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Finance and industrial strategy

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Abstract: The paper is focused on the role of finance in the context of the implementation of industrial along the lines of industrial strategy. It argues that there is not a shortage of savings for the funding of investment, and that attention should focus on the direction of savings in ways compatible with development and sustainability. An underlying theme paper is that the financial sector has to serve the economy and industry, rather than vice versa. The financial sector should be re-structured in ways which are conducive to sustainable development. This would involve focusing activities of the financial sector on commercial banking, promotion of a financial sector less prone to financial instability, and direction of funds. A well-designed financial transaction tax along with other taxes on the financial sector would aid focusing the financial sector onto commercial banking activities. The promotion of a more diverse (e.g. in forms of ownership) and regional based banking system could contribute to stability. A combination of ‘directed lending’ with requirements that a stated proportion of bank lending be directed towards specified areas such as ‘green investment’, small and medium sized enterprises, and the birth of a State development bank are advocated.

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1. Introduction

An industrial strategy involves the government adopting a broad view of the future development of the economy in terms of which sectors are to be built up and developed. It can also involve perceptions of which types of firms are in need of support (often this is viewed in terms of small and medium sized enterprises), the roles of foreign direct investment etc. The implementation of an industrial strategy requires the funding of investment in ways which are consistent with the over-all strategy. This is to rather state the obvious, but it does have important ramifications. It first raises the question of whether there is sufficient funding available. The answer which we give to that is, in broad terms, there is. The second relates to the direction of funds, that is does the funding flow into those sectors which are to be developed etc.. If the financial sector allocated funds in an efficient manner and in the required direction, there would be little requirements for the direction of funding.

The relationship between finance and industry is a long-standing issue. Collins (1991), for example, in a survey book on industry and finance in UK in the period 1800-1939 opens with ‘Have the banks failed industry? In Britain there has long been a sizeable body of opinion that believes so. Throughout this century [that is the 20th] economists and other commenters have expressed doubts about the role placed by British monetary institutions in providing the financial serves – especially the provision of long-term finance—essential for nourishing a modern, competitive industrial sector’ (p.9)

The structures and activities of the financial sector have changed since those debates on banks and industry. There have been processes of financialisation. By financialisation at a general level we mean ‘the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’ (Epstein, 2005, p.3). It is the forms which
financialisation in the UK has taken over the past 30 to 40 years which attracts our particular attention. These include the continuing growth of the financial sector particularly in terms of ‘value added’ albeit with relatively little growth of employment, growth of activities focused in the creation of and trading in derivatives, securitization, the pyramid of assets and liabilities, the growth of consumer debt, the tendency for shifts in the shifts in the direction of flow of funds with corporations becoming net savers and shifts to de-regulation and ‘light touch’ regulation. There has been the further emphasis on ‘shareholder value’, which many have argued pushes in the direction of lower investment. For example, ‘regarding investment in capital stock, financialisation has been associated with increasing shareholder power vis-à-vis management and labourers, an increasing rate of return on equity and bonds held by rentiers, and decreasing managements’ animal spirits with respect to real investment, which each have partially negative effects on firms real investment.’ (Hein, 2012). There have been many changes in the relationships between the financial sector and industry (as well as with households). The focus of our attention here is how well the financial sector operates to serve industry in terms of the provision of financial services and specifically the financing and funding of investment. Two aspects of recent financialisation which are particularly relevant for what follows are the forms in which the financial sector has grown and the higher levels of savings by corporations\textsuperscript{4}. The

\textsuperscript{1} The precise dating is not crucial here. However note that financialisation is often associated with the period since circa 1980. For the UK the liberalisation represented by the Competition and Credit Control in 1971, the instability of the financial system evidenced by the house price boom, credit explosion (following Competition and Credit Control) and the near-collapse of the banking in 1973.

\textsuperscript{2} This is value added as reported in the national income accounts: it should not be taken to imply that the financial sector generates value [however value may be considered].

\textsuperscript{3} See Shabani, Tyson, Toporowski, and McKinley (2014) for a detailed story.

\textsuperscript{4} This should not be read as saying the other features are unimportant for a general consideration of the role of the financial sector and financialisation.
first means that the activities of the financial sector (and the resources deployed there) are increasingly concerned with transactions in ‘existing pieces of paper’ with profits from such transactions arising when asset prices are rising and through arbitrage opportunities. The other side of that is that activities become less focused on the funding of investment. The second has involved that corporations having savings in excess of their investment (in capital formation), as will be evidenced below; and the counterpart of that is that corporations seek to find outlets for their savings in the form of financing consumer debt and the purchase of financial assets. It also means that as far as corporations are concerned there is not a shortage of funds; indeed it is rather that there is an excess.

There has been a long-standing literature which has been concerned with ‘economic development and financial development’ (which I have recently reviewed in Sawyer, 2014a), which has generally found a positive relationship between the two though without determining the direction of causation. However, more recent work has cast doubt on the sign and strength of the financial sector, and hence whether recent developments in the financial sector, notably the growth of securitization, have detracted from the role of the banking system in the allocation of savings. It should also be noted that financial development has generally been measured by variables such as bank deposits relative to GDP, market valuation to GDP, whereas the growth of the financial sector in the past few decades has been particularly focused on securitisation etc. These type of developments are not conducive to the role of the financial sector in linking savings with investment and with the financing of investment. Epstein and Crotty (2013) extend this argument when they write that they derive a ‘very preliminary range of estimates’ which ‘suggests that the financial sector in the United States is extracting 2-4 times as much income relative to the services it provides to the real sector in the
decade of the 2000’s as it did during the high growth period of the 1960’s. This suggests that the financial sector may need to be only one-half to one-quarter as large as it is currently to serve the existing needs of the real sector.’ (p. 13). Although this is specific to the US, many similar factors would be at work in the UK. One aspect of that is that the financial industry (and particularly if a broad FIRE (finance, insurance and real estate) definition is used) has become a significant industry in its own right. Whereas the relationship between finance and industry was viewed in terms of the degree to which finance went to domestic industry and to the foreign sector in earlier times, it would also now be viewed in terms of its contribution to employment, output and more so to the current account position. In former times, the financial sector and the exchange rate would be considered in terms of the interests of the City for a stable high exchange rate, now it could be viewed in terms of the impact which financial sector activities has on the exchange rate in a floating exchange rate world, and thereby the impact on other exporting sectors. Thus with regard to industrial strategy, that should now include a strategy for the financial sector, as well as a strategy which enables the financial sector to serve industry in general.

It is to state the obvious that any industrial strategy involves investment (broadly interpreted), and that such investments have in some way to be funded. As such, there are always issues of the quantity of funds and the direction of the funds. In other words will there be sufficient funds for the levels of investment required for a successful industry strategy and will the funds available be channelled in the relevant directions. The chapter begins with a consideration of the roles of the financial sector and relationships with the industrial sector. There have been long-standing debates going back more than a century of the failures of the financial sector vis-à-vis the industrial sector. The processes of financialisation over the past three decades have involved
developments of the financial sector which have been to the detriment of the industrial sector. The key roles of the financial sector should be the financing of (through bank loans) and the longer term funding of investment, and the need to reconstruct the financial sector to focus on those roles. There is then a need to re-focus the financial sector away from the development of 'exotic' financial products (derivatives) which do little for savings and investment, and which absorb resources: a financial transactions tax could be one element for that re-focusing and provide funds for industrial development. The thrust of this introduction will be the argument that the financial sector has to serve industrial development (and economic performance more generally) rather than its own interests and the extraction of rent from the rest of the economy.

The banking system has a particular crucial role to play here. One feature of banks (narrowly defined) is that their liabilities are means of payment, i.e. treated as money. The undertaking of investment ahead of savings requires that banks provide loans to firms, which not only creates money (in the form of bank deposits) but enables the investment to be financed and to take place. In turn, the investment stimulates savings. At the end of the circuit when the savings have been generated, there is the flow of funds to the firms. The first key role of banks is then to provision of loans which can initiate investment ahead of savings. But to state the obvious this relies on the willingness of banks to provide loans and firms to acquire the loans. The second key role of the financial sector as a whole is the re-allocation of the funds which have been generated.

A pervasive feature of finance is that there will be forms of credit rationing -- by which we mean that the cost of finance will reflect the provider perception of the risks
attached notably the likelihood of default (partial or total). The higher the perceived risk of default and the higher the perceived costs of default (e.g. what proportion of the loan would be recoverable in the event of default as it is secured against other property), the higher will be the cost of finance; and a higher cost of finance may itself shift the risk of default. In a world of uncertainty where the risks of default are not known, it is the perceptions of the borrowers on the risks which are relevant. Further, the risk of default depends on the actions of the borrower in a range of ways; and hence the perceived risk will also have to take into account the possible actions of the borrower. The assessed risk of default may be sufficiently high that the cost of borrowing becomes very high and in practice there would not be lending.

The perceptions of lenders on risk will be strongly influenced by a wide range of social and economic factors: some groups (e.g. ethnic, gender) may be systematically judged high risk and face high costs of borrowing. In the context of industrial strategy the significant question is the allocation of funds to specific sectors such as small and medium size enterprises, environmental friendly investment.

2. Investment and savings

It is argued that there is an ‘over-savings’ issue in the UK economy and not a shortage of funds (and this is reflected in the budget deficit when it is recalled that from national accounts budget deficit = private savings minus private investment plus capital account surplus). There has been a long-standing imbalance between private savings and private investment (which is detailed below for the past decade), which has shown up in consumer debt, budget deficits and financial investment by corporations. It is argued

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5 See Sawyer [2014b] for a detailed survey of the relationships between finance and industry with a particular focus on the roles of credit rationing.
that an industrial policy would not involve a higher level of investment (as compared with the level prior to the financial crisis) but a re-structuring of investment which is more environmental friendly. Thus it is not a matter of a general insufficient funding for investment, but rather the need to ensure that finance is forthcoming from banks and that funding is channelled in the socially desired directions.

Table 1 near here

Some broad sweep statistics on investment in the UK are given in Table 1, covering the period 2004 to 2012. In the period of the mid 2000s prior to the financial crisis, gross investment relative to GDP averaged 19.02 per cent, of which 17.40 per cent of GDP was private investment and 1.62 per cent public investment. The figures presented in Table 1 suggest that the savings made by non-financial corporations substantially exceeds the investment which they undertook, and similarly for financial corporations. Savings undertaken by households (which in this context would also include unincorporated firms) had low savings prior to the financial crisis\(^6\), aligned with the rising debt of many households on the back of rising house prices. Combined with an inflow of capital from the rest of the world (the counterpart to the current account deficit) a government budget deficit is an inevitable feature which is in effect required to absorb the excessive savings.

It is a well-known feature of many industrialised economies that the general shift away from wages and towards profits has not been associated with a comparable rise in investment. Related to that, and as is apparent from Table 1, the savings out of profits by corporations exceed the investments of corporations, leaving the corporations with a

\(^6\) In the years 2004–2008, savings as percent of disposable income for households averaged 2.6 per cent; for years 2009–2012, averaged 6.9 per cent. However, in the years 2004–2008 household expenditure and gross disposable income were virtually equal, and the savings of households were largely accounted for by ‘the change in net equity of households in pension funds’. Source: National Income Accounts, 2013, Table 6.1.6.
surplus of funds which have to be lent out, directly or indirectly, to others, notably to
government (thereby help to fund the budget deficit) and to households (which may
show up in the extension of credit to the household sector).
From 1990 through to 2007 growth of GDP averaged 2.4 per cent per annum7 with
infamously 63 successive quarters of output expansion and in the words of the then
governor of the Bank of England Meryyn King this was the 'nice' period -- non
inflationary continuous expansion. We postulate that the rate of investment was broadly
consistent with the economic growth achieved (that is there was not a major rise or fall
in the capital-output ratio). An investment ratio in the upper teens appears to be
consistent with the type of growth rate that was experienced in the 1990s and 2000s. We
further postulate that a growth rate in per capita terms of the order of 2 1/2 per cent
appears to be the ceiling on the growth of the UK economy, and further that the future
growth rate is likely to be slower rather than faster than that for two essential reasons.
The first relates to environmental considerations and whether the planet is capable of
withstanding continuing growth at the rates experienced over the last few decades. The
second is the perception that growth rate of productivity has slowed: in the UK
productivity has declined in the years since 2008, and this may portend slowed
productivity growth in the future. From these considerations we postulate that the
requirements for investment funds are not going to be substantially higher than they
were in the first part of the 2000s. However, there will be requirements on the direction
of funding – particularly in the direction of environmentally friendly direction. Further,
consideration must be given to the ways in which the ways in which the savings of
corporations ahead of their investment requirements are utilised.

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7 Excluding the recession years of the early 1990s, the average for 1993 to 2007 is just under 3 per cent
per annum.
3. Financial sector and industrial strategy

The financial industries are industries, and as such would come under the general rubric of industrial policy. Indeed industrial policy in the UK could be characterised by ‘defend’ the City of London, a notable example being the responses to proposals from the European Union over financial transactions taxes.

There has been much talk of the re-balancing of the UK economy – with precious little indication of what that means and little movement in the direction of re-balancing. An industrial strategy is at heart a strategy for the re-balancing of the economy. By re-balancing we mean securing a macro-economic balance at a high level of employment which does not rely on a series of ‘unsustainable processes’ (Godley, 1999). The ‘boom’ of the mid-2000s was heavily reliant on consumer debt fuelled by rising house prices – both of which have strong elements of unsustainability (also the profits of the financial sector). The excess of savings over investment in the corporate sector as revealed in Table 1 could be similarly seen as a source of imbalance – the consequence of such an excess is that the corporate sector is a lender – whether to the household sector (consumer debt), to government (budget deficit). The further requirement is for changes in the industrial structure which are more compatible with the sustainable growth of the UK economy.

The financial sector has been compared by some, notably Shaxson and Christensen (2013) in terms of a ‘finance curse’ which echoes the arguments of a ‘resource curse’ which can afflict countries with large natural resources. There is not space here to fully develop the argument, but let us consider some of the possible effects. The real exchange rate is higher than it would be otherwise. This, of course, can be viewed as a benefit since imports become cheaper to the benefit of consumers. But, as is well-known from the North Sea oil experience, a high exchange rate operates to the
detriment of other industries. This could mean a reallocation of resources though the financial sector is in general not employment-intensive as other industries. The authors argue that the finance curse involves ”country capture” – where an oversized financial sector comes to control the politics of a finance-dependent country and to dominate and hollow out its economy’.

The underlying points being made here are two-fold. The first is that the policies towards the financial sector should be viewed within the context of an overall industrial strategy. This involves debates over the future role of the financial sector as employer and whether it should continue to receive the support of recent years. The second is that the key role of the financial sector should be to facilitate sustainable development in the real economy. The financial sector should then be viewed in terms of the services it provides to support industry and its development (though not limited to that).

4. Institutional arrangements

The underlying assumptions here are that there is not a shortage of potential savings which would fund investment, and that the major issue is the direction of funds rather than the quantity. In this respect, let us note that a higher level of investment would generate a higher level of savings through an expansion of the economy (and also a higher level of tax revenue and imports). It is also taken that the major role of the financial sector should be the financing of investment and the channelling of savings into investment.

In light of the financial crisis, its long-lasting impacts on economic prosperity and employment and the costs of that crisis (in terms of ‘bail-outs’ and of lost output), there

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8 The stress should be on potential savings as savings can only be realised if there is prior investment, government net spending and net exports.
has been much discussion of reforms of the financial system and its regulation. Although there has, in not general, been much discussion of the links between industrial strategy and reforms of the financial sector, those discussions can be drawn on here. The purposes of such reforms of the financial system would be to construct a financial system less prone to instability and crisis. If reforms were carried through, and their purposes achieved, that would be over-all beneficial for economic performance. But how far would it aid industrial development and strategy?

Here we argue for four ‘reforms’ of the financial sector which would aid industrial strategy (and economic performance more generally). We would argue that these reforms would also facilitate a less unstable financial system.

The role of financial transactions taxes

The key role of the financial sector (alongside provision of a transactions technology) is the provision of bank loans to finance investment and linking savings and investment. The trading of existing financial assets, the growth of ‘fictitious capital’, and the rise of assets and liabilities (relative to GDP) contribute little to that key role. A particular recent example has been the development of high frequency trading (HFT), which relies on computer algorithms in the context of trading strategies carried out by computers to move in and out of positions in seconds or fractions of a second. ‘As of 2009, studies suggested HFT firms accounted for 60-73% of all US equity trading volume, with that number falling to approximately 50% in 2012.’ ‘Financial markets have undergone a dramatic transformation. Traders no longer sit in trading pits buying and selling stocks with hand signals, today these transactions are executed electronically by computer algorithms. Stock exchanges’ becoming fully automated ... increased the number of transactions a market executes and this enabled intermediaries to expand their own

use of technology. Increased automation reduced the role for traditional human market makers and led to the rise of a new type of electronic intermediary (market maker or specialist), typically referred to as high frequency traders (HFTs)’ (Brogaard, Hendershott, and Riordan, 2013).

The rise in the frequency of trading in equity, and the development of derivatives and high volume trading raise a range of interesting issues for industrial policy. The growth of high frequency trading raises issues of corporate governance: some-one who is the (proud) owner of equity in a company for a second cannot exercise much influence on the corporate governance of that company!. Further, when price movements are in effect following a random walk, then high frequency trading is akin to playing the casino. High frequency trading exacerbates the issues raised by Keynes in the 1930s when he wrote that ‘Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done... The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States.’ (Keynes, 1936, p.159 and p.160). The casino analogy should also be viewed in terms of who profits from HFT – in the case of the casino we know it is the ‘bank’: for HFT those operating the system appear to find it highly profitable, but at whose expense?

The essential rationale for a financial transactions tax remains and is indeed reinforced by financialisation, by which we mean the growth of the financial sector in its...

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10 See Gower (2010) for advocacy of financial transaction tax in the context of the growth of high frequency trading.
economic activities, power and influence, and the specific direction which financialisation has taken in the past three decades with the growth of securitisation and derivatives. The advocacy of a financial transactions tax is not to preclude other taxes on the financial sector such as financial activity taxes. The advantages of a financial transaction tax would not only dampen down the resources deployed in the buying and selling of existing financial assets which are of little social benefit, but also serve as a source of tax revenues which can be deployed for the funding of public investment.

Separation and ring fencing
There has been substantial discussion of the separation of ‘narrow banking’ from ‘casino banking’; less pejoratively expressed as separation between commercial banks and investment banking/securities trading. Such a separation was embodied in the American Glass–Steagall Act, the final repeal of which in the 1999 Gramm–Leach–Bliley Act has been attributed a role in the generation of the financial crisis of 2007/09. The response of the UK Independent Banking Commission (2011) was ‘ring fencing’ – that is while a financial institution could engage in both commercial banking and investment banking there would be internal separation between the activities, with the intention of ‘insulating UK retail banking from external shocks and of diminishing problems (including for resolvability) of financial interconnectedness’. They proposed that a ‘wide range of services should not be permitted in the ring-fence’. The ‘activities [which] should not be carried on inside the ring-fence: services to non-EEA customers, services (other than payments services) resulting in exposure to financial customers, ‘trading book’ activities, services relating to secondary markets activity (including the purchases of loans or securities), and derivatives trading (except as necessary for the retail bank
prudently to manage its own risk.’ (Executive summary Independent Banking Commission, 2011, p.11).

The essential arguments for ‘ring fencing’ relate to the stability of the financial system. The concern here is somewhat different, namely for the focus of the financial sector on the savings—investment linkages and not on trading in existing assets.

*Structure of the banking sector*

The structure of the banking sector can be viewed in terms of what would be conducive for financial stability, and indeed much of the discussion on the structure and regulation of the banking sector has focused on that issue. The focus here is somewhat different directly on the structure of the banking system which would aid industrial policy and strategy, though financial stability would generally aid industrial development.

The Independent Bank Commission (2011) viewed its recommendations as aiming to ‘create a more stable and competitive basis for UK banking in the longer term’, which ‘means much more than greater resilience against future financial crises and removing risks from banks to the public finances. It also means a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, efficiently channelling savings to productive investments, and managing financial risk’ . (p. 7).

The British banking sector is highly concentrated as has been the case for the last century. The proposals here would run along three lines.

The first comes from banks concentrating on ‘channelling savings to productive investment’, to which we would add the role of the initial provisions of loans for investment. The other side of that is the discouragement of dealings in derivatives and other financial assets. This can come from the ‘legally enforceable separation between retail and speculative banking. This would help to contain the toxic effects of future
crises. However, merely separating the banking arms is not enough because speculators would continue to be funded by monies from savers, pension funds and insurance companies to finance their gambling habits’ (Sikka, 2014, pp.21-2). Policies such as this are generally proposed with regard to lessening financial fragility and proneness to credit bubbles. From the perspective here they are viewed in terms of the linkages of savings and investment.

The second is diversity of the banking system. Although building societies were technically not banks for many years, and their key function was the provision of housing funding and a vehicle for household savings, they were mutual organisations providing specialised services. The German banking system stands in some contrast to the UK system with a range of different ownership forms (private, public and mutual) and the local and regional focus of much of the banking system with landersbanken, savings and co-operative banks. Without eulogising the German system it does seem to have been rather more adept at funding small and medium sized enterprises and less prone to financial instability.

‘All of this suggests that government can and should play a central role in structuring the financial system to achieve sustainable long-term economic growth. And in contrast to the current system, which centralizes power in mega-firms and directs capital in just a handful of channels, an ideal system would be more decentralized and create more diverse channels for capital investment.’ (Block, 2014, p. 12)

‘This kind of automation is a particular problem with small-business lending. Since failure rates of small business loans are high, the computerized algorithms tend to limit credit to firms that have already proven themselves or to firms that have collateral in

11 See Detzer, Dodig, Evans, Hein, and Herr (2013) for detailed survey of the German financial system.
the form of real property. This tends to bias credit availability toward real estate development and away from other endeavors. The best way to overcome this dynamic is to introduce significant competition from financial intermediaries who are not seeking to generate profits. These could take the form of credit unions, community banks, nonprofit loan funds, or banks that are owned by government entities; but the key is that their mission is defined as facilitating economic development in a particular geographical area. With this mission, they have a reason to employ loan officers who develop the skill set needed to provide credit to individuals and firms who fall outside the parameters of the standard lending algorithms.’ (Block, 2014, p. 16)

The third is to reduce the degree of concentration in the banking sector, some of which could be achieved through more diverse organisations, and the application of competition policy more stringently to the financial sector. The reduction of concentration could go alongside a more regionally based banking system. But this raises the losses of economies of scale. ‘However, these industry studies rely primarily on case studies and anecdotal evidence to support their claims. The majority of academic studies, on the other hand, do not find positive evidence for economies of scale and scope beyond a relatively small size. For instance, Saunders [1996] surveys at least 20 empirical studies and finds little evidence of scale economies for banks with assets greater than $5 billion. Similarly, in a survey of more than 50 studies by Amel et al [2004], the minimum efficient scale in retail commercial banking appears to be somewhere below $10 billion in assets, depending on the sample, country and time period. Applying these findings to the global population of banks in 2008 would suggest that several hundred are above the threshold at which no positive evidence for economies of scale could be found. Beyond a certain size there may even be diseconomies of scale, possibly due to the complexity of managing large institutions
(Haldane [2010]). While some recent studies are more supportive of the existence of scale economies in banking, including a review of studies of mergers and acquisitions in banking by DeYoung et al (2009), taken together the bulk of the empirical literature to date has failed to identify material economies of scale in commercial banking beyond a relatively modest size.’ (Davies, Richardson, Katinaite, Manning, 2010, p.325)

However, in a more recent paper it has been argued that ‘from a standard model of bank production that does not control for any TBTF [too big to fail] funding cost advantage, we find evidence that scale economies exist for our international sample of large banks. These results are similar to recent findings in the literature.’ (Davies and Tracey, 2014 p.243). But, and most significantly, ‘from both methods that attempt to uncover the production technology for banks that is unaffected by TBTF [too big to fail], we no longer find evidence of scale economies for our sample of large banks. These results imply that estimated scale economies for large banks are affected by TBTF factors.’ (Davies and Tracey, 2014 pp.243-4)

**Guided lending**

An important element of an industrial strategy is to seek to ensure that funds flow in the direction which is compatible with that strategy. This can involve some degree of guided lending – that is requirements that a specified proportion of their lending are to those sectors identified for development and growth. In the current circumstances, we would advocate that the key focus here should be on green and environmentally friendly investment. This could draw on the US experience of the Community Reinvestment Act (CRA), introduced in 1977 and revised in 1995, whereby banks and other financial institutions are legally required to direct a portion of funds to lending to the local community. ‘The Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in
which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations. The CRA requires that each depository institution’s record in helping meet the credit needs of its entire community be evaluated by the appropriate Federal financial supervisory agency periodically. Members of the public may submit comments on a bank’s performance. Comments will be taken into consideration during the next CRA examination. A bank’s CRA performance record is taken into account in considering an institution’s application for deposit facilities’ (http://www.federalreserve.gov/communitydev/cra_about.htm; accessed March 2014). Dayson, Vik, Rand and Smith (2013) explore the use of a Banking Disclosure Act as ‘it is believed that disclosure could support research into the determinants of underinvestment and lending, which in turn would aid by enhancing our understanding of financial exclusion and underinvestment. In particular, it would help identify groups and areas less likely to access financial services’.

The underlying philosophy is that banks are making credit allocation decisions all the time, and the decisions which come out are not necessarily socially desirable. The purpose here would be to seek to ensure that sufficient credit is channelled in the directions consistent with the overall industrial strategy. The local aspects of this is stressed by Sikka when he writes that ‘banks should be part of local communities. They should not be permitted to up sticks and leave local communities in the lurch. Maintaining a socially desirable network of branches should be a necessary quid pro quo for a deposit-taking licence and the state’s deposit protection guarantee. Each branch closure must be sanctioned by the regulator, and banks must be required to demonstrate that after closure, the local community’s access to banking services will not suffer’ (Sikka, 2014. p.24). An alternative view on this is that ‘government has an active role to play in allocating credit to finance productive economic activity, and it
should use a full range of policy tools including interest rate subsidies, loan guarantee programs, and tax incentives to assure that capital flows in the most productive directions.’ (Block, 2014, p.13)

**Development Banks**

A further arm in policies designed to strengthen an industrial strategy which has to be put on the table is the establishment of a State sponsored development bank along the lines of the European Investment Bank to generate funds in the financial markets for onward lending to enterprises including small and medium sized enterprises. The UK Green Investment Bank could be one arm of this.

Insofar as a State sponsored development bank was drawing on government funds (as the Green Investment Bank does) it would run into the objection that it adds to budget deficit and to the public debt. Our response to that would be that borrowing for investment also adds to the assets of the public sector (whether through infrastructure investment or through onward lending to the private sector), and that the concern should be that the funds are well used, adding to the desired direction of investment, and aiding the achievement of full employment. There is no ‘tipping point’ for the national debt to GDP ratio which threatens growth\(^\text{12}\). But also note that as with the European Investment Bank any lending by governments can be leveraged through direct borrowing by the development bank, and that such borrowing (as is the case with the European Investment Bank) does not appear on the balance sheets of any national or EU organisation.

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\(^{12}\) See Harndon, Ash and Pollin (2014) for critical assessment of work which purported to show that there was a ‘tipping point’. Arestis and Sawyer (2014) provide an extensive discussion of the points mentioned in the text.
5. Concluding comments

One theme underlying this paper is that the financial sector has to serve the economy and industry, rather than vice versa. It has been argued that an industrial strategy would contribute to a re-balancing of the economy [a significant element of which would be an improvement in net exports]¹³. It has been asserted that there is not an essential lack of savings in the UK economy, and that the focus needs in the short run to be on raising investment levels back to around the pre-crisis level, and in the longer term to channelling savings and investment into areas of development and sustainability. Although it has not featured in this piece, much of that focus has to be on ‘green investment’ and environmentally sustainable investments. The financial sector should be re-structured in ways which are conducive to sustainable development. This would involve focusing activities of the financial sector on commercial banking, promotion of a financial sector less prone to financial instability, and direction of funds. A well-designed financial transaction tax along with other taxes on the financial sector would aid focusing the financial sector onto commercial banking activities. The promotion of a more diverse (e.g. in forms of ownership) and regional based banking system could contribute to stability. Specifically in terms of industrial strategy and development, we advocate a combination of ‘directed lending’ with requirements that a stated proportion of bank lending be directed towards specified areas such as ‘green investment’, small and medium sized enterprises, and the birth of a State development bank.

¹³ It should be noted that some combination a rise in net exports and reduction in net savings (savings minus investment) has to accompany a reduction in the budget deficit as a matter of national income accounting.
References


Gower, R. (2010), Financial Crisis 2: the rise of the machines, The Robin Hood Tax (downloaded from robinhoodtax.org.uk)


## Table 1 Savings and Investment in the UK

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<td>13.37</td>
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<tr>
<td>Non-financial corporations</td>
<td>9.60</td>
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**Source:** Calculated from *National Income Accounts 2013*
Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 [contract number : 266800]. The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

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?’
THE PARTNERS IN THE CONSORTIUM ARE:

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