

# Transcript

Globalization: What's new? And what are the implications for policy?

The historical evolution of "the city"

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Contributor: This week we are looking at the historical evolution of the City of London in the UK and financial sector more generally. In terms of the UK financial sector, there have been peculiarities of the British economy given its historical development as a major colonial power originally.

So I'll say something about that, then Keynes' pamphlet called 'The Economic Consequences of Mr Churchill' which illustrates some of these points. And then discuss some of the problems about having too large a financial sector; does it stop finance going to industry? Does it stop talent going to industry? Does it generate short-termism and that leads on to the more general issue about the Anglo-Saxon model, the UK and US model based on laissez-faire free market systems as against European and Asian systems which tend to be more regulated.

In terms of the British economy, obviously the financial sector grew up at the time when British companies were working internationally, and the focus of the City of London was from the beginning the global operations of the UK economy rather than domestic industry. That has led to

criticisms both that the UK government tend to favour the City of London, the financial sector, because of their global aspirations rather than domestic industry. But also, the concern that domestic industry is starved of investment because of the global interests of banks.

And also, a culture of short-termism across the UK industry because financial markets tend to work to shorter term horizons than does manufacturing industry, where new products and processes can take years to develop.

Now, John Maynard Keynes the economist, his first sort of famous work was at the end of the First World War, when the settlement had put big reparations payments on Germany, required Germany to pay large reparations payments to Britain and the other victorious powers. And at the time, John Maynard Keynes had criticised this policy in a pamphlet called 'The Economic Consequences of the Peace', saying it would undermine the German economy, it would prevent Germany recovering from the First World War, and that would be disastrous in political terms eventually, sooner or later. I think he was proven right.

Now, in 1925, Britain rejoined the Gold Standard to try and re-establish their previous hegemony internationally in terms of having the Gold Standard linked to the pound. And in order to emphasise the point that the British economy was as strong as it had been before the First World War, it rejoined the Gold Standard at the same rate as before the First World War. The Chancellor of the Exchequer who did this was Winston Churchill.

Keynes criticised it at the time, said that that was putting the pound at too high a value, people would therefore not be able to buy British goods, being quoted in UK pounds they wouldn't be able to afford, and

therefore Britain would get locked into a recession. He was proven right in that, most dramatically with coal, British coal was just too expensive and that was a good example because coal was fairly easily bought elsewhere and traded.

But the government at the time thought that the economy worked as economic textbooks say it should, and that you could just cut prices by cutting wages, and therefore tried to do that with the coal miners in 1926 and caused a general strike.

Now eventually Britain was forced off the Gold Standard, because as Keynes had warned, it was unsustainable and indeed a previous Labour minister who had been in the Labour government who had failed to leave the Gold Standard then said, "Well no-one told us you could do that." Not realising they could have left the Gold Standard.

It was only after the Great Depression and the Second World War that the Bretton Woods agreement set up a new Gold Standard, this time based on the dollar and the IMF, the World Bank. And in fact Keynes was the leader of the British delegation to the Bretton Woods Conference, although he did criticise the eventual Bretton Woods agreement by saying that it didn't put enough onus on the strong countries, the ones with the surplus, to take action as against the weaker countries.

The reason it did that was of course America was a strong country with a surplus and therefore didn't want surplus countries to have to take action. That's when Keynes made one of his famous quotes where on the boat going over to America he was told by the British civil servants that the British government was no longer prepared to put their proposals because the Americans wouldn't accept them, so he said, "Because the Americans won't listen to sense, you are proposing to talk nonsense."

And eventually actually the U.S. abandoned the Gold Standard in 1971, largely as a result of the Vietnam War, which was it was thought by the American government too unpopular or not popular enough at home to enable it to be paid for through taxation. So instead the American government basically printed money to pay for the war, that led to more dollars overseas being than there was gold in Fort Knox, and therefore it became unsustainable for the U.S. to continue to underpin the Gold Standard.

In terms of lack of finance to industry, it is certainly true that Britain has had relatively low growth in manufacturing output historically, certainly since the Second World War. That has been, has certainly coincided with a relative lack of investment in industry compared to the other competitor economies, although obviously there's a question about cause and effect.

In terms of lack of talent to industry, there's the problem of graduates from universities going into the city rather than into science and engineering, and certainly in contrast to Japan, Germany, China, a lower proportion therefore of British graduates have gone into manufacturing because of the number who have gone into the financial services sector.

Then the problem of short-termism relates to the fact that market-driven financial systems compel companies to focus on short-term performance. Again through no fault of their own, the managers think if they don't and if the share price falls, then where you have a culture of allowing hostile takeover bids which America and Britain certainly do, then that company, that manager's company is vulnerable to being taken over, the management replaced. Possibly just short term measures put in to boost profits and boost the share price, then the company can be sold on again at a profit.

So where there is a large financial sector on the look-out for those sort of prey, that's always a pressure on managers. And finally on short-termism, certainly in the UK context one of the problems has been where finance has been made available to industry, to non-financial firms has often been on the basis of overdraft funding rather than long-term loans or even banks buying shares in the company. The problem with overdraft funding is they can be withdrawn at any time, and that can then lead to the collapse of the companies.

Now, in a project I was involved in with Professor David Guest from the University of London, executives of companies were asked about this pressure from short-termism and this was a quote from Head of Human Resources in a company, who was saying precisely this, that the people in charge of Human Resources, others in the company were interested in the long term but the accountants, the finance people were always looking at the short term.

He said, "We've got two groups on the board. They are tasked to deliver profit, and we are tasked to deliver sustainable, long term performance, so the tension is – I'm into – less fundamentally, we design the system and they are saying we haven't got time, we haven't got time, got to keep squeezing the pips."

This is illustrated nicely in a cartoon of Dogbert the Consultant reporting to the Board of Directors, "Your profits are plunging, and the problems won't be easily solved." He's got the diagram of the size of the brains of their competitor companies, all with large brains, the size of brains of beavers, relatively small, and the size of your brains, he's saying to this company's Board of Directors, very small. The problem will not be easy to solve, and the Directors of this company with the small brains say "So, what shall we do? Cut the training budget again?"

That's always the danger when economies go into recession, that companies which are otherwise quite healthy are forced to – feel forced to cut discretionary spending like on training, because they feel they can't cut dividend payments because that will result in their share price falling and they'll become vulnerable to potential hostile takeovers. This is one of the problems with the stock exchange based system versus the bank based system in continental Europe.

The final point to make was one put to me by someone who knows the financial sector in Britain and other countries well. He said the difference is if say you're in Holland and you're growing tulips in your back garden, you're developing new breeds and you've got some new strain of tulip that had a better colour, better scent than other tulips. It clearly had some commercial possibility, you'd take it to the bank, show what you'd done, they'd probably take you down the corridor to the division that deals with agriculture and introduce you to whoever it was there who knew most about that particular market for tulips.

Whereas if you went into a big bank in London, in the City of London and said, "I've got these tulips that I've been breeding," they'd probably call security. Because they just don't have that culture of knowledge and involvement with the local industry, because they are so much more skewed towards the global financial interests that the UK financial sector, the City of London grew up originally to service.

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