcile the UK's position as an international financial centre with stable banking in the UK' and create 'greater resilience against future financial crises and remove risk from banks to the public finances' (Independent Commission on Banking Final Report 2011, p7). However, given the Commission's focus on regulation, as opposed to structural reform of banking, the proposed reforms, were modest. They included adoption of Basle III and ring fencing retail banking from wholesale banking, but no fundamental reform of investment banking.

In publishing proposed legislation for these changes in 2011, HM Treasury commented that the crisis was 'caused both by failures in the financial sector, and by failures in regulation of the financial sector. Financial institutions did not manage their business prudently and, in particular did not understand the risks inherent in the business they were conducting. Regulators and supervisors failed to provide the robust scrutiny... needed... ... firms have become so large, interconnected and complex that their failure posed a serious threat to the financial system and the regulatory system lacked the tools to deal within this "too big to fail" problem' (HM Treasury, 2011 p5). Proposals included restructuring of the UK regulatory responsibilities. This included assigning responsibility for financial stability to the Bank of England with two new bodies, the Financial Policy Committee and the



Prudential Regulatory Authority being responsible for macro and micro stability respectively (HM Treasury, 2011) plus a regulatory authority for business conduct. The central aim was to ensure that the failure of institutions should be at the expense of private sector stakeholders rather than public bailouts. But again, no fundamental reform was proposed.

Overall, the reforms, whilst a reasonable response to normal systemic risk, fail to address many fundamental uncertainties that the period of financialization has created. Foremost among these problems is that the scale, complexity and global nature of finance is, in itself, destabilising to the economy. It is unlikely that any national regime can substantially change this situation in the highly internationalised UK financial system with effective international harmonization and coordination of regulation unlikely for the foreseeable future. Here, it should be noted that the UK government's hostile attitude towards EU regulation is clearly an obstacle to greater international regulation. Secondly, the culture of financialization as it manifests itself in the financial sector remains fundamentally unchanged and permissive. Characteristics such as elitist individualism, risk taking, 'short term-ism' and fundamental detachment from the real impact of banks, apart from the enrichment of bankers, remain unchanged. 'New' innovations are likely to appear to replace the old, but their risk, elitism and destabilizing nature seem likely to remain the same. This is further discussed below and in section 2.5.

Finally, the political will and ability to execute substantive reform is questionable. A number of factors are responsible for this problem. Firstly, one of the cultural characteristics of financialization is the hegemony of financial elites, including in political influence and control. Acting in their own best interest, financial elites have sought to prevent reform, including of the operational structures and activities of banks and of pay and incentives. Fierce anti-regulation lobbying by the financial services industry has continued throughout the period of review of regulation with a



determination to prevent any substantive regulation and reversal of the processes of financialization that has enriched those elites<sup>2</sup>.

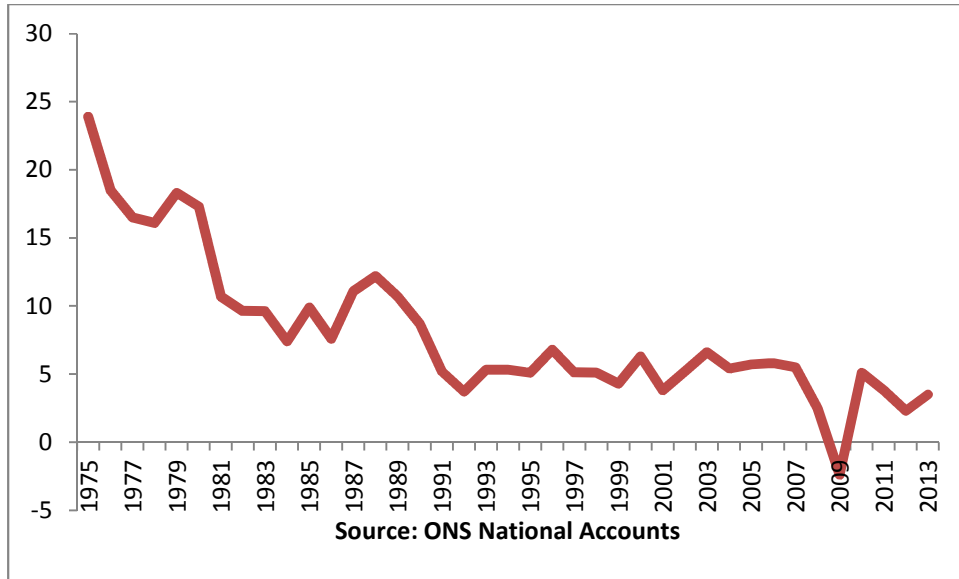
Secondly, reformists had to address the issue of confidence in the banking system and that the fear of reform during crisis could potentially deepen such a crisis in the short term and thus undermine the long-term intent of reforms. Such a possibility was advanced by anti-reform lobbying and reforms won limited interest from political parties and the public. During the period of stability and market optimism that preceded the crisis, the pressure from the various interest parties for financial reform was weak, despite, as discussed earlier, many calls for it to take place. During the crisis, alarms were raised that any radical reforms would undermine the fragile confidence remaining in the markets, and thereby make the crisis worse. In this way reform efforts were effectively neutered.

After the above historical discussion on the long-run development in the era of financialisation this section continues to look at these developments by analysing macroeconomic data associated with the UK economy. As a first step Figure 2.1 shows UK's annual GDP growth rate for the period 1975-2013. As evident the UK's GDP growth has been relatively steady in the period between 1992-2007. In 2008 GDP growth turned negative as the country entered in recession following the global financial crisis.

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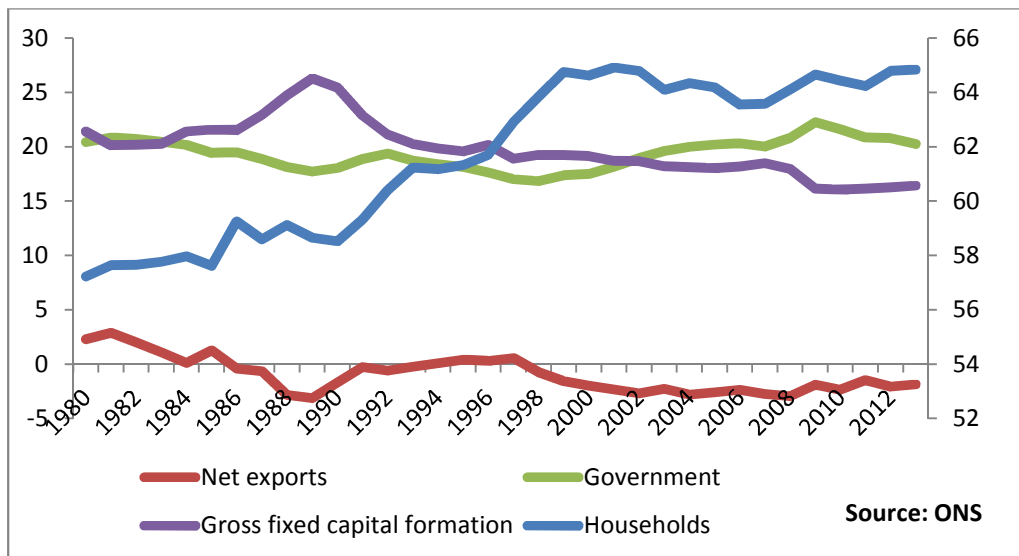
<sup>2</sup> Even within the UK establishment there has been criticism of the actions of vested interests within the financial industry who have sought to prevent or minimise reform. Melvyn King, former Governor of the Bank of England, for example, commented that "Already we see vested interests rise up to defend their bonuses and profits" in August 2012 ([http://news.bbc.co.uk/today/hi/today/newsid\\_9718000/9718062.stm](http://news.bbc.co.uk/today/hi/today/newsid_9718000/9718062.stm))

**Figure 2. 1 GDP Growth Rate**



Looking at GDP components, Figure 2.2, it is apparent that household consumption remains the main contributor of UK's GDP. Gross fixed capital formation has steadily declined, by around 10 percent of GDP since 1992, falling from 26 percent in 1992 to around 16 of GDP in 2013. Whilst net exports have contributed negatively since 1997.

**Figure 2.3 Components of GDP (households right scale)**



In relation to changes in GDP, shown in Table 2.1, gross fixed capital formation and private consumption have been the main drivers of GDP growth in the period between 1980 and 1988. The significance of gross fixed capital formation has since gradually declined and contributed only 0.88 percentage points to GDP growth in the period 2009-2013. During the same period private consumption has also declined accounting for 4.84 percentage points. Net exports on the other hand turned positive after 2002, contributing 0.8 percentage points to GDP growth during 2009-2013.

**Table 2.1. GDP growth and contributions to changes in real GDP- cyclical averages**

	1980- 1988	1989- 1996	1997- 2002	2003- 2008	2009- 2013
<b>GDP</b>	10.6	6.35	4.97	5.25	2.46
<b>Gross fixed capital formation</b>	12.01	3.86	3.65	4.58	0.88
<b>Government</b>	10.1	6.03	6.23	6.93	1.9
<b>Households</b>	25.73	16.5	14.38	12.37	4.84
<b>Net exports</b>	-1.67	1.76	-1.95	0.05	0.8

Source: ONS, authors own

calculations

## 2.1 Sectoral financial balances

The financial balance of the external sector has been consistently positive since 1997, off-setting the UK current account deficit (Figure 2.1-1). The financial balance of the government sector has been negative since 2002. The deficit increased quite



substantially during the 2008 crisis. The financial balance of the private sector on the other hand have been negative from 1997 until 2002, and has since remained in positive, indicating that the private sector has been accumulating assets. The surplus of the private sector increased after 2008, reaching its peak in 2009, accounting for 8.21 percent of GDP. But it has since fallen and in 2013 the surplus was negligible.

**Figure 2.1-1 Financial Balances (percent of GDP)**

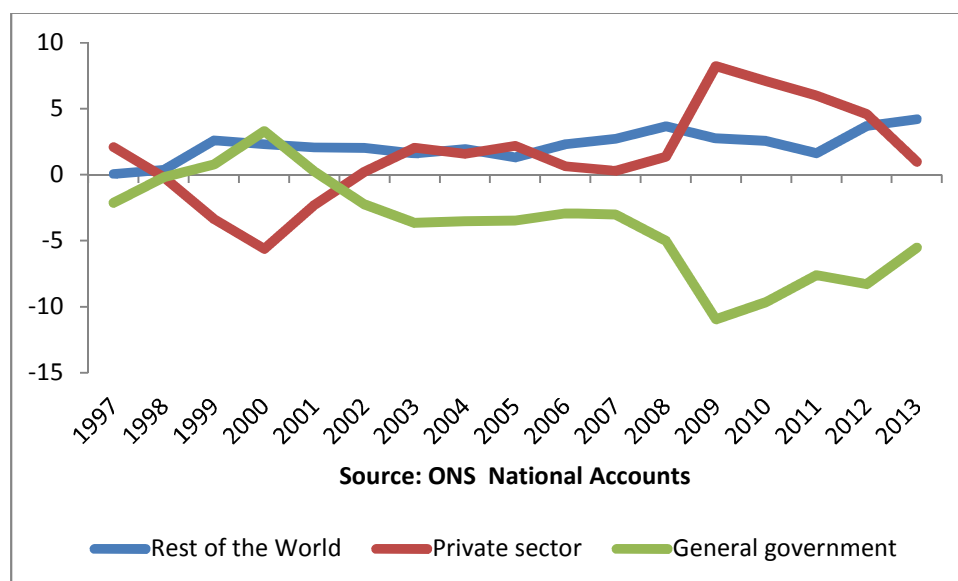
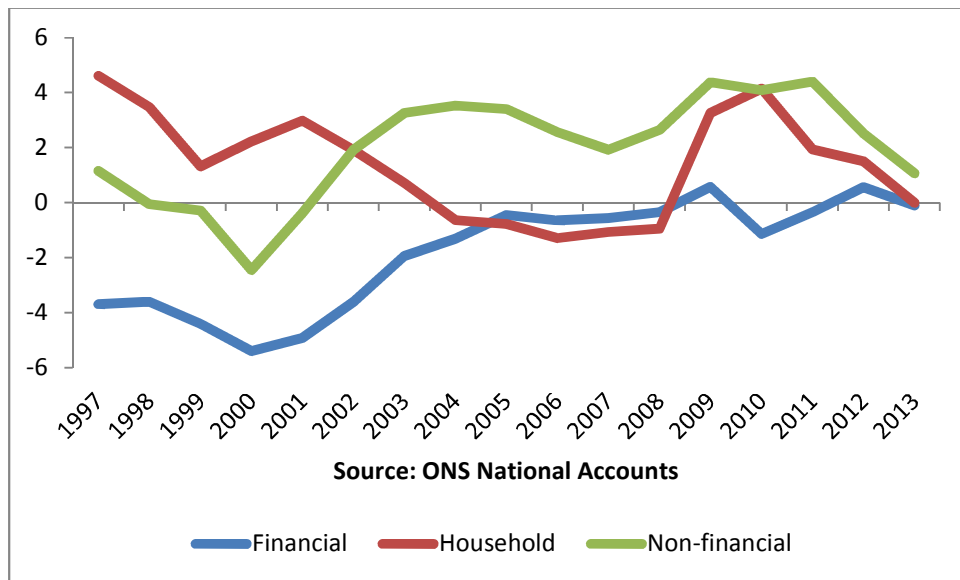


Figure 2.1-2 shows the components of the private sector, which combine the financial balances of the household, non-financial and financial sector. As evident the non-financial corporate sector has switched from running a financial deficit during 199-2001, to running a financial surplus for the rest of the period under consideration. The surplus reached its peak in 2011, accounting for around 4.40 percent of GDP. The financial balances of the financial sector on the other hand have been mostly negative for the period 1997-2003 except for 2009 and 2011 and 2013. The household sector follows the same pattern as the private sector explained above. It switched from running a deficit up until 2004, remained quite balanced until



2008, and then run a surplus in the subsequent years. Again, the surplus has fallen and the net position was balanced as of 2013.

**Figure 2.1-2 Financial balances of Households, Financial and Non-financial sector- percent of GDP**



From this evidence it can be broadly concluded that the UK can be characterised as debt led consumption growth. Hein (2012) suggests that this type of long-run development prior to the crisis is characterised by negative financial balances of the household sector, positive financial balances of the overseas sector with high contributions of private consumption and negative contributions of external demand. However, in Britain's case this is due to London's position as an international financial centre, with significant employment in financial services because of the indebtedness of households employed in other sectors of the economy.





### 3. Structural Transformation: Long-run effects of Financialization on the Economy

The overt political agenda of governments since the 1980s opened many aspects of British life to market dynamics. It led directly to privatisation and corporatisation of state assets, acceptance of commercially produced information as a guide to policy, use of market models to design and manage public sector enterprises and employment of advisers from private, especially financial, companies.

The Government, because it accepted the proposition that unrestrained markets constantly tend towards equilibrium, ceased to concern itself about the stability of the financial system on a systemic basis nor on whether it was serving the needs of the real economy, in particular, the financial requirements of investment.

Reliance upon monetary policy to control the macro-economy and freely floating exchange rates coupled with employment in Government of policy advisers from the finance sector meant that the financial system supplanted manufacturing as a prime source of political influence. This led from the 1980s onwards to financial companies being progressively freed from regulatory restraints and supported by the monetary policy operations that were undertaken. This political agenda continued even after the financial crisis of 2007 where financial regulatory reform remained insipid and subject to continual watering-down by the financial lobby meaning that, at the time of writing, little substantial reform has been implemented despite widespread public anger at the industry and the on-going revelations of fraud and corruption within the industry such as manipulation of LIBOR and foreign exchange markets and numerous consumer frauds.

### 3.1 Financialization and distribution

As discussed in the UK country study, the period of financialization, and particularly since 2000, has reinforced the inequalities – defined as both income and asset inequality - that had set in during the 1980s. Inequality has also widened further since the 2007 crisis.

Looking at the income distribution the Gini coefficient is incorporated in the analysis as a measure of inequality. Table 3.1-1 depicts both measures of Gini coefficient-Gini coefficient for households' disposable income and market income- have increased since in mid 1980s. The Gini coefficient for households' disposable income in 1985 was around 0.30, increasing to 0.35 in 1990. In the years that followed it declined slightly and by 2010 increased again to the 1990's level, reaching 0.34. On the other hand, the Gini coefficient for households' market income has risen steadily since mid 1980s. In 1985, it was around 0.46, increasing to 0.52 in 2010.

**Table 3.1 -1 Gini coefficient for market income and disposable income**

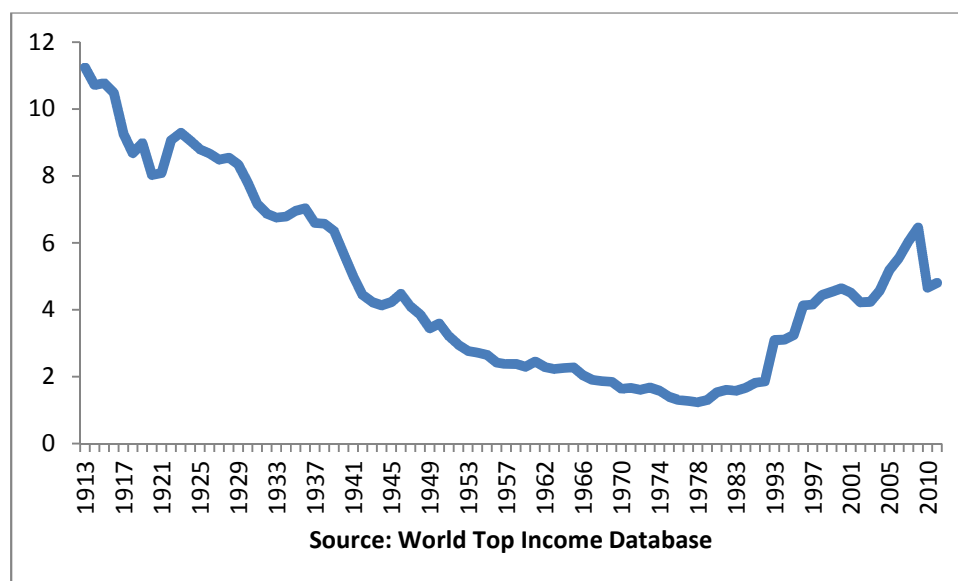
Year	1985	1990	1994	2000	2005	2010
<b>Gini coefficient for households' disposable income</b>						
	0.3094751	0.3546592	0.3368171	0.352	0.3345285	0.3410515
<b>Gini coefficient for households' market income</b>						
	0.468745	0.4904395	0.5066043	0.512	0.5032603	0.5229336
<b>Source: OECD</b>						

By 2010 the average income of the richest 10% of the population was twelve times that of the poorest 10%. This disparity was even greater when examining the top 1% who, by 2010, earns 15% and the top 0.1%, 5% of total national income (Source: OECD, 2011). As shown in Figure 3.1-1 the top 0.1 percent income shares in the UK



it is clear that since early 1980s it has increased steadily. Even though the top 0.1 percent income shares were substantially high during the early 1900s, declining steadily and reaching the lowest level in the 1970s, after 1980s began to increase again until 2007.

**Figure 3.1-1 Top 0.1 percent income share<sup>3</sup>**



Such rising inequality has been attributed to globalization and technical change, both arguably accompaniments to financialization, although evidence to support this remains ambiguous. However there is a consistent finding that institutional and regulatory structures are critical to income disparity (OECD 2011). In the UK, a number of such factors can be considered in relation to financialization.

Firstly, clearly within the financial sector itself and in selected corporations, earnings accelerated and provided high-skilled, high wage employment. This was particularly marked for the top earners. At the bottom end of earners, and especial for the low skilled, protective structures have been destroyed and replaced by

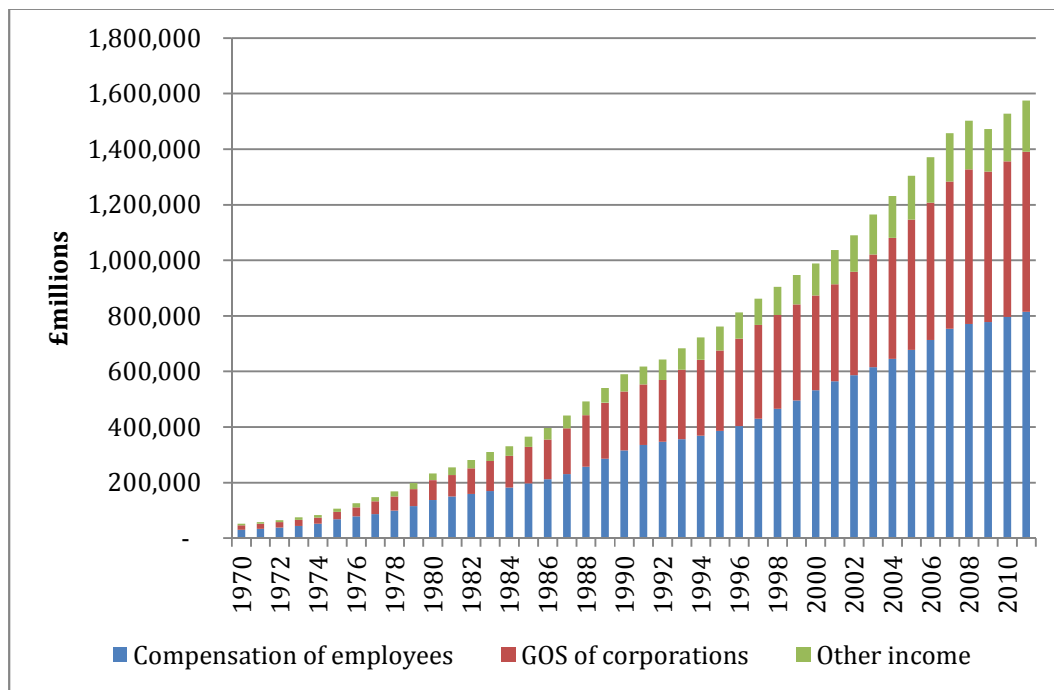
<sup>3</sup> The data combines two separate periods, which are merged together: The period between 1913-1986 shows the top 0.1 income shares of married couples and single adults and the period between 1993-2011, shows the 0.1 top income shares of adults.



neoliberal employment conditions. This included the breakdown of traditional labour unions during the Thatcherite governments and the development of “flexible labour markets” under successive government legislation which removed protection for employees.

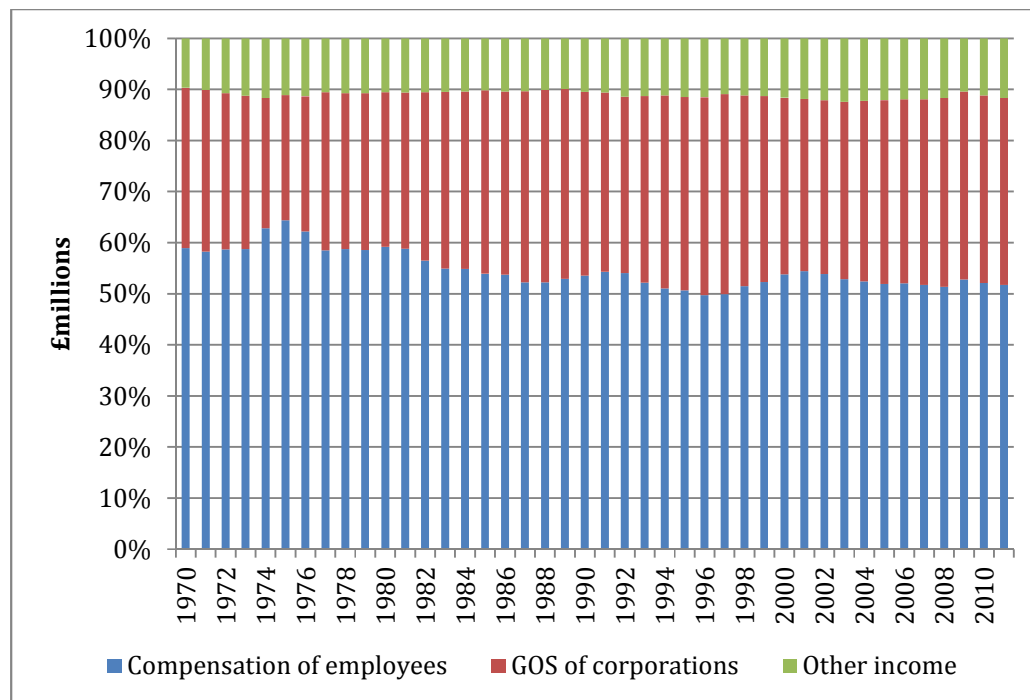
Secondly, the share of national income that has been received by workers as opposed to beneficiaries of financial income or “rentiers” (That is profits including those distributed as dividend or interest) has shifted in favour of rentier incomes. This is illustrated in Figures 3.1-2 and 3.2-3 below. As can be seen, although all income components grew in absolute terms, reflecting GDP growth, the share of national income received by employees declined by approximately 10% between 1970 and 2011.

**Figure 3.1-2 Share of national income by income component (1970-2011)**  
**Percentage terms**



Source: ONS

**Figure 3.1-3** Share of national income by income components: (1970-2011)



Source: ONS

Table 3.1-2 shows the mean and median income in the UK since mid 1980s. Half of UK's working age population earned much more in 2010 than in 1985. In fact the earnings have increased steadily since mid-1980's. In the two decades from 1990 to 2010, the earnings of the 50th percentile of the UK's working population have more than doubled, increasing from £7902 to £16333. The same pattern can be seen for the mean income. The average income of the UK's working age population has more than doubled since 1990, increasing from 9628 to 19866 in 2010.

**Table 3.1-2 Mean and Median income- in current prices**

Year	1985	1990	1994	2000	2005	2010
Median	5239	7902	9183	11648	14280	16333
Mean	6242	9628	11146	14352	17201	19866

Source: OECD

Looking at the ratio of income share accruing to the median income (D50) to the income of the lowest decile (D10), in Table 3.1-3, it is evident that this ratio increased from 1.9 in mid 1980s to 2.2 in 1990. This implies that the median income group has recorded an increase in their income relative to the lowest decile. On the other the ratio D90/D50 has remained relative stable, fluctuating within the 2-2.1 ranges.

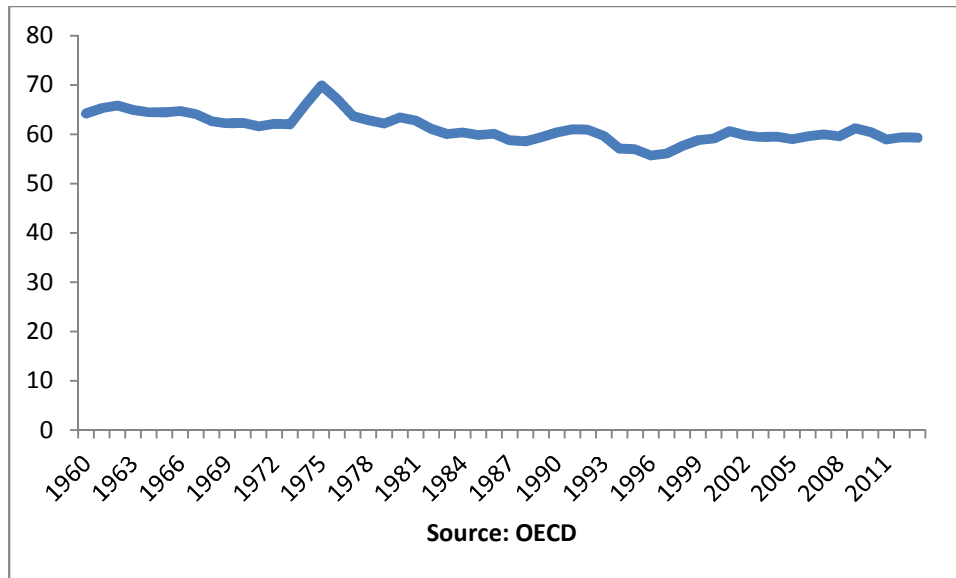
**Table 3.1-3 D9/D5 and D5/D1 disposable income decile ratio**

Year	1985	1990	1994	2000	2005	2010
D90/D50	2	2.1	2.1	2.1	2	2.1
D50/D10	1.9	2.2	2	2.1	2	2
<b>Source: OECD</b>						

The adjusted wage share in UK has fallen steadily since 1975, as evident in Figure 3.1-4. In 1975 it was nearly 70 percent of GDP, reaching its lowest point in 1996, accounting for around 55 percent of GDP. It has then increased but still remains low, at 59 percent of GDP in 2013, compared to the 1975 level.

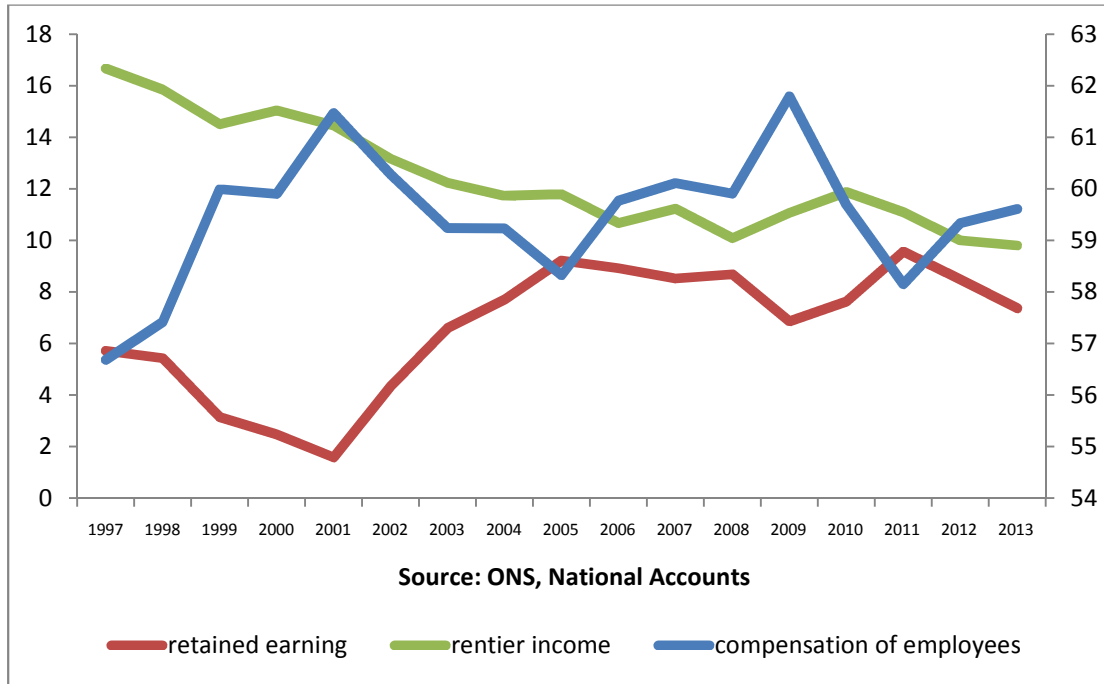


**Figure 3.1-4 Adjusted wage share**

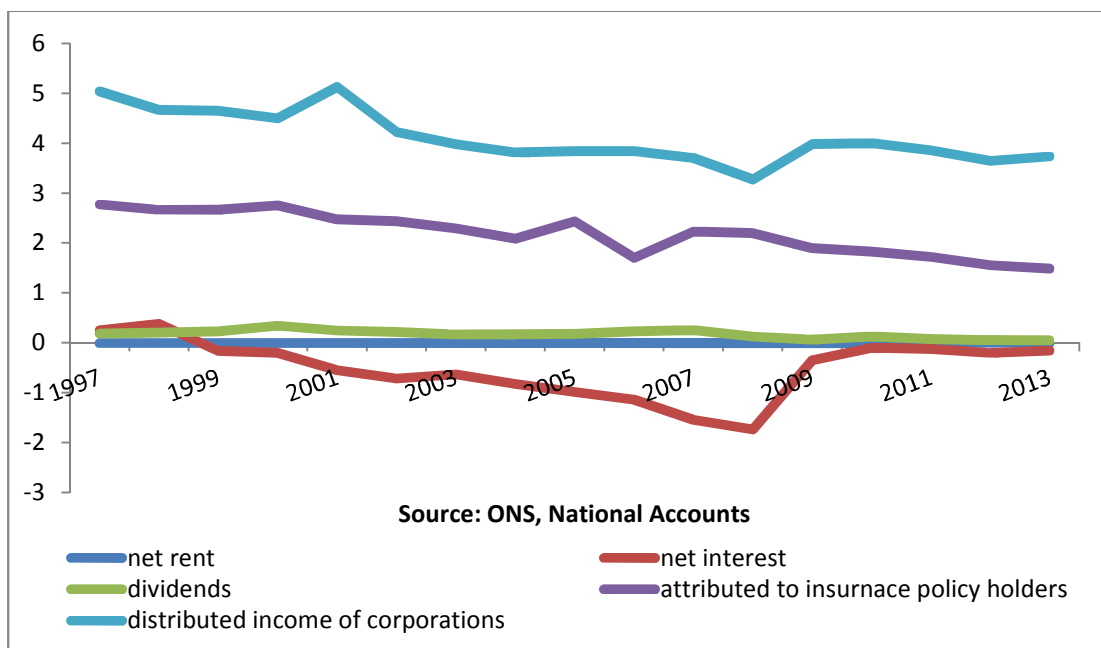


Using the same methodology as Dunhapat (2012), the rentier share in national income for UK is calculated and shown in Figure 3.1-5. The findings suggest that from 1997 until mid 2000s, the income share (compensation of employees as a percentage of national income), declined at the same time as retained earnings increased. Rentier income on the other hand shows a downward trend, since late 1990s. Looking more closely at the components of rentier income Figure 3.1-6, it becomes apparent that such decline can be attributed to negative share of net rent and net interest in net national income. Distributed income and attributed to insurance policy holders are the highest components of rentiers' income in the UK for the period 1997-2013.

**Figure 3.1-5 Income shares in net national income, UK, 1997-2013 (percentage of net national income)**



**Figure 3.1-6 Components of rentiers' income as a share in net national income**



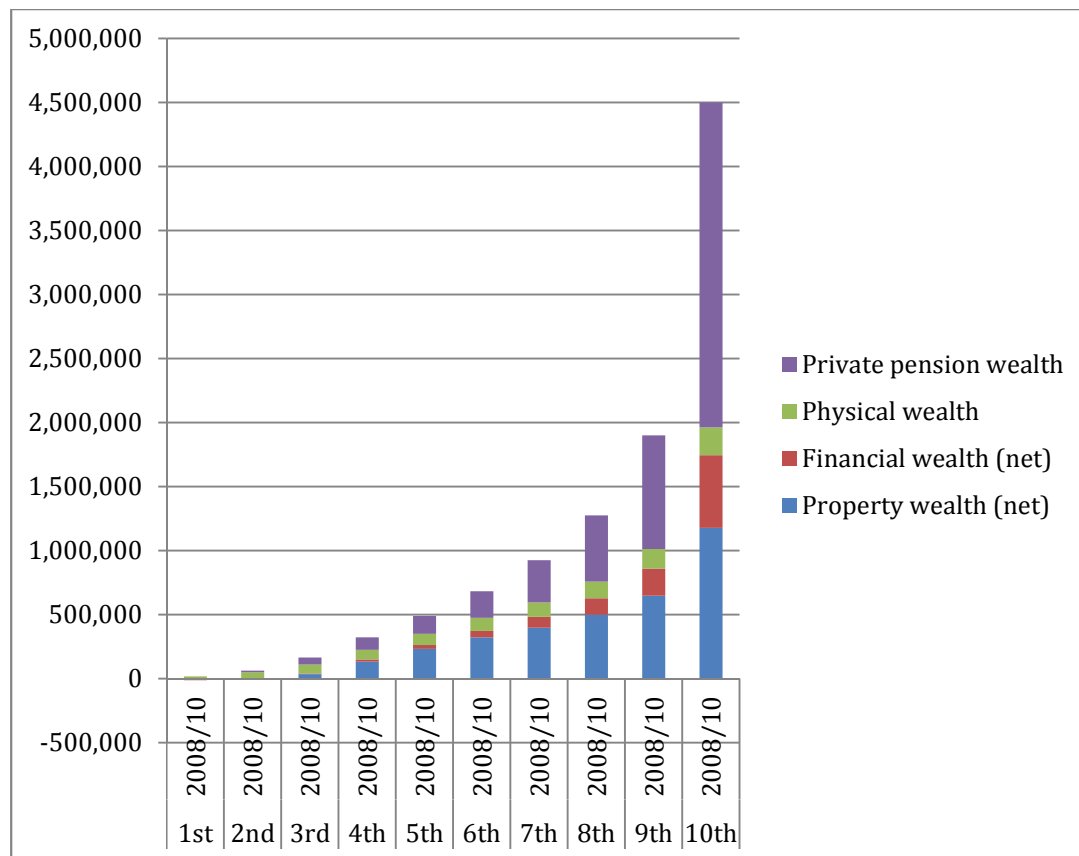




The second aspect of inequality – and one of particular relevance to the UK because of the housing market inflation - is asset inequality. In 2010, aggregate total wealth of all private households in the UK was £10.3 trillion and the Gini coefficient for asset wealth was 0.61. As the Gini coefficient indicates, wealth was highly unequally distributed. The top decile of households held £4.5 trillion or 44% of wealth, making them 4.3 times wealthier than the bottom 50 per cent of households combined. The top two deciles owned 62 per cent of all wealth or £6.4 trillion and held 92 times the wealth of the bottom two deciles which amounted to a mere £0.06 trillion. (Source: ONS). In addition, and masked by the above aggregates, in 2010 nearly a quarter (24.3 per cent) of households had negative net financial wealth. As noted in the UK Country study, a major factor in these high levels of asset inequality have been the property price inflation and related borrowing and unsecured, typically consumer, borrowing which have been fundamental structural aspects of financialization.



**Figure 3.1- 7 Total aggregate wealth: by deciles, 2010 £ Million**



**Source: Wealth and Assets Survey (Latest 2010 shown), Office for National Statistics**

The pattern of inequality in the UK during the period of financialization was characterised by rising income and asset inequality. However, the links of this rising inequality to financialization requires further analysis, including examination of direct and indirect effects and of the overt political economic factors. In part, this was the direct result of the spread of markets and market-like structures in the long 1990s. Markets magnify differences in outcome so as to direct resources to those alternatives which yield the greatest returns. Such magnification exacerbates income differences between individuals and companies.



The growing disparities of income and wealth were an important part of the “construction of consent” among those with access to property and appreciating assets. Their consent allowed the systematic dismantling of labour protection which unleashed “market” dynamics that allowed capitalists to increase the proportion of profit acquired by capital versus labour. This led to further political support for the growth of inequality and formed an obstacle to social welfare policies that were concerned with redistribution of income or wealth and an effective progressive dismantling of the welfare state.

Indeed, this was partially because the wealthier classes have become alienated from the welfare state. The previous welfare functions of government to provide them with education, health care and pension provision have been replaced by the “emergence of inflated property and financial asset markets as a “welfare state of the middle classes... (which) socialise the financial liabilities of those owning such assets... This has had the political consequence of alienating those with property from a welfare state system for which they pay but from which they derive little benefit. This disconnection lies behind the middle class taxpayers demand to reduce the cost of that welfare state by concentrating state benefits more narrowly on “those in need”. In its turn such constriction reinforces that middle classes alienation from the state system” (Toporowski, 2010, p.94). The political consequence has been acceptance of the neoliberal agenda of dismantling the welfare state currently being enacted by the Tory government.

In addition it has allowed the development of “state-administered social welfare as a system for prosecuting the poor” (Toporowski, 2010a, p95) where “minimum income is increasingly delivered with a degree of institutional bullying and hectoring, ostensibly to make welfare claimants more active in securing their financial independence”. Reminiscence of the Victorian workhouses, it has become acceptable to punish the poor through provision of apparent assistance which is neither functionally adequate nor fairly distributed. “The selective penalization of

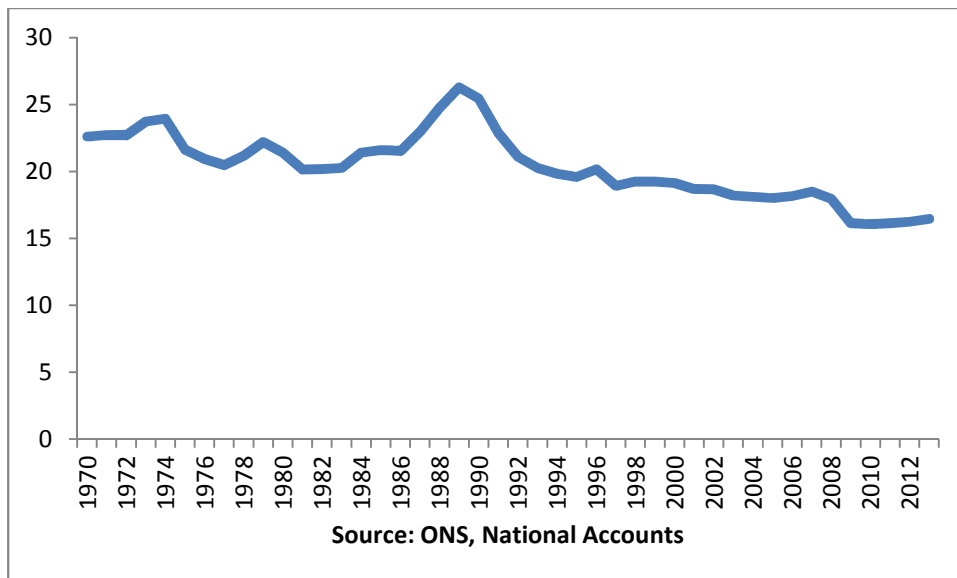


those without property or income is a natural consequence of a state welfare system that is no longer comprehensive because the middle class is increasingly opting out of it” (ibid).

### 3.2 Financialization and investment in capital stock

As stated in section 2 of this paper, gross fixed capital formation in UK has declined steadily since the late 1980s. This is also shown in Figure 3.2-1, where fixed capital formation is calculated as a percentage of real GDP.

**Figure 3.2-1 Gross fixed capital formation as a percentage of GDP**



Looking at the growth contributions of fixed capital formation, shown in Figure 3.2-2, it is evident that transport and equipment has been the most significant component in the period between 1997-2013. However, during the recession of 2008, the decline in the growth rate of other machinery and equipment was the main contributing factor of the decline in GDP.

**Figure 3.2-2 Growth contributions of fixed capital formation-annual growth rate**  
 %

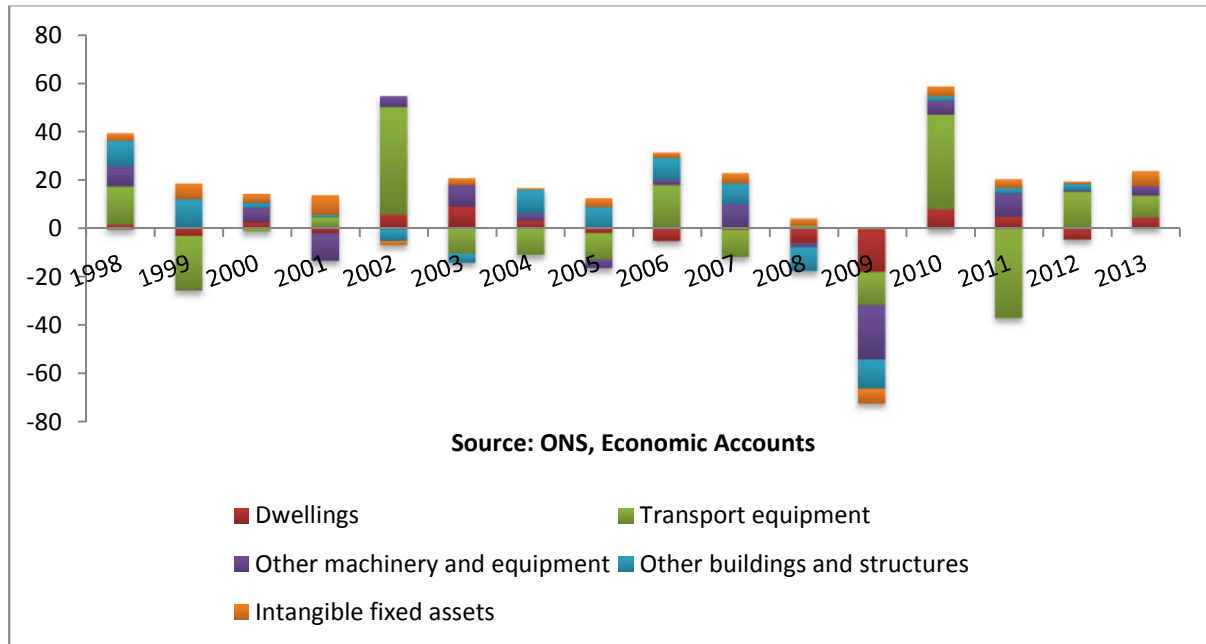
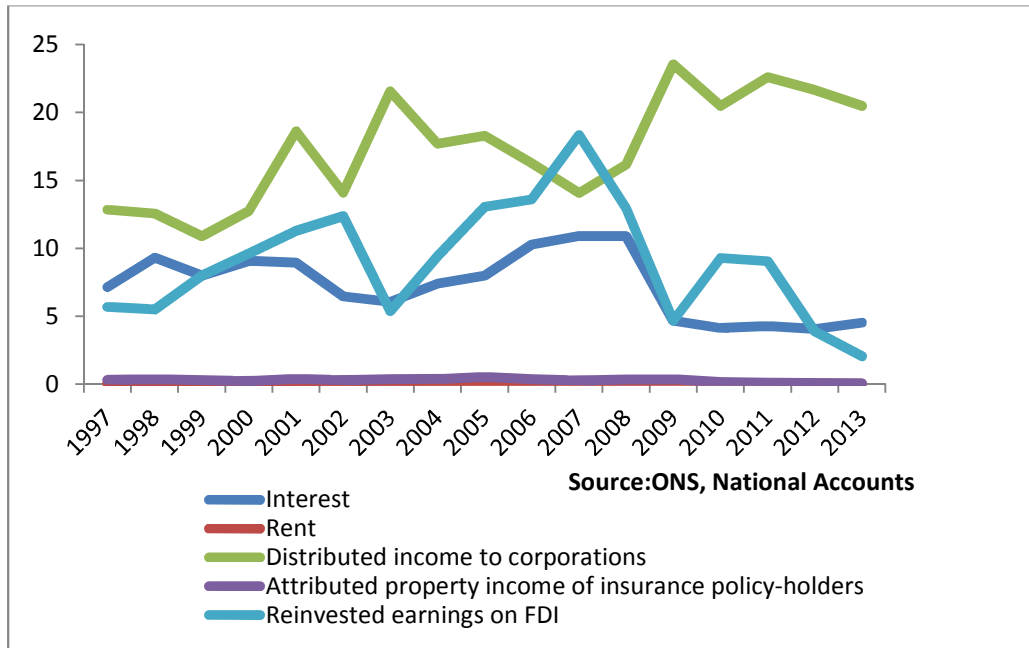


Figure 3.2-3 shows the financial profits of UK non-financial corporations in operating surplus. The figure reveals that distributed income to corporations (dividends) and reinvested earnings on direct foreign investment have contributed significantly since 1997 up until the 2007 crisis. Interest income on the other hand increased by nearly 3 percentage points from 1997 to 2007. More specifically interest income, as a share of operating surplus in 1997 was 7.15 percent, increasing to nearly 11 percent in 2011. On the other hand, rent income and income attributed to insurance policy holders show no significant share in operating surplus during 1997-2013.



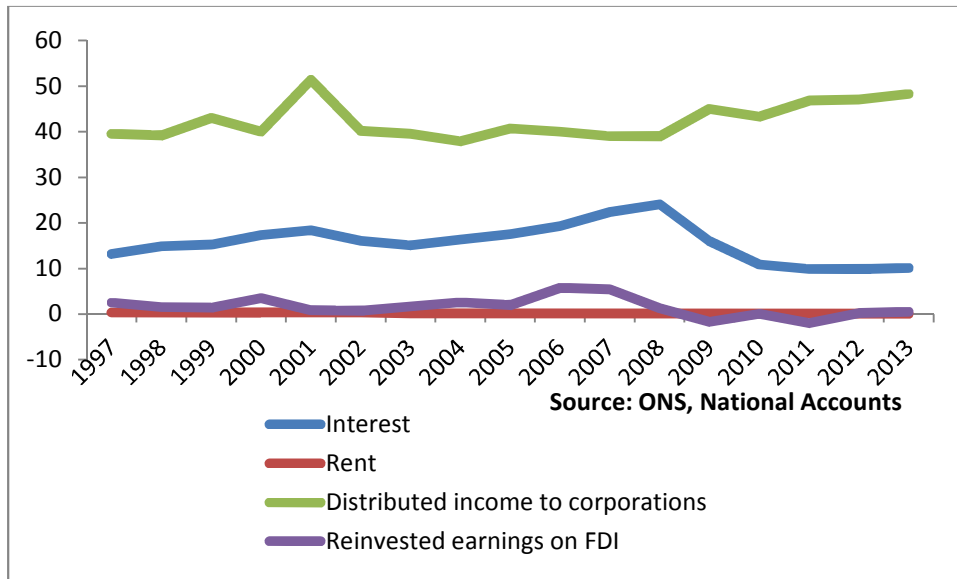
**Figure 3.2-3 Sources of operating surplus of non-financial corporations (percent of gross operating surplus)**



In relation to the uses of gross operating surplus, shown in Figure 3.2-4, dividends are the most significant components. This means that a large share of the operating surplus has been paid to shareholders during the period 1997-2013. What is perhaps more interesting is the increase in the dividend payments after the 2007 financial crisis. These findings correspond neatly with the financialisation hypothesis.

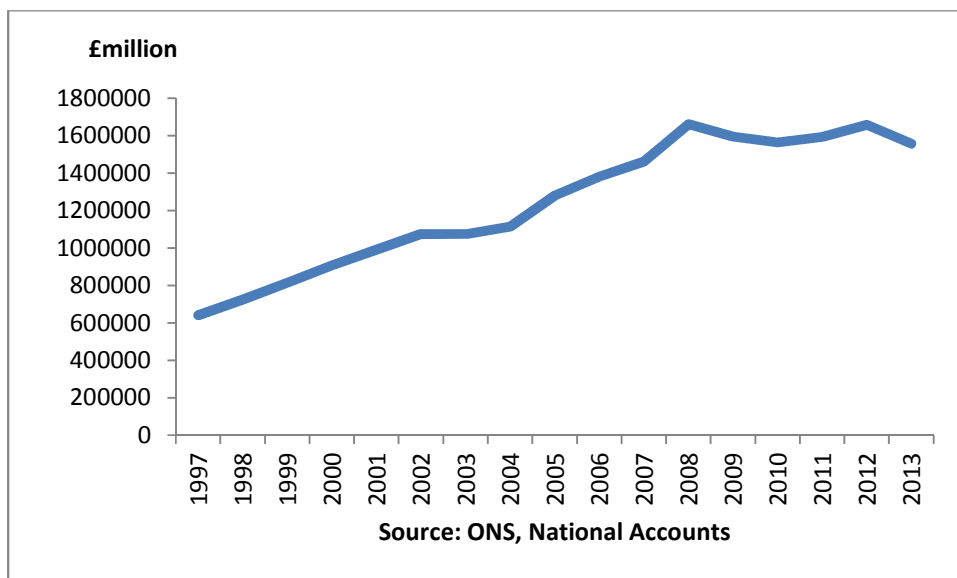


**Figure 3.2-4: Uses of operating surplus of non-financial corporate sector (as a percentage of gross operating surplus)**



Looking at the indebtedness of the non-financial corporate sector, in Figure 3.2-5, it is clear that such indebtedness has increased nearly three-folds since 1997. In 2008, gross indebtedness reached its peak, amounting to £ 1661 billion.

**Figure 3.2-5 Non Financial Corporate Debt<sup>4</sup>**



<sup>4</sup> Non-financial corporate debt represents total financial liabilities minus shares and other equity.



A common objective of UK governments throughout the years has been to promote and maintain the role of the City of London as a leading global financial centre. This objective has arguably been at the core of key economic policy decisions. For example, in the period prior to the sterling devaluation in 1967, the City of London pledged, with the then Labour government, not to lower the exchange rate, even though it seemed economically beneficial to do so in the sense that not only it would have reduced the strain on foreign reserves but also British industry would have benefited from it by increasing sales and profits. The City pledged with the government not to devalue the pound, amid worries that it would harm their international position by imposing major losses on those foreign investors that held sterling deposits and investment in London. Eventually in 1967, the government decided to devalue the pound. In the event, the London markets not only did not suffer any major losses but also it marked the beginning of a new role as a multilateral offshore centre.

Since then, and through the deregulation and Big Bang reforms in the 1980s, governments have indeed succeeded in promoting the position of UK's financial sector as a leading international centre. However, its growth has evolved in such a way that some believe it to have created an "unbalanced economy". While the financial sector has increased enormously in the last 30 years employment in the UK manufacturing sector has deteriorated markedly over the same period. Williams et al (2011), state that the output of manufacturing sector has remained nearly at the same level as that of 1979 whereas employment in the sector has declined from 6 million in 1979 to just 2.5 million in 2011. This is because the UK's manufacturing sector has lost a significant export market share whilst import penetration has risen sharply.

The growth of the financial sector, which is associated with financial innovation in wholesale finance, has to some large degree, changed the conventional role of banking in the economy. Banks no longer focus on their traditional role as a financial intermediary for the real economy in channelling savings from households





to firms that invest. Rather, their role – where the core of its business became proprietary trading- is “ to manage and transform risk for an outside corporate customer” (Williams et al 2009). The business model created by the financial sector was one in which retail services joined with wholesale through complex securitization and as a consequence banking became a “giant transaction-generating machine”, from which the finance sector was able to create, the much anticipated, high amounts of “shareholders value”.

In the corporate sector these changes in the financial sector had three important impacts.

Firstly, the changes restructured the methods of financing and balance sheet structure for non-financial corporates towards financial activity and increased leverage within non-financial corporations. Increasing leverage in the corporate sector in itself is not a major concern if applied to productive use, such that it generates enough resources, not only to meet its financial obligations but also to contribute to economic growth<sup>5</sup> and welfare. However, high levels of debt became an issue, when the credits provided by the financial sector induce instability by inflating asset price bubbles (In share markets and in commercial real estate) rather than facilitating productive investment with more stable income and liquidity benefits.

This occurred, in particular, through increased merger and acquisition activity with the rising (albeit pro-cyclical) mergers and acquisitions activity involving British companies since the 1980s, as illustrated on figure 5. As Toporowski comments, “Financial inflation changes the way in which the economy works though the impact of this inflation on corporations or companies financing themselves in these capital markets... (with an) extended festival of merger and acquisition activity and balance sheet restructuring” (Toporowski, 2010a, p65). This led to corporation’s financial

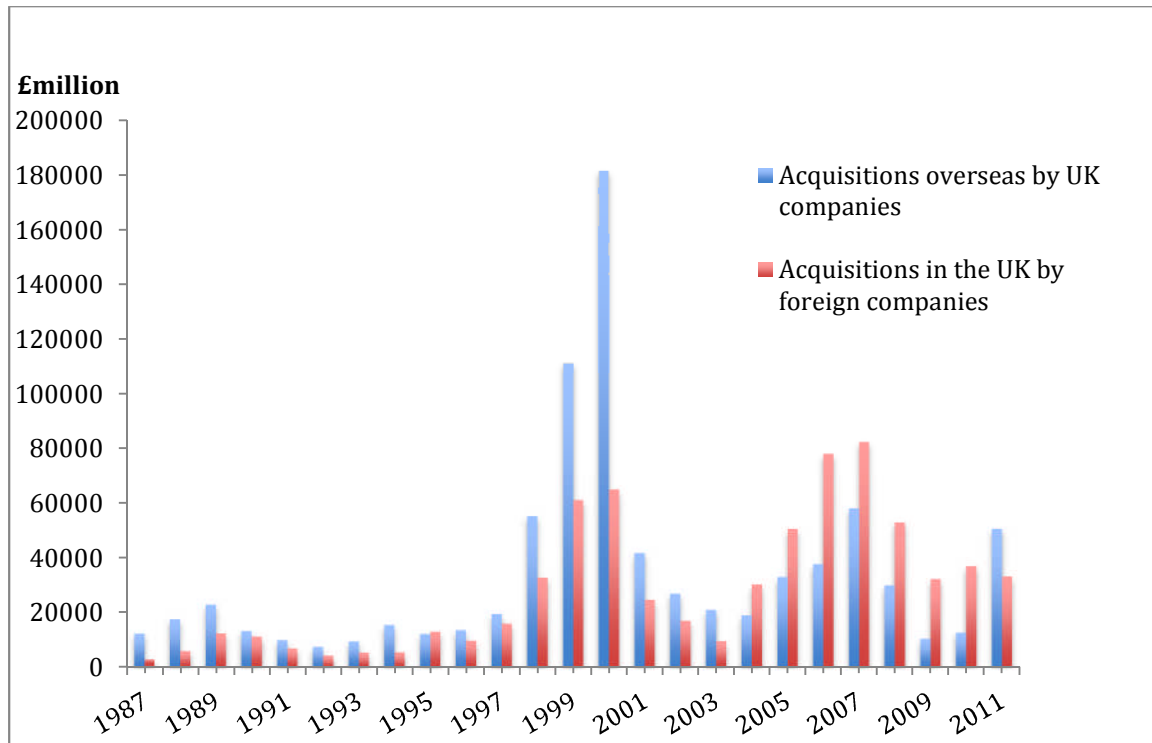
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<sup>5</sup> By means of increasing employment, infrastructure, profits, improve productivity etc.



structure became more fragile and reliant on the future income flows of those corporations (Toporowski, 2010; Barwell and Burrows, 2010).

**Figure 3.2-6 International mergers and acquisitions involving UK companies**



Source: ONS

Secondly, the shift encouraged a shift in focus from production – including investing in capital stock - to financing methodologies, undermining capital investment in stock and encouraging non-financial companies to invest in financial, not non-financial assets. Indeed, in the UK, between 1996 and 2008 the proportion of productive business investment as a percentage of GDP remained constant at 10%, whilst bank lending to productive investment fell from 30% to 10% over the same period. Such a shift fundamentally undermined investment in both on-going production and future innovation by corporations.



Thirdly, these structural changes encouraged financial investment that in which the returns can be made more rapidly than in the production of tangible goods or assets. At this point it is worth noting the views of those economists, who did to some extent foresee the outcome of asset price inflation on economic activity, but were neglected by the policy makers of advanced capitalist economies. In the twentieth century a number of economists have argued that the financial system can cause economic crisis<sup>6</sup>. From the early 1990s, Toporowski has argued that inflation in the capital market induces financial fragility in the economy by encouraging equity finance, which leads to the overcapitalization of companies, and by limiting the role of banks as financial intermediaries. At the core of this theory is the suggestion that when capital markets are driven by asset price inflation, the demand for long-term securities increases as investors are attracted by additional returns of capital gains. An excess demand for long-term securities results in changes on the structure of balance sheet operation of companies. They find it easier to increase profits by substituting debt finance with equity in takeover and/or mergers and acquisition (often overseas), than through productive investment. In addition, the substitution of debt finance with equity, makes the banking system more fragile. When banks lose their best and safest customers, corporations and governments, they are forced to lend to less financially secure borrowers, carrying greater risks.

The fact that the UK corporate sector drew little credit, under conditions for which bank credit was cheap and easy to obtain, to fund any productive investment, provides support for Toporowski's theory. Asset price inflation raised the real exchange rate thereby reducing the cost of acquiring overseas assets while also reducing the competitiveness of the UK economy.

This shift from production to finance as the fundamental activity of non-financial corporation's is a new phenomenon that characterises the UK's financialization and

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<sup>6</sup> Such as Minsky's views on the instability of modern capitalism and Hobson's prediction that collateralize lending could lead to asset inflation.

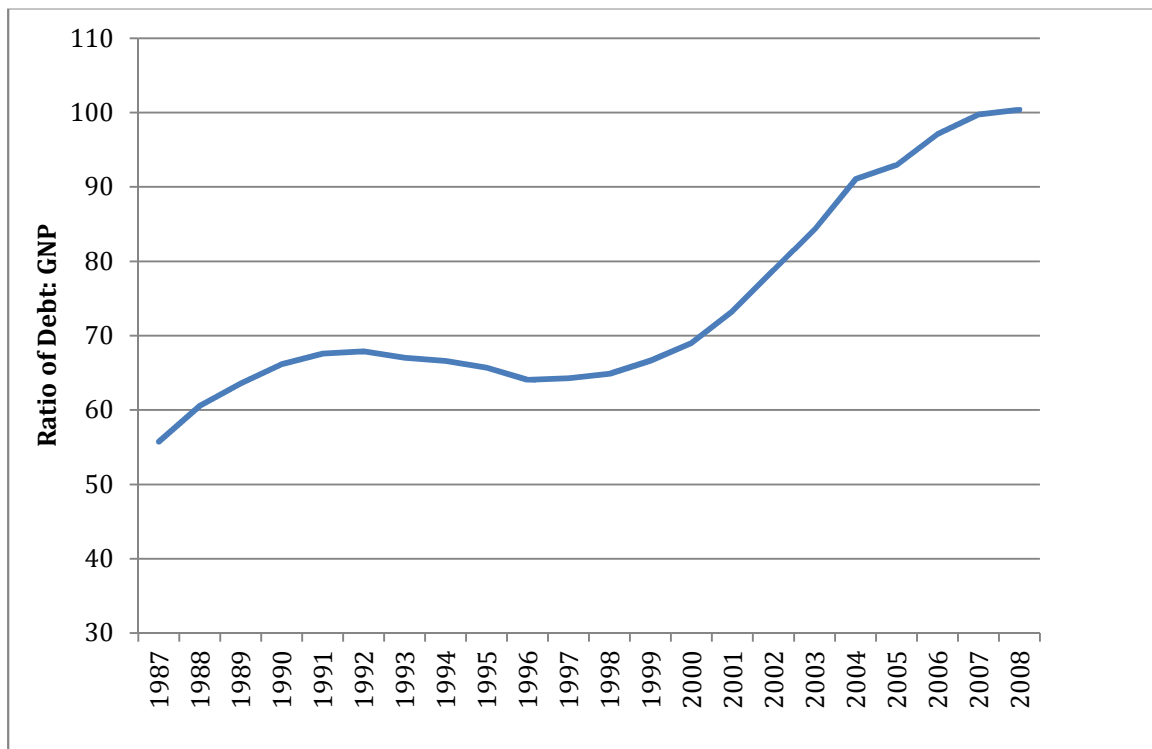


has had significant long term negative implications for the overall economic structure of the UK.

### 3.3 Financialization and consumption

As noted in the previous section, the culture of the period of financialization encouraged increasing leverage in the corporate sector. However, leverage also rose in the household sector. It is this leverage that links financialization to consumption. This is illustrated in Figure 3.3-1 below, where the levels of debt within the UK household, as measured as a ratio against GNP, accelerated continually from the mid 1990s, from approximately 55% to 100% of GNP .

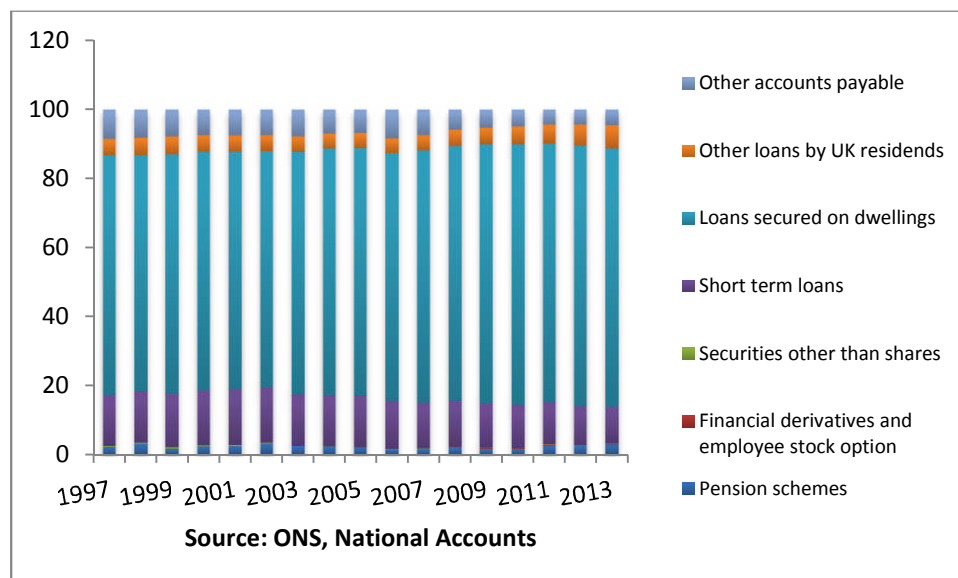
**Figure 3.3-1 Household debt as a ratio to GNP**



Source: Barwell and Burrows (2010) (Secondary source: post 2008 data not available)

Looking more closely at the components of financial liabilities of the UK's household sector, shown in Figure 3.3-2, it is apparent that loans secured on dwellings (loans) is the most significant components of the sector's debt. As can be seen, mortgage debt has increased steadily during the period between 1997-2013. In 1997 it accounted for around 69 percent of total financial liabilities, reaching its peak in 2010, accounting for around 75.5 percent of total liabilities.

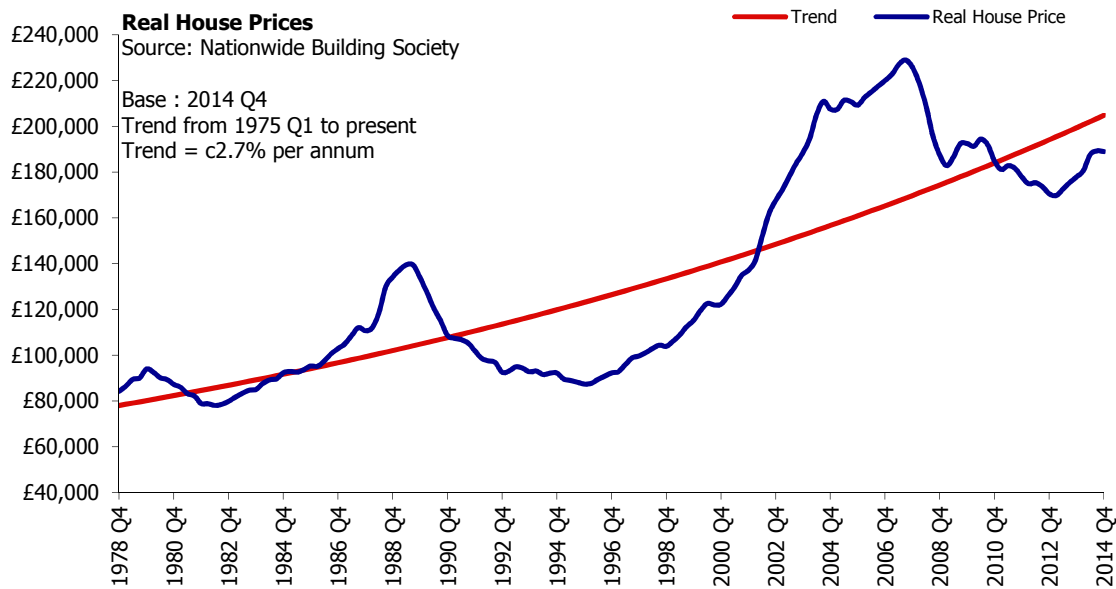
**Figure 3.3-2 Components of financial liabilities as a percentage of total liabilities**



The rise in the levels of mortgage debt as a percentage of total financial liabilities can be explained by a decline in house prices after the 2007 financial crisis, as shown in Figure 3.3-3. House prices increased rapidly after mid 1990s, reaching its peak in the first quarter of 2007.



**Figure 3.3-3 House prices adjusted for inflation**



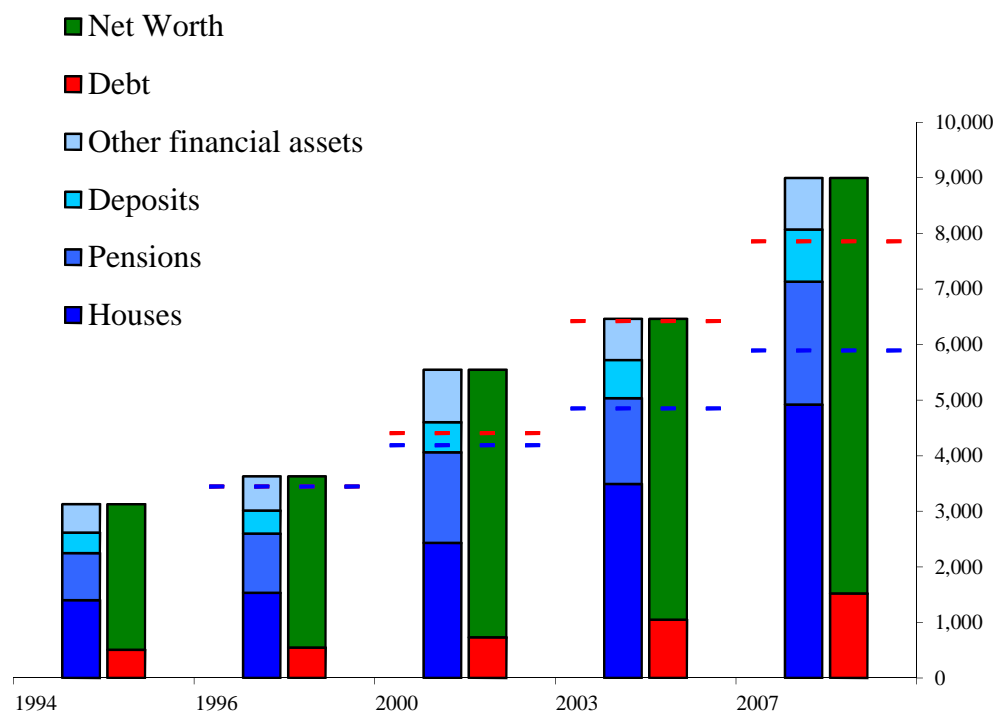
**Source: Nationwide Building Society**

Short-term loans are the second largest components of household debt. In 2007 short-term loans accounted for 13 percent of total liabilities increasing to just over 16 percent in the early 2000s. In the second half of the decade, late 2000s, the shares of short-term loans fell in total liabilities fell to 14 percent. After the 2007 crisis, this share has fallen even more accounting for 12 percent. However, in the years 2012-13 it has fallen to the lowest level ever, accounting for just over 10 percent of total liabilities.

The reasons behind this huge surge in borrowing by households can be seen in the changes in household balance sheets as illustrated in Figure 3.3-4 below. As can be seen, household net worth increases. This increase, however is primarily due to increases in the value of the housing stock, which grew from £1.4 trillion to £4.9 trillion and from 53% to 66% of net assets between 1994 and 2007. Pensions and deposits also increased in value but remained relatively constant percentages of total net worth. Mirroring these changes in housing assets were increases in debt, which tripled from £0.5 trillion to £1.5 trillion in the same period. Burrows of the

Bank of England, whose data is presented here, comments “The household sector took on bank loans, predominantly to finance house purchases. House prices began a long march upwards, boosting net worth for house owners through revaluation effects” (Barwell and Burrows 2010, p. 11).

**Figure 3.3-4 Household Balance Sheets (1994-2007) £billions**



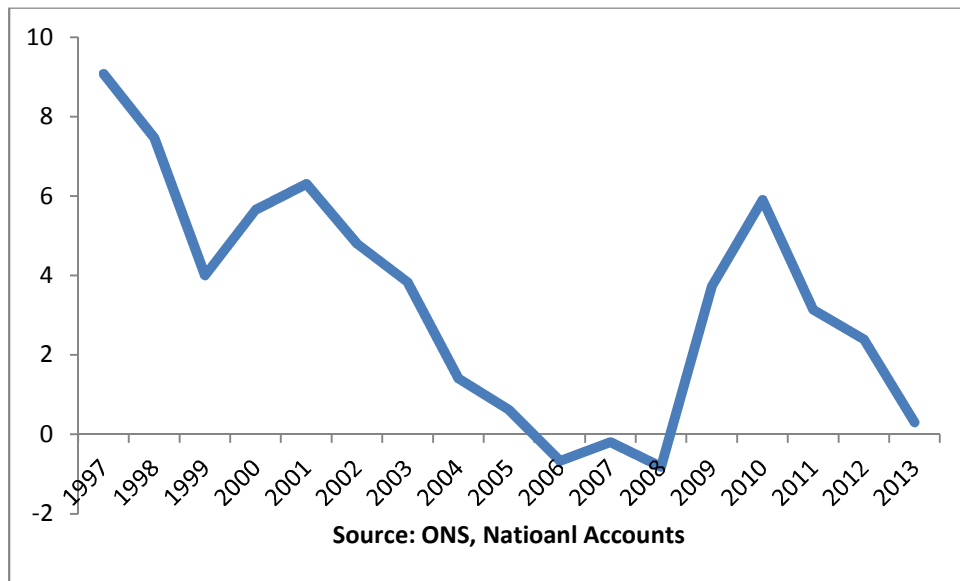
Source: Barwell and Burrows (2010) (Secondary source: post 2007 data not available)

However, the UK has experienced a number of novel phenomena that are unique to the period, and that are the underlying processes of structural, not empirical, financialization. Primary amongst these were changes in the consumption and savings patterns of households shifted to a pattern whereby consumption was growing faster than real earnings (Borrows, 2011).

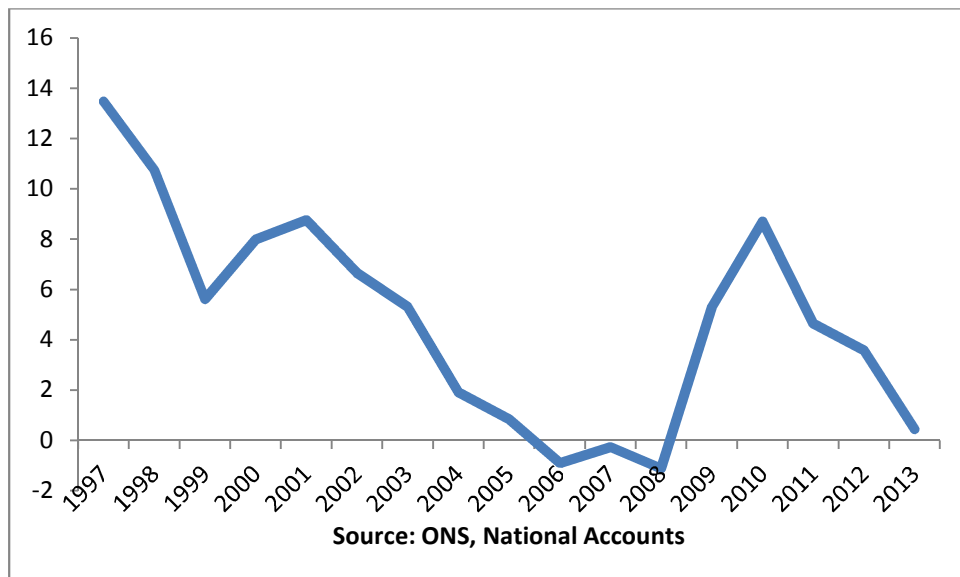


This was partially financed through a simple decline in savings, as illustrated in Figure 3.3-5 below, with a switch in households behaviour from savings to consumption. Indeed, there was a long-term decline in savings, with households savings fell to all time lows by 2007. The propensity to save out of wages and salaries, shown in Figure 3.3-6 shows similar declining pattern.

**Figure 3.3-5 Propensity to save out of disposable income**



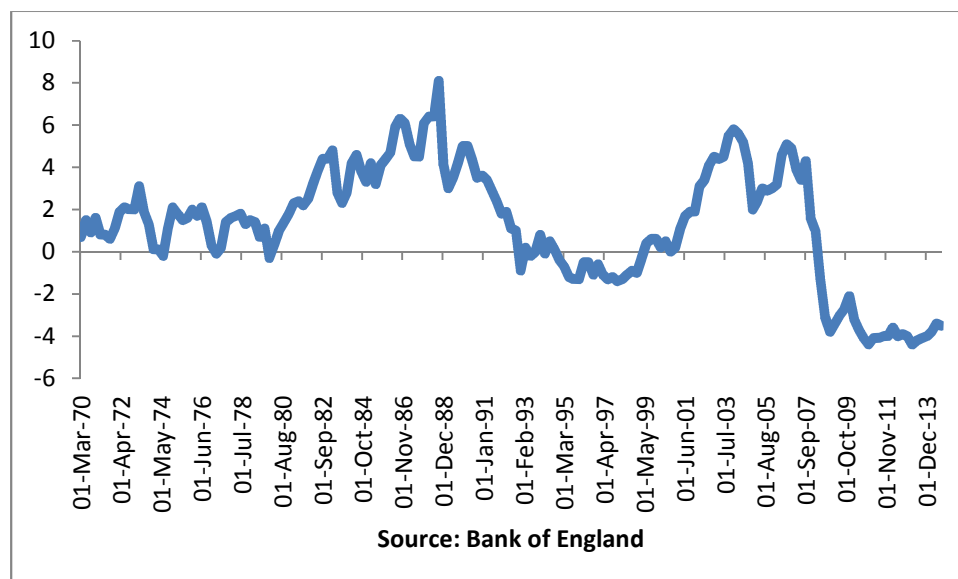
**Figure 3.3-6 Propensity to save out of wages and salaries**





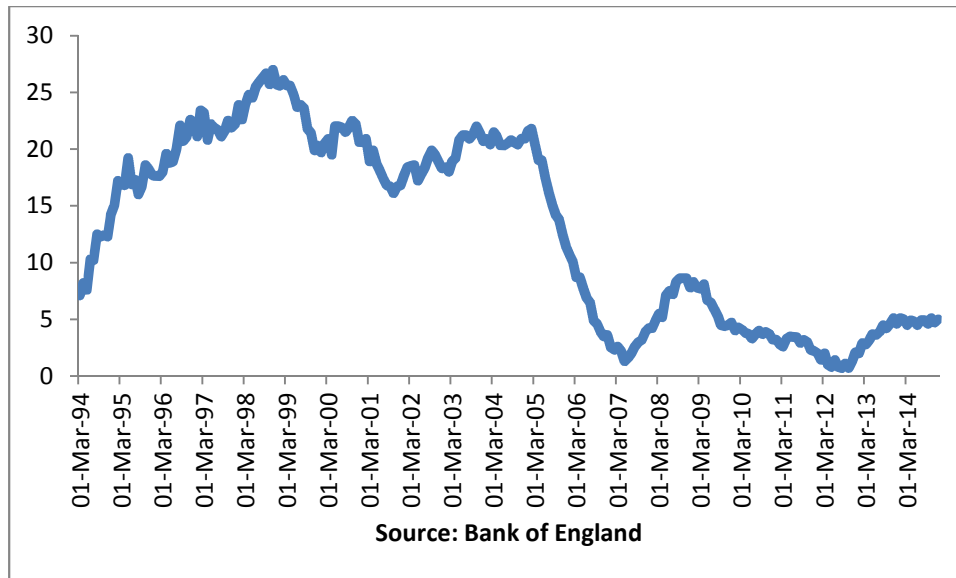
However as consumption expanded further, simple declines in savings switched to borrowing for consumption. As noted, increased borrowing was for housing purchase. However, amongst property owning classes, unrealised gains in housing became a method to secure borrowing against for consumption. Termed “equity withdrawal”, such borrowing grew every year from 1997 to 2007, peaking at £140 billion annually in 2006 before sharply declining during the financial crisis (Reinhold, 2012). This trend can be observed in Figure 3.3-7 which shows the quarterly percentage change in equity withdrawals since 1970. Similarly, unsecured borrowing through credit cards also expanded, as shown in Figure 3.3-8.

**Figure 3.3-7 Equity withdrawals (quarterly percentage change)**





**Figure 3.3-8 Credit card lending to individuals ( 12 month growth rate )**



The cumulative effects of this financing for consumption was a major factor in the long boom of the 2000s where consumption, which composed the dominant share of GDP, grew at a rapid rate. However, by 2011, this cycle of inflated consumption was collapsing and was a major cause of the prolonged recession that occurred in the UK post 2007<sup>7</sup> (Kamath et al, 2011). Overall the inflow of credit into the housing market, and hence indirectly via “equity withdrawal” into consumption, as well as lending directly for consumption was critical and fundamentally new processes that created increased instability in the economy, a key characteristic of the UK's financialization. (The contribution on different components of aggregate demand to GDP growth is shown in section 2)

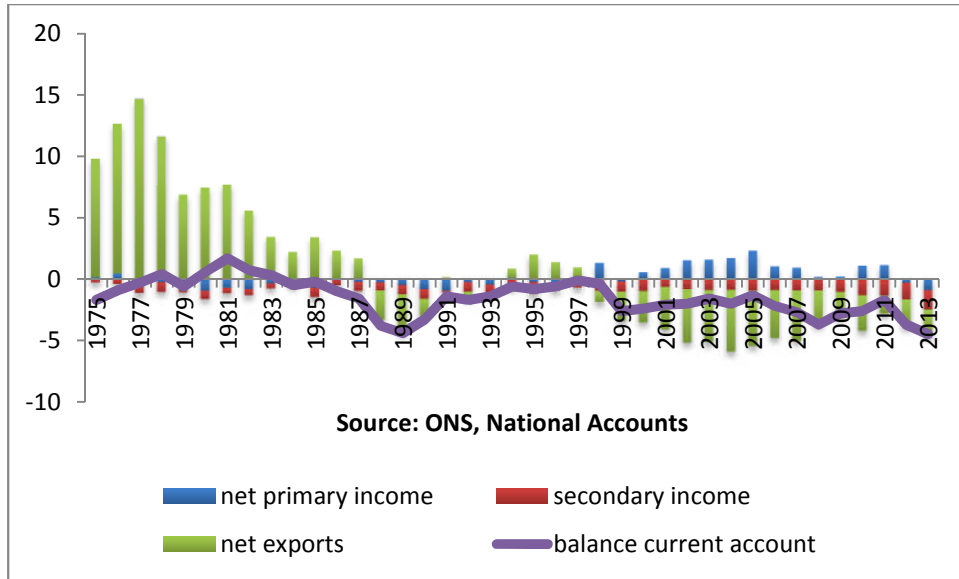
<sup>7</sup> In addition to unemployment and high inflation driving falls in real wages which were also important (Kamath et al, 2011).

### 3.4 Financialization and the current account

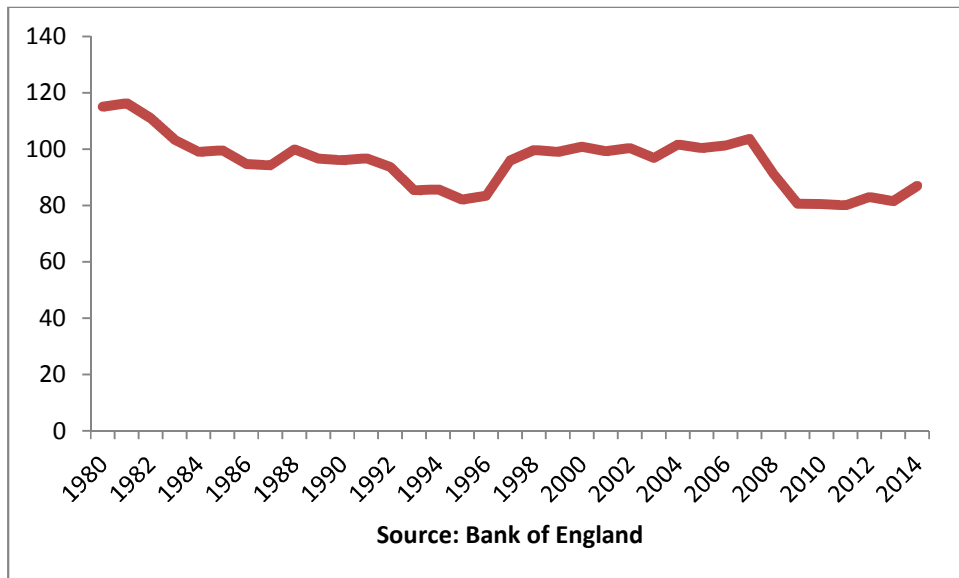
As discussed in section 2 above, and shown in Figure 3.4-1 the UK has run a current account deficit since early 1980s. The deficit has widened significantly in the last decade, especially after the 2007-08 crisis. In 2013 the current account deficit was 4.5 percent of GDP. This has been the biggest deficit since 1975, with the exception of the deficit in 1989 which was 4.4 percent of GDP.

Figure 3.4-1 also reveals that only net primary income has been positive after the late 1990s. Net current transfers and net exports have remained negative during the same period (i.e. since late 1990s until 2013). However, net exports have declined more substantially switching from being highly positive during the late 1970s and early 1980s to consistently becoming negative since late 1990s. Since then they have turned negative and widened during the 2000s. However, after the 2007 crisis, net exports have narrowed by nearly half. For example in 2007, net exports accounted for around 4.12 percent of GDP. By 2013 this deficit had been reduced to 2.16 percent of GDP. Over the same period, in the aftermath of the 2007 crisis, the annual average effective exchange rate has declined, shown in Figure 3.4-2.

**Figure 3.4-1 Current account, UK (percentage of nominal GDP)**



**Figure 3.4-2 Annual average effective exchange rate index (Jan 2005=100)**

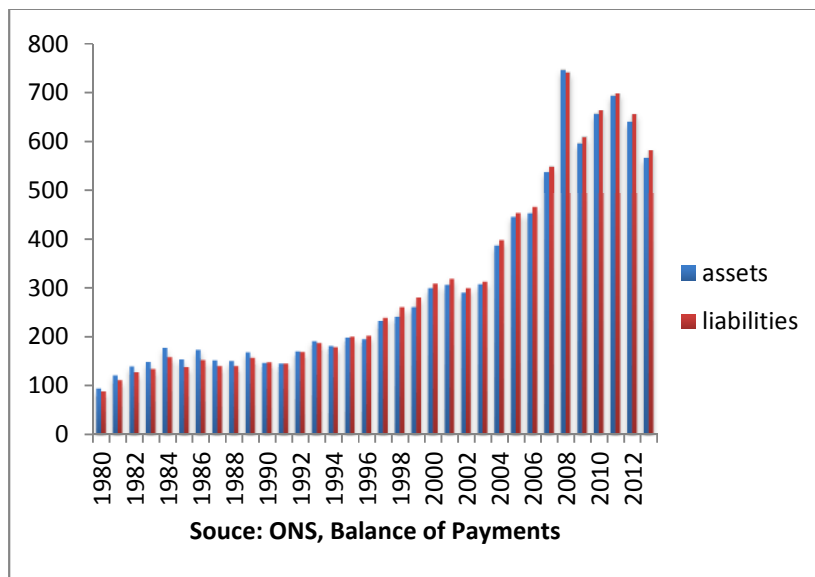


The UK's current account deficit has been associated with negative balances in the International Investment Position (IIP). Figure 3.4-3 shows the gross assets and liabilities, as a percentage of nominal GDP for the period 1980-2013. As can be seen



both assets and liabilities have increased substantially since 1980s. For example liabilities in 1980s accounted for nearly 88 percent of GDP, reaching a peak in 2008, accounting for more than 740 percent of GDP. However, in 2009 assets fell considerably, accounting just over 600 percent of GDP and in 2013 have declined further more accounting for around 580 percent of GDP. The same pattern can be observed for gross assets, which increased substantially from 1980 to 2008 and then declined in the aftermath of the latest financial crisis.

**Figure 3.4-3 Gross assets and liabilities, as a percentage of nominal GDP**

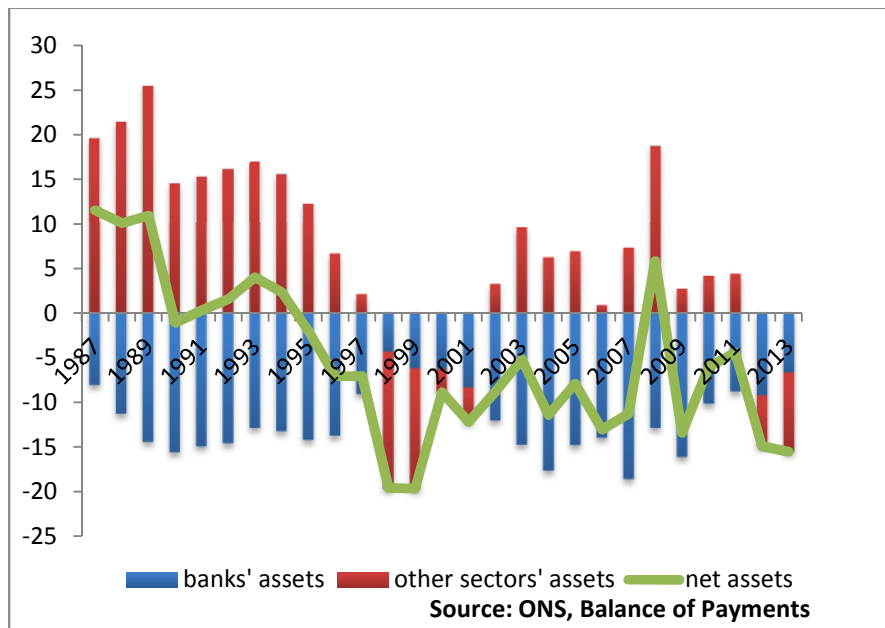


As already stated above, the UK 's Net International Investment Position has been negative since mid 1990s (Figure 3.4-4), with only a short-lived positive balance in 2008. The largest deficit in the UK IIP has been in the years 1998 and 1999. This deficit was associated with negative other sectors assets, accounting for around -20 percent of GDP. Another interesting fact revealed in Figure 3.4-4, is the negative contributions of banks' foreign assets. In the early 2000s banks' assets started to increase reaching the highest level in 2008, accounting for more than 18 percent of



GDP. In the years following the crisis, banks' foreign assets have fallen and remain at historical low levels.

**Figure 3.4-4 UK's International Investment Position (as a percentage of nominal GDP)**



#### 4 Financialization and the economic and financial crisis

##### The Financial Crisis of 2007 and its Aftermath

At the beginning of 2007 global financial markets were continuing the activities established in the previous two decades. From the summer of 2007 onwards the pressures from the global financial system as housing markets slowed down in economies that had experienced house price booms, including in the UK, and mark-to-market losses and liquidity strains escalated, and imploded after the US-based bankruptcy of Lehman's transmitted contagions effects into the global financial system. The UK was affected immediately because of its strong linkages to global

markets and because of its importance as a centre through which business in other countries was conducted. Following these events there were massive government-backed and funded recapitalizations of banks, and central banks in the US and UK provided unprecedented liquidity support. Base rates were pushed to historical lows and substantial quantitative easing was implemented.

**Figure 4.1 The Phases of the Crisis, 2007**



Source: Financial Stability report, Bank of England, October 2007.

Two factors in particular spread contagion in the UK financial markets: The opaque and complex innovation in financial instruments with high embedded leverage; and the widespread 'originate and distribute' business model, in which banks felt relieved of responsibility for due diligence on new loans because of the securitisation of the loans through obscure credit derivatives that assured the value of the loans. Both these had made the risk in the balance sheets of UKs financial institutions increasingly opaque, with much of their funding reliant on short-term money market instruments and sustained demand for credit instruments in capital markets. This



funding combination was consequently susceptible to collapse in confidence amongst other financial institutional and the broader investor and depositor base. When that confidence failed, credit spreads widened substantially and there was a rapid increase in hoarding of liquidity and increased risk aversion in relation to counterparty risks.

In the UK this crisis reached a critical point at Northern Rock which had relied on money market funding and balance sheet management through securitizations. In July 2007 the bank succumbed to a liquidity crisis and the Government was eventually obliged to guarantee all retail deposits and subsequently nationalise the bank (FSB, Bank of England, September 2009). However, by the spring of 2008 it was clear that the dislocation in the financial markets was continuing, based on increasing illiquidity and higher credit spreads in many markets and financial institutions were forced, or chose, to rapidly deleverage and sell assets.

Central banks, including the Bank of England, responded by lowering interest rates and providing longer-term funding based on increasingly low quality collateral. By 2008, further special policy measures were needed. The Bank of England responded by announcing a package of measures, including raising capital for UK banks, the Special Liquidity Scheme and guarantees for UK debt issuances. There was a government-supported recapitalisation scheme for UK banks and building societies, in which major UK institutions participated, including Abbey, Barclays, HBOS, HSBC Bank PLC, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland, and Standard Chartered. These institutions committed to increase their Tier 1 capital and accept government funded capital in the form of preference shares or ordinary equity. In addition, participants in the program were given a Government guarantee for senior unsecured debt instruments for terms up to three years, Commercial paper and certificates of deposit. The Bank of England's Special Liquidity Scheme was extended to include £200 billion to banks and again allowable collateral was extended, including debt issues guaranteed by the Government.

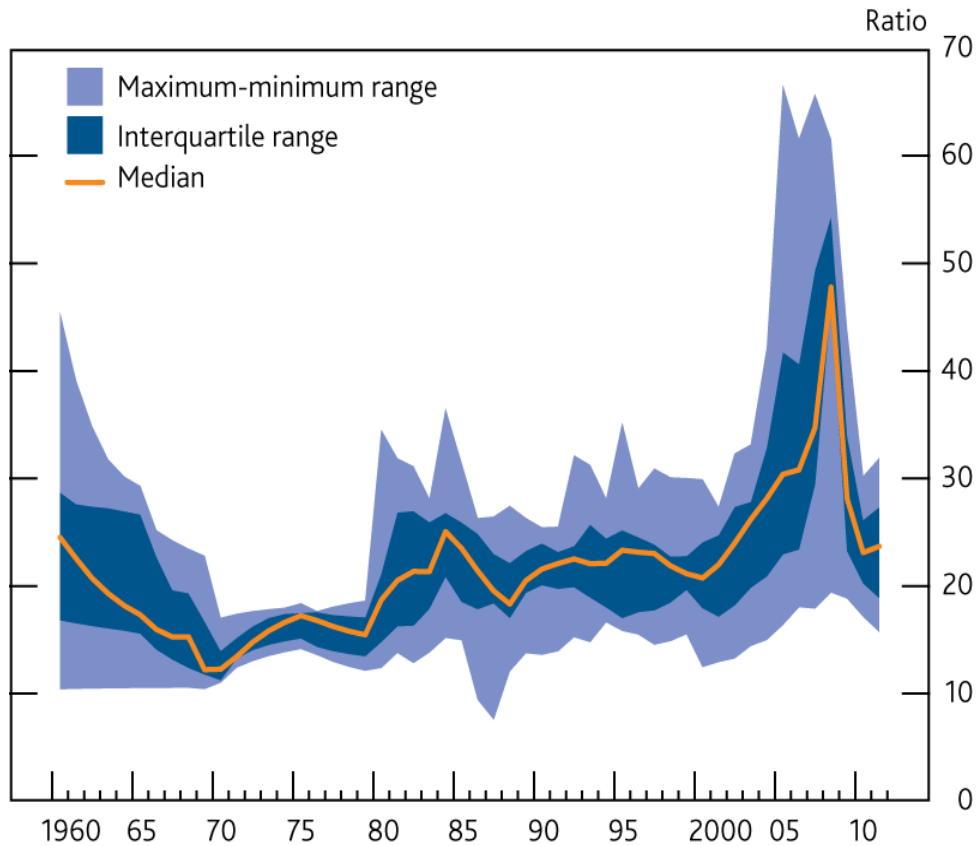




However, these measures proved inadequate for some institutions and there was a wave of nationalizations across the globe, including in the UK. Bradford & Bingley was partly nationalised, Alliance & Leicester was taken over by Banco Santander and Lloyds TSB undertook an acquisition of HBOS. The UK Government was also forced to support UK retail depositors in Icelandic banks following the institutional collapses in Iceland. However, there was renewed concern that the focus in regulation on capital and liquidity requirements had not been adequate as a regulatory approach. Indeed, signalling that it had recognised a structural change in financial markets from prior years, the Bank of England commented that events have “highlighted the need for a fundamental rethink of internationally appropriate safeguards against systemic risk, including through the development of macro prudential policies to dampen the financial cycle” (FSR, October 2008, p1).

By the end of 2009 the acute phase of the crisis in financial markets had abated and financial markets were calming, underpinned by the massive provision of liquidity in all the important banking markets of the world. Funding and liquidity concerns eased and asset markets stabilized. This continued into 2010 despite the Euro-zone crisis. UK Banks did, however, continue to deleverage with, by the end of 2010, leverage returned to the levels of the early and mid-2000s. This deleveraging was achieved by a fall in net lending by UK banks, driven by reductions in the loans to households and non-financial companies as well as lower holdings of non-government debt securities.

**Figure 4.2 UK banks' leverage, 1960 to 2011**



Source: FSR, December 2011

In addition to continued deleveraging, the overall capital position of the major UK banks improved, with issuances of substantial amounts of term debt in 2010 and 2011. However the rebuilding of capital strength continued to be impaired by losses or weak profits. By the end of 2010, core Tier 1 capital ratios, on a Basel II basis, rose by 0.85 percentage points to 9.9% in 2010, the highest level since 1992, although there was notable divergences between banks.

During 2011 market conditions again worsened as the Euro-zone crisis deepened with no apparent sign of any imminent resolution. Nevertheless, despite these concerns, UK banks strengthened their balance sheets with a relative return to stability within the UK financial system. However, at the time of writing, concerns remain over the resolution of the Euro-zone crisis, the caution of UK bank lending,



especially in the household sector, and the macroeconomic outlook in which UK banks operate.

Institutions in a financial system are highly interdependent. Financialization through the creation of markets intensifies and broadens this interdependence. This creates further instability in the financial system and disrupts and changes the relationship of the financial sector to the non-financial sector to the extent of altering the economic functions of the financial system.

There are a number of channels through which this occurs. Firstly, financial institutions are reliant on each other for access to funding, particularly short-term funding. In the financialised system, short-term liabilities have become the predominant form of funding, intensifying the interdependence of institutions in relation to liquidity risk. Such transmission led to the collapse of Northern Rock in the UK and subsequent liquidity crisis in interbank markets.

Secondly, in the financialised financial system, institutions are reliant on each other for assessments of credit worthiness. Credit risks in derivative and other contracts create direct counterparty credit risks between financial institutions. The values of these risks are also intimately linked to perceived valuations of market participants, which are highly subjective due to their reliance on “mark-to-market” and “mark-to-model” values and which, in turn, reflect market sentiment - or a form of Keynesian “animal spirits” and “beauty parade” - rather than inherent value or values which underlie the real economy. This channel of perceived and actual creditworthiness then creates feedback loops into liquidity risk because other institutions are assessing these issues when deciding to lend short-term funds to other financial institutions. This is the primary manner of the broadening of interdependence because of the extent to which assets are subjectively valued, so that valuations are highly reliant upon market sentiment, which determines the liquidity of the assets. Such assets have come to dominate the activities and balance sheets of financial institutions. These interrelationships led to contagion during the 2007-08 financial



crisis, especially after the collapse of Lehman Brothers. At that point, contagion effects were international and led to panic in interbank markets because it was impossible for institutions to assess the creditworthiness of counterparties. This led to a vicious cycle of collapsing asset markets and further falls in confidence and transparency.

These issues also have the consequence of creating closely aligned incentives within financial institutions. This means that all institutions have a tendency to act in similar ways, which creates increased instability through intensifying “herding” behaviour in financial institution and in financial markets. An institution whose lending, deposit taking or market-making strategies are out of line with the rest of the system will incur major imbalances with other institutions. If sustained, this will become a source of suspicion and mistrust – that is a loss of “confidence” - and may lead to reduced access to money market funds. In turn such loss of confidence creates contagion because of the difficulty of then assessing the soundness of other interdependent but non-transparent institutions. Similarly, institutions, whose assets are largely dependent upon these subjective valuations can be assessed as sound and stable until such confidence collapses, either through confidence in the specific institution or in the markets in general. Finally, institutions which enjoy the trust of other institutions have access to larger resources at better terms compared to others not so trusted. This is a source of considerable competitive advantage for favoured institutions.

Interdependence of this type means that each institution faces similar incentives - including a form of Keynesian “beauty parade” in relation to asset valuations - and must expand or contract at a similar speed to others in the system. Thus, financial institutions implicitly act in concert even when they do not explicitly agree to adopt a set pattern of unified behaviour which intensifies instability within the financial system.



Such behaviour may not conform to classical models of monopoly, oligopoly or small-group monopolistic competition. It may also not qualify legally as a cartel. (Although there have also been many instances of explicit price fixing. Recent examples in the UK include collusion to fix LIBOR and exchange rates). It is driven by incentives within private financial institution being aligned and interconnected through market dynamics including those driven by confidence and uncertainty. This means that financial institutions tend to behave in very similar ways in similar circumstances. Moreover, this behaviour pattern, together with the market rules associated with it, discourages alternative competing behaviours. It is also likely that financial institutions are normally in receipt of monopoly surplus in the long run.

The market structure and behaviour created through interdependence means that financial markets have become dis-associated with the real economy in a number of ways.

Most importantly, access to liquidity is not directly linked to the savings and investment decisions taking place elsewhere in the economy. Nor are financial institutions linked directly to real sectors of the economy. Access to liquidity and, hence, the ability of an institution to extend credit is no longer related to “banking fundamentals” such as its creditworthiness of lending portfolios. Instead, it is linked to the subjective and volatile valuation of the market for the OTC traded financial securities which are on its balance sheet. This makes the provision of liquidity to markets for longer-term or less frequently traded securities unstable, reinforcing a tendency to hoard liquidity in the rest of the economy.

This unstable liquidity means that financial institutions do not respond in the stable and predictable fashion that is necessary for the orderly functioning of the monetary transmission mechanism, undermining monetary policy effectiveness. Changes in nominal interest rates and nominal exchange rates are the main ways in which real interest rates and real exchange rates are altered. The base trajectory of nominal interest and exchange rates is determined by the business cycle and the liquidity



management of banks and financial institutions. However, from time-to-time the government or private investors may impose a different pattern. The government can choose to enforce a particular nominal interest rate because it can choose the price at which to issue currency and other government debt. This sort of intervention when pursued consistently may last for many years. For example, Siegel (1992) found that between 1890 and 1980, a period of significant intervention by the Government to reduce interest rates, real interest rates in the UK were much lower than at other periods since 1800. Nominal exchange rates can also be altered by government intervention or by large-scale short-term capital movements to induce movement in nominal exchange rates. Normally, these impacts are limited by the extent of official reserves and so are relatively short-lived.

In theory, it is possible for governments acting in concert to amend this system for significant periods. This may occur if the operation of financial systems is made dependent on access to official reserves and/or official base money and the government undertakes to provide reserves as required by the liquidity needs of markets and institutions. But in an open economy, such as the UK, whose markets intermediate global financial flows, the scale of those liquidity needs may be beyond routine management by the financial authorities in the UK. Hence, there is a constant tendency for structural volatility in all financial systems, the character of which changes over time in systematic ways.

## 5 Summary and conclusions

In the UK, especially since 1990, financialisation has taken the form of a proliferation of credit operations by companies and financial intermediaries. This was enhanced by Britain's position as an international financial intermediary, transmitting to the UK shocks from other parts of the world, and disconnecting financial activity from the non-financial activities that form the basis of the country's prosperity at large. A consequence of this was the high leverage of the financial sector supported by short-term money market operations. When those markets failed, vital supplies of short-term money ceased to be available. This negative sentiment accompanied by a shortage of money market funds occurred in the aftermath of the Lehman Brothers collapse.

The degree of independence from the real economy of the UK, the extent of financial market making and the interdependence between participants in the UK financial system were on an unprecedented scale before 2007. They remain at the same or higher levels today (2014). As a consequence, the benefits of financialisation which include a wide spread of market efficiencies in the form of reduced transaction and waiting costs and an increased range of consumption opportunities in the UK and overseas became available to more people than ever before. It is true that access through the internet and the spread of broadband, especially after 2000, was an important means of access. The later years of the My Bank era in the UK coincided with the rapid growth of broadband networks. It enabled UK households to consume in unprecedented numbers and on an unprecedented scale through a residential housing market whose inflation was fed by credit inflows and growing shortages of affordable housing. Financialisation, was, therefore, a potent force behind the longest and perhaps the most distorted economic boom that has ever occurred in the UK.



However, the regulation of the markets rested on the assumption that all markets (whether financial or otherwise) tended towards stable equilibrium and that systems composed of such dynamically stable markets were themselves dynamically stable. Monetary policy consisted predominantly of setting short-term interest rates in order to achieve a pre-set target range inflation rate. The model input (interest rates) was adjusted so that it was consistent with the desired output (target range inflation). The models used for this purpose either had no financial system or assumed that financial markets were in stable equilibrium. Between 1998 and 2014 prudential control of the UK financial system by the Bank of England, and the provision of liquidity to that system ceased to be at the heart of monetary regulation.

Because, since 1990, UK financialisation was based on making and maintaining new financial markets the UK financial system was rarely in stable equilibrium during that time. Moreover, the leverage of financial system participants rose for much of the long 1990s based on the ready availability of money market funds, often from overseas, which made these participants interdependent. The combination of disequilibrium, leverage and interdependence was manageable provided financial markets kept expanding. Expansion provided the new liquidity required to form the basis of future growth of money market funds. However, when this expansion petered out in the second half of 2007, as the world economic boom slowed, a negative credit accelerator set in and the collapse of the UK money market became almost inevitable.

Following the crisis, all regulatory reactions to the 2007-08 crisis in the UK have been inspired by a determination to ensure that the City of London remains an important international financial centre. The UK Government has proved itself remarkably adept in pursuing this aim.

To sum up, this paper has investigated empirically the development and the effect of financialisation on the UK economy. Section 2, alongside an historical overview of the changes of the UK financial sector, provided an overview of the long-run





development of the UK economy, mainly since the 1980s. Section 3 examined the effect of financialisation on income distribution, investment, household consumption and the country's current account. In relation to income distribution it is argued that income inequality has increased phenomenon in the UK since the mid 1980s. The data also suggests that rentier income has increased whilst retained earnings have fallen during the period between 1997 and the mid 2000s. The effect of growing financial intermediation, on investment in fixed capital, provides evidence that support the financialisation hypothesis. Most notably the data suggests that dividend and interest payments by the non-financial sector have increased significantly during the period under consideration. At the same time investment in fixed capital stock has steadily declined. Financialisation is also evident when analysing the UK's household sector. Perhaps the most revealing evidence provided in this section was the level of debt of the UK's household sector. The high levels of debt were associated with a decline in the propensity to save, which indicates that UK's household 'lived beyond their means'. The last part of section 3, analysed the UK's current account which has been in deficit for most the period between 1980-2013. On the capital account, the country's International Investor Position has been negative during the same period.

Section 4 shows how the UK economy entered into deep recession in 2008. A key factor here was the contagion effect mainly coming from the US, in the aftermath of the Lehman Brothers collapse.

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## **THE ABSTRACT OF THE PROJECT IS:**

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?



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